

this Answer, the ISO will respond to the comments and protests, and explain why they provide no valid basis for the Commission to reject or significantly modify the ISO's proposal. In addition, the ISO will demonstrate that its CPM proposal is fair and reasonable, and should be approved by the Commission.²

I. MOTION TO FILE ANSWER

The ISO recognizes that, unless authorized by the Commission, the Commission's Rules of Practice and Procedure preclude an answer to protests. Accordingly, pursuant to Rules 212 and 213 of the Commission's Rules of Practice and Procedure, 18 C.F.R. §§ 385.212, and 385.213 (2010), the ISO respectfully requests leave to file its answer to the protests filed in this proceeding. The ISO also requests, to the extent necessary, leave to file this answer out-of-time, or in the alternative, for an extension of time until January 19, 2011 to submit this answer in response to the protests and comments.

The ISO submits that good cause for the requested waiver exists because this answer will aid the Commission in understanding the issues in the proceeding, provide additional information to assist the Commission in the decision-making process, and help ensure a complete and accurate record in the case.³ In particular, the ISO believes that this answer will aid understanding and inform the decision-making process by providing additional explanation and support for the essential provisions in the ISO's proposal -- the new CPM designation for a resource at risk of retirement needed for

² Capitalized terms not otherwise defined herein have the same meaning as set forth in the ISO Tariff, Appendix A, Definitions.

³ See, e.g., *Entergy Services, Inc.*, 116 FERC ¶ 61,286 at P 6 (2006); *Midwest Independent Transmission System Operator, Inc.*, 116 FERC ¶ 61,124 at P 11 (2006); *High Island Offshore System, L.L.C.*, 113 FERC ¶ 61,202 at P 8 (2005); *Entergy Services, Inc.*, 101 FERC ¶ 61,289, at 62,163 (2002); *Duke Energy Corp.*, 100 FERC ¶ 61,251, at 61,886 (2002); *Delmarva Power & Light Co.*, 93 FERC ¶ 61,098, at 61,259 (2000).

reliability and the rate change for the CPM capacity payment -- that were the focus of the comments and protests.

The ISO also submits that good cause exists for permitting the ISO an additional eight business days, from January 6 until January 19, 2011, to file its answer to the protests and comments in this proceeding. In accordance with the Commission's directive, the ISO filed its tariff amendment in this matter on December 1, 2010. The Commission set December 22, 2010 as the due date for protests and comments. The timing of these filing dates was such that there were several holidays during the time the answer ordinarily would have been prepared, and key personnel whose input was required for the drafting of a complete answer to the issues raised were either unavailable or had limited availability. Further, the logistics of finalizing the answer earlier in January were complicated by the relocation of the ISO's offices to a new corporate headquarters effective January 18, 2011, and the activities and efforts required for that move. The ISO does not believe that this short extension represents an undue delay that will interfere with the Commission's consideration of this matter since the ISO submitted the filing 120 days in advance of the date that the automatic sunset provisions will trigger termination of the ICPM and Exceptional Dispatch mitigation measures.

For these reasons, the ISO respectfully requests that the Commission accept the ISO's answer on this date.

II. SUMMARY

Like the ICPM, the CPM provides an orderly, pre-approved means for the ISO to procure backstop capacity where and when needed to meet Reliability Criteria or

otherwise maintain reliable grid operations. Although RA programs are in place under California law, and RA requirements have been established by Local Regulatory Authorities, there are instances when resource adequacy resources are not sufficient to meet all of the operational needs of the ISO and enable it to meet applicable reliability criteria. This circumstance could happen as a result of load serving entities failing to comply with resource adequacy requirements, unforeseen or changed circumstances affecting system conditions or grid operations, or the ineffectiveness of procured RA resources at meeting the ISO's specific reliability needs. It is imperative that the ISO have the appropriate tools at its disposal under such circumstances to maintain reliable operations. In particular, the CAISO needs the ability to procure resources when such instances occur in order to maintain the reliability of the CAISO Balancing Authority Area. The CPM provides the ISO with that ability and should be accepted by the Commission without a sunset provision.

The majority of protests and comments submitted in response to the ISO's proposed CPM tariff amendments focused on the two issues – the risk of retirement provision and the CPM compensation rate based on going-forward costs. This answer explains why those protests and comments are erroneous, unfounded, and/or unsupported, and fail to provide any valid basis for the Commission to either reject or modify the ISO's proposal.

The risk-of-retirement CPM designation will allow the ISO in a current RA compliance year to procure capacity from a resource that is uneconomic and at risk retirement but that will be needed for reliability during the following RA compliance year. While the protests and comments of numerous parties suggest that the provision be

rejected or modified, the bottom line is that the ISO needs this backstop mechanism to enable it to procure capacity that is needed to maintain reliability, especially under circumstances where the configuration of the grid could be much different a year from now than it is today due to a substantial amount of variable energy resources that are expected to come on line in the interim and the potential retirement of other resources. Allowing a unit to retire could leave the ISO without the requisite ability to address any reliability concerns that arise because of a large increase in renewable resources during the intervening year. The ISO cannot ignore this eventuality and fail to be prepared to operate the grid under a dramatically changed system fleet. It is imperative that the ISO have this backstop procurement mechanism as a last resort to maintain reliability under significantly changing circumstances.

The ISO proposed to set the default CPM compensation at \$55/kW-year, based on the same going-forward fixed costs methodology that was applied for ICPM. The dollar figure has been updated based on more current cost information. Generation-related parties argue that this methodology is unjust and unreasonable because: it does not contribute sufficiently to recovery of fixed costs, and thus does not create incentives for new entry or incremental investments in existing generation; it does not sufficiently fill in the perceived gaps in the CPUC's RA program; and does not adequately consider the role that the CPUC's failure to adopt a long-term RA program will have on the purpose of the CPM. Several load-related entities argue that the going-forward fixed costs approach is conceptually correct, but needs to be tweaked in ways that would reduce the CPM compensation paid to generation.

While much of the opposition is framed in the Federal Power Act's "just and

reasonable” standard, this opposition does not highlight any meaningful deficiency in the ISO’s proposal. Indeed, were the going-forward fixed costs methodology unjust and unreasonable, the Commission would not have accepted it as the basis for the ICPM compensation. Like ICPM, the CPM compensation methodology is just and reasonable because it provides fair compensation for the nature of service called for when a resource receives a CPM designation. The CPM is designed to procure short-term capacity to backstop RA procurement. It is not meant to incent new entry, nor is it designed to replicate the outcome of a competitive capacity market. The going-forward fixed costs methodology is constructed to ensure that CPM-designated resources will recover the costs associated with meeting the limited obligations a unit must meet where it accepts a CPM designation.

III. ANSWER

A. The Risk of Retirement CPM Designation is Just and Reasonable

The provision in the ISO’s filing that generated the most controversy in comments and protests was the proposal to enhance the existing ICPM design by adding a new risk-of-retirement CPM designation category. Proposed Tariff Section 43.2 will permit the ISO to procure the capacity of a non-RA unit that has demonstrated that it will shut down in the current year because it will be uneconomic for the resource to remain in service but whose operation is projected by the ISO to be needed to meet operational or reliability needs during the following calendar year. The ISO has made its intent clear that the new CPM designation for a resource at risk of retirement will be a last resort, backstop measure. The ISO will issue this CPM designation only in very limited circumstances, subject to the ability of the resource requesting the designation to

meet stringent requirements, and following a robust process that allows for stakeholder discussion of the ISO's finding of need for the resource and an opportunity for load-serving entities to contract bilaterally with the resource and thereby obviate the need for a CPM designation, as set forth in proposed ISO Tariff Section 43.2.6. NRG's answer offers limited support for the ISO's proposal.⁴

PG&E,⁵ SCE,⁶ SDG&E⁷, CMUA,⁸ NCPA,⁹ Six Cities,¹⁰ and the CPUC¹¹ object to the proposed risk-of-retirement provision on similar grounds. They argue that it will duplicate, or conflict or interfere with, measures that are already designed to address reliability needs. These measures include the following: (i) the Reliability Must-Run ("RMR") process through which the ISO can procure generation for a year that is needed to address local reliability needs and meet applicable reliability criteria; (ii) the CPUC's RA program that requires load serving entities to procure and make available to the ISO capacity equivalent to their RA obligation for the next compliance year; (iii) the Long-Term Procurement Planning (also referred to as "LTPP") proceeding in which the CPUC considers ISO system-wide needs for all load serving entities using a 10-year planning horizon in order to address issues such as what new resources should be procured, how increasing amounts of variable energy resources should be integrated, and what replacement generation is needed to eliminate reliance on units that use once-through cooling; and (iv) CPUC Operating Standards 22 and 23 of General Order

⁴ NRG Answer, pp. 2-7.

⁵ PG&E Comments, pp. 3-6.

⁶ SCE Comments, pp. 4-5.

⁷ SDG&E Protest, pp. 2-5.

⁸ CMUA's Protest, pp. 3-4, cites to the RA program and RMR provisions.

⁹ NCPA Comments and Limited Protest, p. 7.

¹⁰ Six Cities' Protest and Comments, p. 7, cites to the RMR provisions as providing authority to the ISO to procure the required resources.

¹¹ CPUC Limited Protest and Comments, pp. 9-11, 20.

167 that require generating facilities to provide the CPUC 90-days advance notice of any planned retirements or other changes in a unit's operating status.

The main fallacy of the arguments of these parties is that they assume that one or more of these other measures can address the specific need to which the proposed risk-of-retirement CPM designation is targeted, and therefore that the ISO's proposal will supplant these existing measures. That assumption is not correct. Rather, the ISO's proposal was carefully designed to address a narrow situation that none of the existing measures can address, specifically, the situation where a resource at risk of retirement that is needed for reliability in the following RA compliance year (year 2) is not procured for the current or imminent compliance year (year 1). In such a situation, the resource does not meet the RMR eligibility requirements, as the RMR structure is designed for year 1 procurement only. The resource is also not procured in the bilateral market as an RA resource, and importantly, because the resource is not needed in year 1, it would not qualify under the existing ICPM provision (which will carry over to the new CPM) that authorizes the ISO to backstop an identified deficiency in the annual RA showings by the load serving entities. In addition, the resource will not be replaced with new generation through the most recent LTPP in time to meet the year 2 need, and is not deemed to be needed for reliability purposes by the CPUC under its General Order 167 operating standards. Thus, it is precisely the inability of the existing mechanisms to address this situation and the quickly (and significantly) changing nature of the generation fleet -- and the significant operational challenges these changes raise for the ISO -- that motivated the ISO's proposal and characterize the circumstances under which the risk-of-retirement backstop procurement proposed by the ISO will be

considered. In other words, only if all other available procurement measures fail will the ISO consider procuring the at-risk resource, and even then the resource must submit a request for the designation to the ISO and meet strict requirements, and the ISO must discuss its finding of need with stakeholders and allow an opportunity for bilateral contracting by the load serving entities, before the CPM designation can be issued. The ISO reiterates that the risk-of-retirement CPM category is measure of last resort. The parties' concerns that this CPM category duplicates, or will supplant or conflict with existing measures are all misplaced.

Although the ISO anticipates that this CPM designation will be seldom used, and only in very limited circumstances where all other forms of procurement fail, the provision is essential to ensure that the ISO has the requisite ability to keep a critical unit in service that is at risk of retiring because it will be needed for reliability during the following year. The CPUC,¹² SDG&E,¹³ and CMUA¹⁴ claim that the ISO has not justified its need for the extended authority. They are mistaken. The ISO provided clear justification in its initial filing in this docket. As discussed in the ISO's transmittal letter, the authority to issue a CPM designation to procure capacity at risk of retirement is critical to the ISO's ability to respond to the challenge of the changing technological composition of the supply fleet and continue to maintain grid reliability. For example, California's 20% renewables portfolio standard (which increases to 33% by 2020) will significantly increase generation by variable energy resources on the system. It is imperative that the ISO have the generation fleet capability needed to accommodate these changes and integrate the renewable energy into the ISO grid operations. In

¹² CPUC Limited Protest and Comments, pp. 17-20.

¹³ SDG&E Protest, p. 4.

¹⁴ CMUA Protest, p. 3.

addition, the proposal will enable the ISO to mitigate any adverse affects on transmission system operation resulting from a generator retirement. This fundamental requirement is addressed by NERC Standard IRO-001-1.1 which gives Reliability Coordinators the authority to have plans in place to ensure the reliable operation of the grid.¹⁵ The proposed backstop will give the ISO the ability to maintain capacity on-line that is otherwise uneconomic and at risk of retirement in the current year one but will be necessary to meet these needs in the following year.

It is important to remember that variable energy resources will be coming on line in significant quantities in future years. Although the ISO may not need a particular existing unit in year 1 to maintain reliability and ensure the proper integration of renewables, it could be needed during year 2 when an even greater number of intermittent resources will have come on line. If the unit the ISO needs to maintain reliability in year 2 were to retire before that because it is not economically viable, the ISO's ability to maintain reliability in year 2 when the unit is really needed will be jeopardized and there would be insufficient time for other new resources to be installed that could maintain reliability. Under these circumstances and a significantly changing environment, the risk-of-retirement provision is critical for the ISO. The ISO needs to be proactive and cannot afford to "bury its head in the sand" when it comes to reliability. This specific proposal reflects the ISO's efforts to address potential future reliability concerns and not in the future be stuck in the position of having insufficient tools in the tool to address new and evolving reliability concerns in the future. Without this authority, the ISO will be powerless to maintain that resource on line and compensate it for its capacity.

¹⁵ <http://www.nerc.com/page.php?cid=2|20>.

In its protest, the CPUC claims that the ISO's proposed risk-of-retirement provision will improperly interfere with the CPUC's jurisdiction. However, as discussed in this answer, the ISO intends the designation to be a last resort measure if all other processes, including the CPUC's, otherwise fail. The designation will neither duplicate nor conflict with the CPUC's processes. It is only if the at-risk unit is not procured through the CPUC's RA program or as a result of the requirement in its operating standards that a unit provide 90-days advance notice of any planned retirements or other changes in the unit's operating standards that the ISO would engage in backstop procurement of the unit as a failsafe measure if the unit is uneconomic in year 1 but will be needed for reliability during year 2.

Further, the jurisdiction asserted by the CPUC does not align with the Federal Power Act that gives FERC plenary jurisdiction over the nation's wholesale energy markets. As discussed in IEP's reply to the CPUC's protest, the risk-of-retirement provision (like the other CPM designations that the CPUC has not challenged) falls within FERC's jurisdiction over practices affecting wholesale rates. It allows the ISO to designate and make CPM payments to a resource that (i) meets the stringent requirements of proposed ISO Tariff Section 43.2.6 and (ii) accepts the CPM designation to remain operational, along with the availability obligations and bidding requirements for a CPM resource as set forth in ISO Tariff Section 43.4.1 (renumbered as 43.5.1 in the proposed amendment).¹⁶ Also, given that FERC has previously asserted jurisdiction over centralized capacity markets, backstop capacity like that undertaken by the ISO, and PJM's MISO's and ISO-New England's backstop procurement mechanisms that allow these ISOs and RTOs the ability to procure units

¹⁶ IEP Reply, p. 8.

that are needed for reliability, but are at risk of retirement, it is difficult to comprehend why FERC would lack the authority to grant the ISO similar authority which it has granted other ISOs and RTOs.

FERC's exercise of this plenary authority is limited only by the prohibition in the Federal Power Act against direct regulation of generation facilities. Again, as discussed in IEP's reply, the CPUC fails to explain how this proposed backstop procurement mechanism constitutes direct regulation of generation facilities.¹⁷ The risk-of-retirement CPM designation is voluntary; it must be requested by the resource owner. The resource owner may choose to accept a risk-of-retirement designation (if offered) or opt to retire the unit instead. Given the discretion that the resource owner may exercise, the CPUC is incorrect that the risk-of-retirement provision is an impermissible direct regulation of generation facilities. The ISO agrees with IEP that the risk-of-retirement designation and compensation authority is no more a direct regulation of generation facilities than the other CPM categories that FERC has already approved, including Exception Dispatches which are mandatory.¹⁸

The CPUC alleges that the ISO's reference to the risk-of-retirement provisions in place for the Midwest Independent Transmission System Operator, Inc. ("MISO") and PJM Interconnection, LLC ("PJM") is misplaced because those provisions and the compensation they provide to resource owners differs from the ISO's proposal. The ISO's point in referring to the MISO and PJM risk-of-retirement provisions in the transmittal letter was that the ISO's proposal is not without precedent. The Commission has already approved the concept of maintaining a unit on line that is at risk of

¹⁷ *Id.* at 9-10.

¹⁸ *Id.* at 10.

retirement but needed for reliability. The ISO acknowledges that elements of the MISO and PJM provisions differ from what the ISO has proposed. In fact, the ISO discusses those differences later in this answer. The differences in the structure of the provisions, however, does not nullify the fact that the Commission has the authority and has exercised such authority to approve the concept of risk of retirement backstop procurement as just and reasonable way to keep uneconomic units needed for reliability in operation.

The CPUC also alleges that the risk-of retirement provision creates a gaming opportunity where a resource knowledgeable of its importance to reliability could falsely threaten to retire in order to receive a CPM designation and compensation, or withdraw its notice of intent to retire if it does not receive the expected designation.¹⁹ This allegation ignores the multi-layered safeguards against the gaming potential that already exist in the Tariff and that the ISO has built into its proposal.

Proposed ISO Tariff Section 43.2.6 sets forth stringent requirements that a resource must meet in order to even be eligible for consideration as an at-risk resource. These requirements prescribe specific circumstances, all of which must occur, for the resource to be eligible for the designation. With regard to the resource's own status, it must not be under contract to provide RA capacity or otherwise be currently subject to a CPM designation due to a deficiency in a load serving entity's annual RA plan, and it must be uneconomic for the resource to remain in service during the current RA compliance year. There are also circumstances external to the resource that must occur. Studies performed by the ISO must establish the reliability need for the resource during the following RA compliance year and project that no new generation will be in

¹⁹ CPUC Limited Protest and Comments, p. 8.

operation in time to meet that need.

More importantly, Section 43.2.6 requires that resource owner submit documentation and information to the ISO that supports the resource's request, including an affidavit by an executive officer of the resource owner that attests to the resource's lack of economic viability. The documentation and affidavit will be subject to ISO Tariff Section 37.5.1.1 that requires the submission of accurate and factual information, without being misleading or omitting material information. Further, the ISO's Department of Market Monitoring ("DMM") committed at the public Governing Board meeting on November 2, 2010 to review the documentation and affidavit supporting a request for a risk-of retirement CPM designation, subject to possible referral to the Commission under existing ISO Tariff Section 37.8.2 if DMM has a reasonable belief that the resource appeared to have withheld its capacity from bilateral procurement or otherwise engaged in market manipulation.

In addition, the ISO has included a provision in its proposal that is intended to remove the financial incentive for a resource owner to game a risk-of- retirement request. Under proposed Tariff Section 43.2.6.1, if the ISO issues a risk-of-retirement CPM designation prior to or during the pendency of DMM's review of the supporting documentation and affidavit or the Commission's investigation of a referral by DMM, the CPM payments are subject to refund. In the event that the review or investigation concludes with a finding that the request is inaccurate, misleading, or evidences market manipulation, the resource owner can be required to refund the CPM payments it received.

In combination, the stringent requirements that must be met for a CPM

designation to be issued, the review by DMM of the request to determine whether the request may violate the Rules of Conduct in ISO Tariff Section 37, the possibility of a referral and Commission investigation, and the potential refund of CPM payments related to a request found to violate the Rules of Conduct should deter a resource owner from engaging in the gaming activities of concern to the CPUC. These are reasonable and necessary measures to ensure that a risk-of-retirement request is valid, and not an attempt to game the system.

The protests and comments of several parties raise issues with the process the ISO will follow in considering a request for a risk-of-retirement CPM designation. The CPUC claims that the process lacks transparency, objective standards, and reasonable notice.²⁰ SDG&E questions the ISO's capability to forecast future capacity needs with sufficient accuracy and specificity to support the CPM designation commitment.²¹ Six Cities suggest that the ISO should be required to issue a market notice informing the market of a request for a risk-of-retirement CPM designation within five days of receiving the request, perform a cost/benefit analysis of the alternatives to the designation on a request-by-request basis, and provide earlier notice to the market of a reliability need for the resource so load serving entities have a longer procurement opportunity.²² Although NCPA opposes the risk-of-retirement CPM designation category, it does urge the Commission, if it accepts the overall designation, to accept the qualification requirements proposed by the ISO, and no less stringent requirements.²³

²⁰ CPUC Limited Protest and Comments, pp. 15-17.

²¹ SDG&E Protest, p. 4.

²² Six Cities Protest and Comments, pp. 6-8.

²³ NCPA Comments and Limited Protest, p. 8.

In response to these concerns, the ISO offers the following clarifications of its process and the technical analysis it will perform in determining whether the resource requesting a risk-of-retirement designation will be needed for reliability. The ISO intends to use production simulation to evaluate whether the fleet of RA resources procured for year 1 (the current or imminent RA compliance year) is sufficient to meet expected operational flexibility requirements in year 2 (the following RA compliance year). The ISO intends to follow a multi-step process whereby the generating facility is studied for its impact on local reliability, operational flexibility for the system and potential generator retirements in the area, given the best available information regarding grid conditions for year 2 and the assumed availability in year 2 of RA resources procured for year 1 and any new generation that will achieve commercial operation to meet year 2 needs. This analysis will consist of a power flow and voltage stability analysis, transient stability analysis, and dynamic and reactive margin studies under a 1-in-10 peak load case in order to evaluate adverse effects on the transmission system as well as operational flexibility requirements. This analysis will consider the characteristics of the individual resources in the fleet and will be able to highlight resources that have non-generic resource flexibility that have not been secured either for year 1 as RA or for year 2 under the long-term procurement proceeding.

An example of how the ISO is working towards identifying needs for specific types of units in areas where changes in the technical composition of the system are expected is through retirement of once through cooling resources. The ISO is working with various State agencies to evaluate electric reliability impacts to the ISO controlled grid due to compliance with the State Water Board's once-through-cooling policy and its

jurisdiction in the South Coast Air Basin to meet AB 1318 requirements. From these studies, the ISO will determine the capacity needs to meet applicable national and regional reliability standards (i.e., NERC and WECC standards) for local as well as zonal areas for intermediate and long-term horizon (i.e., from five to ten years).²⁴

The ISO believes that the study method for a unit at risk of retirement will provide comprehensive and reliable forecasts of expected system conditions and resource reliability needs for purposes of considering a CPM designation request. They will be structured to provide sufficient information for the ISO to draw sound conclusions about whether a resource will be needed for reliability, either for its location or operational characteristics, during the following year. Further information about the technical analysis and study process will be included in the Business Practice Manual (“BPM”) for Reliability Requirements. This clarification, and the further detailed information to be included in the BPM, provides the specificity the CPUC claimed was lacking in the ISO’s proposal.

The BPM for Reliability Requirements will also discuss the specific information that a resource owner must submit to the ISO in support of a request for a risk-of-retirement CPM designation. We disagree with the CPUC that the required information should be specified in the Tariff rather than the BPM and that this represents a lack of specificity that warrants rejection of the ISO’s proposal. The supporting documentation that the ISO will require from the resource owner will be a list of financial, technical, and operational information. It is appropriate, and consistent with the ISO’s practice, to include this level of detail about informational requirements in the BPM.

²⁴ <http://www.caiso.com/27ce/27ceb7465560.pdf>.

With regard to the timeline the ISO has proposed for processing a risk-of-retirement CPM designation request, the ISO disagrees with the CPUC²⁵ and Six Cities²⁶ that the comment, notice, and procurement periods are too short.²⁷ To the contrary, the timeline reasonably balances over a 12-week period the time needed by the ISO to perform its analysis and determine whether the requesting resource is needed for reliability, with the opportunity for stakeholders to provide input on the matter and load serving entities to engage in procurement.

Once the request is filed, the time line provides that the ISO will perform its reliability analysis within three weeks. The ISO will complete its financial analysis, obtain management review, and, if the request meets the ISO's requirements, initiate consultation with the CPUC and undertake preparation of its report within four weeks of the date the request was submitted. During week five, the ISO will issue its report and a market notice of the report's availability. The stakeholder process will continue through week seven with the opportunity to file comments and a stakeholder conference call. After the stakeholder process is complete, load serving entities will have the opportunity to procure the resource during weeks eight through twelve before the ISO actually issues the designation.

Six Cities asserts that a period of four weeks does not present a realistic opportunity for procurement to take place. In order to allow a longer opportunity for procurement, Six Cities suggests that the ISO modify its proposal to require that the ISO (i) alert the market earlier of a perceived reliability need and (ii) provide market notice of

²⁵ CPUC Limited Protest and Comments, pp. 15-17

²⁶ Six Cities Protest and Comments, pp. 6-7

²⁷ ISO management presented the timeline to the ISO Governing Board at its meeting on November 2, 2010 at which the Board authorized this filing. The timeline to this answer as Attachment A.

the request for a CPM designation at the time the request is received.²⁸ There is no basis for these suggestions. Six Cities has offered no explanation why procurement is not possible within a four-week timeframe nor why it would be either beneficial or cost effective for load serving entities to undertake procurement before the ISO has completed its evaluation of a risk-of-retirement request and assessment of the reliability need.

The ISO considers the 12-week period for the ISO to perform its studies and analyze the request, for a stakeholder process to be conducted, and for procurement to occur to be an aggressive, yet reasonable, schedule. Due to the 90-day notice requirement for terminating a Participating Generator Agreement,²⁹ the end of the period cannot be extended. The 12-week period will end coincident with the date specified in that agreement for a resource to give notice that it is terminating its Participating Generator Agreement (or in some cases that it should be removed from an Participating Generator Agreement that covers multiple units) in the event that the resource no longer seeks to participate in the ISO's markets. Given this time constraint, the ISO believes that its proposed timeline reasonably and fairly allocates time among the numerous activities that will occur during the 12-week period.

Six Cities suggests that the ISO perform a cost/benefit analysis of the alternatives to the designation on request-by-request basis.³⁰ Under ISO Tariff Section 43.4(2), the ISO is required to consider the capacity costs of the eligible capacity in making CPM designations, including those for at-risk units. The ISO will include in the

²⁸ Six Cities Protest and Comments, p. 8.

²⁹ The pro forma Participating Generator Agreement is located in the ISO Tariff, Appendix B.2.

³⁰ Six Cities Protest and Comments, p.7.

BPM for Reliability Requirements a description of the cost analysis the ISO will undertake for risk-of-retirement CPM designation requests.

SCE³¹ and CMUA³² suggest that instead of adding the risk-of-retirement CPM category to the Tariff, the ISO should convene a stakeholder process in coordination with the CPUC to consider what tariff-based mechanisms should instead be used to address issues associated with unit retirement, once through cooling, renewables integration, and cost allocation. The ISO believes that discussion of tariff-based mechanisms to address these issues will be undertaken in various stakeholder processes, which could occur over an extended period of time. However, what the arguments of SCE and CMUA ignore is that the risk-of-retirement provision has already been considered in a lengthy and rigorous stakeholder process during which stakeholders availed themselves of the numerous opportunities to express their views about the ISO's proposal. Given that the ISO has already conducted this stakeholder process and, as a result, proposed the risk-of-retirement provision as the tariff-based mechanism to address the reliability need, it appears to the ISO that SCE and CMUA do not support the outcome of the process rather than have issues with the process itself.

The bottom line, however, is that no matter what new products and tariff-based mechanisms are developed, the ISO still needs a backstop mechanism to enable it to procure capacity that is needed to maintain reliability, especially under circumstances where the configuration of the grid could be much different a year from now than it is today due to an influx of variable energy resources that come on line in the interim and the potential retirement of other resources. Allowing a unit to retire could leave the ISO

³¹ SCE Comments, p. 5.

³² CMUA Protest, p. 4.

without the necessary tools to address any reliability concerns that arise because of a large increase in renewable resources during the intervening year. The ISO cannot bury its head in the sand and fail to be prepared to operate under a dramatically changed paradigm. It is imperative that the ISO have this backstop procurement mechanism in reserve in its “toolbox” as a last resort to maintain reliability under significantly changing circumstances. The ISO opposes delaying implementation of needed backstop procurement authority until an unknown future date. As discussed above, the ISO currently lacks the ability to maintain a unit in service that will be needed for reliability in the following year.

SWP recommends that the ISO modify the allocation of risk-of-retirement CPM costs. SWP objects to the ISO’s proposal to allocate the costs of such CPM designations to all Scheduling Coordinators for load serving entities that serve load in the TAC area where the need for the designation arose, based on each Scheduling Coordinator’s percentage of actual load in the TAC area to total load in that area. SWP suggests that the ISO instead allocate the costs to load serving entities in the TAC area based on their proportionate share of the TAC area load at the time of the ISO annual coincident peak demand.

The ISO disagrees with SWP’s recommendation. Fundamentally, there is no reason to assume that the need for the resource in question will be driven exclusively or even primarily by peak-load conditions. In fact the analytical findings that indicate need for a CPM designation for risk of retirement would be more akin to the reliability issues that lead to Exceptional Dispatches, which are not necessarily tied to peak load. Therefore, the allocation proposed by the ISO is the same as the allocation driven by a

CPM for a significant event or Exceptional Dispatch. It also will spread the cost responsibility for the CPM designation to those entities that will benefit most by the ISO's backstop procurement. In addition, SWP implies that an RA shortfall would exist as a result of a generator retirement and thus should be settled accordingly.³³ This characterization does not accurately reflect the timing of a risk-of-retirement CPM, however. As described above and in the ISO's filed proposal, this type of CPM designation would not be a response to an RA procurement shortfall because it is intended to look beyond the current or imminent RA compliance year to the subsequent year, for which no RA procurement has yet been required.

B. The Significant Event CPM Designation Covers a Shortfall in Variable Energy Resources

During the stakeholder process, the ISO considered modifying existing ISO Tariff Section 43.1 (renumbered in the filing as Section 43.2) to expand the circumstances in which a CPM may be issued to include situations where the output of variable energy RA resources is lower than their RA capacity values. It is possible that for periods of time, due to circumstances beyond the resource operator's control, such as a prolonged weather event, the variable energy resources will be unable to produce energy reflecting its full RA capacity requirement. This reduced output for a significant portion of variable energy RA capacity could adversely impact reliability. Upon further review, however, the ISO determined that this situation is already covered by existing authority in ISO Tariff Section 43.1 that authorizes backstop procurement for a significant event. Therefore, the ISO is not proposing to modify that Section to address underperformance by variable energy RA resources. Even though the ISO is not proposing this

³³ SWP Protest, p. 3.

modification, and has not issued a CPM to address underperformance by variable energy RA resources, several parties object to the notion that the existing authority in Section 43.1 would allow such procurement to occur.

The CPUC objects the ISO using the CPM to procure capacity where variable energy resources are performing significantly below their RA value. The CPUC contends that ISO backstop authority to address this circumstance is not necessary because the methodology the CPUC uses to determine the qualifying capacity value for variable energy resources already accounts for such unavailability by taking historical production values into account. The CPUC also questions whether the underperformance by variable energy resources constitutes a significant event and suggests that the issue should be instead addressed in an ISO stakeholder process and a CPUC RA-related rulemaking proceeding.³⁴

The ISO does not agree with the CPUC's interpretation of the ISO Tariff. A prolonged and substantial underperformance by variable energy RA resources would constitute a CPM Significant Event as defined in the ISO Tariff. Existing and proposed definitions in ISO Tariff, Appendix A, respectively define an ICPM or CPM Significant Event as:

A substantial event, or a combination of events, that is determined by the CAISO to either result in a material difference from what was assumed in the resource adequacy program for purposes of determining the Resource Adequacy Capacity requirements, or produce a material change in system conditions or in CAISO Controlled Grid operations, that causes, or threatens to cause, a failure to meet Reliability Criteria absent the recurring use of a non-Resource Adequacy Resource(s) on a prospective basis.

³⁴ CPUC Limited Protest and Comments, p. 20.

Although the CPUC methodology for determining qualifying capacity takes historical performance into account, there nonetheless could be weather conditions that cause wind or solar facilities to perform so far below their RA capacity value for an extended period of time that it would represent a material difference from the assumptions used to calculate the qualifying capacity value. Similarly, such underperformance by variable energy RA resources could lead to a threat or failure to meet applicable reliability criteria unless backstop procurement occurs. Both of these circumstances fall clearly within the definition of a CPM Significant Event and justify backstop procurement.

WPTF questions whether procurement for transitory uses is necessary given that the RA obligation of load serving entities includes a 15 percent planning reserve margin requirement. WPTF requests that the Commission direct the ISO to develop new or modified ancillary service products to address its operational reliability requirements so they can be priced in the market and factored into forward procurement decisions.³⁵ As just discussed, the circumstances in which the ISO would issue a CPM designation for underperforming variable energy RA resources would not be transitory, as WPTF alleges. To qualify as a CPM Significant Event, the underperformance by wind or solar facilities would be so far below their RA capacity value for an extended period of time that it would represent a material difference from the assumptions used to calculate the qualifying capacity value or threaten reliability.

With this explanation how underperformance by variable energy RA resources could qualify as a CPM Significant Event, the ISO urges the Commission to reject the

³⁵ WPTF Protest, pp. 12-13.

arguments made by the CPUC and WPTF and again approve this category of backstop procurement, but without a sunset provision.

SCE recommends that the Commission require the ISO to follow a documentation process and issue quarterly reports about CPM procurement to address underperforming variable energy RA resources so that stakeholders can monitor the designations and ascertain how much of a problem the underperformance may be. This recommendation is unwarranted. The ISO Tariff already contains comprehensive reporting requirements about all CPM designations. Under existing ISO Tariff Section 43.5 (renumbered to 43.6 in the filing), the ISO is required to:

- Issue a market notice within two business days of a CPM designation that describes the cause of the designation, the name of the resource procured, the expected duration of the designation, and the initial designation period;
- Post a designation report (and provide a market notice of the availability of the report) that: describes the reason for the designation and explains why backstop procurement was necessary; provides details about the designated resource, capacity amount, duration, and price;
- Post a report (and provide a market notice of the availability of the report) that: identifies non-market and repeated market commitment of non-RA capacity; and that includes the name of the resource, the IOU service area or local capacity area, the maximum capacity committed; the type of procurement, the reason the capacity was committed, information as to whether all RA resources and any previously-designated CPM capacity were used first, and if not, why not; and

- Include a summary of CPM costs in the operations report provided to the ISO Governing Board at each board meeting.

SCE has not explained how these numerous reports are deficient or somehow fail to provide sufficient documentation and information for stakeholders to monitor CPM designations for Significant Events. In the ISO's view, the information already required to be reported contains the documentation and information needed for stakeholders to monitor all CPM designations, not just those for CPM Significant Events. The reporting requirements suggested by SCE are therefore unnecessary and should be rejected by the Commission.

C. The Selection Criteria Do Not Create a New CPM Designation; They Help Select Optimal Resources to Receive a CPM Designation

The ISO proposes to amend Section 43.3 (which will be renumbered as 43.4) to expand the criteria the ISO may consider in selecting the resource to receive a CPM designation from other candidate resources. The two new selection criteria are the operating characteristics of the resource, such as dispatchability, ramp rate, and load-following capability, and whether the resource is subject to restrictions as a use-limited resource.

Six Cities and NCPA support the addition of these CPM selection criteria. Both parties recognize that expanding the CPM selection criteria to include consideration of the operating characteristics and use-limited status of eligible resources will better enable the ISO to designate specific capacity that will be most effective in addressing the reliability need underlying the CPM designation, to the benefit of ratepayers.³⁶

³⁶ Six Cities Protest and Comments, p. 3; NCPA Comments and Limited Protest, p. 6.

WPTF objects to this modification and mischaracterizes the ISO's proposal as expanding the reasons for procuring capacity through the CPM to include operating characteristics and differentiate between use-limited and non-use-limited resources.³⁷

SCE does not support adding operational characteristics to the CPM selection criteria. SCE is concerned that, unless the market is advised of the ISO's operational needs and given the opportunity to procure capacity with the necessary attributes, the ISO's backstop procurement could be inefficient and duplicative, and increase costs to customers.³⁸

WPTF and SCE seem to misunderstand the modification the ISO is proposing to the selection criteria in ISO Tariff Section 43.4. The key element of the proposal these parties overlook is that the selection criteria do not expand the basis for the ISO to issue a CPM designation; they merely allow consideration of resource-specific traits to aid the ISO in selecting the optimal resource to receive the designation.

To clarify the CPM designation and selection process, the ISO will first make the determination to issue a CPM designation.³⁹ Only after the ISO has made the decision

³⁷ WPTF Protest, p. 11.

³⁸ SCE Comments, pp. 5-6.

³⁹ Under proposed ISO Tariff Section 43.2, the ISO will have the authority to issue a CPM designation to address the following circumstances – (i) to cover instances where a Scheduling Coordinator fails to show that it has procured sufficient Local Capacity Area Resources in an annual or monthly RA Plan; (ii) to correct a collective deficiency in Local Capacity Area Resources in the annual RA Plans of applicable Scheduling Coordinators after the opportunity for LSEs to cure the deficiency has been exhausted; (iii) in response to a Scheduling Coordinator's failure to show sufficient RA Resources in an annual or monthly RA Plan to comply with each LSE's annual and monthly demand and reserve margin requirements; (iv) if the ISO determines that a significant event is occurring that creates a need to supplement the already-established RA requirements; (v) to offer CPM procurement for resources that are issued an Exceptional Dispatch for a reliability or operational need; and (vi) to maintain in service capacity at risk of retirement within the current RA compliance year that will be needed for reliability by the end of the following calendar year. The first five of these CPM categories are already in place under ICMP; only the risk of retirement is new under CPM.

to issue a CPM designation will the ISO apply the selection criteria,⁴⁰ including resource operating characteristics, in order to identify the specific resource from the pool of eligible resources that is best suited to meet the reliability need giving rise to the CPM and that best maximizes the value that the ISO and ratepayers will receive the CPM designation. These criteria determine the unit that should receive the designation. Accordingly, the use-limited status and operational characteristics of the unit will not be the basis for the decision to engage in backstop procurement, as WPTF and SCE seem to believe. Adding authority to the Tariff for the ISO to consider resource operating characteristics and use-limited status will not expand the reasons for which a CPM can be issued; they merely refine the selection criteria the ISO uses to choose the resource that will receive the designation. This will ensure that the ISO selects the resource(s) that most effectively meets the ISO's needs and maximizes benefits to ratepayers. For example, a unit that will be required to offer into the ISO's markets everyday will be better positioned to meet the ISO's reliability needs, and provide more value to ratepayers for the costs they will incur, than a resource that has no such obligations.

The ISO disagrees with SCE that adding resource operating characteristics to the list of selection of criteria in proposed ISO Tariff Section 43.4 will be inefficient, duplicative, or increase costs. Under renumbered ISO Tariff Section 43.9, the scheduling coordinator for a load serving entity that is allocated the cost of a CPM designation will receive credit toward the load serving entity's demand and reserve

⁴⁰ Under proposed ISO Tariff Section 43.4, the selection criteria are: (i) the effectiveness of the unit at meeting the reliability need; (ii) the capacity costs associated with the unit (*i.e.*, whether the unit will accept the default compensation or requires a higher cost-based compensation level); (iii) the quantity of a resource's available capacity relative to the amount of capacity the ISO needs; (iv) the operating characteristics of the resource; (v) whether the resource is subject to restrictions as a use-limited resource; and (vi) for designations due to insufficient RA resources, the effectiveness of the eligible capacity in meeting local and/or zonal constraints or other ISO system needs.

margin requirements, or RA obligation. This credit should offset the duplication or increased costs of concern to SCE.

D. The ISO's Proposed Going-Forward Fixed Costs CPM Compensation Methodology is Just and Reasonable, both in Theory and as Applied to the Specific Default Compensation Rate of \$55/kW-year

1. Introduction

In response to the ISO's proposal to set the default CPM compensation at \$55/kW-year, based on an updated application of the same going-forward fixed costs methodology that was utilized for ICPM, the protests have largely fallen into two camps. Generation-related entities, including WPTF, IEPA, EPSA, GenOn and NRG (collectively, Generator Parties) all separately argue that the going-forward fixed cost methodology is insufficiently remunerative and thus unjust and unreasonable. The Generator Parties argue that the ISO should instead adopt a payment methodology based in some fashion on the cost of new entry (CONE). Load-related entities, including PG&E, Six Cities, and the CPUC approve the going-forward fixed costs approach as a concept but all believe that the specific proposal should be adjusted in ways that would reduce the CPM compensation paid to generation.⁴¹

Rather than an indictment of the CPM proposal, the ISO believes that the nature of this opposition — generation predictably arguing for a higher CPM payment and load, to the extent it objects, arguing for a lower CPM payment — is evidence of the reasonable balance reflected in the ISO's default CPM payment. The ISO's proposed CPM payment methodology and default payment is carefully crafted to provide just and

⁴¹ Unlike the Generator Parties, entities representing load have not universally condemned the CPM compensation proposal. For example, SCE specifically comments that the ISO's proposed default compensation of \$55/kW-year based on going-forward fixed costs with deductions for peak energy rents (PER), "is reasonable and consistent with the overall RA program design." SCE Comments, at 3. SDG&E likewise raises no objection to this aspect of the ISO's proposal.

reasonable compensation for the specific service that a CPM-designated unit is called on to provide to the ISO and is consistent with the approach previously approved by the Commission.

2. Generator Arguments that Going-Forward Fixed Costs Provides Insufficiently Low Compensation

In opposition to the ISO's CPM proposal, the Generator Parties raise four broad arguments in support of their general contention that the proposed CPM is unjust and unreasonable, and thus should be rejected. They claim that:

1. The going-forward fixed costs plus 10% methodology fails to compensate resources sufficiently by, *inter alia*, failing to contribute sufficiently to recovery of fixed costs that are not included in the going-forward fixed costs methodology. The CPM's methodology thus does not provide incentives for either entry of new generation or incremental investments in existing generation.
2. The ISO's proposal is fatally deficient because it failed to consider compensation methodologies besides going-forward fixed costs and CONE.
3. The CPM mechanism does not sufficiently fill the gaps in the CPUC's RA program.
4. The ISO's proposal fails to consider adequately the role that the CPUC's failure to adopt a long-term RA program will have on the purpose of the CPM.

When the ISO filed the ICPM tariff amendments, it was faced with responding to many of these same arguments. Indeed, these are the same arguments some of these parties have been making unsuccessfully for years in the RCST, TCPM, ICPM, and now CPM proceedings. While those parties are certainly within their rights to assert the same arguments over and over again, in light of the success of the ICPM mechanism, the fact that the ISO has never needed to make an ICPM designation because a load serving entity was deficient in meeting its RA obligations, and in the absence of

materially changed circumstances or new factual evidence, it is hard to see what justification there would be for the Commission to reverse course one-hundred and eighty degrees and find that a going-forward fixed costs methodology for short-term backstop capacity procurement is unjust and unreasonable, but a methodology based on Cost of New Entry (“CONE”) is just and reasonable. Indeed, the ISO’s proposal increases the default backstop capacity rate by 34%, far outpacing the rate of inflation since the ICPM was approved.

In its ICPM Answer, the ISO responded to generators’ arguments in favor of CONE over going-forward costs by offering the following basic points of perspective:

First, the CAISO is not attempting to create a centralized capacity market with the ICPM. Second, the ICPM is not intended as a mechanism to incent new generation. Third, the ICPM is not intended to be a referendum on the state RA program or to modify the RA program. The ICPM is merely an interim, administrative mechanism that will permit the CAISO to efficiently procure backstop capacity on a short-term basis from existing resources that have capacity available and which are willing to make that capacity available to the CAISO via a forward ICPM designation in order for the CAISO to meet reliability needs that arise. Further, designations under the ICPM are voluntary; units owners are not required to accept them. Given the interim nature of the ICPM (the ICPM will automatically sunset on December 31, 2010), the uncertainty as to whether (or when) there will even be any ICPM procurement, and the fact that the ICPM is merely intended to “fill” any gaps in LSE procurement or permit the CAISO to undertake short-term procurement in response to unplanned, unexpected Significant Events, the ICPM clearly will not – and cannot reasonably be expected to – “drive” new investment or repowering of existing units.

To the extent protesting parties take issue with the state’s RA program, then they should raise their issues with the CPUC. Concerns with the RA program should not be addressed within the context of this proceeding.

Aside from the references to the interim nature of the ICPM, this preface applies with equal force to the Generator Parties' arguments in the instant proceeding. Focusing on the specific function the CPM is meant to serve (rather than the functions the Generator Parties wish it to serve), the CPM is remarkably fit for the purpose it is intended to serve, while also providing just and reasonable compensation for the services CPM-designated resources will provide. Also, generators control the decision whether to even accept an ICPM designation, as CPM designations are voluntary. Any use of CONE-based compensation would unravel the proper fit between the intended function and the design of the CPM mechanism.

a. Generator Argument #1 – CPM Compensation Based on Going-Forward Fixed Costs Does Not Sufficiently Contribute to Fixed Cost Recovery and thus Does Not Provide Incentives for Either Entry of New Generation or Incremental Investments In Existing Generation

IEPA provides several arguments as to why the CPM will not provide sufficient cost recovery or proper investment incentives, and is thus unjust and unreasonable. IEPA claims that a going-forward fixed costs methodology denies generators the ability to make meaningful contributions towards full fixed cost recovery.⁴² For example, IEPA notes that going-forward fixed costs do not include fixed capital financing costs. Because of what IEPA believes is pervasive market price suppression through application of the ISO's mitigation mechanisms, IEPA argues that such fixed costs cannot be recovered through the ISO's markets. IEPA argues that the money that generators lose through this mitigation must be recovered elsewhere to ensure recovery of fixed costs.

⁴² IEPA protests, at 44-49.

According to IEPA, this inability to recover fixed costs will be exacerbated by two future factors that IEPA believes the ISO has failed to consider in its CPM proposal. First, IEPA argues that the CPM proposal fails to acknowledge the impact of implementing California's renewable portfolio standards.⁴³ Integrating renewable resources will increase the operational importance of gas-fired resources, while simultaneously decreasing the revenue such resources will earn from energy and ancillary services markets. IEPA argues that the ISO's failure to account for these decreased revenues in the CPM is unjust and unreasonable.⁴⁴ Second, IEPA claims that California's environmental regulations, including the elimination of Once Through Cooling, tighter emissions standards, and a "cap and trade" program, will all require existing generation to make significant incremental investments to maintain availability.⁴⁵ IEPA argues that, in limiting CPM compensation to going-forward fixed costs, the ISO ignores the need to make such incremental investments.⁴⁶ IEPA also claims that the CPM's failure to provide an avenue to recover these predicted costs and failure to create incentives to make these needed investments also renders the CPM unjust and unreasonable. IEPA draws a comparison to MISO, which has a similar backstop capacity program that is meant to supplement RA procurement.⁴⁷ IEPA finds it significant that MISO bases its deficiency penalty on CONE, rather than going-forward fixed costs.

EPSA argues that the CPM's going-forward fixed costs methodology is insufficient because it will not stimulate entry of new generation resources. In EPSA's

⁴³ *Id.* at 5-6.
⁴⁴ *Id.* at 32-36.
⁴⁵ *Id.* at 6-7.
⁴⁶ *Id.* at 10.
⁴⁷ *Id.* at 43.

view, based on established Commission precedent, it is unreasonable for the ISO to claim that the CPM “should be considered independently of the need to incent new generation.”⁴⁸ According to EPSA, “every market element has an effect on investment decisions,”⁴⁹ and as such, the CPM cannot be evaluated without that goal in mind. Like IEPA, EPSA notes MISO’s use of CONE.⁵⁰ While some variation among regional markets is acceptable, EPSA believes that the design of MISO’s and the ISO’s backstop capacity mechanism are so similar that the ISO’s use of going-forward costs cannot be justified in light of MISO’s reliance on a CONE-based compensation methodology.⁵¹

WPTF argues that the CPM proposal fails to compensate existing units for the value provided by their capacity. By failing to establish proper incentives, WPTF believes that the ISO fails to send proper incentives for the addition of new capacity.⁵² While acknowledging that the CPM is not meant to be a capacity market, WPTF nevertheless argues that it is important for the CPM process to generate the proper signals that can then inform the forward contracting process.⁵³ WPTF argues that the MSC opinion’s view about the need to send signals to demand in constrained areas raises the same fundamental view.⁵⁴ Like IEPA, WPTF argues that limiting capacity payments to going-forward costs denies resources a reasonable opportunity to earn a return of and on capital due to the ISO’s market power mitigation procedures.⁵⁵

NRG notes that it joins IEPA’s protest and writes separately to highlight a few additional points. In terms of the adequacy of compensation, NRG argues that

⁴⁸ EPSA protest, at 11.

⁴⁹ *Id.* at 12.

⁵⁰ *Id.* at 18-19.

⁵¹ *Id.*

⁵² WPTF protest, at 5-6.

⁵³ *Id.* at 8.

⁵⁴ *Id.* at 9.

⁵⁵ *Id.* at 10-11.

inadequate compensation creates a “run to failure,” in which deferred maintenance and deferred capital expenditures continue to grow over time.⁵⁶ As the run to failure continues, the size of those needed incremental investments grows and making such investments become increasingly less reasonable in light of more losses over time. The result, according to NRG, is that units needed for reliability are incentivized to run until they break down, at which point they will be retired.

None of the arguments raised by IEPA, EPSA, WPTF, or NRG justify revising the methodology the ISO proposes to retain for purposes of basing CPM capacity payments. The CPM is meant to purchase short-term capacity on a backstop basis from existing non-RA resources to address specific reliability needs or fill deficiencies in actual RA procurement. As explained in the ISO’s transmittal letter in this proceeding, the going-forward fixed costs methodology is closely tailored to these goals “because it provides all units, at a minimum, with compensation for that which the ISO requires – maintaining the ability to stay in the market and submit bids to provide energy.” CPM is not – and is not intended to be – a multi-year forward, centralized capacity market. For three reasons, CONE-based CPM compensation would not serve these goals.

1. New entry cannot compete with existing resources to provide CPM capacity because short-term CPM designations will be made as a result of unexpected and transitory events that cannot be remedied in the timeframe it would take for new entry to occur. Stated differently, only existing resources can receive CPM designations.
2. “[I]ncreases in CPM compensation could impact RA procurement in some locations by creating incentives for unit owners not to sign bilateral RA contracts”⁵⁷ A high CPM price would create incentives for units to withhold their capacity from the bilateral RA process in the hopes of receiving a more remunerative CPM designation.

⁵⁶ NRG protest, at 6-7.

⁵⁷ *Id.* at 23.

3. The CPM is not designed, nor is it intended to function, as a multi-year capacity market. A capacity market is meant to provide signals about the value of capacity and thus one of its functions is to incent new entry or incremental investments where appropriate. In those circumstances, CONE may be an appropriate reference price. Those circumstances, however, are not the circumstances surrounding the CPM proposal.

The Commission previously has found that a backstop capacity procurement program with these goals, justifications, and pricing provides just and reasonable compensation for units providing the backstop capacity. The Generator Parties' arguments provide the Commission no basis upon which to question its prior determination, nor do they provide the Commission any basis (or new evidence) upon which to conclude that the considered and deliberate policy design decisions the ISO made in the course of developing the CPM renders the CPM unjust and unreasonable. While cloaked in the "just and reasonable" language of the Federal Power Act, the Generator Parties' arguments amount to nothing more than statements of what would be more advantageous to them.

The CPM is not intended to incent the entry of new generation resources, nor is it designed to provide incentives for existing generators to make incremental investments in existing units. As explained above, given the uncertain⁵⁸ and short-term nature of a CPM designation, it would be an unreasonable business decision for a prospective new entrant to base its entry decision on the prospect of possibly receiving a CPM designation for as short as 30 days. The pertinent question thus becomes: Is it unjust and unreasonable for the ISO to propose a short-term backstop capacity procurement compensation methodology that fails to provide investment incentives? The clear answer has been – and remains – no.

⁵⁸ The CPM is uncertain in the sense that a unit generally will have little advance notice that it will be offered a CPM designation.

The Generator Parties offer no compelling arguments or evidence to suggest that the answer is yes. EPSA's argument that Commission precedent requires every market element to support new generation investment is unavailing. If that were the case, the Commission never would have been able to approve RCST, TCPM, ICPM, RMR or PJM's and MISO's risk of retirement backstop procurement tariff provisions. The very concept of "backstop procurement" contemplates a "last ditch effort" to procure existing capacity to meet reliability needs; it in no way conjures up visions of a multi-year forward centralized capacity market designed to incent new generation. In reviewing a market, it is appropriate for the Commission to inquire as to whether the combination of market elements, taken together, creates incentives for new entry. It is not, however, the case that every individual market element, taken on its own, in isolation of the overall market structure, should be designed with that single goal in mind. Competitive power markets must be designed with a variety of necessary goals in mind. One of those goals is to create incentives for new entry. In this instance, the ISO not only has a backstop capacity pricing mechanism, it has scarcity pricing, Energy price caps that are rising, a bilateral Resource Adequacy regime that allows for resources to receive capacity payments, and CPUC-imposed penalties on LSEs that are deficient in meeting their obligations. As the Commission noted in a MISO Order where generators objected to the fact that MISO was not procuring capacity on behalf of deficient LSEs, the Commission recognized the appropriateness and importance of MISO's RA construct whereby LSEs meet their planning reserve requirements through bilateral contracting and stated that "financial charges assessed to deficient LSEs, in combination with scarcity pricing, should together provide long-term incentives for LSEs to obtain

adequate capacity via bilateral contracts such that additional procurement by the Midwest ISO is unnecessary.”⁵⁹ Compared to MISO, the ISO offers more opportunities for generators because it has a mechanism that allows the ISO to procure capacity from generators, and make capacity payments to them to fill LSE RA deficiencies (which is what the generators in MISO wanted), and its marketplace also has scarcity pricing and CPUC-imposed financial penalties for LSEs that are deficient in their RA procurement.

Another goal that needs to be considered is maintaining grid reliability. The fact that the CPM is not intended to incent new generation is beside the point because the sole purpose of the CPM is to advance the latter goal of maintaining grid reliability by providing the ISO with a backstop procurement mechanism.

The probative value of IEPA’s and EPSA’s respective comparisons to MISO’s CONE-based backstop capacity mechanism is similarly unpersuasive. The suggestion that MISO’s capacity procurement approach is materially indistinguishable from the proposed CPM but for the use of CONE is wholly without merit. First, the Commission rejected arguments that MISO be required to procure capacity on behalf of deficient LSE’s.⁶⁰ Second, each month that an LSE is deficient in its RA procurement MISO will charge that LSE a monthly deficiency charge that is derived based on CONE; however, any deficiency charge payments are made to those LSEs that are not deficient. The funds collected by MISO are not used by MISO to procure capacity to fill the deficiency, and none of the charges are paid to generators.⁶¹ In other words, MISO’s CONE-based charge is designed to be a deficiency penalty to be levied against LSEs where their

⁵⁹ *Midwest Independent Transmission System Operator, Inc.*, 127 FERC ¶ 61,054, P 24 (2009) (“MISO I”).

⁶⁰ *Midwest Independent Transmission System Operator, Inc.*, 125 FERC ¶ 61,060, P 132 (2008) (“MISO I”), order on reh’g *MISO II* at PP 24-30.

⁶¹ *MISO I* at P 132; *MISO II* at PP 24-30.

procurement is deficient; it is not a payment to procure capacity from generators. As the Commission has stated, the “primary aim of the [MISO penalty] is to *induce* the LSE to build or contract for capacity to meet its resource adequacy requirements.”⁶² Also, as IEPA itself acknowledges,⁶³ the funds collected by the ISO are not paid to specific generators from which capacity was procured. Instead, the penalty funds get redistributed to LSEs that were not deficient and to suppliers that participated in the preceding month’s capacity auction.⁶⁴ Indeed, the fact that the deficiency charges in MISO are not a payment to generators belies the notion that MISO’s design even involves capacity procurement from generators or a capacity payment to generators based on CONE.

On the other hand, CPM (and its predecessors) do allow the ISO to procure backstop capacity from generators to fill LSE RA deficiencies, if the generators agree to the designation. Thus, the CPM mechanism includes the mechanism that the generators in MISO wanted but did not get. In any event, CPM is not a penalty scheme; it is a mechanism pursuant to which the ISO can procure backstop capacity. Indeed, it would make no sense for the ISO to propose a penalty scheme along the lines of MISO because the CPUC’s RA program already levies fines against LSEs that are deficient in their RA procurement. Any ISO penalty program would be redundant of the CPUC’s and interfere with the workings of its RA program. In instances where those penalties are triggered by LSE RA deficiencies, the LSE must pay the CPUC-defined penalty plus the costs of the CPM designation. Certainly, this constitutes an effective deterrent against LSEs shirking their RA procurement obligations. Finally, MISO’s proposal was

⁶² *MISO II* at P 46 (italics in original).

⁶³ IEPA protest, at 43.

⁶⁴ *MISO I* at P 10.

considered by the Commission contemporaneously with the ISO's ICPM proposal. If the Commission believed that it was inappropriate for MISO and the ISO to calculate their backstop capacity payments according to different methodologies, the Commission had ample opportunity to express that view. The Commission's silence on this point is telling. As the Commission noted in *MISO II*, "we continue to reject a one-size fits all approach to resource adequacy in the various RTOs and reaffirm the need to allow for regional differences for the reasons we discussed above."⁶⁵ In particular, to the extent IEPA and others are requesting that the Commission convert the CPM to a multi-year forward centralized capacity market, the Commission expressly rejected such a proposal in *MISO I* (at P 39) stating "we reject arguments that a mandatory auction or mandatory centralized capacity market is necessary to ensure resource adequacy." The ISO's well-structured regime that: (1) allows for LSEs to invest in and procure sufficient capacity to meet their RA obligations, (2) permits the ISO to procure backstop capacity for those LSEs that are deficient in their RA procurement, (3) subjects deficient LSEs to CPUC imposed deficiency penalties, and (4) includes a scarcity pricing mechanism, creates more than enough incentives for LSEs to procure sufficient capacity.

Finally, it is instructive to review recent entry of generation. As Six Cities points out in its reply brief, the significant recent new entry of generation capacity belies the argument that going-forward fixed cost compensation in a backstop capacity procurement program has a deleterious impact on entry of new generation.

Thus, the CPM mechanism, combined with other ISO market payments and the CPUC's RA program, provides adequate opportunities for fixed cost recovery. The ISO also submits that its proposed default CPM capacity payment is more than

⁶⁵ *MISO II* at P 30.

reasonable and is more than generous to allow resources to earn revenues well beyond their mere going-forward costs. First, the ISO has based the default CPM compensation on the gas unit with the highest going-forward costs of the types of gas-fired units evaluated by the CEC. Any gas-fired unit that is not a new 50 MW simple cycle gas-fired unit built by a merchant generator will therefore enjoy additional fixed cost recovery beyond its going-forward costs. Second, the ISO is paying a 10% adder above and beyond the going-forward costs as calculated by the CEC, so every unit is, at a minimum, earning at least an additional 10% toward its fixed cost recovery. Third, the going-forward cost calculation used by the CEC and the ISO includes property taxes in the going-forward cost calculation for all resources it will procure under CPM. The ISO notes that the Commission previously has found that costs such as property taxes are only appropriate for a unit that wishes to retire because such costs are not avoided if the unit is merely mothballed.⁶⁶ Fourth, based on evidence that is available to the ISO, the ISO estimates that the annual fixed revenue requirement (not just the going-forward costs) of the units in the fleet that are eligible to receive CPM payments is below the default CPM capacity payment of \$55/kW-year.⁶⁷ Generators have not offered one iota of evidence to the contrary. Considering that none of the 23 ICPM designations ever lead to a cost-based justification for compensation above \$41/kW-year, it stands to reason that as compared to ICPM, the CPM will provide more recovery to fixed costs than the ICPM. Finally, the ISO notes that the CPM mechanism does not include a deduction of Peak Energy Revenues (PER). Thus, all revenues that suppliers

⁶⁶ *New York Indep. Sys. Operator Corp., Inc.*, 122 FERC ¶ 61,211, P 81 (2007).

⁶⁷ CPM Transmittal Letter, at 23. See also *Cal. Indep. Sys. Operator Corp.*, Motion for Leave to File Answer and Answer of the California Independent System Operator Corporation 35-36, Attachment A, & Attachment B, FERC Docket Nos. ER08-556-000 and ER06-615-020 (Mar. 17, 2008) (“ICPM answer”).

earn in the markets are additive to the CPM capacity payment they would receive. Those revenues can be applied toward fixed costs not recovered through the CPM payment.

As a factual matter, several parties argue that the other opportunities to recover full fixed costs are extremely limited. Citing several studies from the ISO's Department of Market Monitoring, IEPA and WPTF claim that generators have been unable to recover costs through energy and ancillary market revenues. As Six Cities points out in its reply brief, however, ISO revenue analysis does not account for RA contracts and notes that RA contracts will be the primary means for new generation investment. Furthermore, the ISO's revenue analysis was based on new generation, rather than existing generation. For this reason, the revenue analysis to which IEPA and WPTF says nothing about cost recovery for existing units.

The IEPA's protest also claims the CPM proposal is deficient for failing to cite specific revenue calculations. The ISO has relied on a new CEC cost study. In its ICPM filing the ISO also relied on a CEC cost study and found the results to be reasonable. Considering that the proposed changes result in a 34% increase in the level of the CPM capacity payment, there is no reasonable basis for generators to raise objections; indeed, they do not raise specific objections to the results of the CEC's study. The ISO only has portions of the data needed to conduct this analysis because RA contracts and long-term supply contracts constitute a significant portion of a unit's revenues. In the ISO's ICPM answer it highlighted this point, noting that: "It is significant that for all the objections IEP and California Generators raise to the proposed ICPM price, there is an unnatural silence when it comes to providing specific cost data

for their facilities, although they alone control such data.”⁶⁸ The same response holds just as true today.

IEPA further argues that the CPM compensation methodology fails to account for the opportunity costs associated with the obligations of a CPM. This argument is fundamentally flawed because receiving a CPM designation is optional. These supposed “opportunity costs” are nothing more than the trade-off the owner of the unit makes in choosing whether to accept the CPM designation. If having a guaranteed payment of going-forward fixed costs is not a fair exchange for having the availability obligations, then the designation can be rejected.

Multiple parties argue that the ISO has failed to consider the impact of that renewable integration and other environmental programs will have on future cost recovery. The problem with this argument is that it is entirely speculative. There is no way to know with specificity what those cost impacts may be. Even assuming, *arguendo*, that the CPM should be designed to recover those future unknown costs, the pertinent question is whether the CPM mechanism will provide just and reasonable rates based on the circumstances as they are today. If and when future circumstances render the CPM payments unjust and unreasonable, those questions can be addressed. In all likelihood, the ISO will be adding new products that will provide generators with additional revenue earning opportunities.

In the end, the Generator Parties’ arguments about full fixed cost recovery are nothing more than an attempt remake the fundamental nature of the ISO’s markets into a hybrid that has both market-based rates and guaranteed full cost recovery. As the Commission has recognized on numerous occasions, if generators desire guaranteed

⁶⁸ ICPM answer, at 58.

cost recovery, they should file for cost-based rates.⁶⁹ If the Generator Parties truly believe that the ISO's market power mitigation procedures are unduly restrictive and have evidence demonstrating that these procedures result in unjust and unreasonable compensation, then the Generator Parties can avail themselves of their rights under § 206 of the Federal Power Act. Those arguments would be wholly separate and apart from the limited question of whether the ISO's proposed CPM compensation methodology provides just and reasonable compensation for the obligations entailed by accepting a CPM designation.

According to IEPA, the ISO's argument that CPM designations would only be made from existing resources tacitly acknowledges that a competitive capacity market would yield prices above going-forward costs. The ISO, however, in IEPA's view fails to justify why the CPM should not be designed to replicate the outcome of a competitive market.⁷⁰ According to IEPA, this ISO view that the CPM is not a capacity market is a non sequitur because the CPM is only what the ISO proposes it to be. The question, according to IEPA, is what should the CPM mechanism be? According to IEPA, it should be a mechanism that replicates what competitive outcomes would be in a capacity market.⁷¹ As indicated above, the Commission has rejected requests to require specific RTOs to implement a centralized capacity market in lieu of a bilateral procurement regime.⁷²

⁶⁹ See, e.g., *Bridgeport Energy LLC*, 113 FERC ¶ 61,311 (2005).

⁷⁰ IEPA protest, at 36.

⁷¹ *Id.* at 36.

⁷² IEPA's assertion of what the CPM should be misunderstands the Commission's role under the Federal Power Act. It is up to the ISO to say what the purpose of the CPM is. The Commission can consider that purpose and consider whether the proposed mechanism is an appropriate way of achieving that purpose. The fact that there may be other proposals designed to serve other purposes is wholly irrelevant. Further, citation to ISO comments at the CPUC regarding the importance of a capacity market are not germane to the instant proceeding. There may be value in adopting a long-term capacity market

Both EPSA and IEPA also find fault with the assertion that high CPM compensation will impact bilateral RA contracting. According to IEPA and the Stoddard affidavit, the concern that increased CPM compensation could impact bilateral RA procurement is overblown because it assumes that a unit owner would forgo a year-long bilateral RA contract in hopes of receiving a monthly CPM designation.⁷³ IEPA ignores a key fact: CPM procurement for local resource needs and collective deficiencies can be for up to one year because the term of procurement for local RA capacity is one year. Also, the year-ahead procurement period for the summer is five-months, not one month. Thus, if there were a deficiency in that procurement, the ISO could procure backstop capacity for up to five months. Higher backstop capacity prices also impact LSEs because, in addition to the deficiency penalties they would pay the CPUC, they would also have to pay the costs of backstop procurement.

IEPA also asserts that the ISO has provided no foundation for its view that CPM prices above going-forward costs would interfere with bilateral RA procurement.⁷⁴ As the Commission noted in the ICPM order, high CPM prices could put upward pressure on bilateral prices, but IEPA argues that if the CPM price is too low it could create a disincentive for LSEs to meet their RA requirements. According to IEPA, the ISO bears the burden of providing evidence justifying which impact the CPM price would have. Due to the opaque nature of the RA contracting process, IEPA claims that the ISO cannot present such evidence to the Commission. EPSA also hints at this point in

or auction mechanism. Simply because the ISO has identified a long-term need for California, it does not follow that the ISO is compelled to address that need with the first market design initiative that comes along or even that it is the ISO's, rather than the CPUC's, obligation to design the mechanism that will serve that long-term need for California.

⁷³

Id.

⁷⁴

Id. at 39-43.

asserting that the lack of a CONE-based backstop compensation unnaturally distorts the bilateral RA contracting process by suppressing bilateral prices.⁷⁵

In the ICPM order, the Commission clearly found that the ICPM's intent of not interfering with the RA process was a necessary and important element of the proposal, stating "it is important that the proposed ICPM backstop capacity price does not significantly influence current bilateral prices."⁷⁶ The ISO retained this design element based on the express findings in the Commission's ICPM order. Here, IEPA and EPSA argue that the ISO failed to provide evidence to substantiate the Commission's prior decision. For several reasons, this argument must be rejected. First, it is not the ISO's obligation to substantiate a prior Commission decision. In the absence of citation to material changed circumstances, this attempt to make it the ISO's obligation is nothing more than a collateral attack on a prior Commission decision. IEPA and EPSA fail to show any material changed circumstances, and as such their arguments amount to little more than a collateral attack on a prior Commission order. Second, IEPA and EPSA suggest that the ISO has failed to provide evidence to prove that higher CPM prices would raise bilateral RA contract prices. To reject this assumption, one must make the counterintuitive assumption that *higher* CPM prices would lead to *lower* bilateral RA contract prices. Third, IEPA's and EPSA's arguments are also problematic because, as Six Cities points out in its reply brief, the generators have much better access to bilateral RA contract prices than the ISO does. After all, they are the entities entering into these contracts, not the ISO. One must question why the generators would make a purely theoretical argument when they have access to

⁷⁵ EPSA protest, at 10.

⁷⁶ ICPM order, at P 43.

data needed to make a quantitative argument to support their position. Their failure to provide any support for their claims is telling. Fourth, the notion that low CPM prices create incentives for LSEs to be deficient in the RA process so that they can pay the CPM price ignores the penalties such LSEs would also have to pay under the RA program for being deficient. Stated differently, deficient LSEs not only have to pay the costs for the backstop capacity procured by the ISO, they also have to pay the deficiency penalties charged by the CPUC for those LSE's that are deficient in their RA procurement. Fifth, in the history of the ISO's backstop procurement – RCST, TCPM, and ICPM – the ISO has never had to designate backstop capacity to fill an RA deficiency. Thus, any claim from the generators that the purportedly low CPM capacity payments will result in LSEs not procuring sufficient capacity simply has no basis in fact. Finally, the only clear evidence on the matter in the record of this proceeding is an affidavit included in the CPUC's protest. According to the Shumavon affidavit, even moving the default price from \$41/kW-year to \$55/kW-year would have an impact on bilateral RA prices. It stands to reason, based on this affidavit, that moving to CONE-based compensation, in which the default price would increase five-and-a-half times from the ICPM default price,⁷⁷ would have an impermissibly large impact on bilateral RA prices.

b. Generator Argument #2 – The ISO Failed to Consider Compensation Methodologies Besides Going-Forward Fixed Costs and CONE

IEPA alleges that the CPM proposal is “overly simplistic” because it only considers two compensation methodologies, CONE and going-forward fixed costs.⁷⁸

⁷⁷ The CONE price estimated in the ISO's Straw Proposal was \$229/kW-year.
⁷⁸ IEPA Protest, at 19-21.

According to EPSA, the ISO filing assumes that if it rejects CONE-based compensation then the default choice is going-forward fixed costs. IEPA considers this a simplistic decision-making process that failed to consider middle alternatives and thus poses a “fatal deficiency” in the ISO’s proposal. As such, IEPA urges the Commission to reject the CPM proposal and instead institute a paper hearing process to determine the proper CPM price designed according to IEPA’s desired design principles.⁷⁹

This criticism fundamentally misapprehends the nature of the Commission’s review under § 205 of the Federal Power Act. *City of Bethany v. FERC* firmly establishes the principle that the Commission’s review of a proposed rate, term, or condition need only be just and reasonable.⁸⁰ The Commission does not consider whether a proposal is the best possible proposal or “whether a proposed rate schedule is more or less reasonable than alternative rate designs.”⁸¹ Thus, the potential alternatives to going-forward fixed costs that the ISO did or did not consider are legally irrelevant. The Federal Power Act does not dictate a particular decision-making process. Instead, it mandates review only of the reasonableness of the outcome from whatever decision-making process is employed.

Furthermore, the fact that this criticism comes from IEPA is particularly ironic considering it was absent from the ISO’s stakeholder process. There is a fundamental incoherence in IEPA arguing about the sanctity of process, while at the same time sandbagging the ISO and failing to join its fellow stakeholders in the hard work conducted in the stakeholder process.

⁷⁹ IEPA Protest, at 68.
⁸⁰ 727 F.2d 1131, 1136 (D.C. Cir. 1984).
⁸¹ *Id.*

Finally, the ISO objects to IEPA's suggestion that there be a paper hearing regarding an appropriate "middle ground" level of compensation. IEPA offers no middle ground proposal and did not propose any middle ground alternative during the stakeholder process. The ISO notes, as discussed above, that its proposal is not a pure going forward costs scheme because the ISO is (1) using the most expensive gas-fired unit upon which to base the default going-forward cost price, (2) proposing a 10% adder to the cost associated with that unit, and (3) including property taxes for all units which is not typically a going-forward cost for all units. Thus, the ISO's proposal is in the middle ground between CONE and going-forward costs. In any event, the Commission has ample evidence before it to determine that the CPM proposal is just and reasonable. Further, if IEPA has evidence to support its supposed "middle ground" approach, it should have offered it in the ISO's stakeholder process or in the instant proceeding. IEPA did not and, as such, it should not be permitted to take advantage of its inaction and failure.

c. Generator Argument #3 – The CPM Mechanism Does Not Fill the Gaps in the CPUC's RA Program.

Both IEPA and EPSA argue that the CPM proposal is deficient because it does not fill the perceived gaps of the CPUC's RA program. The Stoddard affidavit included in IEPA's protest devotes substantial attention to alleged deficiencies in the current RA program and the ways in which the CPM fails to remedy those deficiencies.⁸² IEPA also, however, acknowledges that "broad reforms of California's resource adequacy program, including solutions that Mr. Stoddard suggests, are beyond the scope of this

⁸² IEPA protest, at 25-26 and Stoddard Aff. at 7-20.

proceeding.”⁸³ EPSA similarly claims that the ISO’s backstop procurement mechanism must be designed to fill in what it considers to be the holes in the RA program.⁸⁴

This notion that the ISO must address purported shortcomings of the CPUC’s RA program is in conflict with the Federal Power Act’s reserving for the states the authority to determine long-term resource adequacy requirements.⁸⁵ It is not the ISO’s responsibility to either render public judgment on the purported gaps in the CPUC-administered RA process nor is it the ISO’s obligation to design a comprehensive program to address those purported deficiencies. Again, this argument is based on the CPUC’s decision not to pursue a multi-year forward, centralized capacity market at this time. However, the limited question the Commission must address in the instant proceeding is whether the CPM payment mechanism provides just and reasonable compensation for the services that an existing generation unit owner must provide in exchange for that payment if it voluntarily agrees to accept the CPM designation. Whatever deficiencies there may be in the RA program, those deficiencies have no bearing on that limited question. In any event, as indicated above, the Commission has recognized that there is no one size to fit all RA programs and has declined to impose a capacity market on MISO in place of the bilateral procurement scheme that is in effect there. There is no reason for any different decision here especially given that the ICPM has functioned successfully, and the ISO has not been confronted with LSE deficiencies in their RA procurement.

⁸³ IEPA protest, at 26.

⁸⁴ EPSA protest, at 5.

⁸⁵ 16 USC 824o(i).

d. Generator Argument #4 – The CPM Proposal Does Not Account for Changed Circumstances Since Adoption of the ICPM

Citing to the same provision of the ICPM order (P 42), both EPSA and WPTF argue that the Commission’s prior acceptance of the going-forward cost methodology for ICPM was specifically predicated on the CPUC’s then-pending long-term RA proceeding.⁸⁶ EPSA additionally cites this passage to support the notion that the Commission’s ICPM approval was conditioned on the ICPM being a temporary measure. EPSA suggests that in the absence of these two factors, the Commission would have ordered the ISO to adopt CONE-based compensation that created incentives for new generation entry. EPSA argues that in light of the CPUC’s decision to maintain a year-by-year RA process, the function that will be served by the CPM is different from the function that was served ICPM.⁸⁷ Along the same lines, IEPA argues that several important “facts on the ground” have changed since ICPM was approved, the most notable of which is that the CPUC left the RA program unchanged, rejecting multi-year capacity commitment in an auction or transparent market mechanism to procure RA capacity.⁸⁸

As an initial matter, EPSA’s and WPTF’s claim that the CPUC’s decision to maintain a year-by-year RA process constitutes a changed circumstance defies logic. The CPUC’s retention of an RA structure that existed at the time of the ICPM decision is not – and cannot constitute – a changed circumstances. This is the identical framework under which the ICPM (and TCPM mechanism before it) operated. Given that the Commission found the ICPM to be just and reasonable under this existing RA

⁸⁶ EPSA protest, at 13; WPTF protest, at 20-21.

⁸⁷ EPSA protest, at 6-7.

⁸⁸ IEPA protest, at 4-5.

framework, it is illogical to claim that essentially the same mechanism and pricing scheme is not just and reasonable under this same framework. Stated differently, if ICPM pricing was just and reasonable under the existing year-to-year framework, there is no basis to find that the similar CPM pricing mechanism that will be operating under the same framework is unjust and unreasonable. Indeed, from a generator's perspective, the CPM capacity payment is increasing by 34%, far above the rate of inflation. It is difficult to fathom how the revised backstop capacity price is unjust and unreasonable under those circumstances.

Their arguments are also flawed because they read too much into the ICPM order, "cherry pick" general language while ignoring other key findings (in the same paragraph), and ignore the fact that the Commission already adjudicated the ICPM's going-forward fixed costs methodology and found it to be just and reasonable under a RA program that remains in existence today.

The passages from the ICPM Order EPSC and IEPA cite do nothing to establish what the Commission would have done in a counterfactual world in which the ICPM proposal were a permanent mechanism made while the CPUC were not considering a long-term RA program. The complete passage cited by EPSC states:

"[W]e note that the CPUC is currently engaged in an effort to implement a long-term capacity procurement mechanism. In recognition of the CPUC's ongoing proceeding, we are not inclined to modify the proposed backstop capacity price by adopting a pricing methodology, based on the cost of new entry, to support long-term capacity investments. As discussed above, we find that such a methodology for pricing ICPM backstop capacity would not encourage new investment. Further, we note that the ICPM is scheduled to sunset by December 31, 2010. In its evaluation of the CAISO's predecessor backstop capacity procurement mechanisms, the RCST and the TPCM, the Commission

expressly rejected cost of new entry pricing because we found the short term capacity procurement under these mechanisms did not provide sufficient long-term price signals to indicate the need to build new generation. Like the RCST and TCPM mechanisms, the ICPM is not designed to evaluate whether new investment is actually needed, but rather it provides the CAISO with a temporary tool to procure additional existing capacity when the capacity procured by LSEs under the resource adequacy program is insufficient to meet reliability needs.”⁸⁹

This passage certainly acknowledges the ICPM’s temporary nature and the then-pending CPUC proceeding. This passage, however, also clearly shows the Commission’s awareness and support of the basic design principles of the ICPM. The Commission accepted that the ICPM, like the CPM, is designed to procure backstop capacity for short-term needs. Based on this design principle, the Commission found that CONE-based pricing for “backstop capacity would not encourage new investment.” This passage, accordingly does nothing to support the suggestion that but for the CPUC proceeding and but for the interim nature of ICPM, the Commission would have ordered CONE-based pricing in the ICPM proceeding. Without establishing a causal link between the Commission’s prior decision and the then-pending CPUC proceedings, it is difficult to see how the CPUC’s decision to maintain the status quo represents a change.

The argument that the CPUC’s failure to adopt a multi-year RA program represents a material changed circumstance is also flawed because it ignores the reality that in the ICPM order, the Commission determined that it was just and reasonable to base payment for backstop capacity based on going-forward fixed costs where there is a year-by-year RA program. If the ICPM (and now CPM) payment methodology

⁸⁹ ICPM Order, at P 42.

coupled with a yearly RA process created unjust and unreasonable compensation, then the Commission could not have approved it. Since ICPM was approved, the ISO's Energy bid caps have increased significantly and the ISO has also added a scarcity pricing regime. This means that generators' revenue opportunities for generators are enhanced from what they were at the time the Commission approved ICPM. Reviewed in this light, the opponent's argument is nothing more than the curious assertion that the changed circumstances are that the circumstances did not change. This is thin gruel upon which to justify a one-hundred and eighty degree pivot in the Commission's position on the ISO's compensation methodology for backstop capacity.

3. Load Arguments that the ISO's Proposed Default Compensation Provides Excessive Compensation to Generators

The CPUC opposes the proposed default compensation of \$55/kW-year because it believes that figure is excessive and may interfere with bilateral contracting.⁹⁰ Citing recent activity in the RA process and the affidavit of Aram Shumavon, the CPUC asserts that the proposed default compensation rate is above the prices that have been negotiated through bilateral contracts. The CPUC also objects to paying the same compensation to units receiving a Risk of Retirement designation as to the other CPM designated units. According to the CPUC, resources that are actually providing capacity for reliability should not receive the same compensation as resources that are being paid to defer retirement. They are being paid for two reasons and should receive two different payments. Additionally, the CPUC reasons that the units contemplating retirement are probably going to be older and fully depreciated plants, rather than new

⁹⁰ CPUC protest, at 21-22.

single-cycle combustion turbines. Units receiving a risk of retirement designation thus should not receive as much money as the other units.

PG&E generally supports the going-forward fixed costs methodology, but argues that one adjustment should be made.⁹¹ PG&E argues that there should be a deduction for Peak Energy Revenues. PG&E reasons that not making such a deduction would overcompensate resources, particularly in light of the 10% adder.

Like the CPUC, Six Cities questions the 34% increase in the default compensation.⁹² Six Cities generally agrees that going-forward fixed costs is the correct conceptual approach for CPM payments. Rather than applying this methodology to the highest cost unit, Six Cities reasons that the CPM payment should be based on the going-forward fixed costs of the units most likely be procured or dispatched by the ISO, plus the 10% adder. Given that no unit has attempted to justify a payment higher than \$41/kW-year, Six Cities believes there is no evidence to support a 34% increase in the default payment.

In responding to these protests, the ISO first notes that no party has alleged that the ISO has incorrectly applied the going-forward fixed cost methodology to the figures contained in the CEC's most recent report. As the ISO explained in its transmittal letter, the figures contained in the CEC's 2009 report were more accurate in some respects than the 2007 report that was the basis for the ICPM default compensation figure. Thus, it is not accurate to claim that the ISO has deliberately chosen to impose a 34% increase in the default payment. The higher default compensation level for CPM as

⁹¹ PG&E protest, at 7-8.

⁹² Six Cities protest, at 4-6.

compared to ICPM is simply the result of plugging more accurate numbers into the identical formula that was used for ICPM.

Six Cities' suggestion that the CPM payments should be based on the going-forward fixed costs of the units most likely be designated under CPM is undesirable for two reasons. First, it is entirely speculative because the ISO has no way of knowing what type of units are most likely to receive designations in future years, especially as system conditions change with the increase integration of intermittent resources. Second, following this suggestion would force units whose going-forward costs are legitimately above the costs of the reference class of unit to make cost-based justifications with the Commission. The ISO does not believe it would be appropriate to design the CPM with the expectation that units will make such cost-based filings. While the ISO believes that option should be open to units, the ISO does not wish to create incentives for parties to have to make such filings. On the other hand, calculating the costs based on the highest-cost class of generating units would lead to cost-based waivers only in exceptional circumstances.

PG&E's proposal to offset CPM compensation by PER should be rejected because PER deductions are more commonly made as part of a multi-year forward capacity market based on CONE. In that context, the capacity payment is meant to capture full fixed costs. Where that is the case, a PER deduction can be appropriate to prevent over-compensation. In the context of CPM, which only involves short-term capacity procurement and is not meant to compensate for full fixed costs, PER is undesirable because it would mitigate energy market revenue unnecessarily.

E. Exceptional Dispatches

1. Retention of the 30-Day Term is Appropriate

The ISO's proposal adds Tariff Section 43.3.6 to provide that Exceptional Dispatch CPMs shall have a term of thirty days. Inclusion of this provision is consistent with existing Tariff Sections 43.2.1 through 43.2.5 that establish the term for the other types of CPM designations. The thirty-day term is consistent with the ISO's current practice of issuing Exceptional Dispatch CPM designations for thirty days.

Only one party opposes this provision. IEP claims that the ISO is proposing "a minimum 30-day term for CPM designations, including those resulting from Exceptional Dispatches."⁹³ IEP argues that the thirty-day term is unjust and unreasonable and should be extended to an annual term. NCPA supports the thirty-day designations.⁹⁴

IEP's argument is misleading, contrary to the Commission's ICPM Order,⁹⁵ and unsupported by fact. In addition, the ISO notes that IEP did not raise this issue during the stakeholder process despite numerous opportunities to comment and provide input on the ISO's CPM proposal.

IEP's claim that the ISO is proposing a minimum thirty-day term for all CPM designations is misleading. The ISO is not proposing to change the minimum one-month term or the maximum term for each category of CPM designation as set forth in existing ISO Tariff Sections 43.2.1 through 43.2.5. Those term periods will remain the same under CPM. The only term provisions being proposed by the ISO are to add new Tariff Section 43.3.6 to reflect the thirty-day term for Exceptional Dispatch CPMs and to

⁹³ IEP Protest, p. 59.

⁹⁴ NCPA Comments and Limited Protest, pp. 4-5.

⁹⁵ *Cal. Indep. Sys. Operator Corp.*, 125 FERC ¶ 61,053, at P 89 (2008) ("ICPM Order).

set the term for the new CPM category of resources at risk of retirement needed for reliability, which will have a minimum commitment of one month and a maximum commitment of one year, based on the number of months for which the capacity is to be procured with the current RA compliance year.

More importantly, IEP's arguments about term length have already been rejected by the Commission. In the ICPM proceeding, IEP asserted that allowing term lengths of only one-month contradicts the need of the generator owner to establish fixed operations and maintenance budgets ahead of time and to plan to complete capital investments. IEP argued that designation terms should be offered on an annual or multi-month basis, consistent with planning, operation, and investment timeframes.

The Commission rejected IEP's arguments as unfounded. The Commission approved the minimum thirty-day ICPM designation recommended by the ISO as consistent with the monthly construct of the RA program, as follows:

We accept the CAISO's proposed minimum 30-day ICPM designation because it is consistent with both the resource adequacy program and prior Commission action, and disagree with commenters who complain that 30-days is too short. The resource adequacy program requires LSEs to make a monthly procurement demonstration and, to meet this requirement, LSEs may choose to contract on a monthly basis. Therefore, it is likely that certain resource adequacy resources operate under monthly arrangements. For this reason, we find that the ICPM proposal to offer a minimum 30-day designation is consistent with the resource adequacy construct. Further, the 30-day minimum designation is consistent with prior Commission action. For example, in the TCPM proceeding, the Commission found that a minimum 30-day designation of non-resource adequacy resources was necessary to ensure that non-resource adequacy resources receive comparable treatment and just compensation when called upon to provide capacity services. For these reasons, we find that IEP's concerns about the CAISO's discretion to designate resources for minimum 30-day terms are unfounded, as a 30-day term is consistent with the resource adequacy construct. Additionally, we reiterate that

the ICPM is voluntary, such that resources interested in pursuing longer designations, may do so through other capacity procurement programs.⁹⁶

In the instant proceeding, IEP has offered no grounds that warrant a different ruling in the instant matter. IEP is now arguing for an annual term on the grounds that Exceptional Dispatches are mandatory and that CPM designations occur because the designated resources are “filling the gap” created by insufficient seasonal or annual RA capacity procurement.⁹⁷

IEP’s argument is based on a factually incorrect assumption that Exceptional Dispatch CPMs result from insufficient seasonal or annual RA capacity procurement. To the contrary, Exceptional Dispatch is a means to address unanticipated and short-term reliability problems that could not have been anticipated during the normal RA process. Specifically, existing ISO Tariff Section 43.1.5 provides, in pertinent part, that an Exceptional Dispatch ICPM may be issued pursuant to Section 34.9.1, Section 34.9.2(6), (9), or (10), or Section 34.9.3. Section 34.9.1 authorizes issuance of Exceptional Dispatches as follows:

. . . in addition to or instead of resources with a Day-Ahead Schedule dispatched by RTM optimization software during a System Emergency, or to prevent an imminent System Emergency or a situation that threatens System Reliability and cannot be addressed by the RTM optimization and system modeling. To the extent possible, the CAISO shall utilize available and effective Bids from resources before dispatching resources without Bids. To deal with any threats to System Reliability, the CAISO may also issue a manual Exceptional Dispatch in the Real-Time for Non-Dynamic System Resources that have not been or would not be selected by the RTM for Dispatch, but for which the relevant Scheduling Coordinator has submitted a Bid into the HASP.

The referenced subsections of Section 34.9.2 allow Exceptional Dispatch in these circumstances:

⁹⁶

Ibid.

⁹⁷

IEP Protest, pp. 59-63.

- (6) to provide Voltage Support;
- (9) in the event of a Market Disruption, to prevent a Market Disruption, or to minimize the extent of a Market Disruption; or
- (10) reverse the operating mode of a Pumped-Storage Hydro Unit.

Under Section 34.9.3, the ISO may also issue Exceptional Dispatches to address transmission-related modeling limitations, as follows:

The CAISO may also manually Dispatch resources in addition to or instead of resources with a Day-Ahead Schedule or dispatched by the RTM optimization software, during or prior to the Real-Time as appropriate, to address transmission-related modeling limitations in the Full Network Model. Transmission-related modeling limitations for the purposes of Exceptional Dispatch, including for settlement of such Exceptional Dispatch as described in Section 11.5.6, shall consist of any FNM modeling limitations that arise from transmission maintenance, lack of Voltage Support at proper levels as well as incomplete or incorrect information about the transmission network, for which the Participating TOs have primary responsibility. The CAISO shall also manually Dispatch resources under this Section 34.9.3 in response to system conditions including threatened or imminent reliability conditions for which the timing of the Real-Time Market optimization and system modeling are either too slow or incapable of bringing the CAISO Controlled Grid back to reliable operations in an appropriate time-frame based on the timing and physical characteristics of available resources to the CAISO.

From these Tariff provisions, it is clear that Exceptional Dispatch CPMs may be issued to address specific system conditions giving rise to a reliability concern of an immediate nature that has short-term duration. These requirements for issuing Exceptional Dispatch CPMs simply do not support a term longer than thirty days, let alone a year-long designation.

In addition, the ISO's actual experience with Exceptional Dispatch ICPMs countervails IEP's argument. Since the ICPM authority became effective approximately 20 months ago, the ISO has issued only 23 ICPM designations for 703 MWs, all of which were exceptionally dispatched. If IEP were correct that the Exceptional Dispatch ICPMs are necessary to address insufficient seasonal or annual RA procurement, then

the ISO would expect that backstop procurement to address a chronic RA procurement shortfall would have been far more frequent and for larger amounts of capacity. Instead, over the past 20 months, 20 different units responded to a range of reliability concerns.

IEP's suggestion that the CPM term should be extended for resources at risk of retirement needed for reliability is also unfounded and at odds with the RA program construct. As proposed by the ISO, resources at risk of retirement in the current RA compliance year that the ISO determines will be needed for reliability by the end of the following calendar year would receive a CPM designation for the remainder of the current RA compliance year. The ISO does not propose to extend the CPM designation into the following year. Under the RA program, an at-risk resource needed for reliability in the following year should be procured through a bilateral arrangement during the annual RA procurement cycle for the next RA compliance year. This obviates the needs to extend backstop procurement beyond the end of the current year.

For these reasons, the Commission should again reject IEP's position and decline to modify the terms of the CPM designations.

2. Retention of Mitigation Measures is Appropriate for Exceptional Dispatches That Address Reliability Requirements Related to Non-Competitive Constraints and Environmental Constraints

The ISO's proposal modifies ISO Tariff Section 39.10 to maintain the two mitigation measures for Exceptional Dispatches that address reliability requirements related to non-competitive constraints and the environmental constraints associated with Delta Dispatch, and delete language containing sunset provisions that would otherwise cause that Section, and related existing Sections 11.5.6.7, 43.1.5, and 43.2.6,

to automatically terminate twenty-four months following the effective date of the Section, which was March 31, 2009.

Under these mitigation measures, the ISO mitigates the energy bids of resources that receive Exceptional Dispatches in these two situations so that they receive the higher of their default energy bid or the locational marginal price. Resources with capacity contracts, i.e., resource adequacy resources, reliability must-run resources, and ICPM resources, earn no additional capacity-related revenues through Exceptional Dispatch. However, non-resource adequacy resources can accrue additional supplemental revenues because they have no guaranteed fixed cost recovery for providing capacity and because locational marginal prices will likely be suppressed when Exceptional Dispatch instructions are issued.

WPTF and IEP have filed protests in this proceeding that object to retaining the mitigation measures. WPTF contends that it is not appropriate for the ISO to continue mitigating energy bids for exceptionally dispatched units unless the ISO (i) provides them another means for recovering their fixed costs, or (ii) revises its Competitive Path Assessment, which WPTF alleges is overly conservative because it deems untested paths to be non-competitive. In support of this argument, WPTF cites to the analysis of the Competitive Path Assessment that the ISO's Department of Market Monitoring performed and the ISO's report on the performance of the Local Market Power Mitigation Mechanism.⁹⁸ IEP objects to continuing the mitigation measures because the ISO has not addressed the shortcomings in its modeling and testing for non-competitive transmission paths nor justified permanent imposition of the mitigation measures.⁹⁹

⁹⁸ WPTF Protest, pp. 18-20.

⁹⁹ IEP Protest, pp. 63-67.

The ISO's modifications to retain the two mitigation measures are consistent with the Commission's Exceptional Dispatch Order.¹⁰⁰ In that order, the Commission made clear that it only accepts mitigation measures that address well-defined structural problems in the market. In accordance with that principle, the Commission accepted as just and reasonable the ISO's proposal to mitigate Exceptional Dispatches for the purpose of addressing reliability requirements related to non-competitive constraints and the environmental constraints associated with Delta Dispatch. The Commission found that the ISO had met its burden of showing the potential to exercise market power in both of these situations.¹⁰¹

With respect to the non-competitive constraint situation, the Commission concluded that:

. . . the previously approved market power mitigation provisions of the MRTU Tariff require the CAISO to conduct a competitive path assessment to determine which transmission paths are competitive and which are non-competitive. The competitive path assessment is an objective and well-defined methodology that identifies transmission paths, which, if constrained, could enable suppliers to exercise market power. By definition, a supplier exceptionally dispatched to address a contingency on a non-competitive transmission path would be able to exercise market power, due to the pre-determined lack of competition along that path. The parties generally agree that mitigation of EDs to relieve constraints on non-competitive paths is appropriate.¹⁰²

With respect to the Delta Dispatch environmental constraints, the Commission concluded that:

. . . the CAISO has met its burden of showing the potential for the exercise of market power by resources exceptionally dispatched to address the Delta Dispatch. During several weeks of the year certain resources are limited by environmental restrictions in the San Francisco Bay. As a result

¹⁰⁰ *Cal. Indep. Sys. Operator Corp.*, 126 FERC ¶ 61,150, at P 267 (2009) ("Exceptional Dispatch Order").

¹⁰¹ *Id.*, at P 74.

¹⁰² *Ibid.*

of the restrictions, the CAISO must manually dispatch combinations of resources in a particular order during the same period of time every year. Specifically, as has been shown in other proceedings, the operator of the Pittsburg 7 unit knows with a high degree of certainty that it will be dispatched regularly during this period, creating the potential for it to exercise market power. Further, we find that Mirant has not provided sufficient evidence to support its claim that its units that are subject to the Delta Dispatch constraint will fail to recover adequate compensation towards their fixed costs under the CAISO's proposed mitigation. For these reasons, we accept the CAISO's proposal to mitigate resources that are exceptionally dispatched to address the Delta Dispatch.

Further, the same structural problems exist today as formed the basis for the Commission's conclusion in the Exceptional Dispatch Order that mitigation was necessary in these two situations due to the potential to exercise market power. There continue to be constraints related both to non-competitive transmission paths and Delta Dispatch. However, the vast amount of energy dispatched through Exceptional Dispatch was for reasons other than to mitigate congestion on non-competitive paths.¹⁰³ The on-going nature of these structural problems justify including the mitigation measures in the ISO Tariff.

F. A Sunset Provision is No Longer Necessary and Should Not Apply to the Proposed CPM Provisions

Effective ISO Tariff Sections 39.10 and 43 provide for the Exceptional Dispatch mitigation provisions and the ICPM, respectively, to automatically terminate at midnight on the last day of the twenty-fourth month following their effective date, *i.e.*, March 31, 2011. In its tariff filing, the ISO proposes that the CPM be adopted as a feature of the ISO's market design without a sunset date.

Few protests or comments were submitted on this issue. Six Cities concurs with the ISO's proposal to implement CPM for an indefinite term without a pre-established

¹⁰³ <http://www.caiso.com/27d4/27d4102502e760.pdf> .

sunset date. However, in light of significant market design changes underway, Six Cities requests that the Commission direct the ISO to review the appropriateness of the CPM elements approximately one year after they become effective, and thereafter on a periodic basis.¹⁰⁴ The CPUC argues that the CPM should sunset in two years. The CPUC claims that with ongoing significant changes in market conditions and market design, the burden should not be on consumers to challenge the justness and reasonableness of the CPM provisions.¹⁰⁵

Both parties base their recommendation for mandatory review of the CPM provisions on the expectation that the ISO's market structure will change significantly over the coming year. Although the ISO agrees that major policy initiatives like convergence bidding and the integration of renewable resources will result in market design changes, we disagree that these changes justify limiting the CPM to an interim status. The ISO proposed that the ICPM be interim because the CPUC had a rulemaking proceeding underway to consider the long-term design of the RA program, in particular, a multi-year forward RA capacity procurement obligation and a centralized capacity market, either of which would have had a direct effect on the need for and design of a backstop capacity procurement mechanism. In contrast, neither Six Cities nor the CPUC has explained what effect the market changes they reference are expected to have on backstop procurement. Further, neither party has identified any issues or problems with the design or effectiveness of the backstop procurement mechanism that warrant continuation of its interim status.

¹⁰⁴ Six Cities Protest and Comments, p. 4.

¹⁰⁵ CPUC Limited Protest and Comments, p. 22.

Absent a direct impact by other market design changes, or any issues with the essential design elements or function of the backstop procurement mechanism, there is no valid reason to adopt the CPM subject to a sunset date that triggers automatic termination or mandatory review on a set schedule. In response to stakeholder concerns about ensuring that the CPM price does not become stale, the ISO has committed to include in the Business Practice Manual for Reliability Requirements a process to review the level of the CPM payment through a stakeholder initiative to be conducted every two years. If during that process, or otherwise, the ISO determines that another element of the CPM should be reviewed, the ISO will address the issue through a stakeholder initiative and/or Section 205 filing.

IV. ATTACHMENT

The ISO has included the following document as an attachment to its answer in this proceeding:

Attachment A CPM Process for Capacity Needed for Reliability But At Risk of Retirement Gives Deference to CPUC Process First – CPM timeline.

V. CONCLUSION

For the reasons discussed above, the ISO request that the Commission accept the CPM tariff amendment without change, except for the clarifications provided by the ISO in this answer.

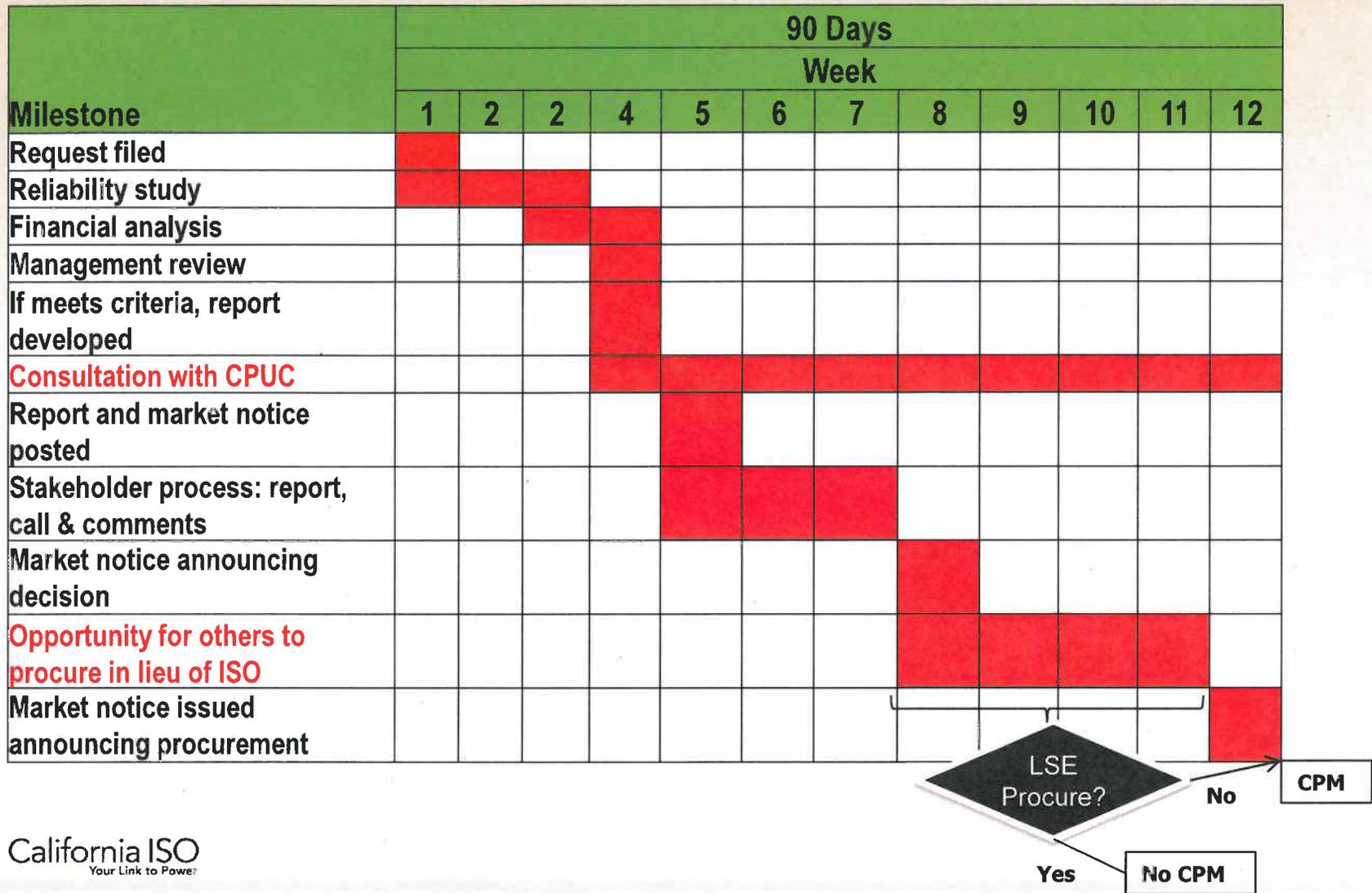
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Attorneys for the California Independent
System Operator Corporation

Dated: January 19, 2011

ATTACHMENT A

CPM process for capacity needed for reliability but at risk of retirement gives deference to CPUC process first.



CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in the above-captioned docket, in accordance with the requirements of Rule 2010 of the Commission Rules of Practice and Procedure (18 C.F.R. §385.2010).

Dated this 19th day of January, 2011 at Folsom, California.

/s/ Anna Pascuzzo

Anna Pascuzzo