BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Consider Refinements to and Further Development of the Commission's Resource Adequacy Requirements Program.	R.05-12-013 (Filed December 15, 2005)

PROPOSAL FOR LOCAL RESOURCE ADEQUACY REQUIREMENTS BY THE ALLIANCE FOR RETAIL ENERGY MARKETS

Gregory S. G. Klatt
DOUGLASS & LIDDELL
411 E. Huntington Drive #107-356
Arcadia, California 91007
Telephone: (626) 294-9421
Facsimile: (626) 628-3320
klatt@energyattorney.com

Attorneys for
ALLIANCE FOR RETAIL ENERGY MARKETS

Date: January 24, 2006

TABLE OF CONTENTS

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Consider Refinements to and Further Development of the Commission's Resource Adequacy Requirements Program.	R.05-12-013 (Filed December 15, 2005)

PROPOSAL FOR LOCAL RESOURCE ADEQUACY REQUIREMENTS BY THE ALLIANCE FOR RETAIL ENERGY MARKETS

The Alliance for Retail Energy Markets ("AReM") [1] hereby submits its proposal for Local Resource Adequacy Requirements ("Local RAR") in accordance with D.05-10-042, *Opinion on Resource Adequacy Requirements* ("Phase 2 Decision"), dated October 27, 2005[2] and the procedural schedule set forth in the Commission's *Order Instituting Rulemaking to Consider Refinements to and Further Development of the Commission's Resource Adequacy Requirements Program* ("OIR"), dated December 15, 2005. In the Phase 2 Decision, the Commission requested utilities and other interested parties to submit a "comprehensive proposal" for implementing a Local RAR for 2007.[3] With this filing, AReM respectfully provides its Local RAR proposal focusing on requirements that are reasonably attainable, cost-effective, and designed to prevent market power abuse. Further, because the terminology used for this topic is complex and confusing, AReM also submits a proposed glossary of terms in Attachment 1.

[1] AReM is a California mutual benefit corporation whose members are electric service providers that are active in California's direct access market. The positions taken in this filing represent the views of AReM but not necessarily those of any individual member of AReM or the affiliates of its members with respect to the issues addressed herein.

[2] D.05-10-052, p. 81.

[3] The points and issues contained in this filing have been discussed with and reviewed by the California Large Energy Consumers Association (CLECA). CLECA is supportive of AReM's comments contained herein and finds them generally consistent with its own concerns about Local RAR issues as raised in the past. However, CLECA does not share AReM's support of locational pricing in this document.

I. EXECUTIVE SUMMARY

AReM applauds the Commission's action in D.05-10-042, which delayed implementing Local Resource Adequacy Requirements ("Local RAR") for Load-Serving Entities ("LSEs") until 2007 and allowed time for proper regulatory review and assessment. Reliability requirements are complex and technically challenging to address. AReM's proposal focuses on doing the tough ground work necessary to support a reasonable and defendable Local Resource Adequacy ("RA") Policy for California and ensuring that the ultimate policy approach adopted is right for California's consumers. AReM urges the Commission to adopt a Local RA Policy with the following key components:

- **Set a Reasonable and Attainable Local Requirement for LSEs** -- A Local RAR[4] should be set for LSEs only for local reliability areas where the LSE has a reasonable chance of meeting the requirement. In short, the Commission must establish local requirements that are both reasonable and attainable. LSEs must have a fair chance to meet the requirement or the "requirement" has no meaning. To accomplish this policy objective, the Commission should require LSEs to meet a Local RAR in a local reliability area only if (a) sellers in the local area have no market power; (b) generation is available for purchase; (c) creditworthy counterparties are available; and (d) generation is a cost-effective option compared to transmission upgrades or operational actions. When one or more of those conditions are not met for a local reliability area, the Commission should not set a Local RAR for LSEs for that area. In that event and until the conditions are met, the CAISO should purchase needed capacity under cost-of-service contracts[5] with the costs then charged to all loads in the local reliability area ("Backstop Role"). At the

[4] AReM uses the term "Local RAR" to mean a LSE-specific, megawatt requirement set for a particular local reliability area.

[5] Alternatively, the proposed Reliability Capacity Services Tariff ("RCST") (EL05-146-000) could be used for this purpose, if approved by the Federal Energy Regulatory Commission ("FERC"), deemed effective by the Commission at mitigating local market power, and with the costs allocated to all loads in the Local Capacity Area.

same time, the CAISO should actively pursue transmission upgrades to relieve the constraints.

- **Allow demand response programs, interruptible tariffs and other market based solutions to help** -- These solutions are both cost effective and more immediately deployed than generation and transmission infrastructure. Moreover, making these options available to LSEs and end users will mitigate market power in local areas dominated by a single generator or owner and allow more time to make transmission upgrades.

- **Conduct Independent, Third-Party Review of CAISO's Proposal** -- An independent firm should be hired to provide a comprehensive third-party review of the CAISO's technical approach, compare it with industry standards, and recommend modifications. The Commission has a duty to ensure that the requirements imposed on LSEs are reasonable, effective and likely to provide the expected reliability gains. Because the CAISO's local reliability studies provide the technical underpinnings for the Commission's Local RA Policy, the Commission must provide for comprehensive, technical review by a third party, thorough vetting by parties through evidentiary hearings and determination of the local reliability approach that is right for California. Of particular interest would be a third-party evaluation of the merit and value of using a Probabilistic Risk Assessment ("PRA") methodology in place of the deterministic approach used in the CAISO's technical study. PRA tools have proved themselves to be superior in terms of increasing reliability in a cost-effective way.

- **Subject CAISO's basic assumptions to a cost/benefit test** -- The CAISO's Local Capacity Requirements ("LCRs") are based upon a more severe set of failure criteria than that used in the Reliability Must Run ("RMR") analysis, generally by assuming two or more failures (N-2) instead of one (N-1). As the CAISO's technical report indicates, this is an important reason why the LCRs are higher than RMR requirements. This basis should be questioned until a cost-benefit analysis demonstrates that there is, in fact, a real increase in local

reliability. It is not immediately apparent that there will be fewer system failures than we are experiencing today.

- **Assess Potential for Exercise of Market Power and Determine Upfront Remedies** – The Commission should conduct a comprehensive review of the potential for exercise of market power in each local area and identify upfront remedies. Exercise of market power is a significant concern for LSEs and, if left unchecked, will burden California consumers with high prices and hamper competitive markets for the foreseeable future. The Commission must establish local reliability areas that are sufficiently large to minimize market power and provide market liquidity. In addition, the Commission must adopt upfront market power remedies, such as rules to address pivotal suppliers and requirements for backstop contracts that mitigate market power and allocate costs appropriately.

- **Provide Incentive to Relieve Transmission Constraints** – An automatic transmission upgrade and an exemption from meeting the Local RAR should be triggered if more than 70% (or an alternative agreed-upon percentage) of the local generation must be purchased by LSEs to meet the proposed local requirement. Local reliability areas are created by transmission constraints. Incentives are necessary to ensure that transmission owners and the CAISO are taking the necessary steps to relieve constraints, rather than overburdening LSEs with an out-sized generation requirement. The CAISO would perform its Backstop Role until the upgrade is completed.

- **Use Penalty Dollars to Fund Capacity Purchases and Upgrades** – The penalty dollars paid by LSEs should be used to take action to address the reliability problems. When the Commission sets a Local RAR for LSEs in a local reliability area, the LSEs must meet it or be penalized. The LSE's penalty payment should be used to reimburse the CAISO for the LSE's share of the costs for purchase of local capacity, if needed. Any excess penalty dollars should go into a fund to build upgrades to relieve the transmission constraint.

- **Adjust Local RAR to Reflect Load Migration** – Each LSE's Local RAR for the monthly showings should be adjusted on a monthly basis to reflect load migration. Monthly load migration can be significant. LSEs losing load will have an incentive to off-load their local capacity, while LSEs gaining load should be obligated to pick up the new local capacity they need to meet the local requirements.

- **Exempt LSEs with a Local RAR Less Than 1 MW** -- If any LSE has a Local RAR of less than 1 MW for a local reliability area, that LSE should be exempt from meeting its requirement for that local area. This is a serious issue for smaller LSEs or LSEs with tiny loads in some local reliability areas. With the overarching policy goal of setting reasonable and attainable Local RARs, fractional requirements should provide a clear case for an exemption.

- **Allow Waivers** – Requests for waivers by LSEs that are unable to meet their Local RAR should be allowed where (a) market power is being exercised; (b) generation is unavailable for purchase; or (c) available counterparties are not creditworthy. Establish an expedited process to act on the waiver request with due process for the LSE. If granted, the LSE pays no penalty, but would pay its share for capacity purchased by the CAISO, if needed. If denied, the LSE still must meet the Local RAR or pay a penalty.

- **Send Price Signals to Counter Seller Market Power and Avoid Anti-Competitive Outcomes** – Locational price signals must be sent to consumers. Price signals can be sent by requiring utilities to charge a Local RAR adder to bills of customers in the local reliability areas. Price signals encourage consumer response as a counter to seller market power. In addition, they avoid anti-competitive outcomes and discriminatory treatment of consumers of utilities versus other LSEs. If the Commission is unwilling to send this price signal, then it should not impose a LSE obligation and any local reliability needs should be met by the CAISO and the costs socialized to all consumers.

II. INTRODUCTION

In D.05-10-042, the Commission properly determined that it had insufficient information on the record to establish a Local RAR for LSEs.[6] However, the Commission committed to move quickly and stated its plan to adopt Local RARs by June 2006 and require LSEs to comply with these new requirements beginning with the September 30, 2006 showing for 2007.[7] To move the process forward quickly, the Commission requested interested parties to submit Local RAR proposals in January 2006. In addition, the Commission issued a new rulemaking (R.05-12-013) in December 2005 to address both the Local RA Policy and further refinements to the rules for Resource Adequacy.[8]

AReM commends the Commission for taking the time necessary to do the job right. A Local RAR will impose significant costs on California consumers and the Commission has a duty to ensure that those costs are reasonable and provide the expected "bang for the buck." AReM supports a LSE-specific Local RAR with requirements that are both reasonable and attainable. Further, AReM believes that any rational Local RA Policy must provide incentives to relieve the transmission constraints that create the local reliability areas in the first place. Any "one-sided" approach to reliability that focuses solely on generation and ignores demand side, transmission and operational options will overburden consumers and fly in the face of the Commission's dicta that "reliability at any cost" is "not a policy option."[9] AReM submits that the Commission must implement a "many-sided" package of solutions to local reliability needs, in order to minimize, to the extent possible, excessive costs for California consumers and ensure adequate mitigation of market power. With this filing, AReM builds on policy pieces it submitted during the Phase 2 Workshops and lays out a process to ensure that the Commission reaches both a reasoned and practical decision on local reliability.

---

[6] The decision affirmed the Commission's interest in taking charge of the Local RAR issue as follows: "…approving the CAISO's preliminary proposal at this time would, in effect, constitute an inappropriate delegation of our own authority to make determinations regarding the balancing of reliability and the costs of achieving that reliability." (D.05-10-042, pp. 80-81)

[7] The Commission recently reaffirmed this commitment in R05-12-013, p. 5.

[8] *Ibid*, p.2.

[9] *Ibid*, p. 8.

III. OVERARCHING POLICIES FOR LOCAL RAR

In the Phase 2 Decision, the Commission listed a number of topics for which it requested comment.[10] First, however, it suggested that parties submit ideas about appropriate overarching policies for the Local RAR. In particular, the Commission referred to AReM's proposed overarching principles from its opening comments on the Phase 2 Workshop Report:[11]

> *"We note that the policy principles suggested by AReM in its opening comments may represent an appropriate starting point for discussions of local RAR policy; however, we do not necessarily endorse the AReM positions stated therein."*

AReM's two proposed overarching principles were: (a) transmission must be part of the package; and (b) higher costs must provide commensurate gains in reliability.[12] AReM reaffirms its support for these two overarching principles and adds three more critical policy principles. The five proposed overarching policies are described below.

1. **Local RARs must be attainable –** This point is key. As is discussed extensively below, LSEs must have Local RARs that they can meet. Having a requirement that is unattainable is without meaning, essentially providing the "show" without the "substance." LSEs faced with an unattainable requirement will be forced out of business, reducing competition and making California consumers the real losers. The Commission must focus its efforts on ensuring that its requirements are reasonably attainable by *all* LSEs.

2. **Any increase in costs to consumers must be commensurate with gains in reliability --** This concept meshes well with the Phase 2 Decision's emphasis that "(u)ltimately, measures that are proposed to promote greater grid reliability

[10] D.05-10-042, p. 81.
[11] *Ibid*, footnote 19, p. 81.
[12] *Comments of the Alliance for Retail Energy Markets on Phase 2 Resource Adequacy Requirements Phase 2 Workshop Report*, p. 40.

should be evaluated by weighing their expected costs against the value of their expected contribution to reliability."[13] AReM believes this step to be critical. Thus far, the CAISO's requests for additional reliability needs have been accepted unchecked. This unquestioned acceptance must now end and the Commission has the obligation to provide the essential "checks and balances" in the process. As the Commission has affirmed repeatedly, "'reliability at any cost' is not a policy option."[14] Although additional dollars can always be spent, at some point, the return in reliability gains will greatly diminish. At that point, the "bang for the buck" is gone and additional expenditures are essentially wasted dollars. The Commission should be on the lookout for the point at which we reach this level of diminishing returns and stand ready to modify its RA policy accordingly.

3. **Transmission upgrades must be required to relieve the local constraints --** Local reliability areas are defined by transmission constraints. Therefore, any program to address reliability for those areas must include transmission upgrades. A cost-effective approach would be to select the least-cost option be it transmission, generation or operational action that achieves the required level of reliability. The Commission must determine how to incorporate transmission into its Local RA Policy.

4. **The size of each Local Capacity Area must be sufficiently large to allow for adequate market liquidity –** This issue has been raised repeatedly by AReM. The local areas must be sufficiently large to allow both for market liquidity and reduced opportunity for exercise of market power by the internal generators.

5. **The Commission should review its RA requirement annually and phase it out as California develops adequate generation, transmission and markets that ensure reliability --** AReM proposed biennial reviews of the RAR in its Phase 2

[13] D.05-10-042, p. 8.
[14] *Ibid*, p. 8.

Workshop Comments.[15] One of the primary goals of Resource Adequacy is to provide incentives for development of infrastructure in California.[16] As with any goal, success is achieved when the goal is met. The Commission has an obligation to review the Local RA program regularly to measure its success, make critical modifications and, ultimately, end it when it has achieved its goals. Only then, can the markets begin to operate unfettered and provide the maximum possible benefit to California consumers.

IV. THERE IS A NEED FOR INDEPENDENT, THIRD-PARTY REVIEW OF CAISO'S LOCAL RELIABILITY APPROACH

AReM highlights one key component of its proposal for a Local RA Policy – the need for an independent, third-party review of the CAISO's local reliability approach. Reliability assessment is a specialized field and the CAISO's studies provide the technical underpinnings for the Local RAR imposed on LSEs. There are multiple millions of dollars at stake for California consumers and the Commission has a duty to obtain both a comprehensive, independent technical review of the CAISO's proposal and objective evidence of industry practice and standards for *planning* requirements to meet the NERC and WECC reliability standards. To fulfill this duty, the Commission should engage an independent firm to provide a comprehensive assessment of the CAISO's proposed approach for determining the Local Capacity Requirements ("LCRs") and, ultimately, conduct hearings to adopt its own technical approach.

The CAISO is not a state agency, and yet not simply another intervenor with a proposal it is promoting and seeking concurrence on from the Commission. Rather, the CAISO is the only entity that is making such proposals and AReM is concerned that the CAISO's proposals receive the same scrutiny prior to adoption or implementation that a utility would receive in making a rate case proposal. The Commission must consider the proposal and give the public, particularly those who will be paying for the costs of such proposals the opportunity for reasoned and effective discourse and debate.

[15] *Comments of the Alliance for Retail Energy Markets on Phase 2 Resource Adequacy Requirements Phase 2 Workshop Report*, p. 13.
[16] D.05-10-042, p. 7.

Because of its technical nature, AReM proposes that the Commission engage an independent firm to evaluate the CAISO's technical approach and provide needed guidance on the state of industry practice. In short, AReM is convinced that a review by an independent, third party is essential either to verify the reasonableness of the approach or recommend appropriate changes.

Many stakeholders have concerns about the CAISO's local reliability approach and its high and controversial estimates of LCRs[17] (see Table 1). The Commission must ensure that the CAISO's proposals are just and reasonable and will provide measurable and cost-effective improvements in reliability.

Significantly, the CAISO's final local capacity report for 2006 ("2005 Report")[18] set LCRs 55% higher than capacity required from RMR units, yet failed to address the many questions and concerns raised by the stakeholders about the underlying assumptions and final results. The CAISO attempted to explain its 55% higher requirements by asserting that the proposed requirements reflect (a) the actual conditions under which the CAISO must operate, whereas the LARS do not; (b) 500 kV path "mitigation;" and (c) 1-in-10 peak load. By contrast, the CAISO claims that LARS[19] does not reflect these same requirements.[20]

[17] *Local Capacity Technical Analysis, Overview of Study Report and Final Results*, filed with the Commission as Attachment 2 to the "Motion of the California Independent System Operator Corporation to Augment the Record Regarding Resource Adequacy Phase 2," September 23, 2005.
[18] *Ibid.*
[19] The Local Area Reliability Study ("LARS") is conducted annually by the CAISO to determine the megawatts required from RMR units.
[20] 2005 Report, pps. 1-2.

Table 1

SUMMARY OF CAISO'S 2006 LOCAL CAPACITY REQUIREMENTS (LCR)

Local Capacity Area[21]	2006 Total Local Capacity Requirement (MW)	Total Dependable Local Area Generation (MW)	2006 LCR as % of Total Local Area Generation
Humboldt	162	168	96%
N. Coast/N. Bay	658	888	74%
Sierra	1,770	1,713	103%
Stockton	440	458	96%
Greater Bay Area	6,009	7,591	79%
Greater Fresno	2,837	2,651	107%
Kern	797	839	95%
LA Basin	8,127	10,309	79%
San Diego	2,620	2,957	89%
TOTAL	**23,420**	**27,574**	**85%**

Source: *Local Capacity Technical Analysis, Overview of Study Report and Final Results,* CAISO, September 23, 2005, p. 13.

AReM is concerned about many of the assumptions and conclusions of the CAISO's 2005 Report. For example, AReM questions whether the CAISO is blurring the distinction between operational requirements and planning requirements. While the CAISO may have valid *operational* needs, the Local RAR – a *planning obligation* – is not the appropriate means for solving an operational problem. As discussed at several meetings of the CAISO's Market Surveillance Committee in 2005, the CAISO's operational needs can be met most cost-effectively through CAISO purchases of targeted generation products. It is the CAISO's obligation to define its operational needs and the products to meet those needs – rather than to attempt to off-load this obligation to LSEs in an unworkable and excessively-expensive form. In discussions with CAISO staff, the

[21] In the 2005 Study, the CAISO now uses the term "Local Capacity Areas" or "LCAs" instead of its previous term "Local Reliability Areas" or "LRAs".

technical representatives of a number of stakeholders, particularly transmission planners of the larger LSEs, criticized the CAISO's study assumptions as being overly restrictive and leading to inflated local reliability requirements.

In conducting the independent review, the comparison with standard industry practice is especially crucial. For example, when a transmission owner evaluates reliability needs for a local area, it examines both the *risk* of the event (e.g., N-2 has a much lower probability of occurrence than N-1) and the *cost* required to fix the problem. Requiring LSEs and their customers to sign contracts to keep generation running is not typically in the transmission owner's bag of tricks. Rather, the transmission owner looks at upgrades, system protection schemes, other operational actions and, sometimes, building generation. The point is that these fixes are customarily viewed through a cost-effectiveness filter. Given the probability of a particular outage, is it cost effective to fix? AReM fears that such a cost-effectiveness filter is missing from the CAISO's local capacity analysis. Transmission owners frequently ignore low probability "problems" because the cost to solve the problem is prohibitive. The question the Commission must ask (and for which an outside expert opinion would be invaluable) is whether it makes sense to burden LSEs with an out-sized capacity obligation, when transmission owners would never consider addressing the problem in the first place? The Commission must address this key question in its Local RA policy.

To assist in addressing LSEs' concerns about the CAISO's technical approach for local reliability, AReM proposes that the independent firm address the following questions:

- Is the CAISO's local capacity approach consistent with NERC/WECC requirements? If not, how does it deviate and how should such deviations be corrected?
- In addition to providing generation capacity, what other responses to contingencies are allowed under NERC and WECC requirements?
- Should the LCR be determined using the 1-in-5 load forecast used to set the overall RAR? What are the costs to consumers and the

measurable reliability benefits of using a more stringent load forecast, such as 1-in-10?

- Where N-2 contingencies are used as the basis for the local requirements, what is the probability of these events? What is the probability of these events and a 1-in-10 peak load occurring simultaneously?
- What probability of events is appropriate and considered by standard industry practice to be cost-effective for setting local reliability planning standards?
- Should 500-kV path ratings be included when defining the LCRs? Is this an appropriate requirement for a planning standard or is it typically considered to be an operational requirement?
- As a general matter, the CAISO seems to apply more stringent contingency requirements in its proposal for determining the LCRs than it does for determining the need for RMR units. What is the expected added cost to California consumers from using these more stringent requirements? What commensurate increases in reliability can be expected? In standard industry practice for setting local reliability planning requirements, have other jurisdictions used this approach and what has been the outcome in reliability and cost? In standard industry practice, what probabilities are considered to be too low (i.e., a remote chance of occurrence) and therefore rule out generation as a solution? In those cases, what other options are typically considered to be acceptable?
- Should a Probabilistic Risk Assessment ("PRA") methodology be used in place of the deterministic approach in the CAISO's technical study? What cost savings and reliability effects could we expect from using PRA?

- What is standard industry practice in determining that transmission upgrades would be justified in place of generation or operational actions, such as remedial action schemes?
- How does the utility industry differentiate *planning* contingencies from *operational* contingencies in determining local reliability requirements? What is standard industry practice in planning to meet operational contingencies?

The bottom line is that, before imposing LCRs of this magnitude on LSEs, the Commission must thoroughly vet the CAISO's technical approach and make a determination that it represents reasonable and cost-effective LCRs for California consumers – or adopt an alternative new technical approach that does work for California.

V. AReM'S PROPOSAL FOR A COMPREHENSIVE PROGRAM FOR LOCAL RESOURCE ADEQUACY

The LCRs both set the bar for the LSEs' purchases and dictate the dollar outflow needed to meet the requirements. LSEs are concerned about cost-effectiveness and ensuring that the RA purchases they make provide the expected "bang for the buck" to California. Given both the compressed schedule for 2006 and the need for comprehensive and in-depth review of the CAISO's technical studies and assumptions, AReM proposes the following steps toward a reasonable and attainable Local RA policy for California. AReM proposes eight major tasks, as described below.

A. Setting a Reasonable and Attainable Local RAR

The Local RAR will add significant costs to California consumers. The Commission must ensure that its policies and requirements are reasonable, effective and protect against market power abuse. AReM also notes that the extensive amount of analysis that must be conducted calls into question the Commission's proposed schedule of a final decision by June 2006. Until a cost-benefit analysis is applied to the results of the CAISO technical report, which is crucial to this proceeding, it is entirely possible that

a decision could be made that actually decreases local reliability while putting into place long-term costs. Here is clearly a case where expediency can lead to unintended consequences. AReM urges the Commission to take the time necessary to do this right.

1. Conduct an independent, third-party review of CAISO's technical approach for determining Local Capacity Requirements.

As discussed in Section IV, the Commission should hire a firm to conduct an independent and comprehensive review of the CAISO's technical approach for determining LCRs and to compare the CAISO's approach and its underlying assumptions with standard industry practice. Only with an independent, third-party review can this Commission and consumers be assured that the CAISO's approach is right for California. Further, if the review recommends changes to the CAISO's approach, the Commission would then be on firm ground to order such changes. Once a technical approach is authorized by the Commission, the CAISO would use that approach to determine the LCRs for 2007.

2. Following the independent review, the Commission should hold hearings to determine the technical approach for setting the LCRs.

After the independent review is completed, the Commission should conduct hearings to receive public comment and recommendations for making changes to the CAISO's technical approach. The hearings should address standard industry practices in setting local reliability standards, the reasonableness of the CAISO's proposed approach the results and recommendations from the independent review and the ways in which the Commission can incorporate both probability and cost into the CAISO's technical assessment to reduce the possibility that LCRs will be based on low probability events.

3. Order technical approach for setting the LCR.

Following hearings, the Commission would issue an order adopting the technical approach to be implemented by the CAISO in setting the LCRs for California.

4. CAISO conducts Local Capacity Reliability Study for 2007.

The CAISO would revise its technical approach to confirm with the Commission's order and conduct its technical review to identify the Local Capacity Areas and their respective LCRs for 2007. The CAISO will file its final study at the Commission and support it during the hearing process, during which the LSEs will have the opportunity to provide technical witnesses to address the CAISO's study.

B. Conduct Initial Review of Potential Market Power Issues and Remedies.

The number of Local Capacity Areas identified by the CAISO (nine) and the magnitude of the MW requirements (23,420 MW) raise significant concerns about the potential for exercise of market power. For example, the CAISO's own study[22] shows that 85% of the generation capacity within the Local Capacity Areas must be purchased by LSEs to meet the LCRs. Now is the time for the Commission to address this issue. The Commission must conduct an independent review (by its own staff or by engaging a consulting firm) of the potential for exercise of market power in the local areas. For example, the "pivotal supplier test" used by some ISOs may be appropriate[23]. The Commission would then determine ways to minimize market power before it can be exercised, such as maximizing the size of the Local Capacity Areas and prohibiting "pivotal suppliers" from participating. If such upfront mitigation would be inadequate, the Commission would next determine appropriate additional remedies, such as requiring cost-based contracts from suppliers (or, potentially, offering service und the RCST with appropriate cost allocation[24]) and refusing to set Local RARs in Local Capacity Areas where market power can be exercised. This initial and upfront review would be used by the Commission staff in evaluating the CAISO's results from Task A and determining which Local Capacity Areas can sustain a Local RAR (Task C).

---

[22] 2005 Study, p. 13.

[23] See, for example, *Suggested Methodology for Competitive Path Assessment,* CAISO's Department of Market Analysis, July 6, 2005.http://www.caiso.com/docs/09003a6080/36/78/09003a608036782cex.html

[24] The RCST would first have to be approved by FERC and deemed effective for mitigating market power in the local reliability area by the Commission.

C. Establish Local RARs only where (a) the generation option is cost-effective, (b) creditworthy counterparties are available, (c) generation is available for purchase by LSEs and (d) market power cannot be exercised.

The Commission must ensure that any Local RAR it establishes for LSEs is both reasonable and attainable. Using the results of the CAISO's local capacity study (Task A) and the Commission's initial review of market power (Task B), the Commission must evaluate the size and composition of each Local Capacity Area, the number and ownership of internal generators, and the potential for exercise of market power. After completing this evaluation, the Commission can then determine the Local Capacity Areas for which a Local RAR is both reasonable and attainable for LSEs. A discussion of the four conditions that the Commission must consider follows:

Cost-Effective Generation -- As described above, generation options cannot be viewed in isolation. The Commission must first determine for each Local Capacity Area if generation is a cost-effective option. If the probability of the reliability event occurring is low and the costs high, the Commission must examine whether it is indeed reasonable to establish a Local RAR for that area. The Commission could decide, for example, that transmission upgrades or operational solutions (such as remedial action schemes, manual load shedding or other demand response) were more cost-effective. Or, if all such options were costly and the probability of occurrence low, say once in 50 years, the Commission may reasonably choose to forego any action, save the need for the local utility to drop load if the low probability event actually occurred.

Creditworthy Counterparties – Financial problems in the electricity sector continue, as evidenced by Calpine's recent bankruptcy. Since 2001, LSEs have experienced significant difficulty in finding creditworthy counterparties that meet internal risk management guidelines. The Commission should not establish Local RARs when the internal generators in the Local Capacity Area fail to meet basic credit standards.

Generation Must Be Available for Purchase -- The CAISO's 2005 Report indicated that 100% of the generation located in some Local Capacity Areas (Humboldt, for example) is owned by utilities and Qualifying Facilities ("QFs") and would therefore be unavailable for purchase by other LSEs. The Commission could easily determine if the utilities have any extra capacity to sell. If they do, the

Commission could require reasonable sales prices to other LSEs. If not, the Commission could exempt LSEs from meeting a Local RAR for that Local Capacity Area. Further, considering that the generation is already tied up, the CAISO should not be allowed to go out and purchase it over again. Further, as discussed below, LSEs with a Local RAR of less than 1 MW should be exempt. Generators will not be willing to sell tiny, fractional amounts in the market, nor will the CAISO be willing or able to accommodate such tiny amounts for meeting the RA Must Offer Obligation.

Market Power – In Task B, the Commission would conduct an initial review and developed a game plan for addressing market power. The Commission would evaluate each Local Capacity Area to determine whether pivotal suppliers, lack of independent sellers or other conditions indicate that market power is present. If it does exist, the Commission should not establish a Local RAR for that Local Capacity Area.

Once the Commission has evaluated these four conditions for each Local Capacity Area and decided which areas can sustain a Local RAR for LSEs, the Commission would then determine the Local Capacity Requirement (in megawatts) for each and fix it for three years.[25] AReM proposes fixing the Local Capacity Requirement for three years to avoid having to repeat this arduous process each year.

The above discussion focuses on the factors the Commission should consider when deciding to require LSEs to meet a Local RAR for a Local Capacity Area. AReM proposes additional features of this determination process, as follows:

1. **A Local Capacity Requirement that exceeds 70% (or an alternative agreed-upon percentage) of the local area generation should trigger transmission upgrades.**

A trigger is necessary to ensure that the CAISO and the Participating Transmission Owners ("PTOs") have an incentive to relieve transmission constraints. Requiring that LSEs purchase a specified percentage of the generation within a Local Capacity Area should be considered to be a *de facto* indicator that market power exists. AReM proposes 70% for this trigger, as a reasonable compromise between 100% (meaning no competition) and 50% (half of the generation is competing). AReM further suggests

[25] As described in Task E, each LSE would use the Commission-determined Local Capacity Requirement to calculate its Local RAR for the relevant Local Capacity Area.

that more study is needed to set the appropriate percentage as the *de facto* trigger. The Commission should determine the percentage through market power studies and thorough vetting by the affected parties. When the trigger is met for a Local Capacity Area, the Commission should require that cost-effective upgrades be constructed to relieve the transmission constraint. When upgrades are triggered, the PTO would be obligated to take immediate action to eliminate the transmission constraint. In the alternative, the CAISO could solicit interest from third parties to construct the necessary upgrades. Until the constraint is relieved, the CAISO would be obligated to enter into cost-of-service contracts (if necessary)[26] and the Commission would set no Local RAR for that Local Capacity Area.

2. Flexibility in Meeting the Local RAR.

The Commission should confirm in its decision that LSEs may use distributed generation, demand response, manual load shedding and other operational actions to meet their Local RAR. Ensuring these options "count" should offer additional options for smaller LSEs to meet the Local RAR, particularly when their Local RAR is too small for generators to be willing to sell. Also, as proposed below (Task E), LSEs with a Local RAR for a Local Capacity Area of less than 1 MW would be exempt from meeting the requirement for that area.

3. Application of One-Time Penalty.

If a LSE fails to purchase sufficient capacity to meet its Local RAR in a Local Capacity Area as demonstrated in its annual or monthly showing, the LSE will be subject to the RA penalty specified in the Phase 2 Decision.[27] If the CAISO purchases capacity to replace what the LSE failed to provide, the LSE's penalty would be used by the CAISO for payment. No additional payment or penalty would be required of the LSE. Any penalty dollars unspent would go toward building transmission upgrades to relieve the constraint. If the LSE is a utility, the penalty payments will be allocated to the generation component of its ERRA rates, because this cost is, in effect, a cost of

[26] Or, if deemed appropriate by the Commission and approved by FERC, the RCST.
[27] The penalty is 150% times the monthly cost of new capacity for 2006 and 300% for 2007 and beyond (D.05-10-042, p. 94).

generation. This cost allocation approach also ensures that direct access customers pay no share of generation costs incurred by the utility.

4. Limitations on Use of Backstop Contract by CAISO.

If LSEs meet their Local RARs through the annual and monthly showings, the CAISO should not require or enter into any additional backstop contracts. Rather, if the CAISO believes that it requires additional capacity to meet operational needs, it should focus on developing and implementing generation products needed to provide that service and economic incentives to encourage generators to bid to provide those services to the CAISO.

D. When the Commission decides that no Local RAR should be established for a Local Capacity Area and local capacity is still needed for reliability purposes, the CAISO would enter into cost-of-service contracts with local generators or offer service under the RCST, if appropriate.

In the early years, before transmission upgrades are constructed, many of the Local Capacity Areas may fall into this category. In some cases, adequate generation within the Local Capacity Area may be available to meet the load of the local utility and additional backstop arrangements may not be necessary. For cases when additional capacity must be purchased, the capacity costs incurred by the CAISO would be allocated to all loads in the Local Capacity Area. If upgrades are triggered, the CAISO would meet all reliability needs with cost-of-service contracts until construction is completed. Alternatively, the Commission could determine that the CAISO should offer service under the RCST as an appropriate mitigation to market power or other issues in a Local Capacity Area, assuming the RCST or some similar approach is approved by FERC.

E. Allocating Local Capacity Requirements to LSEs

A simple process was proposed during the Phase 2 Workshops, but never adopted. The proposed approach was to use zip codes as a good approximation of customer loads in each Local Capacity Area. The LSEs would use their own billing systems to determine their load within each Local Capacity Area and calculate their own

Local RAR. **AReM proposes one additional critical criterion – LSEs with a Local RAR of less than 1 MW (a fractional share) would be exempt from meeting the requirement**. AReM believes a requirement to meet a fractional Local RAR is patently unreasonable and impractical for a number of reasons, first and foremost being the unavailability of commercial transactions in fractional shares. Secondly, the CAISO is likely to be unable to accommodate fractional amounts for purposes of meeting the RA Must Offer Obligation. Although the Local Capacity Requirement would be fixed for three years, each LSE's Local RAR would be adjusted as its load varied (see Task F). Following is a brief discussion of the steps needed to complete the allocation process for each Local Capacity Area with a Local RAR:

a. The CAISO defines the geographic boundary of each Local Capacity Area by listing all the substations within its boundaries. The CAISO provides this list to the PTOs. The CAISO provides the megawatts of peak load in each Local Capacity Area to the LSEs.
b. The PTOs use the CAISO's list to determine which postal zip codes fall within the geographic boundaries of each Local Capacity Area. The PTOs inform the LSEs of the zip codes within each Local Capacity Area.
c. Each LSE uses its billing system to determine the customers located within each such Local Capacity Area.
d. The LSE adds up the peak capacity for its customers in the Local Capacity Area. For customers without a capacity value, the LSE will convert the megawatt hours of use to a capacity value using pre-determined curves developed by the utilities by customer class.
e. The LSE calculates its proportional share of the Local Capacity Requirement by dividing its total peak megawatts of customer load by the megawatts of peak load in the Local Capacity Area. The LSE applies that percentage to the Local Capacity Requirements to determine its Local RAR for that Local Capacity Area.

F. Providing for Load Migration.

LSEs would adjust their Local RAR annually for each Local Capacity Area to correspond with their CEC-adjusted load forecasts. In addition, as for the System RAR, AReM proposes that LSEs would also be required to adjust their monthly Local RARs for each local area, but only to account for load migration.[28] Because load migration is tracked through Direct Access Service Requests ("DASRs"), verification should be a simple process. Until a tradable capacity market exists, LSEs will have to rely on good-faith negotiations, assignable contracts, and Commission-sponsored bulletin boards for listing trading opportunities. LSEs that lose load will have an incentive to sell (or their contracts will terminate with their customer arrangements). The load will be transferred to another LSE, which will have an incentive to purchase, especially considering that the DASR process will reveal its new load and make the LSE subject to penalties if it fails to make the required showings.

G. LSE Waiver.

A LSE should have the right to request a waiver from meeting its Local RAR if a generator is exerting market power, no generation is available for purchase, or creditworthy counterparties are unavailable. Despite the Commission's best efforts to establish Local RARs only where the LSEs can meet the requirements, unforeseen events will occur. The waiver would provide LSEs with a reasonable off-ramp and allow the Commission to make the final call on whether it should be granted. The LSE would submit its waiver request to the CPUC under confidentiality rules, including documentation supporting its case. The Commission staff would conduct an expedited investigation, giving the LSE the opportunity to respond to questions and defend its request. The staff would then recommend to the Commission whether to grant or deny the request. The LSE would have the opportunity to respond to the staff's determination and the Commission would make the final decision. If the waiver is granted, the LSE would not be subject to a penalty. If denied, the LSE would still be obligated to meet the Local RAR or pay the penalty. If the LSE requests and receives the waiver, the LSE pays for the CAISO for its share of a cost-of-service contract with a local generator (or RCST

[28] D.05-10-042, p. 91.

service, if approved for this purpose), if one is needed. If the LSE is a utility, it would recover those costs through the generation component of its ERRA. A detailed waiver procedure could be addressed in a workshop process or through written comments.

H. Sending Price Signals to Consumers.

One of the more desirable benefits of a Local RAR would be to send a price signal to consumers in the Local Capacity Area that would eventually lead to remedial actions, such as transmission upgrades, to eliminate the problem when cost-effective. Price signals encourage consumer response, such as demand reduction, which can be an effective counter to seller's market power. To send appropriate price signals, utilities would have to allocate the costs of the Local RAR to their customers located in the Local Capacity Area and make these costs transparent – essential to provide non-discriminatory treatment for direct access customers, who must pay the locational costs of service to their Energy Service Providers ("ESPs"). To do otherwise, would create anti-competitive effects on the market. The Commission has chosen to establish a LSE obligation to meet a Local RAR. As a corollary to this obligation, it must then send the locational price signal to consumers. If the Commission is unwilling to send this price signal, then it should not impose a Local RAR obligation on LSEs. Instead, any local reliability needs should be addressed by the CAISO and the costs socialized to all consumers.

In spite of the common complaints we expect to hear from utilities about their inflexible billing systems, AReM believes it a simple matter to create a "Local RAR Charge" for the utilities' customers. For example, each utility could calculate a Local RAR capacity adder (based on the local capacity contracts) for all of its customers in the Local Capacity Area. Two of the utilities, Southern California Edison and San Diego Gas & Electric, have only one proposed Local Capacity Area within each of their service territories. PG&E has seven proposed areas. Also, note that the utilities would already be using their billing systems to identify the customers in each Local Capacity Area by zip code. These same customers could then be targeted for the "Local RAR Charge" on their bills. Allowing the price signals to be sent to consumers and making those prices

transparent will stimulate consumer response, counter seller's market power and avoid anti-competitive effects on the market.

VI. TIMING OF IMPLEMENTATION

Once the Commission issues its final decision on Local RAR, many intervening steps must be accomplished before the LSEs are able to enter into commercial transactions to purchase Local RAR capacity for the showings due September 30, 2006. As a guide, AReM points out that the time allowed for implementation of the Phase 2 Decision was ridiculously short. And, as we have learned in the time since the Phase 2 Decision, unexpected issues arise, misunderstandings or unclear provisions must be resolved, procedures must be followed and additional analysis must be carried out. All of this takes time.[29] The Commission's proposed timetable is extremely tight, especially considering our experience in obtaining draft and final local capacity numbers from the CAISO in 2005. AReM respectfully advises the Commission that LSEs require a minimum of 120 days from the date they have all the information necessary to calculate their Local RAR until they are required to make their first Local RA showing.

VII. CONCLUSIONS

For the foregoing reasons, AReM requests:

- The Commission should adopt AReM's five overarching policies for guiding its Local RA policy.
- The Commission should establish a local requirement only where LSEs can reasonably meet that requirement. LSEs cannot reasonably be expected to meet a Local RAR if the sellers can exercise market power, generation is unavailable for purchase, sellers are not creditworthy, or transmission upgrades or other operational actions are more cost-effective. In that event, the CAISO should purchase capacity under cost-of-service contracts in its Backstop Role, or, if determined appropriate and approved, offer service

[29] As we make this filing, for example, the LSEs are still waiting for the CAISO to provide the final results of their requests for Intertie Allocations, which were due to be completed by January 13 and are essential for making the RA showing for the 2006 summer months.

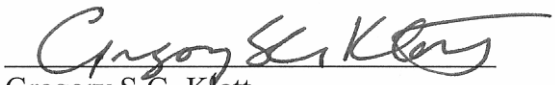
under the RCST, and the costs should be charged to all loads in the Local Capacity Area.

- The Commission should engage an independent firm to provide a comprehensive third-party review of the CAISO's technical approach for determining local reliability needs, compare it with industry standards and recommend modifications.
- The Commission must conduct evidentiary hearings to determine the most reasonable and cost-effective approach for setting local reliability requirements for California, consistent with standard industry practice.
- The Commission must conduct a comprehensive review of the potential for exercise of market power in each Local Capacity Area and identify upfront remedies.
- The Commission's Local RA Policy should include a trigger for automatic transmission upgrades when excessive purchases are required by LSEs in a local area. AReM proposes 70% as that trigger but recommends further study. LSEs would be exempt from meeting their Local RAR for that area and the CAISO would meet any reliability needs until the upgrade was completed.
- The Commission should order that all penalty dollars paid by LSEs be used to address the local reliability problems, including setting up a fund to build upgrades to relieve the transmission constraint.
- The Commission should allow waiver requests by LSEs under certain specified conditions and establish an expedited process with due process to act on the request.
- The Commission must adopt a Local RA Policy that sends price signals to consumers to counter seller market power and avoid anti-competitive outcomes.
- The Commission should adopt the Phase 2 Workshop proposal for allocating the Local Capacity Requirement to individual LSEs and require that each LSE's Local RAR be adjusted for the monthly RA showings to reflect load

migration. LSEs with a Local RAR of less than 1 MW for a Local Capacity Area should be exempt from meeting that requirement for that area.

- The Commission should provide a minimum of 120 days from the date LSEs receive all the information necessary to calculate their Local RARs until they are required to make their first RA showing.

Respectfully submitted,



Gregory S.G. Klatt

DOUGLASS & LIDDELL
411 E. Huntington Drive #107-356
Arcadia, California 91007
Telephone: (626) 294-9421
Facsimile: (626) 628-3320
klatt@energyattorney.com

Attorneys for
ALLIANCE FOR RETAIL ENERGY MARKETS

Date: January 24, 2006

ATTACHMENT 1

PROPOSED GLOSSARY	
Defined Term	**Meaning**
LCA	Local Capacity Area
LCR	Local Capacity Requirement
Local Capacity Area	Geographic areas identified by the CAISO as requiring local capacity to ensure reliable electric service for the load in the area.
Local Capacity Requirement	Term used by the CAISO to mean the megawatts of capacity required in each Local Capacity Area to provide reliable electric service.
Local RAR	The Local Resource Adequacy Requirement, which is defined as the megawatts of generating capacity that a LSE must purchase in a Local Capacity Area to meet the CPUC's Resource Adequacy Requirements. It is determined by taking a LSE's peak load versus the peak load in the Local Capacity Area times the Local Capacity Requirement. Example: Local Capacity Requirement = 40 MW; LCA load = 100 MW; ESP LCA load = 10 MW. ESP Local RAR = 10/100 x 40 = 4 MWs.
System RAR	The System Resource Adequacy Requirement, which is defined as the megawatts of generating capacity that a LSE must purchase to equal no less than 115% of its CEC-adjusted peak load for each summer month.

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of the foregoing document on all parties of record in the above captioned proceedings by serving an electronic copy on their email addresses of record and by mailing a properly addressed copy by first-class mail with postage prepaid to each party without an email address of record.

Executed on January 24. 2006. at Woodland Hills. California.

Michelle Dangott