

**BEFORE THE
PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**

Order Instituting Rulemaking to Promote)
Policy and Program Coordination and)
Integration in Electric Utility Resource)
Planning)
_____)

R.04-04-003

**COMMENTS OF THE
CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION
ON THE ALTERNATE DRAFT DECISION OF COMMISSIONER LYNCH
REGARDING RESOURCE ADEQUACY**

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In accordance with Rule 77.6 of the Commission’s Rules of Practice and Procedure, the California Independent System Operator Corporation (“CAISO”) respectfully submits its comments on Commissioner Lynch’s alternate draft decision regarding resource adequacy (“Alternate”), mailed September 23, 2004.

I. INTRODUCTION

The Alternate modifies the Draft Decision of Administrative Law Judge Wetzell in the following ways:

1. Restricts the obligation on load serving entities (“LSEs”) to satisfy a 15-17% planning reserve margin (“PRM”) to just the summer months of May through September, rather than the year round obligation set forth in the Draft Decision. (See § 3.1.)¹
2. Eliminates the year round 100% month-ahead forward commitment in favor of a limited 100% month-ahead forward commitment for the summer months. (See § 3.7.2.)
3. Rejects acceleration to June 1, 2006 of the full resource adequacy requirement and, instead, maintains the January 1, 2008 deadline for full compliance with the PRM. (See § 3.3.)
4. Exempts all California Department of Water Resources (“DWR”) contracts from deliverability screens. (See § 3.3.)

¹ Any section reference is to both the Draft Decision and the Alternate.

5. Adopts the “current customer” method for forecasting LSE load. (See § 3.3.3)
6. Limits the eligibility of intra-control area system contracts to those written prior to the effective date of the decision, rather than the Draft Decision’s deadline of the end of 2004. (See § 3.5.2.)

Commissioner Lynch proposes each of these changes with the appropriate intention of protecting consumers from paying unnecessarily high costs for resource adequacy. The CAISO concurs with this general objective and believes that the value of all elements of the resource adequacy requirement should be considered in the context of their cost impacts. However, the CAISO strongly contends that proposed changes 1-3 above are shortsighted and, contrary to Commissioner Lynch’s expectations, are highly destructive to the interests of California consumers. The proposed changes will (1) jeopardize realization of the core goal of resource adequacy, which is to ensure reliable grid operations, and (2) impair infrastructure investment and the long-term efficiency of the electricity markets to the economic detriment of LSE customers. Accordingly, the CAISO urges the Commission to reject proposed changes 1-3 to the Draft Decision.

The CAISO also believes change 4 creates an unnecessary risk to grid reliability. Resources are of little value for purposes of resource adequacy unless they can be delivered to load when needed. Given the substantial megawatts associated with the DWR contracts, even if limited to quantities under unit-specific contracts, it is essential to preserve the efficacy of the Commission’s resource adequacy program that deliverability screens be applied to the DWR contracts to the maximum extent possible. As such, the unit-specific DWR contracts should be assessed if technically feasible. In this regard, the CAISO believes, based on its preliminary assessment and information currently available, that the DWR unit-specific contracts will be found to be deliverable, as will most generators internal to California.

Finally, the CAISO agrees with Commissioner Lynch that changes 5 and 6 constitute positive improvements that should be adopted by the Commission, but only as modifications to the Draft Decision. The “current customer” method to LSE load forecasting is preferable to the

Draft Decision’s direction that all LSEs prepare load forecasts on the basis of their best estimate of future customers and loads. The current customer method assures that all customers will be counted and that the effectiveness of the Commission’s resource adequacy requirement will not be undermined by the uncertainties and negative incentives inherent in the “best estimate” approach. Moreover, in its opening comments on the Draft Decision, the CAISO expressed concern that permitting intra-control area system contracts to remain eligible as qualifying capacity if executed anytime prior to 2004 would lead to a rush to execute such contracts prior to the deadline. The Alternate properly prevents this result.

II. THE RESOURCE ADEQUACY OBLIGATION, INCLUDING THE 100% MONTH-AHEAD CAPACITY REQUIREMENT, MUST BE YEAR ROUND

Without analysis, the Alternate purportedly “clarifies” that the 15-17% PRM applies only to the summer months of May through September and, unsurprisingly, in the absence of any year round PRM obligation, also restricts the 100% month-ahead commitment to the summer months.² The Alternate merely states that applying the PRM to the “summer months is adequate to ensure grid reliability” and, with respect to the year round month-ahead commitment, “that the operational details and the impacts on LSEs’ procurement strategies must be more fully developed.”³ This latter statement defies logic. It follows that if LSEs can accommodate the

² The Alternate purports to “clarify” the Commission’s decision in D.04-01-050. However, D.04-01-050 provides that “[b]ased upon the record developed in this proceeding, we believe that a planning reserve level of between 15-17% should be adopted for all LSEs, which should be phased in by no later than January 1, 2008.” (D.04-01-050, mimeo at p. 22.) Nowhere in the decision did the Commission restrict application of the PRM to the summer months, but rather limited the forward contracting commitment to the summer months. (D. 04-01-050, mimeo at p. 30.) The Alternate’s interpretation renders the Commission’s reference to January 1, 2008, nonsensical. A more reasonable interpretation of D.04-01-050, as reflected in the Draft Decision, is that the Commission intended the PRM to apply on a year round basis along with an accompanying 90% reporting obligation one-year ahead.

³ Alternate, mimeo at pp. 9 and 37. The fact that the Alternate even discusses a month-ahead year round requirement after rejecting a year-round PRM demonstrates the Alternate’s fundamental lack of understanding of the structure the resource adequacy requirement generally. It also demonstrates that the purported need to more fully develop operational details and the impacts on LSEs’ procurement strategies constituted mere pretext.

undefined operational details and impacts on procurement strategies imposed by the acceptable summer month-ahead commitment, there is no logical basis to assume that the same accommodation cannot extend to the other months of the year.

More importantly, the Alternate's rejection of the year-round PRM and month-ahead obligations defeats the very consumer protection objectives motivating the Alternate. Resource adequacy benefits consumers by (1) providing, in the long-term, a platform for investment in California's electric infrastructure, (2) supporting, in the shorter-term, reliable system operation, and (3) mitigating the amount and effect of market power by encouraging LSEs to enter into long-term contracts,⁴ as well as by facilitating approval by the Federal Energy Regulatory Commission ("FERC") of more effective local market power mitigation measures. Without a year-round PRM and month-ahead obligation, California consumers will not fully receive these anticipated benefits.

By only establishing a requirement that LSEs satisfy the PRM during the summer peak season, the Alternate fails to provide sufficient "insurance" to California. The approach in the Alternate is based on erroneous assumptions, including that if adequate resources are available during the summer months, adequate resources will be available during the rest of the year, and that there is no need for LSEs to lock up capacity during non-peak periods. The fact that there are adequate resources lined up to meet summer peak loads does not guarantee that such resources will be there in other months because California LSEs will not have ensured such resources are committed to serving California consumers. Thus, by not requiring LSEs to procure sufficient capacity to serve non-summer loads, the Alternate is gambling that the LSEs will not need this

⁴ It was no accident that spot market prices in California stabilized after DWR executed its long-term energy contracts during 2001. Long-term contracts reduce the incentive for suppliers to exercise market power because the revenue associated with the capacity covered by the contract is established and generally not subject to spot market price fluctuations. This fact, as well as the overall reduction in supply purchased through the spot market because of long-term contracts, results in more stable prices and a less volatile spot market. By reducing the obligation of LSEs to contract for capacity during non-peak periods, the Alternate is likely to reduce incentives for long-term contracting and lead to a more volatile spot market during non-peak months.

capacity during non-peak periods. Based on past experience, this could be a substantial losing proposition. Blackouts can occur, and have occurred, during the off-peak winter months. Further, price spikes regularly can occur, and have occurred, during the shoulder months, especially when there are heat waves, low hydro levels, and/or significant quantities of capacity offline for scheduled outages. Accordingly, ignoring non-peak months is inadequate and could unnecessarily expose consumers to high spot market prices and potential curtailments.

The Alternate also undermines the value of the resource adequacy requirement as a catalyst for infrastructure investment. A summer only requirement will skew investment and contracting decisions toward peaking products only. Over the long-term, this could result in under-investment in units needed to efficiently meet generally increasing demand in California.

Finally, the Alternate, unlike the Draft Decision, fails to grasp the linkage between the resource adequacy requirement and the market design set forth in the CAISO's Market Redesign and Technology Upgrade ("MRTU") proposal. In a competitive market generally, all suppliers that are needed for system and local reliability must be adequately compensated in the long run either to recover their fixed costs to avoid shutting down or, when additional capacity is needed, to provide adequate incentive for entry. FERC has stated its view that such a competitive market could function properly without capacity payments, but that this would require greater tolerance of price spikes and higher prices, and less aggressive mitigation.⁵ Simply put, FERC desires to ensure that there are sufficient revenues from market operations (*i.e.*, "revenue adequacy") both to support a supplier's going- forward costs and attract additional investment in the system. In FERC's view, given the presence of a mitigated spot energy market, a viable resource adequacy mechanism is necessary to ensure that suppliers have other means (*e.g.*, capacity payments) to recover their fixed costs. Thus, by failing to impose a year-round obligation, including a month-ahead commitment, either capacity payments received only during summer must be sufficient to

⁵ *Further Order on the California Comprehensive Market Redesign Proposal*, 105 FERC ¶ 61,140 (Oct. 28, 2003), at ¶ 274.

cover annual fixed costs or spot prices must allow for such recovery.

The CAISO is concerned that the rejection of the year round and month-ahead commitment obligations may compel FERC to prefer a reserve shortage pricing mechanism, which would hinder the CAISO's goal in MRTU of obtaining adequate tools to mitigate local market power. The CAISO believes a reliance on a scarcity pricing mechanism, particularly when applied to load pockets, would create incentives for creating "artificial scarcity" via physical withholding and could result in excessive wealth transfers from consumers to producers if the scarcity condition (whether real or artificial) is chronic. Moreover, the development of such a pricing mechanism would add to the overall complexity and cost of implementation. As such, the CAISO strongly urges the Commission to reject changes 1-2 of the Alternate.

III. THE ALTERNATE ERRS BY DEFERRING UNTIL 2008 FULL IMPLEMENTATION OF THE RESERVE REQUIREMENT

The Alternate rejects the recommendation by Governor Schwarzenegger, the CAISO, PG&E, SDG&E, California Manufacturers & Technology Association,⁶ ORA, ALJ Wetzell and others to accelerate full implementation of the 15-17% planning reserve margin to June 1, 2006. Instead, the Alternate maintains the goal adopted in D.04-01-050 of phasing in the planning reserve margin by 2008. Three "findings of fact" summarize the reasons for the Alternate's conclusion:⁷

⁶ *Comments of Pacific Gas and Electric Company on Interim Opinion Regarding Resource Adequacy* (Sept. 20, 2004) at p. 1 [PG&E fails to dispute acceleration despite "submit[ing] these comments to suggest changes and corrections to the DD that the Commission should adopt to improve the final product."]; *Comments of San Diego Gas & Electric Company on Draft Interim Opinion Regarding Resource Adequacy* (Sept. 20, 2004) at p. 3 ["SDG&E believes the case for expedition is strong, and thus supports acceleration of the schedule as proposed."]; *Comments of the California Manufacturer's & Technology Association on the Draft Interim Opinion Regarding Resource Adequacy* (Sept. 17, 2004) at p. 2 ["CMTA submits that unless the Commission takes aggressive action, such as contemplated in the DD, the potential market power situation will only grow worse, as owners make economic decisions to either mothball or decommission aging units that are currently needed during peak demand periods."]

⁷ Alternate, mimeo at 46 [Findings of Fact 4, 5, and 6].

- Shortening the PRM deadline from January 1, 2008 to June 1, 2006 will create potentially significant market power for generators, resulting in increased power costs for consumers.
- Shortening the PRM deadline could lead LSEs to over-procuring resources, or purchasing resources that do not meet their respective local reliability needs.
- Accelerating the PRM deadline to 2006 does not create any new capacity beyond what is already scheduled to come online by that date.

Upon scrutiny, each of the purported justifications for deferring full implementation of the PRM lack merit and should be rejected by the Commission.

A. Delaying Implementation of the Full PRM Exacerbates Market Power Risks and May Expose Consumer to Greater Volatility and Threats of Curtailments

As noted, the CAISO sympathizes with the aim expressed in the Alternate to shield California consumers from needlessly increased costs. However, the Alternate’s fear that shortening the phase-in period will “create potentially significant market power for generators” to the detriment of consumers constitutes mere speculation, conflicts with the record, indiscriminately blurs local and system needs, as well as capacity and energy products, and ignores the threat posed by future market uncertainty. Accordingly, the CAISO strongly submits, as it has throughout this proceeding, that acceleration of the PRM under current market conditions actually supports the goal of protecting consumers from potentially high energy costs and service curtailments.

The Alternate notes that “[s]ince January, the longer term forecast of electricity supply and demand has not significantly changed.”⁸ In January, the Commission concluded, “there are ample resources for California to meet peak demand through 2007.”⁹ The Alternate, therefore, acknowledges that aggregate or system-wide supply conditions currently favor LSE procurement by dampening the threat of the exercise of market power by suppliers. Indeed, recent testimony

⁸ Alternate, mimeo at p. 13.

⁹ D.04-01-050, mimeo at p. 20.

by the IOUs on their long-term resource plans confirms the feasibility of an early phase-in. For example, Mr. Fong Wan, witness for PG&E, corroborated CAISO's frequent contention that market conditions are currently favorable for procurement activities: "We certainly believe that we have been in an environment that's, pricing wise, quite favorable."¹⁰ PG&E recognizes that with the current excess of capacity prices are relatively cheap, and it is less likely that suppliers can subject LSEs to the exercise of market power. In contrast, the Alternate's deferral of full implementation of the PRM to 2008 would require LSEs to procure the last increment of capacity during the same 2007 time period that the Commission anticipates may reflect tightening supply conditions.¹¹

Further, the Alternate's assumption that competition between LSEs for capacity will drive up costs significantly is mere speculation not only because of the current supply conditions, but also because of the limited amount of additional capacity needed by the IOUs to meet the reserve requirement. The DWR contracts cover a significant percentage of the IOUs' current net short. Again, in confirmation of this reality, Mr. Robert Anderson, witness for SDG&E on its long-term procurement plan, acknowledged that an early phase-in would not result in modification of SDG&E's procurement strategy given that they anticipate being in compliance with the planning reserve margin by 2006.¹²

On the other hand, to the extent LSEs are not already meeting the full PRM, the CAISO submits that waiting until 2008 for full implementation could subject California ratepayers to increased costs and, potentially, curtailments if the resource base deteriorates, there is a prolonged period of low hydro conditions, or there is a significant increase in peak demand (in California

¹⁰ R.04-04-003, Reporters Transcript, Vol. 4 at 598:16-18.

¹¹ The CAISO acknowledges that market power can be mitigated by the ability to construct or implement new supply or demand resources to meet the forecasted demand. However, other than possibly combustion turbines for local needs, the CAISO does not believe it is realistic that other large projects could be online by this time unless already through the permitting process.

¹² R.04-04-003, Reporters Transcript, Vol. 1 at 124:18-26.

and/or the West). Simply put, it is highly uncertain whether conditions will or will not remain favorable into the future. If not, LSEs will be forced to meet their resource adequacy obligation in times where tighter supply increases prices. In assessing this risk, the Alternate implicitly fails to recognize that capacity is cheap compared to energy. As California learned during the energy crisis, high spot market prices are not cheap. When capacity is not locked-in in advance, LSEs must rely on volatile spot market prices to serve load, and that approach can be extremely expensive.

The CAISO recognizes that a system-wide surplus does not necessarily hinder the exercise of local market power by suppliers. If this was the Alternate's concern, it again ignored the presence of adequate measures to protect against local market power in the near-term. The CAISO has repeatedly suggested that if evidence that suppliers are exercising market power arises, LSEs can always come back to the Commission and request that the effective date of the reserve requirement be revised. Alternatively, if there is a demonstration that suppliers are exercising market power, the CAISO could step in and execute RMR or RMR-like contracts, whichever is applicable under the circumstances, for a transitional period in order to meet locational capacity needs.

B. Full Phase-in Should Not Lead to Unduly Inefficient Procurement Decisions By LSEs

The Alternate asserts that “[a]ccelerating the PRM deadline before determining the resource counting and deliverability issues in Phase 2 of this proceeding, or before pinpointing the effect on utility load of Community Choice Aggregation or other departing loads, could lead LSEs to over-procuring resources, or purchasing resources that do not, in fact, meet their respective local reliability needs.” There are a number of issues combined in this statement. First, the assumption that the absence of final Phase 2 counting and deliverability (i.e., aggregate to load and imports) standards could lead to over-procurement is unlikely. Application of the counting and deliverability protocols to resources can only result in a reduction, not an increase,

in eligible capacity currently under LSE control. Consequently, an LSE is more likely to be under-procured prior to application of the final counting and deliverability protocols (assuming LSEs possess a reasonable estimate of their load).

Second, the assumption that uncertainties surrounding community choice aggregation and local capacity requirements will lead to over-procurement is overstated. Under the Draft Decision, LSEs possess substantial flexibility in their capacity procurement strategies. The Draft Decision grants LSEs the ability and the opportunity to fill-in 10% of needed capacity between the 90% year-ahead showing and the 100% month-ahead obligation. Accordingly, in the near-term when the uncertainties identified in the Alternate exist, LSEs can secure capacity utilizing short-term transactions to minimize or eliminate the threat of stranded costs resulting from subsequently imposed locational capacity requirements or movement of load. The Draft Decision also recognizes that the adopted year-ahead September 30 reporting date may not be appropriate or practical for identifying resources under LSE control for summer 2006. The Draft Decision, therefore, grants latitude to move the initial year-ahead showing closer to summer 2006.¹³ It is probable, therefore, that with the extension of time to procure and demonstrate compliance for summer 2006, sufficient progress in defining, at a minimum, the parameters for local capacity requirements will have been made to allow LSEs to reasonably estimate the MWs potentially subject to any local capacity requirement. This, in turn, will allow LSEs to allocate this quantity of MWs to transactions with terms of one-year or less. Thus, any claim that an accelerated phase-in would lead to inefficient procurement is exaggerated and should be disregarded.

C. The Inability of Accelerated Phase-In to Spur New Resources Does Not Eliminate Its Value in Preserving Existing Resources

The Alternate accurately finds that accelerating the phase-in date for the full PRM will

¹³ Draft Decision, mimeo at 14 [“As discussed further below, in Phase 2 we direct parties to develop a package of reporting requirements and an initial filing date that reveals resources under the LSEs’ control for 2006. We expect that the second year’s filing requirements, i.e. September 2006 filings for Summer 2007, may be enhanced to more fully reflect our long-term resource adequacy requirements.”].

not result in incremental resources being constructed. However, that is not the objective of an accelerated phase-in. The primary objectives of an accelerated phase-in are to increase reliability, reduce the risk of curtailments, and limit exposure to volatile spot market prices. These goals can be accomplished by ensuring that available resources are committed to serving California loads. In this regard, it is CAISO's belief that rejection of the accelerated phase-in may exacerbate the near-term potential for the "mothballing" and/or retirement of 3,000-4,000MW of generating units.¹⁴ The Alternate ignores this very real risk that existing resources may no longer be available to serve California load in the immediate future. This could result in a capacity shortage if an obligation is not imposed to secure such capacity.

IV. THE ALTERNATE ERRS BY EXEMPTING THE DWR CONTRACTS FROM DELIVERABILITY SCREENS

The Draft Decision allows the long-term contracts executed by DWR during 2001 to "be eligible" as a resource, "but that their qualifying capacity be determined by application of the deliverability screens that are ultimately adopted by this Commission."¹⁵ The CAISO supports this approach and the Draft Decision's unwillingness to "risk California's grid reliability by ignoring contract features, such as deliverability, that can impact reliability."¹⁶ The Alternate takes a different tact by according the DWR contracts "full value," without regard to or application of the deliverability screens.¹⁷

The Commission should reject the Alternate's treatment of the DWR contracts for the

¹⁴ The CAISO has received formal notification that some large older generators will retire prior to 2005 in the event they are not selected in the procurement process. Without a contract, owners of aging generators are not compelled to invest in needed maintenance based on hopes to run in the spot market. TURN argues that even if aging generators retire or mothball now they will likely return to service when needed. It can take from one-to-six months for a mothballed generator to re-commission. As such mothballed units cannot be considered as quasi-available to meet adverse conditions.

¹⁵ Draft Decision, mimeo at p. 27.

¹⁶ *Id.*

¹⁷ Alternate, mimeo at p. 27.

reasons set forth in the Draft Decision. A fundamental tenet of resource adequacy is that resources intended to serve load actually be able to do so. In this regard, of the total quantity of megawatts supplied by the DWR contracts, approximately 3000 MWs involve unit-specific contracts. This is a substantial quantity. Applying the deliverability screens, at the minimum, to these unit-specific DWR contracts advances the goal of grid reliability.

V. CHANGES IN THE ALTERNATE RELATED TO LOAD FORECASTING AND INTRA-CONTROL AREA CONTRACTS SHOULD BE ADOPTED IN THE DRAFT DECISION

A. Current Customer Method

The CAISO agrees with the Alternate that application of the “current customer” method to LSE load forecasting is preferable to the Draft Decision’s direction that all LSEs “prepare load forecasts on the basis of their best estimate of future customers and loads.”¹⁸ The current customer method assures that all customers will be counted and that the effectiveness of the Commission’s resource adequacy requirement will not be undermined by the incentives inherent in the approach adopted by the Draft Decision. It should be noted that the development of a tradable capacity product could address load fluctuation concerns and will be addressed as a second-generation issue.

B. Limitation of Intra-Control Area System Contracts

The Draft Decision provides that “no intra-control area system contracts written after 2004 should be eligible to count as qualified capacity in satisfaction of forward commitment obligations.”¹⁹ In response, the CAISO noted that since intra-control area system contracts cannot readily be screened for deliverability, an incentive exists for suppliers and LSEs to rush into such contracts prior to expiration of the end of 2004 deadline. To address this concern, the CAISO recommended advancing the final date for determining eligibility of an intra-control area system

¹⁸ See § 3.4.2.

¹⁹ Draft Decision, mimeo at p. 21.

contract to October 1, 2004. The Alternate reaches a similar conclusion by proposing to exclude as eligible capacity all intra-control area contracts “written after the effective date of this decision.”²⁰ The CAISO supports this aspect of the Alternate and believes it should be incorporated into the Draft Decision.²¹

VI. CONCLUSION

Based on the foregoing arguments, the CAISO requests that the Commission reject the Alternate, in general, and the changes identified above as 1-4, in particular. The CAISO further requests that the changes identified as 5 and 6 above be incorporated into the Draft Decision.

September 30, 2004

Respectfully Submitted:

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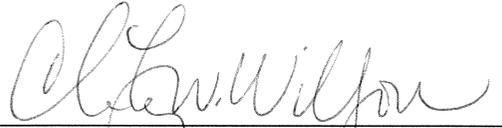
²⁰ Alternate, mimeo at p. 22.

²¹ Much of the concern over restricting the use of intra-control area system contracts for resource adequacy rests on confusion between capacity and energy products. The CAISO does not propose to restrict the use of such contracts going forward to optimize an LSE’s *energy* requirements. The CAISO agrees that liquidated damages and/or intra-control area system contracts can remain a standard product in constructing an LSE’s energy, not capacity, portfolio after the effective date of the resource adequacy decision.

CERTIFICATE OF SERVICE

I hereby certify that I have served, by electronic mail, a copy of the foregoing Comments of The California Independent System Operator Corporation on the Alternate Draft Decision of Commissioner Lynch Regarding Resource Adequacy to each party in Docket No. R.04-04-003.

Executed on September 30, 2004, at Folsom, California.

A handwritten signature in cursive script, appearing to read "Charity N. Wilson", written over a horizontal line.

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