Review of Reliability Must-Run and Capacity Procurement Mechanism

Draft Final Proposal for Phase 1 Items and
Items under Consideration for Phase 2

Comments by Department of Market Monitoring
April 11, 2018

DMM appreciates the opportunity to comment on the ISO's *Draft Final Proposal - Review of Reliability Must-Run and Capacity Procurement Mechanism* published on March 13, 2018.

Comments on Phase 1

The ISO's Review of Reliability Must-Run and Capacity Procurement Mechanism initiative ("Review of RMR & CPM") phase 1 proposes requiring that reliability must-run ("RMR") units have a must-offer obligation. DMM supports a must-offer obligation for all RMR units.

DMM discussed the benefits of a must-offer obligation for RMR units in November 2017 comments on FERC docket ER18-240, stating:

> The limits on market participation by Condition 2 units are economically inefficient, distort overall market prices, undermine the CAISO's automated market power mitigation procedures, and are unjust and unreasonable for consumers. To ensure mitigation of local market power and avoid artificial inflation of overall market prices, the limits on market participation by Condition 2 units must be removed and a must offer requirement must be established for all units under both Condition 1 and Condition 2 of the CAISO's RMR tariff and contract provisions.[1]

Obligating an RMR units' Scheduling Coordinator to submit bids (as proposed in this initiative by the ISO) is a major improvement to the ISO's RMR policy and will achieve the economic efficiency and market benefits described above.

Comments on Phase 2

The second phase of this initiative has a larger scope and longer timeline. The ISO is currently finalizing the agenda items for phase 2. It is critical that the ISO address RMR compensation in phase 2.

RMR compensation currently allows RMR units a return on what the ISO calls the "full fixed cost of service" (i.e., sunk capital costs minus depreciation). DMM believes that compensating a resource based on its full sunk capital costs (after depreciation) is unjust and unreasonable.

[1] *Motion to Intervene and Protest of the Department of Market Monitoring of the California Independent System Operator Corporation*, FERC Docket ER18-240, November 22, 2017, pp. 1-2: http://www.caiso.com/Documents/Nov22_2017_DMMMotion_Intervene_ProtestMetcalfEnergyCenterRMRAgreement_ER18-240.pdf

Review of FERC Rulings and ISO Filings

The ISO contends that FERC requires compensation at "full fixed cost of service" value.[2] This is not correct. FERC has ordered that some fixed cost recovery is reasonable, but has left room for RTO/ISOs to negotiate an appropriate RMR rate somewhere between going forward fixed costs and full fixed cost of service. In a 2015 NYISO RMR tariff filing FERC stated, "[c]ompensation to an RMR generator must at a minimum allow for the recovery of the generator's going-forward costs, with parties having the flexibility to negotiate a cost-based rate up to the generator's full cost of service."[3]

In 2011, the Commission did not approve a CPM filing by the CAISO based in part on concerns that basing compensation on "going forward costs may create the potential for distorted pricing signals and deny resources a reasonable opportunity to recover fixed costs" and that the CAISO did not explain "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."[4]

In a subsequent 2015 tariff filing and Offer of Settlement, the CAISO proposed increasing compensation for CPM resources through a "soft cap" based on an updated estimate of going forward fixed costs of a typical unit plus a 20 percent adder. As explained in the CAISO's 2015 filing:

> […] the CAISO will procure backstop capacity through a competitive solicitation process and pay designated resources their bid price. A soft offer cap will apply to all offers into a competitive solicitation. The soft offer cap is based on the estimated levelized going-forward fixed costs of a merchant-constructed, mid-cost, 550 MW combined cycle unit with duct firing, as reflected in a cost study conducted by the California Energy Commission, plus a 20 percent adder.

Although the CPM soft cap is explicitly based on GFFC (plus a higher 20 percent adder), the CAISO's 2015 tariff amendment and offer of settlement also changed the basis for cost justification (for compensation in excess of this soft cap) from GFFC to the AFRR calculation used for RMR condition 2 units. As noted in the 2015 filing:

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[2] In the ISO's Risk of Retirement Capacity Procurement Mechanism proceeding at FERC, the ISO States:

> They [the protesters] also ignore Commission precedent that compensation for any mandatory backstop designation – which, under the CAISO's proposal, would include ROR CPM designations – must be based on a resource's full fixed costs, not its going forward fixed costs.

FERC Docket ER18-641, February 2, 2018, p. 15: https://elibrary.ferc.gov/IDMWS/common/opennat.asp?fileID=14814948

[3] *Order Instituting Section 206 Proceeding and Directing Filing to Establish Reliability Must Run Tariff Provisions*, FERC Docket EL15-37, 150 FERC ¶ 61,116, February 19, 2015, p. 17: https://www.ferc.gov/whats-new/commmeet/2015/021915/E-8.pdf

[4] *Order on tariff revision re California Independent System Operator Corporation*, FERC Docket ER11-2256, p.20 (FERC 2011 CPM Order): https://elibrary.ferc.gov/IDMWS/common/opennat.asp?fileID=12589782

> Resources have the option to make a filing with the Commission to cost justify a price higher than the soft offer cap based on the formula applicable to Reliability Must Run Resources. These pricing provisions [i.e. the higher soft offer cap and opportunity to justify costs in excess of this cap based on AFRR] respond to the Commission's guidance to provide enhanced fixed cost recovery opportunities to CPM resources.[5]

The CAISO's 2015 filing went on to explain that:

> This CPM Soft Offer Cap adopted in the Offer of Settlement is just and reasonable, in the public interest, and a necessary complement to the competitive solicitation processes. Combined with the opportunity to make a resource-specific cost filing that can take into account all fixed costs (not just going-forward fixed costs), it is simultaneously *high enough* to ensure contributions to fixed cost recovery and *low enough* to provide appropriate market power mitigation.[6]

When approving the CAISO's proposed soft cap for CPM compensation later in 2015, the Commission specifically found that:

> CAISO's proposal to implement a soft offer cap of $6.31/kW-month ($75.68/kW-year), plus a 20 percent adder should allow sufficient recovery of fixed costs plus return on capital to facilitate incremental upgrades and improvements by resources. Further, because the soft offer cap represents the high end of the range of current resource adequacy prices, it should not create incentives for load serving entities to forego bilateral resource adequacy contracts and, instead, rely on CPM backstop procurement.

The Commission's 2015 Order did not indicate that providing guaranteed recovery of sunk fixed costs plus a return on investment was needed to address the Commission's prior concerns. Thus, DMM believes the CAISO's CPM and RMR provisions can and should be modified based on the key market design principle that resources with market power should be mitigated based on going forward fixed cost. If needed, specific targeted provisions can be added to CPM and RMR provisions to address the Commissions prior concerns about setting cost-based compensation high enough to ensure proper long-term maintenance and incremental upgrades may be needed to "satisfy new environmental requirements or address reliability needs associated with renewable resource integration."[7]

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[5] *Tariff Amendment and Offer of Settlement Regarding Capacity Procurement Mechanism Revisions and Request for Waiver of Notice Requirement,* California Independent System Operator Corporation, FERC Docket No. ER15-1783, May 26, 2015, transmittal letter, p. 2: https://elibrary.ferc.gov/idmws/common/opennat.asp?fileID=13885675

[6] Id., p.16.

[7] FERC 2011 CPM Order, p. 20.

Other Issues to Address in Phase 2

In addition to RMR compensation, DMM's comments to FERC on the Metcalf Energy Center RMR described several other existing issues with CPM and RMR policy. DMM strongly encourages the ISO to address each of these issues in Phase 2 of the initiative:

- The timeline of the resource adequacy program and the Capacity Procurement Mechanism process should be moved back to accommodate the actual timeline needed to make decisions about resource retirements and potential alternatives for meeting local needs.[8]
- The CAISO's first option for procuring additional capacity needed to meet reliability requirements – the capacity procurement mechanism – is voluntary and can be declined by suppliers with local market power. This could undermine the capacity procurement mechanism if suppliers view RMR compensation to be more favorable than capacity procurement mechanism compensation.[9]

[8] DMM Motion under ER18-240, p. 8.

[9] DMM Motion under ER18-240, p. 8.