

Stakeholder Comments

Reliability Services Initiative Working Group, March 27, 2014

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The Office of Ratepayer Advocates (ORA) provides the following comments on the Reliability Services Initiative (RSI) working group held March 27, 2014.

1. The California Independent System Operator (CAISO) proposal should not deviate from the Joint Reliability Plan (JRP) agreement.

ORA is concerned that the CAISO proposal for the design of a market-based backstop mechanism goes beyond the Joint Reliability Plan (JRP) agreed to by the CAISO and the California Public Utilities Commission (CPUC) in November 2013.¹ According to the CAISO, one of the main objectives of the RSI is to create a “forward voluntary auction for residual capacity needs.”² As previously noted in comments by CPUC Staff, CAISO’s proposal for a ‘residual capacity’ market with a voluntary component, goes beyond the agreed upon scope of the [JRP].³ Specifically, the JRP agreement states that: “In addition to providing a backstop

¹ Joint Reliability Plan, p. 9, adopted November 14, 2013 available at <http://docs.cpuc.ca.gov/SearchRes.aspx?docformat=ALL&DocID=81666376>

² CAISO presentation, posted March 27, 2014, slide 9.

³ See CPUC Staff comments, March 11, 2014, p. 1.

procurement mechanism to replace the CPM, the ISO will consider allowing LSEs to utilize the auction to clear voluntary bids to buy, and for resources to sell, forward capacity in excess of any forward capacity procurement requirements.”⁴ This provision refers to consideration of a voluntary market to procure forward capacity *above and beyond* any forward RA requirements for years 2 and 3, should the CPUC decide to adopt such requirements. The CAISO appears to deviate from this JRP concept of a voluntary market, by proposing voluntary auctions to procure capacity in the annual and monthly timeframes.

A Capacity Procurement Mechanism (CPM) replacement should be “designed to be used infrequently,”⁵ as CPUC Staff and ORA⁶ have previously noted. CPUC Staff states that “the CAISO may be envisioning a larger procurement role for the ‘residual’ year-ahead and monthly market than the CPUC would likely agree to endorse.”⁷ The CAISO should not pursue CPM replacement market designs that may infringe upon the jurisdiction of the CPUC over resource adequacy and procurement planning. It should not therefore propose market designs that would have insufficient liquidity without participation from CPUC regulated Load Serving Entities (LSEs).

2. CAISO’s proposal for a voluntary capacity auction resembles the Midcontinent Independent System Operator, Inc. (MISO) voluntary capacity auction. It introduces unmanaged risk of a “residual procurement auction” becoming the “de facto” market, a mandatory market, or full-scale centralized market through Federal Energy Regulatory Commission (FERC) intervention or third party court challenge.

In comments on the CAISO’s Reliability Services Issue Paper, ORA outlined pending applications for rehearing at FERC regarding MISO and ISO-NE, and the significant implications that disposition of these cases may have on the economic and legal viability of a potential CAISO Reliability Services Auction (RSA) market design.⁸ For the reasons explained in ORA’s comments, FERC determinations in those cases will likely shed more light on how the

⁴ JRP agreement, p. 8.

⁵ CPUC Staff comments, March 11th, 2014, p. 1.

⁶ ORA comments on Reliability Services Issue Paper, February 18, 2014, p. 3.

⁷ CPUC Staff comments, March 11th, 2014, p. 2.

⁸ ORA comments on Reliability Services Issue Paper, February 18, 2014, pp. 6-9.

current FERC will seek to accommodate states' pursuit of legitimate energy policy objectives such as development of renewable resources. We may find out, for example, whether FERC will require a Minimum Offer Price Rule (MOPR), and if so, whether it will exempt wind and solar resources from application of the rule and under what circumstances (the ISO-NE case). In the MISO case we may find out whether FERC will respect a stakeholder settlement agreement for a voluntary market design, or instead make that market mandatory. We may also find out whether FERC will impose a MOPR in a voluntary capacity market structure to deter the exercise of buyer market power.

ORA's January 28, 2014 comments on the RSI Issue Paper encouraged the CAISO to address the threshold issues of economic and legal viability of a proposed market-based backstop mechanism, and provide a market design proposal that is informed by an understanding of these issues and addresses them with specific recommendations for risk mitigation.

The CAISO did not address these issues in its proposals for market design at either of the RSI Working Group meetings. Instead, the CAISO has provided the following response to ORA's comments:

There is also [a] major difference between the MISO and ISO-NE capacity markets and what the ISO, under the JRP is considering in this initiative[.] **Both MISO and the ISO-NE's capacity market run are the mandated method for the RTOs to ensure that LSEs have procured sufficient resource adequacy.**

The ISO is only proposing an auction for residual procurement. The residual auction would take place after procurement directed by LRAs and therefore would not be affected by any environmental policies directing specific procurement. In the ISO's proposed construct the LRA would be able to completely direct primary procurement how they saw fit. The ISO would then fill-in any gaps needed to reliably operate the grid. There are many potential market designs that could be inserted here, but in all cases the LRA retains autonomy to pursue specific policy objectives.

The discussions in this initiative will include the specifics of resource adequacy mechanisms and markets in both ISO-NE and MISO, as well as in other markets. Because of the specific differences of those markets from the CAISO, as well the

pressing need to replace CPM and address upcoming issues, it would be difficult to delay this initiative to see the outcome other cases at FERC or in the courts.⁹

CAISO's response is not entirely responsive and is puzzling in several respects. First, CAISO states that both MISO and ISO-NE's capacity markets are the mandatory method for the RTOs to ensure procurement of sufficient RA. However, ORA's understanding is that MISO's Planning Resource Auction is currently a voluntary auction, and the majority of MISO's capacity is secured outside of the auction through bilateral contracting.¹⁰ Moreover, CAISO states that its proposal is distinguishable from the MISO construct in that it will only design an auction for "residual capacity procurement." However, the MISO Planning Resource Auction is exactly that. It is a "residual auction" in that it covers procurement of capacity still needed after self-supply and bilateral contracts.¹¹ Second, the PJM Interconnection, LLC (PJM) case discussed below casts doubt on whether a residual auction can remain residual. Third, the CAISO statement that the CPUC would direct the Investor Owned Utilities' (IOUs') primary procurement prior to the auction does not address the fact that the CPUC has no authority to direct generators to execute contracts. Generators may elect not to negotiate with the IOUs, preferring to obtain contracts through the RSA with potentially higher prices.

ORA has previously outlined its concerns with the uncertainty over the potential preemptive impact of organized wholesale capacity auctions on state procurement choices, citing

⁹ CAISO's Stakeholder Comments Matrix – Reliability Services – Issue Paper, posted March 25, pp. 58-59, emphasis added.

¹⁰ See *Initial Brief of the American Public Power Association and The National Rural Electric Cooperative Association on Minimum Offer Price Rule Issues*, FERC docket No. ER11-4081-001, filed October 11, 2013, pp. 13-14, available at: https://www.publicpower.org/files/ER11-4081_Initial_Brief_MISO_MOPR.PDF:

Moreover, the overall capacity construct design in MISO, with its voluntary backstop auction and specific allowances for LSEs to self-supply or opt-out through the flexible Fixed Resource Adequacy Plan ("FRAP"), renders a MOPR unnecessary and, as the Commission observed, ineffective in the MISO resource adequacy construct.[footnote omitted] MISO's resource adequacy construct and Planning Resource Auction are appropriate for MISO because they provide for essentially "residual" service wherein LSEs – most of whom have an obligation to serve and rely mostly on their self-supply owned and contracted resources to meet their planning reserve requirement – can procure capacity not met through non-auction purchases and self-supply arrangements. Such residual markets for capacity are but one vehicle to achieve the Commission's goals for long-term resource adequacy and investment in various types of new resources. In such a voluntary market, where an overwhelming majority of capacity is secured through bilateral arrangements, a MOPR does not fit, and no such blanket buyer market power rules are necessary.

¹¹ *Id.*



several decisions currently pending rehearing and appeal before FERC and the federal courts.¹² ORA will not repeat its discussion of the ISO-NE and MISO cases pending rehearing at FERC. It is worth noting here, however, that the Third Circuit of the U.S. Court of Appeals recently upheld FERC's decision regarding PJM, finding that in eliminating the MOPR exemption for state-mandated resources, FERC did not infringe on state authority, but was exercising its exclusive jurisdiction over wholesale rates.¹³

Briefly, PJM initially proposed a base residual auction for capacity.¹⁴ In 2006, a settlement regarding inserting a MOPR in the auction to mitigate against buyer market power was reached between stakeholders, including PJM and state authorities.¹⁵ A key component of this settlement was that state mandated policy projects would be exempt from application of the MOPR. Then, in 2011, PJM filed an amended tariff to remove the exemption for state policy projects from the MOPR.¹⁶ FERC approved this tariff change over objection from several state regulators who argued that the MOPR impinged on state authority over resource adequacy.¹⁷ On rehearing, certain parties argued that FERC failed to support its departure from the 2006 settlement agreement,¹⁸ in which the exemption for state policy resources was an important reason why some state regulators had supported the settlement. In addition, New Jersey Rate Counsel argued that FERC's action eliminating the exemption from the MOPR "leaves states facing resource deficiencies with the untenable choice of paying twice to satisfy the same reliability need or opting out of the auction entirely"¹⁹, essentially "transforming PJM's residual capacity market into an all-or-nothing proposition (except for favored resource types that are exempted from the rule)."²⁰ In its November 2011 rehearing order, FERC responded to these

¹² ORA comments on RSI Issue Paper, February 18, 2014, at pp. 6-9.

¹³ *New Jersey Board of Public Utilities, et al. v. FERC*, Nos. 11-4245, et al., (3rd Cir. 2014).

¹⁴ *In re PJM Interconnection, L.L.C.*, 119 FERC ¶ at p. 13 (June 25, 2007).

¹⁵ *Id.* at p. 20.

¹⁶ *PJM Interconnection, L.L.C.*, 135 FERC ¶ 61,022 at p. 89 (April 12, 2011).

¹⁷ *PJM Interconnection, L.L.C.*, 137 FERC ¶ 61,145 (November 17, 2011)

¹⁸ *Id.* at 80.

¹⁹ See Request for Rehearing and for Expedited Consideration of New Jersey Division of Rate Counsel, *PJM Interconnection, L.L.C.*, 135 FERC ¶ 61,022, Docket EL 11-20-000 and Docket No. ER11-2875-000 (May 12, 2011) at p. 3.

²⁰ *Id.* at p. 18.

arguments on rehearing, stating that “the MOPR does not interfere with states or localities that, for policy reasons, seek to provide assistance for new capacity entry if they believe such expenditures are appropriate for their state,” and FERC only seeks to ensure the reasonableness of the wholesale prices.²¹ Further, FERC stated, application of the MOPR helps to ensure that wholesale capacity prices remain at just and reasonable levels.²²

By removing the exemption for state-sponsored resources and giving the utilities the choice to either participate fully in the auction or procure capacity entirely outside of the auction, FERC effectively transformed PJM’s base residual auction into a broader capacity market never agreed to by some state regulators. In upholding FERC on review, the Third Circuit stated what FERC actually did was “permit states to develop whatever capacity resources they wish, and to use those resources to any extent that they wish, while approving rules that prevent the state’s choices from adversely affecting wholesale capacity rates.”²³ Contrary to Maryland’s and New Jersey’s arguments that in removing the exemption from the MOPR for state-sponsored resources FERC was infringing on state jurisdiction, the Third Circuit found that ‘enacting rules to prevent the state’s choices from affecting wholesale capacity rates’ “falls squarely within FERC’s jurisdiction.”²⁴ Under the Third Circuit’s opinion, whatever the adverse financial and reliability consequences that may result from PJM’s auction must be borne by the states and their utility ratepayers. The Third Circuit opined, “[t]hus, as in *Connecticut Department of Utility Control*, New Jersey and Maryland are free to make their own decisions regarding how to satisfy their capacity needs, but they ‘will appropriately bear the costs of [those] decision[s],’ [citation omitted], including possibly having to pay twice for capacity.[citation omitted].”²⁵ CAISO’s proposal for voluntary or backstop residual auctions, with administrative rules approved by FERC and subject to later changes by FERC, introduces some risk of a similarly unacceptable outcome for ratepayers in California. FERC may decide to change its rules for a residual auction in California, as it did for PJM, since, as the Third Circuit notes, an agency may alter its policies

²¹ *PJM Interconnection, L.L.C.*, 137 FERC ¶ 61,145, *supra* at p. 89.

²² *Id.* at p. 91.

²³ *New Jersey Board of Public Utilities v. FERC*, *supra*, slip op. at 55.

²⁴ *Id.*

²⁵ *Id.* at 53.

despite the absence of a change in circumstances.²⁶ This is a legal risk that must be acknowledged and mitigated if possible.

The Third Circuit found it is clearly within FERC's authority to change market rules arrived at through PJM's stakeholder process.²⁷ We must acknowledge that a market design agreed to in a CAISO stakeholder process may similarly be subject to changes required by FERC. ORA therefore reiterates its recommendation that the CAISO include these threshold issues of economic and legal viability within the scope of the RSI, and provide a Straw Proposal market design that addresses these issues with specific recommendations for risk mitigation. For example, how will the CAISO's proposed market design and stakeholder process address concerns that a "limited" or "residual" market may become the "de facto" market, a "mandatory" market, or fully centralized market ("the only game in town") as a result of FERC intervention or third party court challenge? How will the CAISO's proposed market design and stakeholder process ensure that California's commitment to preferred resources is not undermined by subsequent changes to the market? Specifically, how can we ensure that California ratepayers do not pay twice for resources?

3. CAISO's proposal for a market-based CPM replacement mechanism should contain a cost-benefit analysis that justifies the likely increase in cost to ratepayers.

Changing the capacity market structure in California and designing and implementing a RSA could impose significant new costs on ratepayers. These could include costs such as business administrative costs for market participants to participate in the RSA, and institutional costs such as initial setup of Information Technology (IT) systems and ongoing maintenance costs. ORA recommends the CAISO proposal for an RSA provide an estimate of these costs.

Second, in the CAISO-proposed RSA, it appears both suppliers and buyers of capacity would evaluate bilateral arrangements by comparing to the prices expected in the RSA. If significant demand participates in the RSA as price takers, the price of capacity would be set based on a clearing price determined by the most expensive bid from those generators needed to meet RA requirements. This dynamic may result in windfall profits for existing, amortized, low-

²⁶ *Id.* at 59.

²⁷ *Id.*

cost resources. In the future, there may not be an incentive for the owners of these resources to accept bilateral capacity prices at a price lower than what they would expect to receive in the RSA. This market participant behavior is likely to increase costs to ratepayers. On the other hand, if limited demand participates in the RSA, the market may either not clear or clear at very low prices. Under this scenario, the “transparent, market-based” CPM price would not reflect market conditions. The CAISO would still need to rely on some sort of administratively determined price to backstop for unsystematic residual capacity needs.

Ratepayers should not be subjected to higher costs without a thorough cost-benefit evaluation of the proposed CPM replacement mechanism. Stakeholders, in addition to ORA, proposed similar cost-benefit evaluations before proceeding with market-based CPM replacement mechanisms.²⁸

4. The CAISO should consider replacing the existing CPM price with a market-based price calculated as a multiple of rolling average RA prices.

The CAISO has stated that it wants a market-based backstop mechanism in order to replace the current CPM’s administratively determined price with a transparent, market-based price. To be clear, as ORA and other stakeholders have noted, replacing the CPM with a market-based mechanism is not a FERC mandate. CAISO acknowledged at the March 27, 2014 working group meeting that FERC guidance does not require the CAISO to run a market in order to obtain a market-based CPM price. Nor is it necessary to create a capacity auction to derive a transparent, market-based price. CPUC Staff states that “[t]he JRP did not presume that a CAISO-run market is the only method to achieve the principles it articulates”²⁹ and that: “CAISO should not assume that a ‘voluntary’ or backstop ‘residual’ market mechanism is the singular or maximal way to achieve efficient resource procurement. CPUC staff urges CAISO to consider whether there is any empirical evidence to demonstrate that the current procurement system is actually an inadequate or inefficient way (relative to the costs/benefits of other options) to achieve procurement needed for resource adequacy programs.”³⁰ That is good advice. California Large Energy Consumers Association (CLECA) too commented that the issues “do

²⁸ CPUC staff comments, March 11th, 2014, p. 3; CLECA comments, March 7th, 2014, p. 2.

²⁹ CPUC Staff comments, March 11th, 2014, at p. 3.

³⁰ CPUC Staff comments, March 11th, 2014, p. 3.

not require the development of entirely new auction mechanism,”³¹ and Calpine says that “it is not obvious that the markets under consideration by the CAISO are obviously better than the current combination of bilateral procurement and an administrative backstop.”³² Before proceeding with a complex auction design, the CAISO should heed the cautionary comment of NRG that whether implementing an auction is even feasible should be part of the early discussions.³³ Dynegy noted that it has substantial experience with residual auctions and “would not recommend them to the CAISO.”³⁴ A variety of stakeholders expressed doubts over whether it is possible to create a new auction mechanism within the proposed time frame and recommend a focus on simpler backstop solutions.³⁵

Stakeholders are concerned that the CAISO’s proposal is overly complex and has significant economic as well as legal viability issues. These concerns include concerns about liquidity and prices, and skepticism with designing a voluntary market-based residual procurement mechanism that could not be used for unsystematic backstop procurement.³⁶ The issues and concerns identified with CAISO’s proposal increase the risk of FERC intervention or third party court challenge seeking modifications of the market mechanism design. In addition, the issues with CAISO’s proposal appear to be in conflict with CAISO’s objectives of “simplification” and “efficiency.”³⁷

For these reasons, among others, ORA supports CPUC Staff’s recommendation that a transparent, market-based price could be based on a multiple of a rolling average of historic reported RA prices in the bilateral market.³⁸ Stakeholders correctly noted at the March 27, 2014

³¹ CLECA comments, March 7th, 2014, p. 2.

³² Calpine comments, March, 7th, 2014, p. 1.

³³ NRG comments, March 7th, 2014, p. 1.

³⁴ Dynegy comments, March 7th, 2014, p. 1.

³⁵ Stakeholder comments on the CAISO RSI Workshop on February 24th, 2014: PGE comments at p. 2, NRG comments at p. 1, Calpine comments at p. 1, CLECA comments at p. 2, CPUC staff comments at p. 2, SCE comments at p. 1, Six Cities comments at p. 1, and TURN comments at p. 2.

³⁶ Stakeholder comments on the CAISO RSI Workshop on February 24th, 2014: Calpine at pp. 1-3, CLECA at p. 2, CPUC Staff comments at pp. 3-4, Dynegy at p. 1, NRG at pp. 1-2, ORA at pp. 2-3, PG&E at p. 4, SCE at pp. 2-3 and p. 5, SDG&E at p. 2, SixCities at pp. 1-3, TURN at pp. 3-4

³⁷ CAISO RSI presentation, posted March 27th, 2014, slides 23-24.

³⁸ CPUC Staff comments, March 11th, 2014, at p. 4.

CAISO working group meeting, that the current bilateral procurement framework is a “market.” Furthermore, this alternative meets the other CAISO principles for a market that has an adaptable structure, simplification, efficiency, transparent process and price.³⁹ Transparency exists in the California RA construct, with LSEs seeking relevant pricing information through bilateral negotiations or competitive Requests for Offers (RFOs). ORA agrees that transparency could be enhanced, for example through the publication of a CPUC-CAISO joint long-term reliability assessment, in collaboration with the CEC, as envisioned in the JRP agreement.

As several stakeholders commented on both the RSI Issue Paper and the February 24, 2014 RSI working group meeting, the existing RA framework has maintained reliability and has served California well. LSEs have met their RA requirements and as PG&E and SCE have noted, “to date, all 26 CPM contracts have been for Significant Events or Exceptional Dispatch (ED) within the month.”⁴⁰ In other words, all CPM backstop procurement to date has been due to unsystematic backstop procurement needs. While the introduction of new flexible capacity products may impact future backstop procurement there is simply no justification for developing voluntary or backstop market-based residual procurement mechanisms that could not be used for unsystematic backstop procurement. Given the success of the existing reliability framework in the context of California’s commitment to use preferred resources and reduce greenhouse gas (GHG) emissions, ORA supports retention of the existing reliability framework with the strategically targeted changes to address clearly identified challenges. This approach presents a far lower risk of undermining California’s commitment to preferred resources, raising costs unnecessarily, or introducing unintended consequences.

³⁹ CAISO RSI presentation, posted March 27th, 2014, slides 22-26.

⁴⁰ SCE comments, March 7th, 2014, p. 5.