Memorandum

To: ISO Board of Governors

From: Eric Hildebrandt, Executive Director, Market Monitoring

Date: September 13, 2023

Re: **Department of Market Monitoring comments on capacity procurement mechanism enhancements track 2**

This memorandum does not require ISO Board of Governors action.

EXECUTIVE SUMMARY

This memo provides comments by the Department of Market Monitoring (DMM) on Management's capacity procurement mechanism (CPM) enhancements track 2 final proposal. DMM supports the proposed 16 percent increase in the monthly CPM soft offer cap for several reasons. Since the CPM was established, the amount of capacity procured under this backstop procurement mechanism has remained relatively low and almost all CPM designations have been for only one to two peak summer months of the year – when there is limited or no excess supply available and bilateral capacity prices are highest. The soft offer cap (plus the proposed 16 percent increase) now represents a value for short term capacity payments during these months that is supported by a broad consensus of stakeholders – including suppliers and load serving entities. Most stakeholders appear to generally agree that the proposed soft offer cap represents a reasonable level for the peak summer months under current market and system conditions in the California ISO balancing area and the broader Western regional market. Finally, the ISO has committed to working with stakeholders in 2024 on broader reforms to the CPM in the context of California's resource adequacy program. DMM strongly supports this approach, as it will allow the ISO and stakeholders to focus on a more comprehensive set of changes needed in the overall CPM and resource adequacy framework.

Background

Since the CPM soft offer cap was established in 2014, the ISO's policy has been to set the cap based in part on an estimate of the annual going forward fixed costs of a typical new gas-fired unit plus a 20 percent adder. This annual cost estimate is then divided by 12 to get a monthly value used as the soft offer cap for monthly CPM designations. All CPM designations have been paid at or just below this monthly soft cap. Units receiving these CPM payments also keep all net revenues earned from operating in the market.

The ISO set the current soft offer cap using estimates of annual going forward fixed costs for a 550 MW combined cycle unit derived from reports issued by the California Energy Commission (CEC) in 2018/2019. The ISO tariff requires that the ISO open a stakeholder initiative every four years (at the latest) to examine the cap and consider whether it needs to be changed. In this initiative, the ISO proposes to meet this tariff obligation by increasing the cap by about 16 percent (from $6.31/kw-month to $7.34/kw-month) to reflect assumed increases in labor costs and inflation of other cost components.

Since the CPM was established, the amount of capacity procured under this backstop procurement mechanism has remained relatively low and almost all CPM designations have been for only one to two peak summer months of the year. However, it is generally agreed that the level of the soft offer cap often has a significant impact on prices for resource adequacy capacity in the bilateral market, since this is the price at which the ISO may procure any additional capacity needed for reliability that is not procured through the state's resource adequacy process.

Comments

As noted in DMM's prior comments and filings on the soft offer cap, DMM continues to believe that the annual cost estimates in the CEC's 2018/2019 reports are significantly greater than the actual going forward fixed costs of gas-fired resources.[1] Nevertheless, DMM supports the proposed 16 percent increase in the current monthly CPM soft offer cap for several reasons.

First, while DMM believes the CPM soft cap is based on a significantly inflated estimate of annual going forward fixed costs, this annual fixed cost estimate is then divided by 12 to set the soft cap for monthly CPM designations. In practice, almost all units receive CPM designations for only one to two peak summer months of the year – when there is limited or no excess supply available and bilateral capacity prices are highest. Thus, the current methodology of dividing annual costs by 12 to determine monthly payments does not accurately reflect actual market conditions and how the CPM is used. In effect, this inaccuracy essentially offsets much of the impact of inaccurately high estimates of annual fixed costs.

Second, when originally developed, the CPM mechanism was expected to play an important role in mitigating local market power with areas in which one or two major suppliers were pivotal in terms of the supply of capacity needed to meet local

[1] *Comments on the Capacity Procurement Mechanism Enhancements Track 2 – Final Proposal*, Department of Market Monitoring, August 31, 2023: https://www.caiso.com/Documents/DMM-Comments-on-CPM-Final-Proposal-Aug-31-2023.pdf

Detailed documentation of DMM's review of going forward fixed costs provided in DMM's Answer to the ISO's February 2020 CPM tariff filing: https://www.caiso.com/Documents/AnswerandMotionforLeavetoAnswer-DMMCommentsonCPMTariffFilingER20-1075-Apr32020.pdf requirements. In recent years, however, the amount of capacity procured under the CPM has been relatively low and almost all of this capacity has been for system level capacity rather than for local requirements. From 2020 to 2023, almost all (99 percent) of capacity procured under the CPM has been for system capacity.

Third, the soft offer cap (plus the proposed 16 percent increase) now represents a value for short term monthly capacity payments that is supported by a broad consensus of stakeholders – including suppliers and load serving entities. Most stakeholders appear to generally agree that the proposed soft offer cap represents a reasonable cap for the peak summer months under current market and system conditions in the ISO balancing area and the broader Western regional market.

Finally, numerous stakeholders have requested that the ISO explore CPM-related changes beyond the monthly soft offer cap and in the context of California's resource adequacy program. The ISO has committed to working with stakeholders in 2024 on broader reforms to the CPM in the context of California's resource adequacy program. DMM strongly supports this approach, as it will allow the ISO and stakeholders to focus on a more comprehensive set of changes needed in the overall CPM and resource adequacy framework.

Analysis of recent CPM procurement

The following section provides some analysis of CPM designations over the last nearly five years (2019 through the end of August 2023), which highlights how CPM designations have only been issued during a few peak summer months of the year. As shown in Figure 1, nearly all CPM designations in recent years have occurred in the peak summer months from July to September. All of this capacity was procured at or near the CPM soft offer cap.

- Gas units have accounted for about 76 percent of CPM capacity over this period.
- Battery storage accounts for about 18 percent of CPM capacity over this period. In 2021, a significant amount of battery capacity (506 MW) was procured under CPM since this capacity became operational prior to summer 2021, but had not been used to meet resource adequacy requirements of any load serving entity.
- In September 2023, the ISO procured 242 MW of import capacity under the CPM. This illustrates how, in some cases, the ISO may need to rely on CPM to compete in a regional market to procure capacity in the peak summer months.

Figure 2 summarizes CPM designations over the last four years in terms of how many months during each year individual resources have received CPM designations.

- About 61 percent of these received a CPM designation during only one month of any year.
- About 19 percent of units received CPM designations during two months of any year, with another 18 percent receiving designations for three months of a year.

- Only 2 percent of these units received CPM designations during four months of any year, with all of these occurring in 2020.

Figure 1. CPM designations by month (2019-2023)

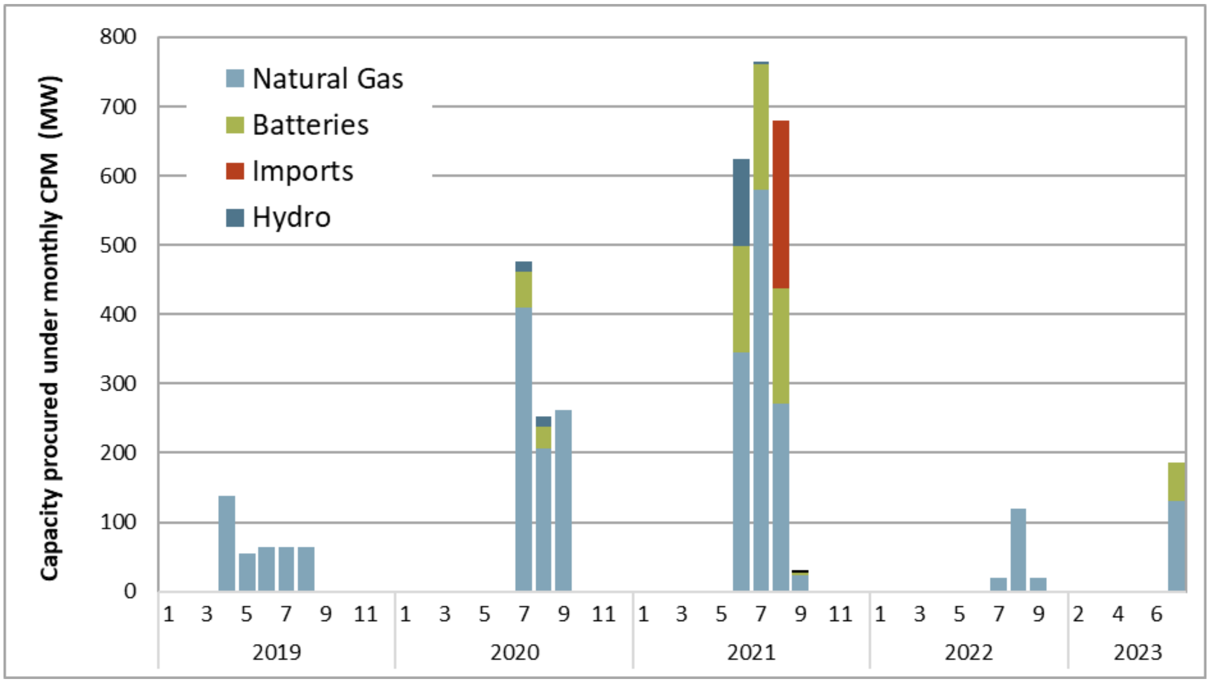

Figure 2. Monthly CPM designations per year received by resources (2019-2023)