Comments of Calpine Corporation on

CPM Soft Offer Cap

Straw Proposal

Comments Submitted: 8/20/19
By: Mark J Smith

Summary:

Calpine appreciates the opportunity to comment and supports the general direction of the CPM Straw Proposal ("CPM SP"). We support the first two elements of the proposal (CPM soft cap level and compensation in light of concentration) with the limited modifications recommended below. We recommend that the third component (bids above the soft cap) be modified to be consistent with potential for full cost-of-service compensation in the second element.

1. <u>Maintain the CPM Soft Offer Cap</u>

Calpine fully supports the retention of the current soft-offer cap, as proposed in the CPM SP.

First, as described in both Calpine's initial comments and the CPM SP, the underlying costs of the reference unit – a CCGT – have not materially changed. In fact, a comparison of the appropriate line items from CEC studies from 2014 and 2019 shows, arguably, no change. But as described below, this deterministic view of the soft offer cap, while necessary is entirely insufficient.

Also, several parties have suggested that the CAISO change the reference unit that is used to determine the soft cap. Calpine supports the CAISO proposal to resist these alternatives at this time. CCGTs are likely to be a significant component of the reliability requirements (especially of net load ramps) of the CAISO fleet for the foreseeable future. While the CAISO could consider, at a later date, a change to the reference unit, such as the net cost-of-new-entry of a storage unit, it should only do so as part of a much larger structural reform.

Second, and much more important, the level of the CPM soft cap must be designed to create proper incentives to contract in the bilateral markets. It must be viewed as a "goldilocks" level – high enough to encourage competitive bilateral transactions, but not so low that it be considered a superior alternative to those competitive negotiations (more on that in section 2, below.)

In fact, with rising RA compensation levels, this is no time to reduce the level of the soft cap and perhaps consideration should be given to raising the cap.

The CAISO and many interveners in the CPUC's investigation of reliability matters (R16-02-007) demonstrate that capacity supply and demand margins are tightening and absent significant and uncommon action, capacity shortfalls in excess of 4,000 MW are possible as early as 2021[1]. Reducing the soft cap in this environment could, probably would, result in significant increases in the volume of RA deficiencies as LSEs, or in their stead, a newly envisioned CPUC-proposed Central Procurement Entity defers procurement at prices above the soft cap to the CAISO mechanisms.

The CPM mechanism was never designed to be a primary procurement vehicle and would have significant shortcomings if used in that manner. Calpine has in the past, identified that the CPM design of an as-bid, vertical demand-curve, non-transparent clearing mechanism is inappropriate as a capacity clearing structure. In fact, if the CPM becomes a significant part of forward procurement, it should be redesigned to meet the existing multi-year-forward capacity obligations with a single (marginal bid) clearing price. The vertical demand curve should be replaced with a mechanism that references new entry costs and eliminates the bi-modal pricing outcomes[2] produced by a vertical demand curve.

Finally, another important aspect of the soft offer cap is that it creates a "safe harbor" offer price that reduces transactions costs as well as CAISO/FERC review and process costs. That is, bids below the soft offer cap are presumed to be reasonable and no further demonstration of actual costs is required of the bidder. If the soft offer cap were to be reduced, especially in an environment of rising prices, resource owners would likely bear substantially more transaction costs, risk and delay of deal closure as CAISO and FERC evaluated the reasonableness of bids.

In summary, for all of these reasons, Calpine support retention of the current CPM soft offer cap as just and reasonable.

2. Changes to 12-month CPM designations

Calpine generally supports the proposed provisions for solving annual (i.e., 12-month) RA collective or individual deficiencies. While we would like to understand more about the market power test, we directionally support the conclusion that where there is limited competition, the full cost-of-service is a reasonable cap on compensation *particularly when cost-of-service is above the Soft Offer Cap.*

Calpine, the CAISO and FERC have long adhered to the principle that a resource that is particularly and uniquely needed to meet a reliability need should be allowed to collect its full cost-of-service including both a return of, and on its capital investments. The CAISO unambiguously supports this principle in its RMR filing.

[1] http://www.caiso.com/Documents/Aug12-2019-ReplyComments-PotentialReliabilityIssues-IRP-R16-02-007.pdf

[2] A vertical demand curve can result in very high prices for resources that receive capacity awards and zero prices for all resources above the assumed reserve obligation. This would hasten the retirement of every extra-marginal capacity resource.

Here, the CAISO posits (and Calpine agrees) that there can and will be circumstances – especially in constrained local areas – where the resource options are limited. The Competitive Solicitation Process that is enabled to resolve RA deficiencies may reveal that a limited number of resource bids are available to meet the deficiency. In these circumstances, pivotal suppliers could emerge.

The CAISO proposes a market power analysis – a three pivotal supplier test ("3PST") – to identify conditions under which the residual suppliers could exert market power. Calpine does not object to this test, but just as with the concurrent review of system energy market power, we observe that these tests are indicative of concentration, not dispositive of any abuse of market power. We would like the CAISO to provide examples to the actual workings of such an analysis along with a comparison of, if you will, 2PST, and 1PST.

The CAISO proposes that when the 3PST shows excess capacity, that the CSP will proceed as historically intended and resources will be awarded based on a combination of bid and other factors. However, the CAISO proposes that when reliability targets cannot be satisfied after the three largest bidders are removed, compensation will be based on cost-of-service, not bids[3].

This proposal is reasonable, particularly when the cost-of-service for a particular resource is above the soft offer cap. In fact, at high concentration levels, each resource can be considered uniquely capable of meeting the reliability targets and should have the ability to recover up to the full cost-of-service.

However, applying the same principle to resources that have full costs-of-service *below* the soft offer cap will create undesirable unintended consequences. As Calpine understands the CAISO proposal, in those circumstances, resources would not be paid as-bid into the CSP, but rather, be capped at their lower cost-of-service. Of course, at these compensation levels, resource owners may be unwilling to accept the risk of the continuous must offer obligation and potentially significant capacity replacement costs.

But more importantly, under this "lowest of" compensation circumstance LSEs will be encouraged to avoid bilateral contracting with resources that are presumed to have low costs with the knowledge that the CAISO will backstop those needed resources at below-market compensation levels. This will place more deficiencies in the CPM or, RMR mechanisms – transforming them to a primary procurement vehicles.

This unintended consequence is much more than theoretical and has already been demonstrated by LSEs. In recently filed comments, the CAISO specifically objects to PG&E and SCE proposals to bypass bilateral contracting, presumably because the cost-of-service for certain resources is below prevailing market prices. In R16-02-007, a CPUC proceeding investigating "potential reliability issues" the CAISO says:

[3] The CAISO also clarifies that the full cost-of service would only be considered for full resources, but leaves open the resolution of compensation for partial plant bids that are pivotal. Calpine suggests that the CAISO clarify the compensation rules for partial resource bids when the 3PST fails.

PG&E and SCE both recommend that the CAISO use the reliability must run (RMR) mechanism to procure OTC resources. Although the CAISO retains the right to exercise the RMR mechanism, the resource adequacy program is the "frontstop" and as such, any needed OTC resources should be pursued in the first instance through LSE bilateral procurement.

This pattern of presumed, and now demonstrated behavior is troubling. While the context here is the use of RMR (rather than CPM) for presumptive OTC extensions, the desire to avoid the "frontstop" RA bilateral markets to secure resources below prevailing market prices is unmistakable. Should the CAISO proposal be unmodified, it could be placed in a position where it must negotiate with each and every pivotal resource that buyers believe has, or with creative accounting interpretations should have, a full cost-of-service below the lower of the CPM soft cap or the prevailing market price. Such a "lowest of" market is not just and reasonably.

So rather than mandating that compensation for pivotal, but depreciated resources be capped at below-market costs, the CAISO should consider a rule that these units would be compensated at the higher of bid or cost-of-service. This policy would retain the incentives to bilaterally contract, and preserve market functioning below, and up to the safe-harbor soft-offer cap.

Finally, Calpine generally supports the cost allocation proposal of the CPM SP which initially allocates the costs of any designation based on cause. That is, when deficiencies drive an annual CPM designation, the deficient LSEs would receive an initial cost allocation proportional to their deficiency. The costs of capacity above that needed to satisfy a deficiency would be spread more broadly.

However, Calpine recognizes that absent the changes identified above, this allocation would encourage LSEs to bypass the bilateral market in order to directly benefit by an allocation of below-market capacity costs. Calpine strongly supports cost allocations based on causation and with our proposed modifications to compensation, above, support the CAISO proposal.

3. Bids Above the Soft Cap

The current tariff allows CSP bids above the CPM soft offer cap, but requires that the resource owner demonstrate, using Schedule F of the RMR agreement, that their bid reflects the full cost-of-service. In the RMR proceeding, the CAISO recommended and the CAISO Board approved, a modification to the bid rule which would limit bids above the soft cap to resource-specific, going-forward fixed costs plus 20 percent[4] (GFFC+).

[4] The CAISO should clarify whether it still intends on filing the "toss-up" adder suggested to the Board, or explicitly seek a 20 percent adder.

The ISO indicates that it will file the Board-approved tariff change in conjunction[5] with the matters discussed above.

Calpine did not support this change for bids above the soft cap when presented to the Board, and as described below, does not support that change in today's very different environment.

Calpine has repeatedly objected to this change in the required justification for bids above the soft-cap[6]. In our view, establishing a resource-specific GFFC+ limit on bids is in fact, creating a hard cap on bids at a level much below the alternatives in other FERC-regulated markets, potentially below prevailing market prices and by definition, below the full cost-of-service. The presence of administrative limits on the CSP bids could clearly result in LSEs preferring CPM over bilateral contracting.

As stated by the MSC in their March, 2019, opinion on the CPM/RMR changes, in a highly competitive market, bidders would be encouraged to bid GFFC, but …

> *In a market in which there is a need for investment in new capacity, prices would clear at something resembling the cost of new entry (CONE) less energy and ancillary services revenues (net-CONE). Eastern ISOs strive to replicate such outcomes using capacity demand curves whereby prices rise gradually as reserve margins decline up to a price ceiling that is some specified multiple of Net CONE[7].*

There should be no question that the CAISO market is in need of investment in capacity – either new non-use-limited capacity, or re-investment to maintain existing dispatchable resources. It is similarly clear that the time scale of the CPUC IRP process (10 years) is inadequate to solve the consensus near-term capacity shortage. In this circumstance, Calpine would prefer that the CAISO move CPM to a single-price clearing mechanism based on some multiple of net-CONE.

In addition, Calpine asserts that capacity scarcity will grow over time, possibly causing reliability concern, but not of a scale sufficient to trip the 3PST. In these cases, prices should be allowed to move above GFFC+ through the action of CSP bids. As described below, a rule that allows resource bids "up to" the full cost-of-service would allow market prices to reflect scarcity and allow resources a reasonable opportunity to recover their costs, including a return of and on historic capital. In sum, we strongly believe that limiting bids to resource-specific GFFC+ is unjust and unreasonable and a step in precisely the wrong direction.

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[5] Calpine recommends that the ISO file a single request at FERC and not break these matters into two conjunctive and interrelated, but piecemeal pleadings.
[6] See, e.g., Calpine's Answer in ER19-1647.
[7] http://www.caiso.com/Documents/MSC-Opiniononreliabilitymustrunandcapacityprocurementmechanismenhancements-Mar20_2019.pdf

In addition to these substantive objections, Calpine also will address the CAISO's rationale for not revisiting the GFFC+ proposal in this phase of the initiative.

The ISO August 6, 2019 presentation identifies two reasons that presumptively allow the CAISO to move forward without reconsideration of the previous proposal (1) an assertion that the other proposed modifications herein do not affect GFFC+ proposal, and that (2) no one has ever used this provision to bid above the soft cap. Calpine believes that a further review demonstrates not only a need to revisit the Board-approved proposal, but a slight modification to the current tariff.

First, of course, the current tariff provision has been found to be just and reasonable. When and if this new proposal is filed at FERC the Commission will review all parts of the new proposal in order to evaluate whether they too can be collectively found to be just and reasonable. It is hard to imagine how a proposal to allow some resources to recover their full cost-of-service and concurrently limit all bids to GFFC+ does not need to be considered together or how FERC would consider such a change just and reasonable for pivotal resources.

At the same time, the CAISO has appropriately proposed that pivotal resources uniquely needed to meet reliability requirements should be allowed to recover their full cost-of-service. We agree and assert that there *must be* a path to full cost-of-service. This level of compensation would only be discovered after the failure of a 3PST, and evaluation of hastily submitted[8] cost-of-service submissions. The need for these submissions is, in part, driven by the proposed GFFC+ limits on bidding.

Calpine has long held that the "runway" available for CPM decision-making is too short and changes to the RA process timing or the CPM obligation / availability start are necessary. This added step of composing, filing and evaluating full cost-of-service bids (otherwise prohibited by GFFC+) will only make the decision-time compression worse.

Rather than moving forward with GFFC+, Calpine proposes to slightly modify the provisions of the current tariff that allow resource bids to reflect the full cost-of-service. Specifically, the CAISO should require that CSP bids above the soft cap must exclusively be for whole generation units. As with the CAISO PST3 proposal, resources cannot bid, and the CAISO cannot designate a partial resource. If selected, resources that bid above the soft-cap would be expected to return all energy rents and accept the must offer obligations as designed in RMR. Those bids must be preceded by a FERC 205 filing that would set an upper limit on the actionable bid. Resource owners can bid up to, but not necessarily at, the filed cost-of-service.

This proposal facilities the integration of the 3PST. At the risk of pricing themselves out of the market, resource owners that believe their units could be pivotal could submit, a bid up to the full cost-of-service long before the one-year CSP auction occurs. The bids would be available and properly formatted for any CAISO CSP, including when there is a failure of the 3PST.

[8] The ISO proposes that when 3PST fails, resource owners submit cost-of-service filings in a 5 business days.

Second, the CAISO notes that no party has ever submitted a bid above the soft-offer cap and therefore, the change to GFFC+ does not need to be revisited. Calpine does not understand this reasoning, especially in an environment with tightening supply and significantly rising capacity prices. The absence of bids above the soft-offer cap does not mean that market prices are not and should not rise above the soft-offer cap. Indeed, the transaction costs (e.g., FERC filings) and risks (taking an availability obligation without price certainty) have historically been a strong deterrent to bidding above the cap. But if market prices continue to rise, for example, to levels that are necessary to encourage imports, these deterrents may be overcome.

Calpine is convinced that the Board, given new information – and a more holistic view of the issues at hand – would reconsider their previous approval

Thanks