Stakeholder Comments Template

Subject: Capacity Procurement Mechanism, and Compensation and Bid Mitigation for Exceptional Dispatch

Submitted by	Company	Date Submitted
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This template was created to help stakeholders structure their written comments on topics related to the July 15, 2010 Straw Proposal for Capacity Procurement Mechanism ("CPM"), and Compensation and Bid Mitigation for Exceptional Dispatch. Please submit comments (in MS Word) to bmcallister@caiso.com no later than the close of business on July 30, 2010.

Please add your comments where indicated responding to the topic or question raised. Your comments on any aspect of the straw proposal are welcome. The comments received will assist the ISO with the development of the Draft Final Proposal.

Please provide your comments on the following topics and questions. Your comments will be most useful if you provide the reasons and the business case for your preferred approaches to these topics.

CPM

1. The appropriate duration of the tariff provisions associated with the CPM: should they be permanent or terminate on a certain date or under certain conditions? If the CPM should terminate, please be specific about the date or conditions upon which it would terminate and indicate the reasons for your proposal.

The CPUC understands that the State's current energy market design benefits from the CAISO's having a mechanism by which to procure backstop capacity in the event that Load Serving Entities (LSEs) operating within the CAISO fail to procure the commitment of adequate resources in a timely fashion; or when extreme, unanticipated circumstances change fundamental assumptions about the grid's operation upon which LSEs' CPUC-regulated Resource Adequacy (RA) requirements and Long-Term Procurement Plans (LTTP) were based.

The CPUC believes that CAISO short-term backstop procurement mechanisms; such as Exceptional Dispatch (ED), the Interim Capacity Procurement Mechanism (ICPM) and their successors; are also inherently interrelated with the CPUC's long-term procurement activities and oversight of the bulk of California's retail electricity market. Existing generation units will be drawn by fundamental self-interest into higher-paying capacity markets rather than to lower-paying capacity markets. Accordingly, the FERC determined that a critical element of any backstop procurement mechanism for California is to find a carefully balanced price to promote "longer-term contracting" and avoid undue reliance on the backstop procurement mechanism, i.e., to prevent the backstop mechanism from driving or becoming the primary procurement mechanism.

California's various wholesale and retail energy and capacity markets are undergoing a variety of fundamental changes and developments, such as the ongoing addition of new elements to the CAISO's new Locational Marginal Pricing based Day-Ahead and Real-Time markets and California's efforts to expand the State's reliance upon renewable energy resources. Because of such ongoing changes and potential for creating undue reliance upon short-term backstop procurement, the CPUC has previously supported inclusion of an expiration, or "sunset," date within CAISO backstop mechanism tariff language, such as that included in the ICPM. Such a sunset date may facilitate the State's ability to select and maintain an appropriate level, cost and reliability (e.g. adequacy) of energy supply within the State by requiring intermittent review and reevaluation of backstop procurement mechanisms to assure that such backstop tools keep up with developments in the various wholesale and retail energy and capacity markets.

Specifically, the CPUC Staff is concerned that new features and circumstances in California's wholesale and retail energy and capacity markets (*e.g.* convergence bidding, Resource Adequacy Capacity market developments, reaching for the 20% and 33% Renewable Portfolio Standard [RPS] goals, incorporation of increased demand response resources) may require significant modifications to backstop capacity procurement needs such that the tariff may become out-dated and/or inappropriate in a relatively short time.

The CPUC Staff suggests that the CPUC's RA program and the CAISO's Standard Capacity Product (SCP) have demonstrated the ability of the CPUC and the CAISO to react in concert to changes in the grid and markets, and the increasingly refined local and system reliability and operations needs. The FERC's ongoing VERs Notice of Inquiry and the CAISO's expected increased operational knowledge associated with changes to both the supply and load elements of California's changing markets suggest that a mechanism to revisit the CPM in the near future is prudent. Thus, the CPUC Staff urges that including a sunset provision in the proposed CPM replacement product in two years may provide a mechanism to keep the backstop capacity procurement mechanism fresh and relevant to the markets and grid conditions as they develop over time.

2. The appropriate treatment of resources that may be procured through CPM or Exceptional Dispatch but then go out on Planned Outage during the period for which the resource has been procured. What are your views on the proposed formula in the straw proposal for compensating such resources?

See answer to question 4.

3. Modification of the criteria for choosing a resource to procure under CPM (section 43.3) to provide the ISO with the ability to procure non-use limited capacity over use-limited capacity.

The CPUC Staff supports the CAISO's efforts to effectively maintain short-term grid reliability. The CPUC Staff believes that by definition, backstop capacity procurement should only be awarded to resources to fulfill the operational needs that give rise to the backstop capacity designation. The FERC has ruled that it is a State or Local Regulatory Authority's long-term capacity procurement program that should address the addition of additional needed generation, and presumably the characteristics and/or location of such generation, rather than the CAISO's short-term procurement mechanisms.

The CPUC Staff requests further discussion of the generation criteria that the CAISO may deem necessary for reliable grid operation, and the analysis underlying such criteria. The existing market design and construct was intended to provide the CAISO system with a market that would enhance reliable operation. The CPUC anticipates that if and as the CAISO identifies current or future legitimate operational deficiencies, the CPUC will adapt its procurement programs to reflect such operational needs so that the CAISO may avoid out-of-market procurement. If such short-term out-of-market procurement for specific generation characteristics were necessary, the CPUC would expect such needs to be clearly identifiable in advance, quantifiable, and consistent with the CPUC's Planning Reserve Margin as well as NERC and WECC reliability criteria rather than some unidentified higher level of reliability. The CPUC Staff has not formally requested that the CAISO increase the detail provided in its ICPM reports, but believes that the current revision process and suggestion of increased criteria for ICPM-type designations call for more fine-grained analysis. The CPUC Staff believes that the current single page reports of ICPM designations should be replaced with more detailed reports that indicate in detail the step by step process that resulted in the ICPM designation of a particular unit. Improvements to this process will provide stakeholders with a greater level of comfort with what, in a worst case scenario, can result in unnecessary designation of specific units by CAISO operators in a decidedly non-market-based mechanism. These operational and transparency improvements become much more important as the CAISO considers increasing the duration or frequency of ICPM designations.

4. The three new types of procurement authority for generic backstop capacity the ISO is proposing.

In the Straw Proposal the CAISO seeks to "have authority to procure additional capacity (backstop capacity) to meet certain operational situations that are not currently considered under the ICPM."[1] Such procurement would take place under three circumstances:

- to allow for planned maintenance
- to fill-in for capacity from intermittent resources if the CAISO perceives that output is less than the Resource Adequacy Capacity value assigned to those units by the CPUC
- to procure generation from units that the CAISO believes are needed for reliability but may shut down due to lack of sufficient revenue.

The first two of these circumstances would result in 30-day capacity payment, while the latter would result in a capacity payment of up to a year.

Planned Maintenance

The CPUC Staff sees no evidence that the CAISO requires additional procurement authority for planned outages. The CPUC Staff understands that the CAISO has control over scheduling of maintenance outages, which presumably are scheduled when a generating unit's capacity is not necessary and other capacity is available at no additional cost to ratepayers through the CPUC's RA program. The CPUC's RA program requires that utilities procure "capacity to meet their peak day load for each month, measured in megawatts (MW), plus 15%, for all hours of the month." "The ISO participates in the implementation of [the CPUC's RA] program, relies on its results through the participation of RA capacity in the day-ahead and real-time markets, and utilizes additional mechanisms under the ISO tariff when needed to support its effectiveness, including backstop capacity procurement and the Standard Capacity Product (SCP)."[2] One of the key short-term procurement mechanisms the CAISO uses to obtain capacity is Exceptional Dispatch (ED) procurement. As the CAISO concluded in its Stakeholder Comments Template on Exceptional Dispatch Review and Assessment White Paper, issued on June 10, 2010, "The [CAISO] White Paper notes that Exceptional Dispatches account for only a monthly average of 0.25% of load during January-March 2010." The CAISO's Department of Market Monitoring annual report for 2009 indicates that this statistic is part of a consistent reduction in Exceptional Dispatches since the implementation of the CAISO's MRTU market. The CPUC Staff agrees that ED is not occurring at an alarming or unacceptable rate. Thus, it appears that the current RA Planning Reserve Margin is providing adequate capacity and additional procurement is not required to allow for planned maintenance.

Intermittent Resources

While the integration of intermittent renewable resources is the subject of a broad based CAISO initiative concurrent with the CPM initiative, the CPUC Staff sees no evidence that the CAISO has experienced problems incorporating the current amount of intermittent renewable resources into the grid using the resources made

[1] Straw Proposal at p. 9.
[2] Straw Proposal at p. 4.

available through the CPUC's RA program. The CPUC jurisdictional Investor Owned Utilities provided 15.4% of their total energy bid into the CAISO market using renewable resources in 2009.[3] As discussed above, the CPUC Staff agrees with the CAISO's suggestion that Exceptional Dispatch is not a significant issue in the current markets.

The CAISO's renewable resource integration efforts rightly question the best mechanisms for addressing the effect of increasing amounts of intermittent resources on the grid. The CPUC Staff cautions, however, that creating an intermittent resource-oriented capacity backstop product prejudges the outcome of this very complicated inquiry at the CAISO and in the FERC's proceeding regarding the integration of intermittent resources. California's renewable portfolio standards are likely to increase to 33% by 2020.[4] In order to respond to the State's Renewable Portfolio Standard and regulatory directives, the CAISO is currently conducting studies and other stakeholder processes to determine what changes to the wholesale market design may be needed to accommodate the expected increase in the production of intermittent renewable resources in the coming years.[5] Pursuant to prior technical input from the CAISO, the CPUC has added local area procurement obligations and an Ancillary Services Must Offer Obligation to the CPUC's RA program, and modified the capacity counting convention for intermittent resources to more accurately measure the availability of such resources during peak load periods.[6] The CPUC Staff expects that the CAISO's technical studies will continue to play a key role in the CPUC's long-term energy supply planning and RA procurement programs.[7]

The CPUC anticipates incorporating the results of the CAISO analysis into its procurement activities in order to provide the CAISO with a portfolio of resources that can be reasonably expected to provide long-term reliability. Given the facts that integration problems currently are not currently threatening grid reliability, both the FERC and CAISO are examining the issue of how to best address intermittent resource integration, and that the CPUC has an open LTPP proceeding in which the CAISO is actively participating, the CPUC Staff opposes the creation of new CPM products or the expansion of the applicability of the current backstop capacity procurement mechanism to fill in for perceived deficiencies in renewable resources' capacity.

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[3] See *CPUC Renewables Portfolio Standard Report* [to the California Legislature] *2nd Quarter 2010*, at p. 2, available at http://www.cpuc.ca.gov/NR/rdonlyres/66FBACA7-173F-47FF-A5F4-BE8F9D70DD59/0/Q22010RPSReporttotheLegislature.pdf and http://www.cpuc.ca.gov/PUC/energy/Renewables/index.htm.

[4] Cal. Pub. Utils. Code §§ 399.11-399.20; *CPUC Renewables Portfolio Standard Report* [to the California Legislature] *2nd Quarter 2010*, *supra*, at p. 9.

[5] *CAISO Discussion Paper* [on] *Renewable Integration: Market and Product Review*, issued on July 8, 2010, at p. 3.

[6] D. 09-06-028, *Decision Adopting Local Procurement Obligations for 2010 and Further Refining the Resource Adequacy Program*, issued in R. 08-01-025 on June 18, 2009 at pp. 5-8, 44-45, 45-53.

[7] See generally Cal. Pub. Utils. Code §§ 380, 454.5.

Generation That May Shut Down Due to Insufficient Revenue
The CPUC Staff is concerned that the CAISO's proposal to engage in 12-month contracts for generation units that it believes are needed for reliability, but may shut down due to insufficient revenue, conflicts with State and federal law directing that California's long-term procurement and resource adequacy requirements are established by State laws and policies. This proposal also appears to seek to expand Reliability Must Run procurement. However, four years ago the CAISO observed that its need to engage in out-of-market Reliability Must-Run contracts had been reduced to a small fraction of its former total megawatt volume as a direct result of the implementation of the CPUC's RA program. (CAISO News Release, CAISO Reduces RMR Contracts By 60 Percent, issued on October 16, 2006.) The CAISO's President and CEO, Yakout Mansour also stated in a news release that the reduction in CAISO Reliability Must-Run contracting was a positive movement, as "[i]t is far more appropriate to manage locational needs [through load serving entity contracting]. This is another very positive sign that California's energy industry is back on the right track." (Id.) It is unclear from the CAISO's proposal whether the CAISO intends to replace its Reliability Must-Run program with the proposed 12-month capacity product, or the proposed product is to allow the CAISO to procure resources outside of and in addition to the State's existing, successful program at the CAISO's sole discretion.

The proposed 12-month procurement mechanism conflicts with the CPUC's recently issued *Decision On Phase 2 – Track 2 Issues: Adoption Of A Preferred Policy For Resource Adequacy*[8] in which the CPUC decided not to pursue a CAISO-operated capacity market at this time because, in large part, "[p]roponents of the centralized capacity auction mechanism did not persuasively demonstrate how such a system could be structured to prioritize renewable resources and otherwise support the Commission's environmental goals." (Id. at p. 3.)

The United States Congress and the FERC have recognized the States' historic role in ensuring the resource adequacy through their oversight of load- serving entity procurement.[9] Accordingly, when the CAISO sought to incorporate duplicative resource adequacy requirements in its Market Redesign and Technology Update tariff, the FERC ordered the CAISO to defer to State and Local Regulatory Authority resource adequacy programs where such programs are successfully fulfilling grid reliability requirements.[10] The FERC acknowledged that there was no need for an Independent System Operator to design every detail of a State's resource adequacy program if that program was functioning properly:

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[8] D. 10-06-018, *Decision On Phase 2 – Track 2 Issues: Adoption Of A Preferred Policy For Resource Adequacy*, issued on June 3, 2010 in Rulemaking (R.) 05-12-013, available at http://docs.cpuc.ca.gov/WORD_PDF/FINAL_DECISION/118990.DOC

[9] FERC *Order Conditionally Accepting the California Independent System Operator's Electric Tariff Filing to Reflect Market Redesign and Technology Upgrade* (MRTU Order) at ¶ 1117. See also, Aug. 8, 2005, P.L. 109-58, Title XII, Subtitle A, § 1211(a), 119 Stat. 941 [Energy Policy Act of 2005] codified at 16 U.S.C.S § 824o(i).

[10] MRTU Order at ¶ 1118.

> [FERC's duty to assure grid reliability] does not mean that we must determine all the elements of such a program in the first instance. Rather, we can, in appropriate circumstances, defer to state and Local Regulatory Authorities to set those requirements. Our primary responsibility is to ensure that a workable program exists and is adhered to by all LSEs. (MRTU Order at ¶ 1117.)

Thus, the FERC stated,

> we are not establishing planning reserve requirements, but instead are adopting those set by state and Local Regulatory Authorities in the first instance. We note that the [CAISO-implemented] default MRTU Tariff system RA requirements are triggered only when state and Local Regulatory Authorities have failed to act in order to ensure resource adequacy. (Id.)

As discussed above, the CPUC has established and operated a successful RA program that has resulted in drastic reductions in CAISO out-of-market procurement. The CPUC appreciates the significant technical and analytical input provided by the CAISO to implement the State-mandated long-term procurement and RA programs. As also discussed above, the CAISO has successfully been able to operate the grid with the generation capacity provided by the CPUC's RA program.

The CAISO has failed to produce any evidence that it has any need to procure capacity beyond the portfolio of resources being provided by the CPUC's various procurement programs, with minor supplementation by existing CAISO backstop programs. Further, the proposed expansion of the CAISO's backstop authority conflicts with the FERC's express direction that the CAISO make use of a properly-functioning State procurement system without attempting to circumnavigate State procurement programs.

5. The compensation that should be paid for generic capacity procured under CPM and Exceptional Dispatch. Which method do you support: Option A – CONE net of peak energy rent; or Option B – going forward costs? Are there further modifications needed to either of these pricing options? If you have a specific alternative pricing proposal, please provide it and indicate the reasons for your proposal.

The CPUC Staff opposes the Straw Proposal's compensation Option A because it violates State policy and FERC precedent. The CPUC believes that Option A takes an overly proactive approach which will affect all capacity prices in California, not just backstop capacity prices. The CAISO recognizes in its Straw Proposal that its backstop capacity procurement activities "can play a role in forward capacity pricing and thus possibly in affecting investment decisions."[11] As discussed above, federal law requires that the CAISO defer to the relevant State or Local Regulatory Authority in the design of a capacity product. The CPUC Staff believes that Option A renders the CAISO's proposed "backstop" product more of a "frontstop" by setting prices significantly above current bilateral prices. Such increased prices could incent

[11] Straw Proposal at p. 6.

generation to use the higher backstop price to negotiate a higher forward RA price or withhold capacity from the bilateral RA market in hopes of obtaining more lucrative CAISO backstop capacity payments.[12] Such developments would be the antithesis of the CPUC RA program that the FERC directed the CAISO to respect in exercising its procurement authority. These potential effects are not reduced by the Straw Proposal's design criterion to "[m]inimize reliance on backstop procurement where possible by allowing LSEs to procure capacity through bilateral transactions . . . ."[13] Load-serving entities are not just allowed to procure capacity; load-serving entity procurement should be the primary tool for capacity procurement, as it is now under the CPUC's RA program.

After discounting the option of using market systems to value its proposed backstop capacity product, (Straw Proposal at p. 11) the Straw Proposal suggests two alternative pricing schemes: 1) Option A - capacity price based on the cost of new entry (CONE), and 2) Option B - capacity price based on going forward costs. The Straw Proposal suggests, however, that "[n]either option is a well-designed vehicle for eliciting new investment which in the current market environment, including consideration of substantial renewable energy potentially coming on line over the next decade, would require further guarantees of revenues over multiple years."

The FERC has determined that the CONE is at most an outer boundary for the range of reasonableness of possible backstop capacity compensation.[14] Rather, the FERC explained, the price for backstop capacity should fall somewhere between the cost of operations for an existing generation unit and the CONE.[15] As FERC stated, a "just and reasonable price for backstop capacity should encourage LSEs and generators to engage in longer-term contracting and not rely on the [backstop] mechanism."[16] The Straw Proposal fails to produce evidence that the current payment mechanism has resulted in unreliable grid conditions, the shut-down of generation units that are needed for reliability, or otherwise compromised grid reliability. Thus, there is no apparent reason to modify the current backstop payment mechanism.

As California moves forward with State required environmental policies such as Once Through Cooling and renewable portfolio requirements, the most efficient market solutions in the State risk being precluded by distortions introduced by suboptimal administrative pricing scenarios. Backstop capacity prices that exceed prices available through contracting with CPUC jurisdictional LSEs undermine these policies. Accordingly, any pricing proposal should start from the perspective of continuing current payment systems, or using going forward costs, the Straw Proposal's Option B.

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[12] Straw Proposal at p. 17; see also Id. at p. 12, which states, "[The ISO recognizes that rapidly moving to a backstop capacity price based on CONE could lead to rapid changes in RA prices prior to allowing LSEs to adjust their portfolios or make other investments."].
[13] Straw Proposal at p. 10.
[14] *Indep. Energy Producers Ass'n v. Cal. Indep. Sys. Operator Corp*., 121 FERC ¶ 61,276, at ¶ 23 (2007).
[15] *Id.* at ¶ 70.
[16] *Id*. at ¶ 71.

The CPUC Staff also cautions that the optimal balance of environmental policies, reliability, and cost concerns may involve closely coordinated procurement and retirement efforts that cannot occur if aging fossil-fueled generation facilities are insulated from market signals to repower or retire. This balance, especially in the geographically constrained local capacity requirement areas, is better addressed through the CPUC's LTPP proceeding, which provides an opportunity to balance and regularly update the full range of costs and benefits borne by a broader set of stakeholders than through the development of administrative prices incorporated in FERC tariffs. The CPUC staff believes the Commission's LTPP's ten year forward planning horizon provides a superior cost and benefit comparison than an approximation of a long-term value forced into a short-term frame pricing mechanism. As the CAISO produces more technical analysis regarding renewable resource integration needs, the CPUC will become increasingly effective at addressing the CAISO's legitimate grid operations and reliability needs. The CPUC Staff suggests that the perception of need for increasingly fragmented backstop products should thus decrease.

In sum, California law and policies require that the CPUC seek to procure increasing percentages of California's energy from renewable resources. The CAISO has yet to release its much-anticipated study regarding the feasibility of integration of 33% renewable energy. Thus, it is unclear whether the goal of 33% renewable resource energy supply may be feasible with the use of existing and developing demand response, smart grid, electricity storage and transmission development rather than through the use of existing and supplemental fossil-fired generation resources. The Straw Proposal undermines the State's renewable energy goals by attempting to provide supplemental payments to fossil-fired plants that may or may not be necessary for grid reliability in the increasingly low-carbon future of State energy procurement.

6. The need for the ISO to procure non-generic capacity under CPM and Exceptional Dispatch to meet operational needs.

As discussed above, the CPUC Staff in theory supports CAISO short-term procurement of generation that will actually meet short-term grid reliability needs. It is unclear, however, what non-generic capacity may be required by the State's increased reliance upon intermittent renewable resources. The CPUC Staff thus urges the CAISO to wait until specific resource needs are identified through separate processes currently underway, and continue the collaborative methods already underway between the CPUC and the CAISO to assure that such needs are met either through the CPUC's long-term, load-serving entity-based procurement programs, or through the CAISO's various market and backstop methods.

7. The operational criteria the ISO is proposing to distinguish certain operational characteristics as non-generic capacity (fast ramping and load following). Are

these two characteristics enough, or do you propose additional criteria for operating characteristics that would qualify for non-generic capacity?

See responses to questions 4 and 6.

8. How should non-generic capacity be compensated? What are your views on the proposal to compensate non-generic capacity by applying an adder to the price paid for generic capacity?

See responses to questions 4 and 6.

Exceptional Dispatch

1. Should energy bids for resources dispatched under Exceptional Dispatch continue to be mitigated under certain circumstances? Should such mitigation continue the current practices of bid mitigation as outlined in the straw proposal?

The CPUC Staff urges that energy bids for resources dispatched under ED should continue to be mitigated.

2. Should the ISO change the categories of bids subject to mitigation under Exceptional Dispatch (Targeted, Limited and FERC Approved) and extend the bid mitigation for the existing categories?

3. What is the appropriate compensation for non-RA, non-RMR and non-CPM capacity that is Exceptionally Dispatched? Should the current compensation methodology be extended, updated to agree with what is put in place for CPM for generic capacity procurement?

The CPUC Staff suggests that the current ED payment method provides adequate and appropriate payment.

Other

1. Do you have any additional comments that you would like to provide?