

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

**California Independent System
Operator Corporation**

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Docket No. ER11-2256-000

**MOTION FOR LEAVE TO INTERVENE AND PROTEST
OF THE ELECTRIC POWER SUPPLY ASSOCIATION**

Pursuant to Rules 211, 212 and 214 of the Rules of Practice and Procedure of the Federal Energy Regulatory Commission (“FERC” or “Commission”), 18 C.F.R. §§385.211, 385.212 & 385.214 (2010), the Electric Power Supply Association (“EPSA”)¹ respectfully files for leave to intervene and protest in the above-captioned proceeding. On December 1, 2010, the California Independent System Operator Corporation (“CAISO”) filed proposed tariff amendments to make the Capacity Procurement Mechanism (“CPM”) a permanent part of its tariff.² CAISO’s December 1 Filing seeks to replace the Interim Capacity Procurement Mechanism (“ICPM”), currently scheduled to sunset on March 31, 2011, without addressing many of the flaws that the Commission cited in its order accepting the ICPM in 2008.³

I. INTRODUCTION

It is no secret that capacity revenues are necessary to adequately compensate generators in mitigated energy markets. The need for reinvestment

¹ The comments contained in this filing represent the position of EPSA as an organization, but not necessarily the views of any particular member with respect to any issue.

² *California Independent System Operator Corporation Update to Capacity Procurement Mechanism and Exceptional Dispatch*, Docket No. ER11-2256-000 (December 1, 2010). (“CAISO December 1 Filing”)

³ *Cal. Indep. Sys. Operator Corp.*, 125 FERC ¶ 61,053 at P 41 (2008) (“ICPM Order”).

in new and existing generation is particularly acute in California, where ambitious new renewable energy integration goals, new environmental regulations and certain aging generation assets make sending proper price signals critical to the long-term reliability of the grid. The need to retain and improve flexible thermal resources is particularly important in allowing California to be a leader in integrating renewable generation without sacrificing reliability.

California thus needs a robust and effective resource adequacy program to ensure needed generation and demand response resources are available to meet California's reliability needs. Unfortunately, the current and proposed capacity constructs in California fall far short of what is needed or effective. The instant proposal to basically extend the ICPM into permanence is untenable. Not only will it fail to provide just and reasonable compensation to units being used as backstop capacity but it will also send no price signals to potential new market entrants, demand response resources or owners of existing resources about where to invest increasingly scarce financial resources.

Circumstances have also materially changed since the Commission approved ICPM in 2008. In addition to California's ambitious renewable generation targets, the California Public Utilities Commission ("CPUC") recently terminated its attempt to enact a forward capacity market or make significant improvements to its Resource Adequacy ("RA") program. This failure of leadership means the CAISO's backstop capacity procurement program is effectively the only FERC-jurisdictional means of (1) ensuring that sufficient resources are available to reliably operate the grid; (2) providing investment signals to existing and new resources (including demand responders); and (3)

providing sufficient compensation for resources committed by the CAISO that are needed to maintain the reliable operation of the system.

The CAISO proposes that its permanent capacity procurement authority will now consist of two elements: (1) bilateral contracting requirements for LSEs as directed by the CPUC; and, (2) the instant proposal, which will act as a backstop should the LSEs fail to procure the necessary capacity or will result in the CAISO relying upon resources that were not procured as part of the current RA program. This means that the CAISO will have no jurisdictional means of sending locational price signals, no means of incenting incremental capital investment to meet once-through-cooling environmental and other environmental rules, and effectively no means of ensuring system adequacy beyond the year-ahead time frame (with the exception of a narrowly tailored, deeply flawed and voluntary program for generators at risk of retirement).

The instant proposal must be modified so that it provides a comprehensive backstop to the existing state RA program. This should include incentives for LSEs to contract sufficiently, and should properly compensate resources needed for reliability but not procured under the existing RA program. For example, while California's capacity construct most closely mirrors that of the Midwest Independent System Operator ("MISO"), MISO bases its monthly backstop capacity penalty on the annual Cost of New Entry ("CONE"). That is, an LSE is subject to a deficiency payment equal to one year of CONE for each month that it does not contract with sufficient resources to meet MISO's operational needs. In fact, CONE is part of the design basis in every other organized market with a capacity construct in the country. Similarly, the use of CONE as a base for CPM

compensation should be mandated to allow the program to achieve appropriate price signals and provide reasonable compensation for resources relied upon to maintain reliability of the CAISO system.

Finally, the CAISO's proposal does not address two of the most egregious flaws in the existing ICPM program – that is: (1) the ability of the CAISO to rely on a generating resource's full capacity, while only paying for the minimum load portion of the resource's capacity; and, (2) providing only a month of capacity payments, despite the indivisible nature of a resource's annual costs, and the fact that the CPUC RA program acquires virtually all of its capacity for a full year.⁴

II. MOTION TO INTERVENE & COMMUNICATIONS

EPSA is the national trade association representing competitive power suppliers, including generators and marketers. These suppliers, who account for 40 percent of the installed generating capacity in the United States, provide reliable and competitively priced electricity from environmentally responsible facilities. EPSA seeks to bring the benefits of competition to all power customers.

Many of EPSA's members are interconnected with and/or are pursuing interconnection to the grid in California, and as such represent a significant portion of the supply capacity in that region. EPSA members have been active participants in CAISO's stakeholder processes and EPSA has participated in many of the Commission's proceedings on CAISO issues. EPSA also

⁴ Specifically, the CPUC program requires LSEs to acquire 100 percent of all local RA needs on an annual, year-ahead, basis, and 90 percent of system RA on an annual, year-ahead, basis.

participated in several other proceedings across the country that involved capacity procurement. As a result, EPSA has a direct and substantial interest in the instant proceeding that cannot be adequately represented by any other party, and allowing EPSA to actively participate in this proceeding would be in the public interest. Accordingly, EPSA respectfully requests that the Commission grant this timely motion to intervene.

All pleadings, correspondence and other communications concerning this proceeding should be directed to:

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III. PROTEST

A. Forward Capacity Markets, Resource Adequacy Constructs and CONE.

Any permanent CAISO backstop capacity mechanism must effectively fill in the holes in the existing RA construct until the CPUC implements a program that renders the CPM superfluous. Unfortunately, the CPM backstop proposal does not provide the CAISO with a comprehensive method for ensuring that the RA program is procuring sufficient resources to meet the reliability needs of the CAISO system, or, of fixing deficiencies that may result from the limited year-ahead and location-neutral nature of the CPUC's program.

The very goals of a capacity procurement construct warrant reliance on CONE-based pricing. Currently, an LSE has the perverse economic incentive not to contract with a hypothetical resource needed for local reliability if the price

exceeds the CAISO's anemic \$55/kW-month backstop procurement price. Further, a CONE-based compensation system is the only accepted Commission-jurisdictional means of ensuring that capacity suppliers have a reasonable opportunity to recover their fixed costs in a heavily mitigated energy market.

The need for effective price signals is particularly acute in California, with the most aggressive renewable standards in the country and tough new once-through cooling rules that put 20 gigawatts of coastal gas-fired generation in California in danger of retirement.

i. The Goals of Capacity Markets & RA Programs

Due to market mitigation mechanisms and other ways in which markets mitigate market energy price volatility, the Commission has long recognized that generators generally do not earn sufficient revenues to recover the fixed costs of building new plants.⁵ Thus, administratively determined resource adequacy structures are put in place to ensure that capacity needs are fulfilled and correct price signals are reaching investors. Whether an ISO has a formal capacity auction mechanism in place or utilizes a state-run RA program that requires bilateral contracting for capacity, the goals of both types of program remain the same. The two historical goals of any resource adequacy program have been: (1) to maintain future reliability of the system; and, (2) to attract the necessary amount of investment in new and existing resources necessary to do so.⁶

⁵ *Testimony of Joseph E. Bowring, Independent PJM Market Monitor at the Pennsylvania PUC Hearing on Current and Future Wholesale Electricity Markets.* (October 23, 2008), pp. 7-11. See also *Devon Power, LLC*, 103 FERC ¶ 61,082, P 31 (2003) (ordering location-specific capacity payments to allow generators “an adequate opportunity to recover their [fixed] costs ... so that energy markets alone are not the only way for suppliers ... to recover costs”).

⁶ See: *Devon Power, LLC*, 117 FERC ¶ 61,133 at P 116 (2006) (“The FCM, like LICAP, is designed to establish just and reasonable rates for capacity and stabilize those rates over time.”);

Several markets meet these stated goals by holding an auction that procures capacity on a multi-year forward basis in order to signal investment needs several years in advance. In New England, one of the first markets to institute a forward capacity market, that market evolved as a direct result of the Commission's concern that bilateral Reliability Must Run ("RMR") contracts would have a negative effect on competitive markets.⁷ In a December 2006 order approving PJM's RPM settlement, the Commission noted that it "must approve market designs and rate policies that elicit sufficient investment in energy, transmission and demand response," and stated the Commission approved the RPM settlement, with conditions, "because it achieves those goals, and ensures just and reasonable rates."⁸ The RPM settlement and subsequent approval by the Commission stemmed from an earlier finding by the Commission that, as a result of a combination of factors, PJM's market rules at that time were unjust and unreasonable because they failed to set prices adequate to ensure sufficient resources.⁹ New York ISO has also adopted a capacity market based on a demand curve.

The second and more rudimentary capacity construct is an RA plan, which asks LSEs to forecast and procure the necessary amount of capacity on a shorter-term basis than markets with forward capacity auctions. This construct

see also ISO New England Inc., 125 FERC ¶ 61,102 at P 43 (2008), *order on reh'g*, 130 FERC ¶ 61,089 (2010) ("The purpose of the New England FCM is to attract and retain sufficient capacity to maintain ISO-NE's Installed Capacity Requirement, and to do so, FCM capacity prices will need to average out over time to the cost of new entry.").

⁷ *Order denying complaint re Richard Blumenthal, Attorney General for the State of Connecticut*; 117 FERC ¶ 61,038 (October 11, 2010) at P 3.

⁸ *PJM Interconnection, L.L.C.*, Order Denying Rehearing and Approving Settlement Subject to Conditions, (December 22, 2006), 117 FERC ¶ 61,331 at P1.

⁹ *PJM Interconnection, L.L.C.*, (April 20, 2006), 115 FERC ¶ 61,079 at P 1-6.

requires a “backstop” or “financial incentive” to ensure that LSEs correctly forecast needs and procure the necessary quantity of resources in the right locations. MISO and CAISO both currently employ a bilateral RA capacity construct.¹⁰ In urging MISO to develop its RA construct (a.k.a. Module E), the Commission stated that “[r]esource adequacy is a crucial component of the Energy Markets that can help to ensure new resource development, market efficiency, and reliable operation of the transmission network.”¹¹ As such, since 2004 the Commission has repeatedly required MISO to develop a permanent long-term resource adequacy plan.¹² MISO’s Module E has now been in place for over a year and includes financial settlement provisions to be used if the LSE fails to procure the necessary capacity. Importantly, LSEs in MISO have significant financial incentives that ensure that the LSE procures the necessary level of resources. In fact, an LSE in MISO faces a deficiency payment of up to the annual cost of building a new peaking generator for *each month* in which the LSE remains deficient.

California’s RA initiative, like the program in MISO, is based on a state-mandated planning and procurement process, designed to ensure adequate resources to serve all customers in real time. The program rests on a planning reserve margin and imposes CPUC-developed requirements that each LSE must

¹⁰ In a December 8, 2010 filing, MISO noted that it is looking at moving to a forward capacity auction mechanism, much like the ones found in ISO-NE, NYISO and PJM. *Compliance Filing of the Midwest Independent Transmission System Operator, Inc. for a Plan to Incorporate Locational Capacity Market Mechanisms*; Docket No. ER08-394-024 (December 8, 2010).

¹¹ *Order Conditionally Accepting Midwest Independent Transmission System Operator Tariff Sheets to Start Energy Markets and Establishing Settlement Judge Procedures*, 108 FERC ¶ 61,163 (August 6, 2004), at P 397.

¹² *Ibid.*

meet. While there are serious problems with some of the CPUC's counting rules – including the ability to waive the necessary procurement level if the cost of the capacity exceeds an arbitrary pre-set level and the conflating of some constrained areas into a single zone – the CPUC does require LSEs to acquire 100 percent of their local RA and 90 percent of their system RA needs on an annual, year-ahead basis.

The problem is that the CAISO has proposed to slap deficient LSEs on the wrist by requiring them to pay the costs of a month-long, partial unit CPM designation at a rate that is only nominally higher than the \$40 kW-month waiver trigger currently utilized by the ISO. While the CAISO asserts that a \$55 kW-month backstop, with the inability to look forward more than a single year (except in limited circumstances), is sufficient, it provides no material support for its assertion. Thus, capacity suppliers in California are forced to protest the instant filing, and request that this Commission impose the necessary backstop procurement authority to ensure that the CAISO has the ability to procure the necessary resources to meet its system reliability obligations.

ii. CONE

The capacity auction procurement mechanisms described above send the right price signal to investors based on an administratively and regionally developed number that represents the CONE. CONE refers to the benchmark price to bring a peaking unit (typically the least expensive source of new capacity) to the market. If a system is short of capacity, CONE represents the cost of bringing a new resource into the market in time to meet the reliability

need. In most years, in most markets, where there is a considerable surplus of capacity, generators receive only a fraction of the actual CONE each year.

CONE is also critical to the proper functioning of markets with a bilateral resource adequacy program (like California). In a bilateral RA market, LSEs are required to procure a certain amount of capacity going forward to meet reliability needs. Any time the LSE's forecast falls short, additional capacity should be procured at a price based at, or even above, the administratively determined cost of building a new peaker. If that backstop capacity mechanism provides capacity or a penalty that is too inexpensive, LSEs will have no incentive to procure the correct amount of capacity in the first place, or contract with the necessary resources.

In short, the lack of a CONE-based backstop suppresses forward bilateral contracts, which in turn sends inadequate investment signals to developers or owners of existing generation resources in need of capital expenditures. Reliance on an RA program rather than a forward capacity mechanism does not obviate or diminish the need to base backstop requirements and compensation on the correct price signal, which is CONE.

iii. California's RA Program is Intended to Support and Incent Reliably Supply

California, in particular, has a clear need for a well-functioning, reliable resource adequacy program. With the fairly nascent MRTU market and the self-proclaimed "most ambitious" renewable portfolio standards in the country,¹³ along with aggressive new environmental regulations, the need for the ISO to send the proper investment signals and procure reliable capacity is fundamental.

¹³ See: <http://www.cpuc.ca.gov/PUC/energy/Renewables/index.htm>.

In the instant proceeding, CAISO claims that CPM has no effect on new investment decisions and should be considered independently of the need to incent new generation.¹⁴ This is a puzzling and unconvincing claim. EPSC agrees with past Commission precedent holding that the total market structure must be designed to achieve the goal of sending price signals and, thereby, ensuring system reliability. At the outset of the MRTU proceeding, the Commission recognized that no market element should be evaluated independently of the need to incent new entry and long-term resource adequacy goals. In 2003, the Commission stated:

The Commission believes that the various elements of a regional market should work well together to produce an efficient, well-functioning wholesale market for the benefit of customers over the long term. There are important inter-relationships among such wholesale market elements as the energy market design, the system for congestion management, resource adequacy provisions, and means for mitigating market power. Achieving an appropriate balance among these factors is critical to a well-functioning wholesale market. As part of this balance, market power mitigation should address market power concerns without undermining incentives for new entry and long-term resource adequacy.¹⁵

That same order further asserted:

Those designing elements of a regional market must assess how the various regional choices work together. [] Investment in new generation and other infrastructure is needed to keep supply and growing demand in balance. To invest in such infrastructure, investors must find that the combination of mitigation measures, resource adequacy provisions and scarcity pricing provisions taken together provide a reasonable opportunity to recover the costs of their investments....

For example, a region with little mitigation or mitigation that permits prices to rise quite high to reflect scarcity may not need to have a

¹⁴ CAISO December 1 Filing, p. 23.

¹⁵ California Independent System Operator Corporation, 105 FERC ¶ 61,140 (2003), at P 274.

strong administrative approach to resource adequacy. But a region with a low safety net bid cap and no scarcity pricing to hold demand in check is unlikely to have a market with prices that attract new supply, unless such a region also has an additional approach to resource adequacy that provides additional assurance of capital cost recovery for new investment in the region.¹⁶

CAISO claims that this proceeding has no bearing on, nor should it bear the burden of, incenting investment decisions. This is nonsense. As the Commission has clearly explained, every market element has an effect on investment decisions. Further, it is a test of reason to claim that a Capacity Procurement Mechanism, in particular, has no influence over future capacity investment decisions.

Given the inadequacies of the existing RA program, resources are needed by CAISO that are not procured through the RA process. The compensation to these non-RA resources through CPM are an important and ongoing element of the CAISO market design.

B. Protest of Proposed Compensation Method

i. The Reasons Underlying Going-Forward Compensation Methodology in CPM Are No Longer Viable or Supportable.

The Commission's October 16 Order accepting ICPM was premised on four independent factors: (1) the pendency of a CPUC-sponsored centralized capacity market; (2) that a two-year long ICPM program would not be expected to incent new entry; (3) that a short-term backstop would not influence LSE procurement; and (4) that the ICPM, true to its "interim" name, was temporary. Not one of these factors remains true today.

¹⁶ Id. at P 214.

Indeed, the Commission specifically told CAISO that approval of the ICPM was conditional and directed that “further refinement of the ICPM is necessary.”¹⁷ Yet, the CPM proposal mirrors ICPM almost exactly, most significantly as it continues to base compensation exclusively on going-forward costs instead of CONE. Unlike the ICPM, the CPM filed by the ISO will be institutionalized as a long-run element in the CAISO market design. Therefore, the Commission must consider the CPM *de novo*: evaluate it as a separate proposal as a permanent CAISO design element, and reexamine the logic of accepting a capacity mechanism based solely on going-forward costs.

Factor #1: The CPUC intended to develop its own centralized capacity market.

In the October 16 Order, the Commission was “not inclined to modify the proposed capacity price” because of the ongoing CPUC rulemaking proceeding. The CPUC long-term capacity procurement proceeding, upon which the Commission predicated its denial of the use of CONE as a basis for ICPM, has been closed. Specifically, the Commission found:

[T]he CPUC is currently engaged in an effort to implement a long-term capacity procurement mechanism. In recognition of the CPUC’s ongoing proceeding, we are not inclined to modify the proposed backstop capacity price by adopting a pricing methodology, based on the cost of new entry, to support long-term capacity investments. As discussed above, we find that such a methodology for pricing ICPM backstop capacity would not encourage new investment.¹⁸

On June 3, 2010, CPUC Commissioners unanimously voted to continue bilateral contracting under the CPUC's existing year-ahead bilateral resource adequacy

¹⁷ Order accepting tariff filing subject to modification re California Independent System Operator Corp., 125 FERC ¶ 61,053 (October 16, 2010), at P 22. (“October 16 Order”)

¹⁸ October 16 Order, at P 42.

program and, among other things, rejected various proposals under consideration to develop a centralized forward capacity market administered by the CAISO (R05-12-013)¹⁹ or a bilateral market that looked more than a year ahead.

The CPUC took this action, despite finding significant flaws in California's backstop procurement mechanism, which even the CPUC agrees requires further refinements.²⁰ The decision concluded a rulemaking proceeding spanning almost five years. Thus, California's future capacity needs now must be met by the RA structure approved by the CPUC and the backstop procurement mechanism that this Commission evaluates and approves in the instant proceeding. Thus, the Commission needs to reevaluate its prior decision in light of this change in circumstance.

Factor #2: The Commission found that a temporary capacity procurement mechanism was unlikely to send long-term price signals.

The second basis on which the October 16 Order approved the ISO's interim capacity procurement mechanism was because it was *interim*, and thus could not be expected to send long-term price signals:

¹⁹ The CPUC decision is available here: http://docs.cpuc.ca.gov/PUBLISHED/AGENDA_DECISION/118566.htm

²⁰ "As the CAISO has noted, its RCST and ICPM processes cannot be expected to function as stable backstop mechanisms. While it is our policy to design the RA program in a way that minimizes the need for backstop procurement, we concur that the absence of a durable backstop mechanism is another shortcoming of the current program that jeopardizes the reliability and cost-effectiveness objectives." *Order Instituting Rulemaking to Consider Refinements to and Further Development of the Commission's Resource Adequacy Requirements Program*, D.10-06-018 (June 3, 2010), p. 36. Available at: http://docs.cpuc.ca.gov/word_pdf/FINAL_DECISION/118990.pdf.

ICPM is not designed to evaluate whether new investment is actually needed, but rather it provides the CAISO with a temporary tool to procure additional existing capacity when the capacity procured by LSEs under the resource adequacy program is insufficient to meet reliability needs.²¹

As mentioned above, because the CPUC's forward capacity market proceeding is over, and because the CAISO has effectively proposed to make the ICPM permanent, this rationale for the Commission's approval no longer applies. To the contrary, the backstop mechanism to the RA program will be more important than ever, and will be a primary method of sending signals to invest (or to disinvest) in California, particularly for existing facilities, which are likely to face significant investment decisions over the next few years, driven by environmental capital expenditure requirements and decreased revenues caused by renewable integration. Currently, investors have no incentive to re-invest scarce capital in California, because they *at best* earn their going-forward costs, plus, perhaps, some small share of their fixed costs in the form of inframarginal energy rents.

Factor #3: The Commission has held that even a short-term capacity procurement backstop can influence forward contracting.

Four days after the issuance of the October 16 Order conditionally approving ICPM in California, the Commission issued an order in a similar MISO proceeding confirming that even short-term, backstop capacity mechanisms have an influence over investment decisions. Further, the Commission held that such mechanisms must be based off of CONE in order to send the appropriate incentive. In an October 20, 2008 Order, the Commission stated:

We recognize commenters' concerns that if the market is capacity short, the monthly settlement and deficiency charges will not immediately result in new construction nor maintain resource

²¹ October 16 Order, at P 42.

adequacy. We disagree, however, with arguments that the month-ahead settlement and enforcement provisions thus will fail to promote long-term resource adequacy. We find that properly-structured financial assessments will, over the long-term, create appropriate incentives for LSEs to obtain adequate capacity in order to avoid deficiency charges.²²

Thus, the Commission has issued two conflicting regional opinions on the relevance short-term capacity mechanisms in influencing infrastructure investment and incenting behavior. While EPSA encourages regional differences among the ISOs/RTOs, where appropriate, the markets are not so dissimilar that the exact opposite policy is warranted in two different capacity procurement proceedings. EPSA agrees with the October 20 MISO Order and urges the Commission to settle the two conflicting methodologies by issuing an order in the instant proceeding insisting on CONE as the basis for the CAISO's backstop procurement authority.

Factor #4: The ICPM was expressly intended as temporary.

Finally, the October 16 Order cited the temporary nature of the ICPM proposal as a grounds for approving it for a two-year period :

[A]s a temporary mechanism that is designed to fill gaps between resource adequacy procurement and actual reliability needs, it is important that the proposed ICPM backstop capacity price does not significantly influence current bilateral prices.²³

Though it may be obvious, EPSA finds it necessary to point out in this case that CPM is proposed as a permanent addition to the CAISO tariff. In the proceeding leading up to the October 16 Order, CAISO and several proponents of the going-

²² 125 FERC ¶ 61,060 at P 96. Further explanation of MISO's capacity backstop mechanism can be found in section II.B.ii of this protest. Though the two are not 100 percent similar, there are enough similarities to warrant both being based on CONE, which will be calculated regionally.

²³ October 16 Order, at P 43.

forward compensation methodology argued strenuously that because ICPM was an *interim* mechanism, there was no need to consider its implications on new entry or investment. Indeed, in the instant proceeding, CAISO concludes that, “the ICPM has operated effectively and successfully in fulfilling its intended purpose.”²⁴

However, the intended purpose of the ICPM is different from that of the CPM in light of the disintegration of the CPUC proceeding to make any meaningful reforms to existing RA requirements. In fact, reform of the backstop is even signaled by the CPUC itself as it states that a more durable backstop mechanism is needed as a result of its inaction.²⁵ FERC should consider the reasons for approving CPM’s compensation as wholly different from the reasons for which it conditionally approved ICPM. Not only would basing CPM compensation on CONE make California policy consistent with the rest of the country, it is the only way to ensure just and reasonable compensation in light of the fact that the RA program, coupled with this permanent mechanism, will be the only capacity constructs in the CAISO market.

ii. CONE Is Appropriate and Therefore Utilized in All Other Capacity Markets

Every other capacity construct in U.S. organized wholesale electricity markets is based on CONE in some way. Even markets without a formal forward capacity market base backstop capacity mechanisms on CONE. The reason that CAISO gives for rejecting CONE as a basis for CPM compensation is that CPM

²⁴ CAISO December 1 Filing, p. 15.

²⁵ See: *Comments of the California Public Utilities Commission*, Docket No. ER08-1178-000 (November 6, 2008).

“is not intended to incent the development of new generation,” and thus, does not need to “adopt a price designed to incent the development of new capacity.”²⁶

As discussed above, this reasoning is no longer valid, if it ever was. FERC has, in fact, instructed the ISOs/RTOs to learn from one another and compare their capacity compensation methodology to that of other markets.²⁷ This is because any capacity procurement mechanism – be it primary or backstop, short-term or long-term – affects investment and development decisions. As the Commission explained in the context of the New England Forward Capacity Market, “[t]he purpose of the New England FCM is to attract and retain sufficient capacity to maintain ISO-NE's Installed Capacity Requirement, *and to do so, FCM capacity prices will need to average out over time to the cost of new entry.*”²⁸

There is no question, as the Commission found in the MISO proceeding, and as common sense dictates, that the price of backstop capacity will also affect how well LSE’s forecast and procure the correct amount of capacity under the primary RA program, which in turn, affects investment and development decisions. The Commission has approved and/or mandated a CONE approach in every other market; it should do so here as well.

Since CPM is used to procure LSE RA compliance inadequacies, support for FERC to do so is the use of CONE in MISO’s Module E financial settlement structure. Module E’s financial settlement structure, which is based on CONE, has direct relevance to this proceeding because it is similarly meant as a

²⁶ CAISO December 1 Filing, p. 8.

²⁷ MISO Oct 20 Order at P 74 : “The Midwest ISO should also compare the methodology it proposes with the methodology of other RTOs, such as PJM.”

²⁸ ISO New England Inc., 125 FERC ¶ 61,102 at P 43 (2008), order on reh'g, 130 FERC ¶ 61,089 (2010).

backstop to ensure that the utilities procure enough capacity under the RA program. MISO, however, acknowledges the direct relationship between a backstop mechanism and incentives for new generation. In the ICPM Order, the Commission noted, “we agree with commenters that if resource adequacy procurements were sufficient there would be little need for the ICPM.”²⁹ Now that there is no longer a forward capacity proceeding pending at the CPUC, EPSCA posits that the CPM must assume a role very similar to the financial settlement structure in MISO’s Module E. There is no forward capacity market in MISO, thus the Commission found there that:

The deficiency charge based on CONE should reflect the current cost of new entry in order to provide the proper incentive for LSEs to contract for capacity.³⁰

So too in California should the backstop mechanism provide incentives for LSEs to contract for the correct amount of capacity. An underpriced backstop mechanism offers LSEs little to no incentive to forecast and contract for the right amount of capacity, or capacity that is in the correct location. Thus, new potential investors and new entrants will not be able to actually see when capacity is tight. Therefore, there will be no signals through the RA program for new infrastructure investment. Instead, basing the cost of CPM on CONE will achieve three goals that the financial settlement structure achieves in MISO:

- (1) it will discourage LSEs from under forecasting and under procuring because it will be costly to use the backstop mechanism;
- (2) it will provide just and reasonable compensation to units that are used as backstop capacity; and,

²⁹ October 16 Order, at P 44.

³⁰ *Order conditionally accepting financial settlement provisions re Midwest Independent Transmission System Operator*, 125 FERC ¶ 61,060 (October 20, 2008), at P 76. (“October 20 Order”).

(3) it will send correct price signals to owners and investors in lieu of a forward capacity mechanism.

EPSA encourages the Commission to look at the constructs available for resource adequacy in light of the fact that the forward capacity market proceeding has been terminated. Additionally, the RA mechanism in California is very similar to MISO and Commission policy in the two markets should therefore also be similar.

CAISO is also aware of the benefits and uses of CONE in the other eastern markets to incent new and retain existing capacity, encourage demand response, and drive environmental and discretionary investment in existing units.³¹ CAISO should be directed to use that knowledge to construct a similar CONE-based approach to its backstop resource adequacy program for its own wholesale electric market.

C. Solutions

First and foremost, the Commission should reject the compensation method proposed in CAISO's CPM proposal. The circumstances under which the Commission accepted ICPM in 2008 no longer exist in 2010. There are no longer any plans for a forward capacity market to materialize in California. Thus, the bilateral RA requirements coupled with this CPM proposal are the entirety of California's capacity procurement construct. As such, this proposal is the primary if not only vehicle for sending price signals to non-resource adequacy units that continue to be needed by the CAISO and LSE's in making their RA compliance decisions. A backstop mechanism by which LSEs can procure

³¹ CAISO Commissioned Consultant Paper ISO-NE FCM Capacity Market Design, Scott M. Harvey (October 9, 2007), pp. 1-3. Available at: <http://www.aiso.com/1c72/1c729b3c4f410.pdf>

underpriced capacity when they fall short of what they require skews capacity signals and fails to provide LSEs the incentive to forecast and procure on target with California's actual needs.

As CPM has now become such a prominent piece in California's resource adequacy program, the Commission must mandate that it provide fair payments to generators based on CONE, preferably based on an annual designation for the full output of the plant for the year. EPSA's recommendation here is based on CAISO's Reliability Must Run (RMR) Agreement, which has been in place for over ten years.³² An annual designation for the unit's full output conflicts with the CPM proposal in two key ways: (1) the CPM proposal seeks to compensate a capacity unit for only its energy output rather than its full rated output; and (2) the CPM proposal makes monthly rather than yearly designations.

On the first issue, when a capacity provider commits a whole unit under CPM, it means a commitment to full availability subject to the real time needs of the system. While that unit is available and waiting to be used, it is only compensated if it is used, and even then, CPM would compensate the capacity provider for the exact energy output used rather than the full unit. Thus, the capacity provider may be left with a partial unit that was ready and waiting under its capacity obligations but was never compensated. Capacity constructs have been referred to in multiple places as "reliability insurance," meaning that the market pays a certain premium on capacity to make sure it is available should it be necessary. Thus, there is little to no incentive for units to commit to any

³² See: CAISO RMR Agreement, Article 2.1, available at: <http://www.aiso.com/docs/2001/10/15/2001101510162513782.doc>.

amount of forward availability if they will only be compensated for the actual energy produced in real time.

As for the annual versus monthly designation issue, the arguments made in the ICPM proceeding that the monthly designation results in discrimination remain true. Both RMR and RA contracts in California have annual terms. This disparity in the timing of the contracting terms will result in significantly lower compensation for CPM units than those offering the exact same service under RMR and RA contracts. While RMR and RA contracts have a set compensation for a full year and the ability to recover fixed-costs in many cases, CPM units, which are contracted on a monthly basis and only paid for actual energy output, often have no opportunity to recover fixed costs. An annual designation would offer to CPM units the same stability as RMR and RA units, not to mention the fact that CPUC protocol dictates year-ahead procurement for system peak capacity for the months of May-September. Allowing CPM to designate capacity units on an annual basis would not only make the compensation scheme on par with the RMR and RA programs in California, it would also make CPM consistent with CPUC requirements for capacity procurement.

The annual, full output compensation scheme will ensure that units that commit when LSEs have failed to procure the necessary capacity will be compensated fairly. Further, LSEs will have better incentives to procure the necessary capacity under the bilateral RA program, because backstop capacity will no longer be so under-priced as to be inconsequential. The Commission should not be reticent to mandate this needed change in California; in fact, every major advance in California's wholesale market structure began with a weighty

mandate from FERC.³³ Further, in the event of resource shortages in the CAISO footprint, one can certainly expect the responsibility and blame will not be placed upon inadequate CPUC RA programs or the CAISO, but rather upon the Commission, as it is viewed as ultimately responsible for reliability of the bulk power system.

Should the Commission not mandate an annual designation based on CONE for the full output of the plant compensation for CPM, it should, at the very least, direct CAISO to work with its stakeholders to develop a CPM compensation based on CONE within a specified timeframe.

IV. Conclusion

Wherefore, EPSA respectfully requests that the Commission grant its motion for leave to intervene in this proceeding and consider the comments and protest herein.

Respectfully submitted,



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December 22, 2010

³³ See: *Order Conditionally Accepting CAISO's Comprehensive Market Redesign Proposal*, 112 FERC ¶ 61,013 (July 1, 2005); *Order Instituting a Section 206 Investigation, re: CAISO Reliability Capacity Services Tariff*, 121 FERC ¶ 61,281 (December 20, 2007); *Order Conditionally Accepting Tariff Changes and Directing a Compliance Filing*; 124 FERC ¶ 61,271 (September 19, 2008); *Order On Section 206 Investigation, Technical Conference, accepting in part and rejecting in Part Tariff Provisions, and Implementing Transitional Measures*, 126 FERC ¶ 61,150 (February 20, 2009); *Order Conditionally Accepting Tariff Changes and Directing Compliance Filing*; 132 FERC ¶ 61,045 (July 15, 2010).

CERTIFICATE OF SERVICE

I hereby certify that I have served a copy of the comments by via email or postal mail upon each person designated on the official service list compiled by the Secretary in this proceeding.

Dated at Washington, D.C., December 22, 2010.



Nancy Bagot, VP Regulatory Affairs