Reliability Must Run and Capacity Procurement Mechanism Enhancements Draft Final Proposal

Comments by Department of Market Monitoring

February 25, 2019

I. Overview

DMM appreciates the opportunity to comment on *the ISO's Reliability Must Run and Capacity Procurement Mechanism Enhancements Draft Final Proposal* issued on January 23, 2019.[1] The ISO's proposal includes significant incremental enhancements to the existing backstop procurement design. DMM supports moving forward with these changes as important improvements to the current backstop procurement framework. DMM supports the following incremental improvements to the RMR and CPM framework:

- Fixed compensation above the soft offer cap is changed to being based on Going Forward Fixed Costs (GFFC) instead of using Schedule F of the Pro Forma RMR contract, which includes full cost recovery and a return on sunk fixed costs.
- RMR resources are subjected to a Must-Offer Obligation like RA resources.
- RMR Condition 1 is eliminated.
- The ISO will seek to limit RMR designations only to units that would retire without RMR contracts.

However, FERC has directed ISO to work on comprehensive reforms to its backstop procurement design.[2] The *Draft Final Proposal* does not address some key concerns with the ISO's current backstop procurement mechanisms that may be needed as part of such comprehensive reform. These include:

- The current soft offer cap may be too high for annual CPMs.
- When CPM solicitations are not competitive, resources can attain compensation at or close to the soft offer cap plus retain all market revenues. This compensation may be significantly in excess of a resource's GFFC plus a reasonable return.

[1] *Reliability Must Run and Capacity Procurement Mechanism Enhancements Draft Final Proposal*, California ISO, January 23, 2019. http://www.caiso.com/Documents/DraftFinalProposal-ReliabilityMust-RunandCapacityProcurementMechanismEnhancements.pdf

[2] *Order rejecting tariff revisions,* ER18-641-000, April 12, 2018, p. 18. https://elibrary.ferc.gov/idmws/common/opennat.asp?fileID=14887575

- The ISO's proposed cost recovery above the soft offer cap may be excessive if a supplier can file for its actual GFFC plus 20% and also retain all market revenues.
- The ISO's alternative proposal (which would allow suppliers to file for actual GFFC with no adder and retain market revenues) does not explicitly account for potential costs associated with needed capital additions. FERC has specifically noted that the ISO failed to address this issue in prior CPM proposals.
- While the ISO will seek to limit RMR contracts for avoiding resource retirements, the current process and proposed enhancements could still allow for units that have no intention of retiring to seek RMR compensation.
- The *pro forma* RMR contract allows supplier's discretion over the depreciation methodology used to calculate sunk costs eligible for recovery and return on investment. This could allow for excessive compensation and further enable toggling between market and cost-of-service based compensation.

The *Draft Final Proposal* indicates that the ISO will not address changes to the CPM pricing structure in this current proposal, but states that the ISO is committed to reassessing its soft offer cap in a separate stakeholder process in 2019.[3] Given the important and controversial nature of this issue, DMM encourages the ISO to not delay working on this effort with stakeholders and to keep stakeholders engaged by holding working groups to discuss potential cost studies and alternative pricing frameworks for annual CPM designations.

The *Draft Final Proposal* also states that the ISO will not subject retirement notifications to an economic assessment, citing FERC's 2011 Order on the ISO's risk of retirement (ROR) provisions.[4] Language relating to such economic assessment currently exists in Tariff Section 43A[5] and the Reliability Requirements BPM.[6] These tariff and BPM sections require a resource owner of a unit at risk of retirement to submit an affidavit and supporting financial information to the ISO and DMM which attest and demonstrate a unit is uneconomic absent ISO procurement.

In stakeholder meetings, the ISO indicated that it plans to remove this tariff and BPM language. The ISO proposes to merge ROR provisions under the RMR framework. Therefore DMM encourages the ISO to maintain, at minimum, the current ROR provision that the resource owner attest it will be uneconomic for its resource to remain in service in the upcoming RA Compliance Year absent procurement by the ISO or other entity. This is needed to help deter

[3] *Draft Final Proposal*, p. 43.

[4] *Draft Final Proposal*, p. 17.

[5] Tariff Section 43A.2.6 (5): http://www.caiso.com/Documents/Section43A_CapacityProcurementMechanism_asof_Mar16_2018.pdf

[6] *BPM for Reliability Requirements,* Section 12.6.4.

units that should not retire due to economics but are needed for reliability from seeking RMR compensation.

The remaining sections of these comments provide more detailed comments on these and other issues.

II. CPM compensation

DMM supports the ISO's proposal to change any CPM compensation at prices above the soft offer cap to a structure based on GFFC instead of using Schedule F of the Pro Forma RMR contract. However, the ISO's proposal still does not address some key concerns about CPM compensation.

Soft offer cap for annual CPMs

The ISO's proposal does not address concerns that the soft offer cap may be too high when used as compensation for annual CPMs. In its 2015 CPM filing, the ISO explained that the current soft cap approach is a simple approach that was reasonable under the premise that CPM would be *rarely used* and would typically be used for *shorter periods*:

> The approach adopted in the Offer of Settlement recognizes that the CAISO rarely uses CPM and that, under such circumstances, a simpler approach that avoids complex market power mitigation measures and avoids litigation is a more prudent and reasonable approach….[7]
>
> This will promote efficiency and eliminate burdens associated with developing and establishing proceedings to set prices for individual resources in connection with a mechanism that is rarely used and, when used, typically only results in designations for short periods.[8]

The ISO issued annual CPMs to three resources for 2018.[9] DMM believes it is important and timely for the ISO to reassess its soft offer cap for annual CPMs. The current soft offer cap was justified under the assumption that use of CPM would be infrequent, and even less frequent for annual CPMs. There is some evidence and concern that these assumptions may no longer hold.

Competitiveness of CPM solicitations

Stakeholders have raised concerns that CPM solicitations, particularly annual CPM solicitations, are not competitive.[10] These concerns are based in part on the fact that prices for most CPM

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[7] *Tariff Amendment and Offer of Settlement Regarding Capacity Procurement Mechanism Revisions and Request for Waiver of Notice Requirement,* California ISO, ER15-1783, May 26, 2015, p. 17: http://www.caiso.com/Documents/May26_2015_TariffAmendment_CapacityProcurementMechanism_Revisions_ER15-1783.pdf

[8] Id., p.20.

[9] *December 22, 2017 Year Ahead Local CPM Designation Report*, California ISO: https://www.caiso.com/Documents/December222017YearAheadLocalCPMDesignationReport.pdf

[10] *Comments on RMR and CPM Enhancements Revised Straw Proposal*, SCE, October 23, 2018, p.2:

selections made by the ISO have cleared at or close to the soft offer cap.[11] A lack of competition – coupled with a soft offer cap that is too high for annual CPMs – raises concern that the CPM soft offer cap for annual CPMs is not an effective form of market power mitigation.

DMM encourages the ISO to reassess its soft offer cap for annual CPMs, and to consider suggestions to apply a market power test to CPM solicitations. While the ISO states it will not address the issue of changes to the CPM pricing structure in its current initiative, the ISO has committed to reassess the soft offer cap in a separate stakeholder process in 2019.[12] Given the important and controversial nature of this issue, DMM encourages the ISO not to delay working on this effort with stakeholders and to keep stakeholders actively engaged by holding working groups to discuss potential cost studies and alternative pricing frameworks for annual CPM designations.

Cost filings above the soft offer cap

DMM supports changing cost recovery above the soft offer cap to a structure based on GFFC. However, the *Draft Final Proposal* would allow suppliers to file for recovery of their actual GFFC *plus* 20% and also retain all net market revenues. The may allow for excessive cost recovery.

The ISO contends that the 20% adder is justified by prior FERC direction and is necessary to allow for some contribution to additional fixed costs. However, FERC's reasoning for rejecting the ISO's 2010 soft offer cap proposal ($55/kW-year, based on a reference unit's GFFC plus a 10% adder) was that the ISO simply had not *demonstrated* or *explained* how the proposed methodology would provide sufficient revenues for several specific types of costs or scenarios not directly addressed in the ISO's proposal. As FERC explained:

> …we find that CAISO has failed to demonstrate that the proposed long-term, fixed price CPM, which is based on a resource's going-forward costs plus a 10 percent adder, is just and reasonable compensation for the capacity procured to maintain reliable operations, and find that it may be unjust and unreasonable …..[13]
>
> CAISO, in this filing, has not explained how the use of going-forward costs for CPM compensation will provide incentives or revenue sufficiency for resources to perform long-term maintenance or make improvements that may be necessary to satisfy new environmental requirements or address reliability needs associated with renewable resource integration …[14]

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http://www.caiso.com/Documents/SCEComments-ReliabilityMust-RunandCapacityProcurementMechanismEnhancements-RevisedStrawProposal.pdf

[11] *December 22, 2017 Year Ahead Local CPM Designation Report*

[12] *Draft Final Proposal*, p. 43.

[13] *Order on tariff revisions,* 134 FERC ¶ 61,211, Docket No. ER11-2256, March 11, 2011, p. 19: https://www.ferc.gov/whats-new/comm-meet/2011/031711/E-12.pdf

[14] Id., p. 20.

Based on these findings, DMM does not believe that an adder less than 20% is inconsistent with prior FERC orders and guidance. The ISO has not yet sought to analyze or demonstrate in any FERC filing that a lower 10% adder plus net market revenues received by CPM units would be sufficient to contribute to the type of additional fixed costs or plant upgrades cited by FERC. In addition, DMM notes that the 2010 FERC ruling cited by the ISO applied to the market-wide soft offer cap, and did not apply to resource-specific cost filings above the soft offer cap.

If the CPM process was competitive, suppliers would be expected to submit bids reflecting their GFFC *net* of projected market revenues, plus a reasonable profit. Instead, the ISO's primary proposal would allow suppliers to recover full GFFC *plus* 20% and also retain net market revenues. This may represent excessive compensation for units with locational market power.

Alternative proposal without 20% adder

The ISO proposes to also file an alternative framework for CPM compensation above the soft offer cap which would be based on a resource's GFFC *without* a 20% adder. While net market revenues may provide sufficient contribution to additional fixed costs for certain resources, under the alternative proposal there is no explicit contribution for the types of costs cited by FERC in its 2010 order (i.e. long term maintenance or environmental upgrades).

DMM recommends that instead of assigning an arbitrary percentage adder to GFFC (i.e. 20% as in the ISO's primary proposal) or allowing no adder at all (as in the alternative proposal), the ISO could allow suppliers seeking compensation above the soft offer cap to explicitly file for actual costs associated with long term maintenance or environmental upgrades. DMM believes such additional fixed costs are in practice a form of going forward costs and could be included in a supplier's resource-specific cost filing. Including necessary capital costs in a resource-specific cost filing would prevent resource-specific compensation above the soft offer cap from either being too high or too low.

III. Resources choosing CPM or RMR compensation

Under the *Draft Final Proposal* the ISO will continue to maintain two backstop procurement frameworks, but clarifies that CPM will be used as a backstop to the RA program and the RMR mechanism will be used to address resource retirements. The ISO has outlined a *process* for determining when CPM versus RMR should be used. But continuing to offer two backstop procurement mechanisms with distinct compensation schemes may not prevent pivotal resources (with locational market power) from self-selecting backstop designations based on their preferred compensation. This section discusses issues and potential solutions.

Merging CPM and RMR into a single backstop procurement mechanism

CPM designations will continue to be voluntary and can be declined by suppliers with market power that prefer RMR compensation. DMM shares concerns raised by other stakeholders that under the current and proposed framework, newer pivotal resources with undepreciated capital costs would have an incentive to self-select RMR compensation while older pivotal resources would prefer to self-select CPM compensation. It is not clear what efficiencies this self-selection provides.

A compensation structure based on GFFC plus a reasonable net profit would provide fair compensation to resources contracted for backstop capacity. If a unit needed for reliability would truly retire or mothball if not contracted by the ISO, then compensating the unit based on its GFFC plus any additional net profit would be more profitable for the unit than if it was actually retired or mothballed. GFFC-based compensation also avoids market distortions that may incent resources to seek a backstop capacity contract rather than participating in the RA process.

Paying cost-of-service, defined as a resource's Annual Fixed Revenue Requirement (AFRR), compensates resources with market power for sunk costs and can therefore send inefficient investment signals for longer term substitutes. Specifically, paying a required resource AFRR can create the incentive to build new supply or transmission capacity whose annualized costs would be greater than the existing resource's GFFC but less than the existing resource's AFRR. Investing in the new capacity would be inefficient relative to only incurring the GFFC of the existing resource. DMM provided an example of how providing compensation based on AFFR would encourage uneconomic and inefficient investments in alternatives using approximate values for AFRR and GFFC for the Metcalf Energy Center, which received an RMR designation for 2018.[15]

In the ISO's future discussions of the backstop procurement framework, the ISO should consider consolidating CPM and RMR or at the very least, aligning CPM and RMR compensation and adding supplemental rules to prevent self-selection between designations based on maximization of compensation.

Limiting RMR to units seeking retirement

Since the ISO proposes to retain both CPM and RMR backstop mechanisms, DMM recommends further clarification of when CPM versus RMR should be used. DMM supports the ISO's proposal to require an officer-signed affidavit when a retirement notice is submitted to the ISO. However, because two distinct payment structures would continue to exist under the ISO's proposal, it may be necessary to add provisions around the RMR process to ensure the RMR process is only used when a resource is legitimately seeking retirement.

The *Draft Final Proposal* indicates the ISO will not subject retirement notifications to an economic assessment, citing FERC's 2011 Order on the ISO's risk of retirement (ROR)

[15] *Motion to Intervene and Protest of the Department of Market Monitoring of the California Independent System Operator*, ER-641-000, February 2, 2018, pp. 10-11. http://www.caiso.com/Documents/Feb2_2018_DMMIntervention_Protest-RORCPM_ER18-641.pdf

provisions.[16] Language relating to such economic assessment currently exists in Tariff Section 43A[17] and the Reliability Requirements BPM.[18] These tariff and BPM sections require a resource owner of a unit at risk of retirement to submit an affidavit and supporting financial information to the ISO and DMM which attest and demonstrate a unit is uneconomic absent ISO procurement.

In stakeholder meetings, the ISO indicated that it plans to remove this tariff and BPM language. The ISO proposes to merge ROR provisions under the RMR framework. Therefore DMM encourages the ISO to maintain, at minimum, the current ROR provision that the resource owner attest it will be uneconomic for its resource to remain in service in the upcoming RA Compliance Year absent procurement by the ISO or other entity. This is needed to help deter units that should not retire due to economics but are needed for reliability from seeking RMR compensation.

FERC's 2011 Order rejecting the ISO's proposal to conduct financial assessments of resources requesting CPM ROR designations states the following:

> Further, we note that CAISO proposes to require an affidavit stating that it will be uneconomic for the unit to remain in service in the current year and committing to retire the unit if a CPM designation is not offered. Based on the fact that a market participant is prohibited from submitting false or misleading information to CAISO, the affidavit should be sufficient to establish that a resource cannot continue to operate economically. If the Department of Market Monitoring has reason to suspect that a resource submitted false, inaccurate, or otherwise misleading information in its affidavit, the CAISO tariff requires such a suspected violation to be referred to the Commission for appropriate sanction. Thus, we find CAISO's proposal to conduct financial assessments of resources requesting risk of retirement CPM designations to be unjust and unreasonable and hereby reject it.[19]

Thus, FERC rejected the ISO's proposal to conduct financial assessments of units seeking retirement because the ROR affidavit would require an attestation that the resource is uneconomic to remain in service absent ISO procurement. FERC notes that DMM could then refer entities to FERC if the information submitted in an affidavit was suspected to be misleading. Therefore, in the absence of requiring that suppliers submit financial information to the ISO and DMM under the RMR-CPM policy, DMM believes the ISO should apply requirements applicable to the ROR affidavit to its proposed retirement affidavit and require that suppliers attest resources would be uneconomic to remain in service absent procurement by the ISO or other entity.

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[16] *Draft Final Proposal*, p. 17.

[17] Tariff Section 43A.2.6 (5): http://www.caiso.com/Documents/Section43A_CapacityProcurementMechanism_asof_Mar16_2018.pdf

[18] *BPM for Reliability Requirements,* Section 12.6.4.

[19] *Order on tariff revisions,* 134 FERC ¶ 61,211, Docket No. ER11-2256, March 11, 2011, P.46

Limiting discretion over RMR depreciation methodology

DMM continues to encourage the ISO to consider aligning CPM and RMR compensation. But if the ISO proceeds with separate CPM and RMR compensation, the ISO should refine its RMR compensation. In particular, the ISO should reduce the amount of discretion that resource owners have in selecting the depreciation method that will be used for RMR compensation. The more discretion that resource owners have in choosing the depreciation method used for a resource's cost-of-service RMR compensation, the more likely it will be for resource owners to threaten retirement and to seek RMR compensation rather than signing a resource adequacy contract or accepting CPM compensation.

The depreciation method that a resource owner uses in its calculation of a resource's value can have a very significant impact on that calculation. A recent recipient of RMR contracts in CAISO highlighted this fact:

> Determination of the appropriate depreciation method, proper useful lives and salvage values involves significant judgment, estimates, assumptions and historical experience. Changes in our estimates and methods can result in a significant change in the amounts and timing of when we recognize depreciation expense and therefore significantly affect our financial condition and results of operations from period to period. Different depreciation methods can affect the timing and amount of depreciation expense affecting our results of operations and could result in different net book values of assets at a particular time during the useful life of the asset affecting our financial position.[20]

DMM recognizes that defining the depreciation method, useful life and salvage value that each resource should use for RMR compensation could be complicated. However, the ISO should consider refining its RMR policy to at least prevent resources from choosing one depreciation method and set of input parameters for tax filings or financial statements and then choosing a different method and input parameters to maximize RMR compensation.

[20] *Calpine 2016 Annual Report*, Calpine Corporation, p. 77: http://www.annualreports.com/HostedData/AnnualReportArchive/c/NYSE_CPN_2016.pdf