

INDEPENDENT ENERGY PRODUCERS

To: CAISO
From: Steven Kelly, Policy Director
Date: April 9, 2014
RE: Reliability Services Initiative (RSI) – Market Mechanism Working Group

The Independent Energy Producers Association (IEP) offers the following comments on the CAISO staff's concept presentation regarding the CAISO Reliability Services Initiative (RSI), dated March 27, 2014. IEP appreciates the opportunity to work with the CAISO Working Group on this matter.

- 1. IEP Is Supportive of a Residual Auction Administered by CAISO, If It Satisfies Necessary Market Principles.** As a supplement to forward, bilateral contracting to meet resource adequacy (RA) obligations, a well-designed residual auction can provide important benefits to consumers as well as electric grid operations. On the other hand, a poorly designed program can create perverse incentives and, ultimately, undermine resource adequacy. Any market redesign must be expected to result in just, reasonable, and non-discriminatory outcomes. Accordingly, participation in the residual voluntary market must be available in a comparable manner to all resources capable of providing the products and services sought by the CAISO to meet its operational, reliability needs. Similarly, IEP will expect that the market clearing price (MCP) in the residual, voluntary market be uniform, non-discriminatory, and reflect "forward capacity costs" of the specific products and services sought by the CAISO.

To achieve these outcomes, we believe certain market design principles need to be at the forefront of the consideration of market design changes.

- a. CAISO Market must be Reasonably "Liquid."** The market must be characterized by many Buyers and Sellers to ensure reasonable market liquidity. Liquidity is particularly important, if the MCP of the CAISO residual, voluntary market is to be in anyway determinative of pricing for CAISO backstop procurement.
- b. CAISO Markets Must Consider the Risk of Market Power from Both the Buyer- and Seller-side.** Because the CAISO proposes to link the MCP of the voluntary residual market with the compensation for backstop supply, IEP's concerns over the potential exercise of market power are heightened. Depressing the price in the voluntary residual market could be a strategy to lower the cost of CAISO backstop procurement, which in turn could lower the LSE's overall cost of RA compliance. Load-serving entities have been, and will increasingly be,

engaged in managing demand-response (DR) programs as a demand-reduction or supply resource. An individual LSE might consciously under-procure RA resources in the forward market, rely on the CAISO's backstop procurement mechanism to "backstop" the RA obligation, all the while having strategically bid DR as a supply resource in the *voluntary* market to lower that market's MCP.

- c. CAISO Market Must be Competitive and Transparent.** To the extent that the CAISO administers a voluntary capacity market, key information related to market participation will need to be transparent. In addition to a uniform MCP, the market would have to convey critical market information on a daily basis regarding number of participants (for both the Buy- and Sell-side), volumes cleared, and demand/supply curves bid into the market.
- 2. IEP prefers no auction mechanism to a flawed auction mechanism.** Given the risk of unintended consequences that derive from flawed market design, IEP is particularly concerned that this proposal be sufficiently vetted prior to implementation. In the context of considering additional market design(s) to help serve the RA program, IEP's core observation is "do no harm."
- 3. IEP Recommends a "Pilot Test" of the Residual, Voluntary Market and, Pending Results, De-linking Compensation for Backstop Procurement from the Voluntary Market.** The CAISO proposal for the RSI has two primary components: First, the design and implementation of a residual, voluntary market for capacity/RA products; and, second, a replacement CPM backstop procurement mechanism based in whole or in part on the MCP of the residual, voluntary market. When combined with the existing bilateral, RA market in California, it is fair to say that these proposal is unique and not replicated elsewhere in the country.

In this context, prudence suggests that the CAISO operationally "test" these new market design features prior to linking the pricing outcomes from the residual capacity market to the compensation paid to electric generators pursuant to any backstop procurement authority. As noted below, IEP does not view these two design elements as necessarily linked.

The viability of linking compensation for backstop procurement to a residual, voluntary market design will be dependent on a number of empirical outcomes from the market redesign. Yet, importantly, these outcomes are highly dependent on a well functioning market in a number of critical respects that have yet to be tested.

- a. The Concept of a "Voluntary Auction" Needs to Be Tested.**¹ What is the minimum volume necessary to clear the voluntary auction? What is the minimum number of participants (i.e. Buyers and Sellers) needed to ensure liquidity? How will DR be treated, given that some Buyers may be invested in DR as a supply resource? In the context of linkage to backstop procurement compensation, what happens if the voluntary auction clears zero MWs?

¹ The concept of "Split Auction" needs to be tested as well, if such a proposal continues to be considered. Based on the Working Group discussion on March 27, IEP believes the concept of a "split auction" is no longer being considered. If this is not the case, how does a split auction work? In the context of linkage to backstop procurement compensation, what happens if the voluntary auction clears zero MWs?

- b. The Concept of “Capacity More Difficult to Procure Bilaterally” Needs to Be Tested.** Assuming transparency and clarity in the definition of the product to be procured in the residual, voluntary market, what type of capacity is too difficult to procure bilaterally?

IEP recommends that the residual, voluntary market be deployed and tested for at least 2-3 years prior to using this mechanism as the basis for CPM replacement. A test period of 2-3 years will provide the CAISO, stakeholders and the FERC sufficient data to determine whether (a) the residual, voluntary market is functioning properly; and (2), whether the MCP derived from such market(s) are appropriate for determining the compensation paid to electric generators called by the CAISO pursuant to its backstop procurement authorities.

- 4. FERC Does Not Require Imposition of a “Market-based” Backstop Procurement Mechanism.** IEP’s impression is that the residual, voluntary market proposal is premised on a presumed requirement that the existing CPM mechanism, expiring in early 2016, be replaced by a “market-based” backstop mechanism. Stakeholders have been told that two FERC decisions guide the CAISO to this conclusion, namely the FERC Order on Tariff Revisions issued on March 29, 2013 (i.e. the so-called FLRR Decision; Docket No. ER 13-550-000) and the FERC Order Approving Uncontested Settlement issued on February 16, 2012 (i.e. the so-called CPM Settlement; Docket No 11-2256-000). IEP is not convinced that this analysis is accurate.

- a. FERC FLRR Decision.** In rejecting the CAISO’s flexible capacity and local reliability resource retention (FLRR) mechanism, the FERC stated “... the most effective course of action would be for the CAISO and its stakeholders to focus on the development of a *durable, market-based mechanism to provide incentives* to ensure that the reliability needs are met.” In addition, FERC stated: “Thus, we encourage CAISO and its stakeholder to focus on the development of a *durable, market-based mechanism that provides incentives* to ensure that resources with the adequacy and operational needs CAISO requires are available to meet system needs.” Moreover, the FERC stated that “While we recognize CAISO’s need to have tools in place to forestall premature retirements while it develops a more comprehensive solution, we find that CAISO currently has at its disposal a number of options for addressing imminent resource retirements that may result in reliability threats, including its existing CPM risk-of-retirement provisions.” (Emphasis added).

IEP agrees with the FERC regarding the need to develop durable, market-based mechanisms to provide incentives to meet reliability needs in the forward market(s). However, IEP disagrees with the conclusion of the CAISO that this language neither can nor should be interpreted as framing the mechanism for determining compensation pursuant to any CAISO backstop procurement authority. Backstop procurement, by design and necessity, is conducted out-of-market. As such, it’s a different product. Indeed, the FERC recognized that the existing CPM, wholly based on an administratively determined price, functions satisfactorily for the narrow conditions of procuring resources out-of-market to meet reliability threats faced by the CAISO after the market(s) clear.

- b. FERC CPM Decision.** In the decision approving the CPM Settlement, the FERC noted that “To meet these needs [resource adequacy to maintain reliable grid operations], CAISO relies upon the backstop procurement authority in the CPM and the exceptional dispatch provision of its tariff.” In approving the Settlement, however, IEP can find no dicta as to the need for a successor backstop procurement mechanism or any suggestion as to the basis for compensation of a successor backstop procurement mechanism if one were to be adopted.
- 5. An Administratively Determined Price Is Embedded In RSI Proposal Anyway.** IEP continues to struggle with the concept of using a “market-based” mechanism for out-of-market procurement. Furthermore, as noted above, the current CAISO proposal will require developing compensation to generators in whole or in part on an administratively determined element due to the probability (which is not zero) that the voluntary auction clears zero MWs and, thus, its contribution to the pricing of the proposed backstop procurement mechanism is also zero. Because of this reality, IEP believes that a process will be required to determine administratively a just and reasonable price paid to resources procured by the CAISO ‘out of market.’”
- 6. IEP Recommendations.** As a result of directly linking backstop procurement compensation to the MCP of the proposed residual, voluntary market, the CAISO is risking engulfing the implementation of the latter in contentious debate related to the former. Rather, IEP suggests de-linking the two at this time, and focusing attention on developing a residual, voluntary market element.

In this regard, IEP recommends the following 3-step process for consideration of all the issues currently embedded in the RSI:

- a. Finalize the RSI Market Design, Including the Residual Voluntary Market and Flexible Capacity RA Program Obligation;**
- b. Pilot Test the RSI voluntary, residual market for 2-3 Years; and**
- c. Extend Current CPM Backstop to Meet RA Obligation(s) While “Pilot Testing” the RSI voluntary, residual market concept and design.**

We appreciate the CAISO’s attention to our concerns.