Memorandum

To: ISO Board of Governors

From: Anna McKenna, Vice President Market Design and Analysis

Date: September 13, 2023

Re: **Decision on Capacity Procurement Mechanism Enhancements Track 2**

This memorandum requires ISO Board of Governors action.

EXECUTIVE SUMMARY

The California Independent System Operator (ISO) uses its capacity procurement mechanism (CPM) to address resource adequacy (RA) deficiencies and other potential reliability concerns. When the ISO makes CPM designations, it relies on capacity willingly offered to the ISO by resource scheduling coordinators. To procure such capacity, the ISO conducts annual, monthly and intra-monthly competitive solicitation processes, into which resource scheduling coordinators may offer their capacity to the ISO at prices up to a soft offer cap, currently set at $6.31/kw-month. Any offers above the soft offer cap must be cost-justified at FERC to recover up to a resource-specific cost of service rate.

As required by the tariff, the ISO undertakes a stakeholder initiative to reevaluate the soft offer cap at least every four years. The recently completed review of the CPM soft offer cap was conducted through track 2 of the phased CPM enhancements stakeholder initiative. A holistic reevaluation of the ISO's backstop measures, including CPM, is anticipated as a part of the ISO's upcoming resource adequacy working group process and subsequent initiatives. However, as part of this limited effort, Management recommends simply to increase the CPM soft offer cap from $6.31/kw-month to $7.34/kw-month until broader comprehensive reforms can be vetted.

> ***Moved, that the ISO Board of Governors approve the revision to the Capacity Procurement Mechanism soft offer cap as described in this memorandum dated September 13, 2023; and***
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> ***Moved, that the ISO Board of Governors authorize Management to make all necessary and appropriate filings with the Federal Energy Regulatory Commission to implement the change proposed in this memorandum, including any filings that implement the overarching initiative policy but***

contain discrete revisions to incorporate Commission guidance in any initial ruling on the proposed tariff amendment.

DISCUSSION AND ANALYSIS

The ISO uses its CPM authority to address RA deficiencies and other potential reliability concerns. The ISO's use of its CPM authority is often referred to as "backstop" procurement. The ISO's backstop procurement authority also includes reliability must-run (RMR) contracts, which the ISO uses to retain resources that would otherwise retire but the ISO determines are needed to maintain reliable grid operations based on the results of technical studies and analyses. The ISO can use its CPM authority to procure capacity that is not committed RA capacity or RMR capacity to address specific reliability needs.

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The ISO set the existing soft offer cap of $6.31/kw-month during its CPM replacement stakeholder initiative, which was conducted in 2014-2015. The $6.31/kw-month soft offer cap equals 120% times the levelized going-forward fixed costs of a merchant-constructed, mid-cost, 550 MW combined cycle unit with duct firing, as published by the California Energy Commission (CEC) in March 2015.

The ISO has a tariff obligation to conduct a stakeholder initiative every four years (at the latest) to examine the soft offer cap and consider whether it needs to be changed. In its previous CPM soft offer cap stakeholder initiative, the ISO met that tariff obligation by considering updated combined cycle fixed costs published by the CEC in May 2019. The updated fixed costs did not significantly change from those that were published by the CEC in March 2015. Accordingly, the ISO determined that changes to the CPM soft offer cap level were unwarranted. In track 2 of this CPM enhancements stakeholder initiative and in accordance with its tariff obligation, the ISO has again re-examined the soft offer cap and considered the need for an update.

Pursuant to that re-examination and in collaboration with stakeholders, Management's recommendation is to raise the CPM soft offer cap from $6.31/kw-month to $7.34/kw-month. The recommendation is based on the following three justifications: (1) $7.34/kw-month is a figure based on the tariff-defined methodology for deriving the soft offer cap, using updated CEC-provided combined cycle going-forward fixed costs; (2) the tariff-defined methodology for deriving the CPM soft offer cap is still reasonable and relevant until a broader reevaluation of the ISO's RA processes can be completed[1]; and (3) the

[1] Management believes that using a gas-fired reference resource is still reasonable at this time, given that 66% of the CPM designations made by the ISO from 2019 through 2022 were to gas-fired resources.

proposed increase to the soft offer cap accounts for recent inflation and is directionally appropriate, given the increase in bilateral capacity prices over recent years.

POSITIONS OF THE PARTIES

Management appreciates the diversity of perspectives provided by stakeholders over the past few months, and most recently in comments submitted on July 24, 2023.

Questions about the CEC's 2023 update to combined cycle going-forward fixed costs

In their comments, several stakeholders asked the ISO and CEC to provide more information about the CEC's May 2023 update to the combined cycle going-forward fixed costs. In response to these stakeholder requests, the CEC provided an updated presentation, which includes information about specific aspects of the combined cycle going-forward fixed costs that the CEC updated in 2023. This updated information is embedded within the ISO's stakeholder workshop presentation[2].

Ideas for the next phase of CPM-related policy work

Several stakeholders asked the ISO to explore changes to the derivation and/or structure of the soft offer cap, as well as to broader programmatic changes to the CPM. Management is encouraged by the ideas to enhance the derivation and/or structure of the soft offer cap and explore CPM-related changes beyond the soft offer cap.

The scope of this CPM enhancements track 2 initiative is limited and cannot accommodate changes beyond a straight-forward tariff-driven update to the soft offer cap. However, Management is committed to explore with stakeholders broader reforms to the ISO's backstop processes, including potential changes to the structure of the soft offer cap and/or soft offer cap derivation methodology. For example, in the derivation of the soft offer cap, Management might consider using costs from resources other than combined cycles or incorporating opportunity costs. The timing of this future CPM policy work will be decided in concert with stakeholder input in RA working groups, which are anticipated to meet later in 2023.

CONCLUSION

Based on the tariff-defined methodology for deriving the soft offer cap using updated CEC-provided combined cycle going-forward fixed costs, Management recommends that the CPM soft offer cap be adjusted upward to $7.34/kw-month, as set forth in this memorandum.

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[2] http://www.caiso.com/InitiativeDocuments/Presentation-Capacity-Procurement-Mechanism-Enhancements-Track%202-Jul102023.pptx