Capacity Procurement Mechanism Soft Offer Cap
Straw Proposal

Comments by Department of Market Monitoring

August 20, 2019

Overview

DMM appreciates the opportunity to comment on the ISO's *Capacity Procurement Mechanism Soft Offer Cap Straw Proposal*.[1] DMM supports the direction of the ISO's proposal to test for market power within annual Competitive Procurement Mechanism (CPM) solicitations. This approach will address some concerns raised in the CPM-RMR stakeholder process about the ability for suppliers with market power to self-select preferred backstop compensation.

However, under the current proposal pivotal suppliers could still self-select between full cost-of-service and the soft offer cap. This because CPM designations remain voluntary and the ISO does not propose to apply a market power test to monthly CPM solicitations. A pivotal resource could decline a cost-of-service offer in the annual process in favor of potential monthly payments at the soft offer cap. DMM recommends that the ISO consider additional enhancements to prevent pivotal resources from being able to self-select preferred backstop compensation which may far exceed a resource's actual going forward costs.

DMM also has concerns about the CPM selection process if resources are selected based directly on units' Annual Fixed Revenue Requirement (AFRR). Under this criteria, it seems likely that CPM designations will tend to be offered to highly depreciated, older, and less efficient resources, rather than new more efficient units with less depreciated sunk costs. This could undermine the efficiency of capacity procurement, which would ideally result in retention of the most efficient resources with lowest going forward costs, net of projected net market revenues. At a minimum, the ISO should consider each unit's estimated net market revenues (which would be credited back to ratepayers) in its evaluation of resource costs. However, considering net market revenues in the selection process still does not guarantee that the most efficient resources with lowest going forward costs will be offered CPM designations.

In addition, the level of the soft offer cap remains important under the ISO's proposal. The extent to which a resource owner would have an incentive to decline a CPM offer in favor of potential monthly CPM designations at the soft offer cap depends in large part on the level of the soft offer cap. While the ISO proposes not to change the level of the soft offer cap, DMM believes a closer review of the cost estimates used in the CEC's report is necessary. The CEC report was not intended to be used for setting ISO market rates such as the soft offer cap. Additionally, DMM believes that that some of the costs included in the CEC's O&M estimates may overlap with costs recovered through the ISO market, as described later in these comments.

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[1] *Capacity Procurement Mechanism Soft Offer Cap Straw Proposal*, California ISO, July 24, 2019: http://www.caiso.com/Documents/StrawProposal-CapacityProcurementMechanismSoftOfferCap.pdf

Detailed Comments

DMM supports the ISO's proposal to apply a market power test to annual CPM solicitations. However, self-selection between full cost-of-service and the soft offer cap could still be exercised by pivotal suppliers under the current proposal.

DMM supports the ISO's efforts to effectively mitigate the exercise of market power in backstop procurement processes which should, in turn, improve efficiency and deter market power in the bilateral resource adequacy process. DMM also agrees that backstop compensation should not be so low that it discourages bilateral contracting. However, DMM notes that while bilateral RA contracting and CPM solicitations are both voluntary for suppliers, LSEs could face both LRA penalties and potential backstop procurement costs if they are short of procurement requirements. Thus, resources with market power and LSEs may factor expected levels of backstop costs and RA deficiency penalties actor into bilateral RA offers and decisions. Because there are no market power mitigation measures in the bilateral RA market, the ISO's backstop mitigation measures and compensation may become increasingly important.

DMM also supports the direction of the ISO's proposal to test for market power within annual CPM solicitations. DMM believes this approach will address some concerns raised in the CPM-RMR stakeholder process about the ability for suppliers with market power to self-select preferred backstop compensation. In the RMR-CPM Enhancements stakeholder process, DMM recommended that the ISO consider merging the CPM and RMR constructs instead of continuing to have two separate backstop procurement mechanisms with distinct compensation frameworks. DMM expressed concern that pivotal resources considering inactive status could self-select between CPM and RMR designations based on maximization of compensation, and the opportunity to self-select compensation did not appear to provide any incremental reliability or market efficiency benefit. The ISO's proposal begins to align compensation between the two backstop procurement frameworks.

However, DMM believes that under the current proposal pivotal suppliers could still self-select between full cost-of-service and the soft offer cap. This is because CPM designations remain voluntary and the ISO does not propose to apply a market power test to monthly CPM solicitations. A pivotal resource could decline a cost-of-service offer in the annual process in favor of potential monthly payments at the soft offer cap. The extent to which a resource owner would have an incentive to decline a CPM offer in favor of potential monthly CPM designations at the soft offer cap depends in large part on the level of the soft offer cap. Thus, DMM recommends that the ISO consider additional enhancements which would further prevent pivotal resources from being able to self-select preferred backstop compensation which may far exceed a resource's actual going forward costs. For example, the ISO could consider applying a market power test to monthly CPM solicitations.

DMM has concerns about the CPM selection process under uncompetitive conditions if resources are selected based on lowest AFRR. It is likely that the lowest cost resource(s) will be highly depreciated, older, and less efficient resources.

The ISO proposes to apply a three-pivotal supplier test to annual CPM solicitations. If the solicitation is deemed non-competitive, then the ISO would solicit cost-of-service data from resources eligible to meet the reliability need. The ISO notes that it will have discretion over which resources are selected for CPM designations and will consider criteria such as the reliability need, cost, and operating characteristics. However, the ISO also does not propose to consider net market revenues in its evaluation of resource costs.

If resources are selected based primarily on lowest AFRR, DMM is concerned that highly depreciated, older, less efficient resources will be selected for CPM designations over more efficient resources with lower going forward costs (after considering estimated net market revenues).

DMM believes the outcome of selecting resources based on lowest AFFR could undermine the efficiency of resource adequacy procurement, which would ideally result in retention of the most efficient resources with lowest going forward costs, net of projected net market revenues. At a minimum, the ISO should consider each unit's estimated net market revenues (which would be credited back to ratepayers) in its evaluation of resource costs. However, considering net market revenues in the selection process still does not guarantee that the most efficient resources with lowest going forward costs will be offered CPM designations. Newer, more efficient resources with undepreciated capital could still appear more expensive than older, less efficient and highly depreciated resources.

DMM also understands that the ISO would offer cost-of-service compensation to all resources eligible to resolve the reliability need, regardless of resources having existing bids in the competitive solicitation process (CSP). DMM believes that an improvement would be for the ISO should consider an eligible resource's cost as the minimum of its submitted CSP bid and the resource's cost-of-service rate net of projected net market revenues. Additionally, if the ISO extends a CPM designation to a resource with an existing bid in the CSP, the supplier should not be able to decline the designation, which is consistent with CPM CSP rules today.

The ISO should perform additional review of the GFFC estimates informed by the CEC's report, and consider whether other sources of information are more appropriate to use for setting ISO backstop compensation rates.

The level of the soft offer cap remains important under the ISO's current proposal. The extent to which a resource owner would have incentive to decline a CPM offer in favor of potential monthly CPM designations at the soft offer cap depends in large part on the level of the soft offer cap. While the ISO proposes not to change the level of the soft offer cap, DMM believes a closer review of the cost estimates used in the CEC's report is necessary.

DMM has numerous concerns about the cost data in the CEC reports, and recommends that the CAISO perform additional verification and/or an independent assessment of GFFC. The CEC report was not designed to provide an estimate of GFFC and was not intended to be used for the kind of rate-making that occurs when these data are being used for setting the soft cap. DMM understands that the data on costs of generation in the CEC report were initially developed prior to 2014 based on self-reported data collected through a survey. No details of this survey or the components/assumptions underlying the data used to estimated GFFC are provided in the report.

In addition, based on the limited information provided in the CEC report, the report appears to categorize almost all maintenance as being a fixed annual cost, rather than maintenance costs that actually depend on the usage of the unit (e.g. start-ups, run hours and MWh produced). In the ISO market, a significant portion of these maintenance costs are incorporated in maintenance adders applied to startup, minimum load and energy bids used to dispatch units and provide revenue recovery.

The following example illustrates the degree to which the difference in assumptions about this one factor-- annual maintenance – can increase any estimate of GFFC that is derived from the CEC report.

- Based on data in the CEC report, the GFFC of a unit includes about $41.77/kW- Year of fixed maintenance per year.[2] The CEC report assumes the prototypical combined cycle has a variable O&M value of only $.82/MWh and a capacity factor of 57%. This equates to an annual cost of at least $4/kW- Year in variable O&M (in addition to unit's fixed annual maintenance).[3]
- However, the ISO's market dispatches and compensates combined cycle units at a default variable O&M value of $2.40/MWh, which equates to an annual cost of at least $11.98/kW-Year in variable O&M.[4]
- In addition, ISO's market dispatches and compensates combined cycle units under the assumption that a significant portion of maintenance costs actually depend on the usage of the unit (e.g. start-ups or run hours). Based on a Major Maintenance Adder (MMA) of $400/hour, the unit in the CEC report would recover at least $3.99/kW each year through this MMA.[5]

[2] *Estimated Cost of New Utility-Scale Generation in California: 2018 Update*, California Energy Commission, May 2019, Table D-2:
https://ww2.energy.ca.gov/2019publications/CEC-200-2019-005/CEC-200-2019-005.pdf

[3] $.82/MWh x (57% x 8,670) = $4,094/MW or $4.01/kW.

[4] $2.40/MWh x (57% x 8,670) = $11,983/MW or $11.98/kW.

[5] [$400 x (57% x 8,670)] / 500 MW = $3,994/MW or $3.99/kW.

- Thus, the CEC report assumes only $4.01/kW in non-fixed O&M of the prototypical combined cycle. However, this unit would recover $15.97/kW based on non-fixed O&M values incorporated in the ISO market bids. When the maintenance costs embedded in the CEC report are adjusted to account for this difference ($11.98/kW-Year), it lowers the GFFC from about $66/kW- Year to about $54/kW-Year.

Traditional cost-of-service definitions are not consistent with units switching between market based rates and cost-of-service compensation.

DMM reiterates concerns that cost-of-service compensation framework was designed for resources that were expected to operate under cost-of-service rates all or most of their plant life, not for resources operating under market-based compensation for a significant portion of their actual plant life.[6] Resources that receive CPM designations are also not necessarily resources that would otherwise retire like resources under RMR contracts – resources with CPM designations could, after receiving cost-of-service compensation, go back to earning market-based compensation the following year.

Cost-of-service compensation can result in inefficient investments signals for longer term substitutes.

DMM has expressed in other initiatives and comments that cost-of-service compensation could send inefficient investment signals for longer term substitutes to resolve specific reliability needs.[7] Specifically, paying a generating resource based on its sunk costs creates the incentive to build new supply or transmission capacity which would have an annualized cost greater than the resource's going forward costs, but less than the resource's cost-of-service payment (which includes both going forward and sunk costs).

While DMM has concern about the efficiency of cost-of-service compensation for resources that have been or will continue to operate under market-based compensation, DMM is continuing to evaluate the reasonableness of the ISO's proposal. DMM is continuing to conduct analysis on AFFR versus soft offer cap compensation for various gas resources to assess the reasonableness of the ISO's proposal for using cost-of-service as default compensation when CPM solicitation are deemed uncompetitive.

[6] *Motion to Intervene and Comments of the Department of Market Monitoring of the California Independent System Operator*, Docket No. ER19-1641, DMM, May 21, 2019, pp. 23-24: http://www.caiso.com/Documents/DMMMotiontoInterveneandCommentsonTariffAmendmenttoImprovetheRMRFramework_ER19-1641_May212019.pdf

[7] *Motion to Intervene and Comments of the Department of Market Monitoring of the California Independent System Operator, Docket No. ER19-1641*, DMM, May 21, 2019, pp. 22-23.

Additional comments and observations.

- The Straw Proposal also states that "The full cost of service CPM designation will only be available to resources that are uncompetitive in the annual process."[8] DMM asks the ISO to clarify that mitigation compensation could apply to all resources if the CPM solicitation itself is deemed non-competitive, not just "resources that are uncompetitive".
- While the ISO has not detailed the mechanics of the three-pivotal supplier test, DMM notes that assumptions underlying Local Market Power Mitigation (LMPM) may not hold for assessing the competitiveness of CPM solicitations. In particular, the ISO should consider the treatment of net buyers in the context of the CPM pivotal supplier test. In LMPM, only portfolios of net sellers are considered in determining potentially pivotal suppliers. Net buyers are excluded from the set of potentially pivotal suppliers under the assumption that net buyers do not have an incentive to exercise local market power and increase wholesale spot prices. However, in the context of CPM solicitations, net buyers with supply to offer into CPM CSPs may seek to maximize costs it can recover from other LSEs as CPM costs are shared among all LSEs in TAC area(s) for local designations, and among all LSEs for system designations.
- RMR contracts today are essentially tolling arrangements between a supplier and the ISO, where the ISO holds the dispatch rights to the resource. Resources are paid their AFRR and net market revenues are credited back to ratepayers in the TAC area. However, when resources are put under an RMR contract, individual LSEs cannot contract for the dispatch rights of the resource, removing potential energy hedging instruments from the bilateral market. DMM expects that most CPM solicitations will be deemed non-competitive, and under the ISO's proposal, compensation for resources would align with the RMR framework. Therefore, DMM expects resources under tolling arrangements to the ISO would increase under the ISO's proposal, further removing potential energy contracts and dispatch rights from the bilateral market. This could potentially cause LSEs to face higher prices for energy hedging instruments and/or rely more heavily on unhedged purchases in the ISO's day-ahead market (in which RMR and CPM capacity would be offered at marginal cost).

[8] *Capacity Procurement Mechanism Soft Offer Cap Straw Proposal*, California ISO, July 24, 2019, p. 12.