BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Promote Policy and Program Coordination and Integration in Electric Utility Resource Planning	)	R. 04-04-003

COMMENTS OF THE
CALIFORNIA ELECTRICITY OVERSIGHT BOARD
ON THE CPUC ENERGY DIVISION
CAPACITY MARKETS WHITE PAPER

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September 23, 2005

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The California Electricity Oversight Board (EOB) appreciates this opportunity to comment on the Capacity Markets White Paper (White Paper) prepared by the Energy Division of the California Public Utilities Commission (CPUC or Commission). Comments in reply to this pleading should be directed to the following:

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I. SUMMARY

The EOB recognizes the substantial progress accomplished by the Commission's Energy Division in investigating a workable capacity market structure. The EOB agrees with a majority of the recommendations of the Commission's Energy Division which are included in the White Paper. The EOB agrees that the general capacity market described in the White Paper, compared to alternative capacity market paradigms, is more likely provide appropriate incentives for necessary investment in generation resources while limiting the acquisition and exercise of market power, from a capacity standpoint.

Specifically, the EOB at this time favors development of a performance-based, location-adjusted capacity payment that is derived from a downward sloping demand curve. Further, the EOB agrees that differences in capacity pricing should not vary to an extreme degree above or below the optimal locational resource level, and hence supports a gradually sloping demand curve. In addition to its parallel evaluation of capacity market options, the EOB staff has worked to support the investigation of the CPUC and of the Independent System Operator (CAISO) and it is in the spirit of continuing collaboration that the following comments are offered:

II. EOB RECOMMENDATIONS

The EOB recommends that the following two require further consideration and development from the level of definition reached in the White Paper:

1) *Inclusion of Imports* - Discussion of inclusion of import contracts should be among the highest priorities since the capacity market described in the White Paper does not provide for direct participation by external suppliers seeking to serve resource adequacy requirements.

2) *Peak Energy Rent Subtraction* – EOB staff recognizes the goals of mitigating market power and avoiding duplicative or excessive payments for a single service or product. There are, however, conceptual difficulties in applying a revenue-subtraction mechanism between a defined-price capacity market and a spot energy market being designed to send Locational price signals. The revenue subtraction mechanism could have the effect of subordinating the Locational aspect of the sport energy market to only the level of granualarity provided by the several sub-regions defined for different capacity price curves.

III. DISCUSSION

A. Inclusion of Imports

California's dependency on external sources of generation (e.g., imports), which is particularly significant during peak summer months, necessitates including importers in the

Resource Adequacy (RA) showing, if the CPUC is determined to impose a 100 percent RA requirement on Load Serving Entities (LSEs.) However, the capacity market described in the White Paper does not provide a clear opportunity for suppliers external to either California or the CAISO control area, to participate in or receive capacity payments through the capacity market.

The White Paper recommends that the CPUC "[i]nvestigate the dependability of capacity import contracts during times of high West-wide load."[1] The EOB suggests that an equally relevant investigation is to determine an appropriate relative capacity payment to import capacity, since it is clear that import capacity is necessary for Resource Adequacy, at least during peak months. Depending on how import capacity is taken into consideration in the RA process and compensated, it is possible that incentives could inadvertently induce new investments in generation to be located *outside*, rather than inside, California. The market structure must adequately incent the participation of import capacity (though perhaps only bilaterally) without accidentally creating an incentive preference to locate just beyond the control area borders.

At a minimum, policymakers should create a capacity market that is largely indifferent to the location of new generation with respect to political boundaries and which values the capacity service based only upon operational realities. Arguably, a capacity market should provide a greater incentive for new generation investment within transmission-constrained areas. However, recognition in the capacity market of import capacity must be made, in terms of capacity payments, if a 100 percent or even 90 percent RA showing is to be achieved.

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[1] CPUC Capacity Market White Paper, Page 8, Recommendation 6

B. Peak Energy Rent Subtraction

The White Paper asserts that subtraction of peak energy rents from locational capacity payments will "eliminate market power."[2] The EOB agrees that potential benefits can be derived from subtraction of peak energy rents from the capacity payment. An obvious benefit would be that total wholesale energy costs (including both capacity and energy payments) would tend to be lower. Viewed as a market power mitigation tool, the crediting back of energy rents becomes in effect a spot market bid cap on generators receiving capacity payments.

Notwithstanding the potential benefits, one possible adverse outcome of peak rent subtraction is that it would significantly reduce the meaningfulness of locational marginal pricing in the spot energy market. While the CAISO has proposed to install an aggregated "LAP" pricing mechanism for pricing LSE loads under MRTU, this proposal is designed only to be a bridge toward eventual nodal pricing. If capacity payments are reduced by the amount of peak energy rents, the would make the real price of energy only the residuam of the sopt energy price that does not get subtracted. This could effectively mute real time Locational pricing beyond the ability to have its desired effects.

Another potential problem with subtracting peak energy rents, (a problem which the White Paper Commission acknowledges) is the difficulty in valuing peak energy rents. The EOB supports market power mitigation measures that are transparent and known before the fact; this lowers regulatory risk for market participants. The Commission should work closely with the CAISO to develop energy and capacity market mitigation measures that do not duplicate one another's efforts and will be known in advance by all capacity market participants.

[2] CPUC Capacity Market White Paper, Page 38, line 2

IV. CONCLUSION

In conclusion, the EOB commends the CPUC's Energy Division in its efforts to foster a productive discussion regarding a well-functioning capacity market in California. The White Paper as a very positive milestone in this worthwhile endeavor.

September 23, 2005

Respectfully submitted,

__/ss/ Kenneth L. Glick__________

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CERTIFICATE OF SERVICE

I hereby certify that I have served the foregoing document upon each person designated on the official service list compiled by the California Public Utilities Commission for this proceeding.

Dated at Sacramento, California, this 23rd day of September, 2005.

/s/ Larry Cook

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