August 7, 2018

COMMENTS OF THE CITIES OF ANAHEIM, AZUSA, BANNING, COLTON, PASADENA, AND RIVERSIDE, CALIFORNIA ON THE REVIEW OF RELIABILITY MUST RUN AND CAPACITY PROCUREMENT MECHANISM STRAW PROPOSAL

In response to the ISO's request, the Cities of Anaheim, Azusa, Banning, Colton, Pasadena, and Riverside, California (collectively, the "Six Cities") provide their comments on the June 26, 2018 Review of Reliability Must Run ("RMR") and Capacity Procurement Mechanism ("CPM") Straw Proposal (the "Straw Proposal"):

The Six Cities generally support the Straw Proposal and specifically support the ISO's proposals to –

a) Revise the CPM pricing formula for resources that file at FERC for a CPM price above the CPM soft-offer cap to base compensation on the Going Forward Fixed Costs ("GFFCs") of the resource using the same cost categories and same cost adder used for the CPM reference unit and allowing the resource to keep market revenues earned (Straw Proposal at 17, 19);

b) Delete from the CPM tariff provisions ISO authority to offer a CPM designation for a resource at risk of retirement and add to the RMR tariff provisions authority for the ISO to make RMR designations for needs anticipated during up to three years (Straw Proposal at 17 – 20);

c) Make RMR designations only for needed resources that have notified the ISO of plans for retirement (Straw Proposal at 17 – 18);

d) Provide authority for the ISO to make RMR designations and to dispatch RMR resources for system and flexible needs as well as for local needs (Straw Proposal at 18);

e) Apply both a Must Offer Obligation ("MOO") and the Resource Adequacy Availability Incentive Mechanism ("RAAIM") to all CPM and RMR resources (Straw Proposal at 17 – 18, 25 – 27); the MOO and RAAIM provisions should apply to any and all products that CPM and RMR resources are capable of supplying;

f) Provide in the RMR *pro forma* agreement a default compensation mechanism under which RMR resources will be paid for their costs of service (including an allowed rate of return on capital based on net plant and potentially including major maintenance expenses), with any market revenues earned above the cost of service credited against monthly fixed costs, but with discretion for the ISO to negotiate in appropriate circumstances a compensation arrangement under which an RMR owner would be paid less than its full cost of service and be permitted to retain market revenues earned above its cost of service (Straw Proposal at 17 – 18);

g) Update the allowed return on capital in the RMR *pro forma* agreement (Straw Proposal at 18, 23); the Six Cities discuss below their recommendations regarding the appropriate mechanism for updating the allowed cost of capital under the RMR *pro forma* agreement; and

h) Allocate Flexible RA credits from RMR designations (Straw Proposal at 27 – 28).

With respect to the methodology for updating the allowed cost of capital under the *pro forma* RMR agreement, the Six Cities support the ISO's proposal to update the allowed rate of return on capital for RMR compensation. As the ISO acknowledges, the current rate was established a number of years ago, and it has not been updated to reflect current capital market conditions.

At this time, the Six Cities are not advocating for a specific methodology or approach to updating the rate of return on capital,[1] but provide for consideration by the ISO and other stakeholders several general principles that should apply in the context of establishing a methodology to update the rate.

First, FERC policy should apply to the derivation of the rate of return on capital. Based on current policy, the rate of return on capital should be determined based on application of the two-stage discounted cash flow ("DCF") methodology. For individual utilities of average risk, FERC has previously ruled that the median point estimate of the DCF range should establish the rate. If the same rate of return on capital will be applicable to multiple companies within the same RTO or ISO, FERC policy has been that the midpoint of the DCF range should set the ROE. DCF results vary depending on the risk profile of a particular utility and the time period being evaluated.

Second, it is not appropriate to apply incentives, adders, or other approaches to increase the return on capital as suggested in the Straw Proposal (*see, e.g.*, Straw Proposal at 23, 24) to compensate resource owners for any special risks, such as status as an RMR resource. Such adders are unwarranted given that the RMR construct provides for full compensation to resource owners based on their costs, plus a reasonable return. No party has demonstrated that there are any special risks associated with RMR status for which an increase to the DCF-determined rate of return on capital is appropriate. Similarly, there is no basis for providing an increase in the rate of return on capital associated with an RMR resource's geographic location within the ISO Balancing Authority Area. The Six Cities also do not support application of an ISO/RTO membership adder to the rate of return on capital for RMR resources, nor do the Six Cities support increasing the rate of return based on claims of anomalous capital market conditions.

Third, the ISO should recognize that, while FERC does have a methodology that has been historically used to establish rates of return on equity, and the Six Cities support primary reliance on that methodology to set the rate of return for RMR resources, the application of that

[1] For the cost of debt component of the rate of return, the Six Cities support the use of the actual cost of debt for the resource's parent company.

methodology is not without controversy. Different parties interpret and apply the FERC DCF methodology in different ways. For this reason, FERC-authorized rates of return on equity for ISO Participating TOs are often determined through settlement agreements. For utilities that do not have formula rates, TRRs established through settlements often are expressed on a "black box" basis and do not specify an ROE component. For utilities that do have formula rates, the rate of return on equity is generally the product of settlement discussions and may reflect an increase or a decrease over the median or midpoint of DCF results, depending on various considerations during the settlement process. Thus, at least with respect to FERC-jurisdictional rates of return on equity, it is not accurate to state that "the investor owned utilities … have documented methodologies to complete such calculations." (*See* Straw Proposal at 23.)

In the absence of stakeholder consensus around a particular methodology for updating the rate of return on capital, requiring RMR resource owners to propose, support, and submit their proposed rate of return on capital to FERC for approval would likely prove to be the most workable solution to this issue. However, the Six Cities are open to consideration of alternatives that would produce just and reasonable rates for RMR service, and look forward to continued discussions among stakeholders related to the relevant rate of return on capital.

Regarding the process for completion of this stakeholder initiative, on which the ISO requests input at page 8 of the Straw Proposal, the Six Cities do not see a need at this time to deviate from the process followed generally in the ISO's stakeholder initiatives. It is not clear at this point whether the ISO's recommendations in the Straw Proposal will be unusually contentious or difficult to resolve through the customary stakeholder process, including with respect to the rate of return on capital. If comments submitted on the Straw Proposal reveal an unusually high level of controversy, it may be appropriate to consider whether some alternative process could be more efficient or constructive, but it seems premature to consider modifications to the generally applicable stakeholder process at this time.

Submitted by,

Bonnie S. Blair
Margaret E. McNaul
Thompson Coburn LLP
1909 K Street N.W., Suite 600
Washington, D.C. 20006-1167
bblair@thompsoncoburn.com
202-585-6905

Attorneys for the Cities of Anaheim, Azusa, Banning, Colton, Pasadena, and Riverside, California