

**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.

Rulemaking 04-04-003
(Filed April 1, 2004)

**COMMENTS OF MIRANT CALIFORNIA, LLC, MIRANT DELTA, LLC AND
MIRANT POTRERO, LLC ON CAPACITY MARKETS WHITE PAPER**

James Mayhew
Director RTO Coordination and
Commercial Liaison
Mirant Corporation
1155 Perimeter Center West
Atlanta, Georgia 30338
Telephone: (678) 579-3421
Facsimile: (678) 579-7726
jim.mayhew@mirant.com

Lisa A. Cottle
White & Case LLP
4 Embarcadero Center, 24th Floor
San Francisco, California 94111
Telephone: (415) 544-1100
Facsimile: (415) 544-0202
lcottle@whitecase.com

Attorneys for Mirant California, LLC,
Mirant Delta, LLC and Mirant Potrero,
LLC

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I. Introduction

Pursuant to the Chief Administrative Law Judge's Ruling Providing Notice of Availability of Staff Capacity Markets White Paper and Providing for Comments issued on August 25, 2005 ("Chief ALJ Ruling"), Mirant California, LLC, Mirant Delta, LLC and Mirant Potrero, LLC ("Mirant") submit these comments on the Capacity Markets White Paper ("White Paper") developed by Energy Division Staff ("Staff") of the California Public Utilities Commission ("Commission").

Mirant commends Staff for the analysis presented in the White Paper and generally agrees with Staff's initial assessments and recommendations for developing an organized capacity market in California. The White Paper recognizes the need for a long-term capacity market in California and the fundamental elements that such a market must exhibit. The White Paper also recognizes that a capacity market is essentially a regulatory mechanism designed to compensate for price and revenue investment signals that are lacking in a capped energy market. A well-designed capacity market provides a transparent process where prices can be easily determined and investment signals sent to support existing generation and encourage the construction of incremental generation. A capacity market therefore plays an important role in enhancing reliability by ensuring that the State's generation needs can be met, and in lowering overall energy costs to the ultimate consumers in the long-term by ensuring that the right resource is utilized.

The White Paper is a good starting point for commencing a more formal policy discussion of how a capacity market for California should be designed, implemented and operated. It should be recognized, however, that the process for developing a capacity market is detailed and multi-layered. It will require a significant amount of discussion and input, and will involve the Commission, the California Independent System Operator (“CAISO”), the Federal Energy Regulatory Commission (“FERC”) and numerous parties and market participants, including load-serving entities. This process should be collaborative and open, to reflect the unique requirements of the California market.

The process for developing a capacity market in California also should be structured to take advantage of lessons learned in other markets. The White Paper recognizes that important lessons can be learned from capacity market designs adopted or proposed by the New York Independent System Operator (“NYISO”), the New England Independent System Operator (“ISO-NE”) and the PJM Interconnection (“PJM”). Mirant previously submitted its own white paper in this proceeding describing the conceptual design of the New York capacity market, and summarizing the process followed by the NYISO and the New York Public Service Commission (“NYPSC”) in developing the proposal for that market.¹ Mirant has recommended that California focus on the New York implementation process as an example of how California could go about developing its own single-state capacity market. In particular, Mirant has suggested that the Commission should work collaboratively with the CAISO to follow a process similar to the one used by the NYPSC and NYISO in designing New York’s capacity market.

Mirant’s comments regarding the conclusions and recommendations in the White Paper are set forth below. Mirant first provides general comments regarding the need for an organized capacity market in California, and then addresses the topics highlighted in the Chief ALJ Ruling, namely (1) “Lessons Learned and Related Policy Questions” (Section VI. E.), (2) Staff’s Recommendations (Section VII), (3) Appropriate Roles and Responsibilities of the Commission and CAISO in the Development, Design, and

¹ See “A Whitepaper Presentation on Resource Adequacy Components,” prepared by Mark Younger, Slater Consulting on behalf of Mirant Corporation, dated February 8, 2005.

Potential Implementation of Capacity Markets in California (Section VIII), and (4) Other Significant Issues.

II. Comments

A. General Comments Regarding the Need for an Organized Capacity Market and its Key Features

The White Paper correctly recognizes the need for a long-term capacity market in California and the fundamental elements that such a market must exhibit. The White Paper acknowledges that, in an ideal world, a competitive market would provide sufficient price signals and revenues to induce the retention and attraction of new generation resources.² Unfortunately, for this to occur, the market must be capable of allowing for scarcity pricing, load must be able to respond to those price signals in real time, and the market operator must have the ability in real time to distinguish between different customers who have and have not met their physical capacity requirements. Equally important, the regulatory and political process must allow for price volatility signals to be sent and sustained during periods of price scarcity. Absent this sustained price volatility, no price signal will be sent to encourage market participants to enter into long-term capacity or energy agreements.

Current market fundamentals do not allow, either from an economic or societal standpoint, for an unfettered change in prices to send the scarcity pricing signals or allow for the physical interruption of electric customers who have not planned or paid for the underlying actual generation resource to ensure the continued flow of electricity. Also, as a practical matter, the physical makeup of the system does not allow for adequate demand response by customers or the ability on a large-scale basis to distinguish between customers who can be interrupted and those who cannot. As a result, without a capacity market and with continued price mitigation restricting pricing during periods of scarcity, a load serving entity or a retail access customer can effectively lean on the real-time

² See White Paper at 10.

energy system without having to pay a penalty for not contributing to the underlying physical reliability of the system.

Due to these shortcomings, the current spot energy price mechanism utilized by the CAISO and the price caps and local market power mitigation measures as identified by the White Paper cannot provide the necessary price signals to induce sufficient generation investment. For market-based competitive generation to be built, fundamental price signals must be given through either an energy market or a capacity market to support their development. Without a capacity construct, no rational investor will continue to operate in or invest in a market that fails to provide for recovery of and return on investments. This leads to inefficient use and build of resources and increases overall costs to the ultimate consumer.

It is doubtful that regulators or policy makers in California will want to experiment with an uncapped energy market as a means of ensuring reliability in the electrical grid. An alternative solution – in the form of a capacity market that reflects a societal or regulatory administrative policy approach – is therefore needed to ensure that all customers are contributing towards the underlying reliability of the system. This administrative requirement must place performance criteria on the generator who receives a capacity payment and resource allocation measures on the load serving entity. These dual features will enhance the reliability of the system, ensure equitable allocation of reserve requirements and ensure that appropriate price signals are being sent to encourage long-term generation resource development.

In a capacity market that reflects an administrative approach or a regulatory policy method, to retain existing generation and attract new investment, a price signal must be provided at a reserve margin equilibrium to reflect the recovery of long-run marginal costs for new investment. This then becomes the starting point for a sloped price curve whose pricing changes as the amount of generation in the system intersects at different points on the curve. This approach provides an emphasis for price stability over a period of time as set by the regulatory body.

This administrative model contrasts with a market-based approach that relies on bids to set prices and resolve the defined capacity requirements. Experience in the Eastern markets has shown that the market-based model reflects more of a “boom–bust” approach to pricing that can either under or over value capacity based on the immediate amount of generation available, with less recognition of a planning horizon. It also by default has a tendency to either diminish or over-value the requested capacity by either having too many suppliers bidding for capacity, or too few suppliers providing enough generation for the defined capacity need. It also is subject to greater market power concerns by those who may elect not to participate in the auction, and who do not have an obligation to offer their energy.

The White Paper also recognizes the fundamental elements that must be reflected in any well-designed capacity market. In particular, the market must be locational in its application, it must provide transparency of price through a central clearing market and it must be applicable to all providers to ensure that no “free rider” or market power contingency exists. A properly structured capacity market will recognize that existing and planned levels of generation resources will never match exactly with the reliability reserve-planning margin. Thus the market should exhibit a price structure that diminishes “boom or bust” pricing for generation above or below the planning margin. Instead, a price curve that starts with new entrant pricing and then slopes to reflect the incremental value of generation above the planning reserve margin should be utilized. The White Paper correctly recognizes this.

In addition to these features, there are benefits to designing a capacity market structure that combines an administratively determined new entrant price with energy scarcity price offsets. The administrative use of a new entrant price for reserve planning requirements reflects the fundamental investment signal for what a new investor would expect to receive for building generation to meet the required capacity requirements of the market. By adding an energy and ancillary price offset, the structure gives flexibility to decision-makers with respect to the policy direction for the wholesale market. If a policy decision is made to move toward more recovery of investment dollars in the energy market through the raising of price caps or the allowance of scarcity pricing, then

the energy offset allows for this optionality by reducing the fixed capacity payment to avoid allowing double recovery of costs. Capacity payments by default are reduced and an emphasis on energy scarcity pricing is increased. The use of an offset for energy scarcity pricing also reduces market power concerns.

Market power can be further mitigated by imposing a must-bid requirement on generators that obligates them to bid into the CAISO's proposed day ahead market. The White Paper recognizes that the Eastern markets have adopted this approach, but mistakenly concludes that these measures are less effective because suppliers have the ability to bid high and then export with impunity through virtual bids.³ Staff overstates generators' ability to game the must-bid requirements in the Eastern markets. The must bid requirement is either subject to a two part bid including a cost bid such as PJM requires, or to conduct and impact mitigation pricing in New York and New England which reduces the ability of the generator to make bids that are unacceptably high. Equally important, virtual bidding is available to both suppliers and purchasers in the New York and New England markets, not just to suppliers as the White Paper suggests.

In sum, the White Paper accurately captures many of the reasons that support the development of long-term capacity market. The White Paper also adequately recognizes the trade off between the need to send appropriate price signals to attract and retain generation resources, and the political and physical realities of why this cannot be done only through an energy market. The White Paper recognizes that an administrative regulatory mechanism is needed to ensure that it is the fundamental responsibility of load serving entities and customers to contribute to the total system reliability. Absent this measure, extreme price volatility with the added investment risk will result in a boom-bust environment when the market is either short or long. This type of market environment prevents the market from projecting transparent investment signals to attract new investors or providing signals to retain needed existing generation. Instead, "work arounds" such as imposing a must-offer obligation or reliability must-run requirements are used to ensure that sufficient physical energy is provided or needed

³ See White Paper at 22.

units are retained. Neither approach promotes or sustains a long-term viable market where new nor existing investment is encouraged, and both can be costly to California energy consumers.

B. Comments on Issues Highlighted in the Chief ALJ Ruling

1. “Lessons Learned and Related Policy Questions” (Section VI. E.)

The White Paper correctly recognizes that the lessons of the Eastern markets are important, and should serve as a guide for California as it develops a capacity market proposal. These lessons include recognition that a vertical demand curve produces price volatility that does not promote investment in generation or provide for stable energy prices. The Eastern markets have recognized that the use of a sloped resource curve such as the demand curve can minimize this volatility and reduce the impact of market power by either load or generation. The Eastern markets also have recognized the need to have a central clearing market through which all capacity requirements are recognized and settled. They have recognized the need to have an administratively determined fixed charge based on new entrant pricing to set the pricing for the demand curve. They have recognized that the requirements for a capacity market must be both administratively determined and be responsive to the market forces that reflect changing planning reserve requirements and the amount of generation currently in the market. The Eastern markets also have recognized that deliverability and transmission congestion require that the capacity market have a locational determinant to it.

Many of the issues being raised in reference to capacity markets are contentious. Arguments against capacity markets to a certain extent reflect the traditional regulatory paradigm associated with determining who benefits from capacity in the market and who should be obligated to bear the associated costs. In the Northeast, many of the issues are related to locational differences. In some aspects, certain areas in New England are long with respect to capacity resources and several areas are short with respect to local generation requirements. The arguments in that region thus revolve around the ability to either allocate resources within the region or to provide investment signals to ensure generation development in areas that are short. These arguments are no different than

those that will be faced in PJM or here in California. By nature, they are regulatory rather than market issues and require regulatory decisions to determine how system benefits and costs should be allocated appropriately.

California should take the opportunity to learn from existing lessons by building on the experience of the Eastern markets. Rather than engaging in an extensive effort to attempt to design a capacity market from the ground up, the Commission and other parties should look to adopt rules and measures that have been proposed and are working currently in the Eastern regions. California also should recognize that any process is evolutionary, and that the preferred market design is likely to change over time. California's capacity market proposal therefore should be flexible and should provide for the ability to review and modify the market design as experience is gained.

2. Staff's Recommendations (Section VII)

Mirant provides the following comments and suggestions regarding Staff's recommendations as set forth in Section VII of the White Paper.

Recommendation 1: Adopt a short-run capacity market approach with a downward sloping capacity-demand curve for the CAISO.

At this stage, Mirant agrees that a capacity market utilizing a downward sloping capacity demand curve appears to be the best initial approach. NYISO, NE-ISO and PJM – the three Eastern independent system operators that have extensively explored capacity markets – each has put forth a proposal recommending an administrative charge and some form of demand curve. As the White Paper notes, of the three markets, New York has the most experience in actually implementing and operating a capacity market with demand curve pricing. It also should be noted that each of these markets, building on flaws in the initial design, has implemented or proposed locational capacity markets to ensure that capacity in needed locations is appropriately valued and that capacity in less desirable locations is not overvalued.

The sloping demand curve approach uses an administratively determined new entrant price with a price slope that moves downward with the incremental value of

capacity above the reserve planning margin. This declining price slope provides appropriate investment signals regarding the level of resources in the market compared to the planning reserve margin requirement. As the existing level of capacity in the system moves closer to the reserve margin, the value of the price signal should be close to the new entrant price. As the level of the capacity in the system increases above the required reserve margin requirements, the price signal for the value of the capacity in the market should decrease. This methodology thus provides an appropriate market adjustment to the fixed administrative price.

An alternative to the demand curve approach would be to utilize a forward procurement auction that the system operator conducts for the capacity shortfall for a projected forward forecast period. The forward period could be several years to ten years in length. The system operator would establish the projected capacity shortfall and then conduct a declining cost auction until either the shortfall is satisfied through the bid process or no more generation is bid. The obligation and payment for the capacity bid either would occur in the year of delivery, or an obligation assessment would be imposed in the year in which the capacity auction was conducted. Because this auction or “market based” approach is based on bid and offer requirements, it would need to be monitored for market power concerns regarding the initial bid price and potential withholding problems. Reliability and market power concerns also exist under this method because capacity not selected in the auction still may need to bid into the energy market to ensure reliability. Concerns also arise if the system operator is both the procurer of capacity and the agency responsible for determining if capacity is needed. Although market-based approaches provide an alternative in theory, they quickly lead to a mitigated administrative charge that provides none of the actual market signals provided by the demand curve with respect to the sloping locational price curve.

Assuming that the demand curve remains the preferred approach, Staff’s recommendation should be sufficiently flexible to reflect ongoing developments in the methodology of the demand curve with respect to potential unintended consequences of the sloping price curve. Experience in the Eastern markets has shown that the market adjustment to the fixed price can change significantly with new capacity additions. As

capacity is added to the system, the entire price curve is adjusted downward. This causes the value of all capacity to decrease, thereby undervaluing all capacity instead of simply reducing the value of the incremental capacity added to the system. Depending on the slope of the curve, this phenomenon can result in unintended consequences by increasing, rather than decreasing, price volatility. Thus, further refinements to the demand curve concept may be required to address regional needs in California.

Staff's recommendation also should be sufficiently flexible to allow for the consideration of multi-year demand curve requirements. While the existing New York demand curve is one year, the NYPSC has approved three price curves – one for each of 2005, 2006 and 2007. This will result in the extension of forward pricing for a three-year period. In addition, PJM has proposed in its RPM before FERC to use forward procurement curves for a period four years out. The demand curve methodology does not preclude having multiple price curves like New York, or forward curves as PJM has proposed, or a combination of both one-year and multi-year curves to set price requirements. Flexibility should be allowed to provide for the consideration of these options to encourage both short-term and long-term pricing and investment requirements. Finally, Staff's recommendation should be flexible to allow for potential changes in the methodology to reflect regional requirements and new developments in market and regulatory approaches to capacity markets.

Recommendation 2: Further investigate alternative metrics (e.g. UCAP v ISO-NE's proposed metric based on performance during shortage conditions) and ensure development of an availability metric that is applicable to hydro, wind, thermal and other generation technologies, and to appropriate demand response products.

Mirant agrees with Staff that metrics to determine the availability of generation should be considered and further investigated. Appropriate metrics for hydro, wind, thermal and demand responses have been developed in the Eastern markets, and similar metrics can be developed as to their availability. New York in particular has developed rules for measuring the availability of imports and energy limited resources that should be considered for potential use in California. Although California is more dependent on

imports than New York, imports into New York can account for as much as 2,755 MW out of the total 2005 ICAP requirement of 37,715 MW.

There are several flaws with the critical peak or shortage hour approach proposed by ISO-NE and referenced in the White Paper.⁴ First, if Staff intends to provide a mechanism to stabilize revenues and ensure some level of fixed cost recovery, use of the critical peak hour metric would be inconsistent with that goal. The critical peak or shortage hour methodology gives value only to those resources that are available during the system's peak hours. This concept introduces volatility and risk related to revenue recovery in terms of when peak hours will occur and which units will be dedicated. Recovery for compensation is based on a planned monthly fixed charge developed against the total amount of generation in the system. If a unit is deemed unavailable during the critical peak hours – which can shift month-to-month and year-to-year as a result of transmission constraints, maintenance outages scheduled and approved by the CAISO, or because of economic price reasons – the generator's ability to collect needed investment dollars will be significantly reduced through no fault of the generator.

Second, the critical peak hour concept introduces generation technology bias by only compensating “quick start” natural gas units, rather than recognizing that the totality of the peak requirement from a planning standpoint is being addressed through the capacity market. This technology bias would reward the building of gas-fired quick start units and penalize other types of technology resources and those generators who are operating their resources according to the CAISO's instructions and in the parameters of the operating characteristics of their units. Further, the shortage hour concept may discourage energy limited resources from participating in the capacity market, and may exclude certain types of demand response programs that can and should participate in the capacity market.

Third, the critical peak approach reflects a fundamental disconnect between the capacity requirement from a planning perspective and what will be traded in a capacity

⁴ In fact, the FERC Administrative Law Judge's initial decision rejected the ISO-NE's proposed shortage hour metric. See *Devon Power, LLC et al.*, 111 FERC ¶ 63,063 (June 15, 2005) at ¶¶ 546-550.

market with a real-time mechanism that is more akin to operating reserves. Merging planning reliability requirements and real time operating requirements confuses what is needed to ensure system reliability from a planning standpoint and the immediate security components of system reliability that are met through reserve requirements. The energy requirements from the two are distinct as to the underlying adequacy of sufficient physical generation actually built and available to the system and the immediate security of the system during certain hours of the year.

Fourth, by focusing only on availability and selection by the system operator in critical hours, the critical peak hour approach creates a fundamental difference in the value of capacity in a central market and the value of bilateral capacity for long-term procurement. This would diminish the State's ability to create a tradable capacity product that can be easily utilized in conjunction with bilateral agreements.

As an alternative to the critical peak hour metric, Staff should consider the "EFORD" (Equivalent Forced Outage Rate demand for a unit over 12 months) approach that the Eastern markets have explored. This methodology entails a review of an individual unit's availability to the market that focuses on the requirements of the individual unit to be available to provide reliability to the total system peak, rather than a system dispatch approach that may exclude units from providing energy during certain times through no action by the unit. Instead, the individual EFORD approach measures the totality of the unit's availability over a twelve-month period, including unplanned outage hours. The use of an EFORD approach provides for a uniform tradable capacity product that is straightforward, easily determined and transparent.

Recommendation 3: Consider subtraction of peak energy rents from the capacity payment.

Mirant agrees that scarcity peak rents earned in the energy market should be subtracted from the fixed capacity payment. This could be done in one of two ways: either through an "ex ante" approach based on a forecasted price that is determined in advance (such as what the NYISO currently does); or using an "ex post" or actual

after-the-fact adjustment to the capacity price (as initially proposed by ISO-NE and favored by Staff).

While either method may be acceptable, both have pros and cons that should be examined. The fundamental need for a capacity market is to provide a forward price that is both predictable and stable. The energy rent “offset” should not reduce the price stability or introduce an additional element of risk related to the overall forward price. Rather, the method should prevent extreme price volatility changes either related to weather conditions or unusual operating conditions such as import limits, transmission constraints or plant outages.

The use of an ex-ante forecasted energy price provides a known certainty of the offset up front in the price setting and is not then further adjusted. This provides a level of certainty to those receiving and paying the tariff charge. It is based on a forecast that by definition will not match actual conditions, but should reasonably approximate actual prices if accurate forecasting methodologies are used. This approach has been used successfully by the NYISO. Mirant favors this approach and the price certainty and stability it affords.

In contrast, the ex-post method is based on actual results. Under the original ISO-NE proposal, which was ultimately withdrawn, the monthly auction for capacity would be adjusted after-the-fact by the prior month’s actual scarcity pricing. This method was intended to offer the benefit of reflecting actual changing conditions of energy price scarcity. On the other hand, this methodology introduces a measure of risk related to an after-the-fact true-up of the price and uncertainty regarding the actual value of the capacity product that will be bought and sold by market participants. This results in uncertainty in a market in which you are trying to promote certainty and stability. As a result, the ISO-NE proposed and the ALJ in the interim decision recommended that a 12-month average of prior historical monthly energy pricing instead be utilized. This prevents an after-the-fact introduction of price uncertainty after the monthly capacity market price has been established.

To mitigate these effects, and to level out abnormal conditions during any particular period, the New York approach of a forecasted number or a rolling 12-month or multi-year average could be used. PJM has proposed the approach of using several years of historical average for the energy price offset. This approach prevents capacity prices from being undervalued as a result of “abnormal” events such as an unusually hot summer, an unusual event or abnormal transmission constraints or outages.

In evaluating how to subtract peak energy rents from the capacity price, California also needs to consider what happens if the net energy offset exceeds the total capacity payment. The energy offset also must be designed to recognize the operating characteristics and associated costs of the resources available at peak. For example, if the energy offset is limited to the revenue received at peak, but does not factor in the start-up cost in the hours leading to the peak, the offset is likely to be inaccurately high.

Recommendation 4: Adopt reasonable locational installed capacity requirements with locally varying demand curves.

The key to designing any capacity market is to recognize the value generation has within a local area that may be constrained by either transmission deliverability or by load requirements. The market must reflect locational requirements to reflect the true cost of capacity. If capacity traded in the market is not deliverable, overall reliability will be diluted. PJM has discovered this first hand. PJM has established a single zone market in which all generation was deemed to meet the deliverability requirements. Despite the universal deliverability definition, local deliverability constraints in the east portion of the RTO footprint occurred this summer in PJM that caused congestion and voltage problems. As a result, while PJM was experiencing constraints in eastern zone, it had excess generation in the west that were being backed down.

Locational considerations to zones must be such that the zones are large enough to reflect multiple suppliers and generation requirements while recognizing the underlying physical constraints that require local generation investment. Zones should be broad enough to reflect historical overall deliverability requirements while still recognizing limits imposed by transmission constraints, the potential of market power

among suppliers, and the impact in small zones that adding or retiring generation will have on the sloped price curve.

Recommendation 5: Consider protecting against capacity exports during times of tight supply through the use of capacity prices that fluctuate seasonally.

Mirant agrees that the sloped price curve should reflect seasonal considerations, especially in the context of imports. However, irrespective of how the seasons are defined, it is important that the total annual revenue requirement be collected during those periods. If a seasonal approach is utilized, then the ensuing cost per month must be made such that the sum of all monthly costs equals the total revenue requirement for the fixed charge. In other words, regardless of how many seasonal periods are established and how fluctuations in pricing are determined, the pricing must be structured such that the total payments recover capacity costs as established by the market.

Recommendation 6: Investigate the dependability of capacity import contracts during times of high West-wide load.

Mirant agrees that the dependability and availability of import capacity must be measured such that the capacity value is equal to in-state generation capacity requirements. This measure must include the impact on actual physical deliverability rather than using financial penalties for a resource that defaults on the delivery of actual physical energy. This may require a derating of the import capacity, a raising of the reserve planning requirement, the setting of standards for physical availability and other aspects that will ensure that the power is actually made available to California. If liquidated damages are relied upon, it is important to raise the reserve margin or set standards for physical availability that will derate capacity that is not available.

Recommendation 7: Make the fixed cost-recovery explicit.

Mirant agrees that the administrative charge that sets the price slope of the capacity market must be explicit. The capacity market is to provide for a level of revenue and investment certainty in lieu of collection of revenues from the energy market. As such, the price for the new entrant cost must be determined up front through an audited

method and then set as the tariff price. This will provide price transparency by allowing market participants to determine the value of capacity in the market and what obligations are required for both buyers and sellers as a result of the price.

Recommendation 8: Strive for Regulatory Creditability

Mirant agrees that it is critical to establish certainty in the rules and expectations for the wholesale market and requirements for generation investment in California. Without a clear understanding of market rules and the risk associated with those markets and their certainty, no investment in existing or new generation will take place. While debates with respect to market design can and should be expected, all market participants will require certainty in the rules once they are set. The market design should encourage long-term stability in price and avoid price volatility in capacity investment. Unlike energy markets where volatility is expected, capacity markets should reflect a stable planning horizon in which the underlying value of existing and new generation can be easily determined. Because investment in generation resources generally takes several years, the value of capacity also should reflect some forward period to signal when that generation will be built.

3. Appropriate Roles and Responsibilities of the Commission and CAISO in the Development, Design, and Potential Implementation of Capacity Markets in California (Section VIII)

The White Paper recognizes that both the Commission and the CAISO have a role in the process of developing a proposal for a capacity market in California. Mirant believes that having a single-state market and transmission system provides advantages to California that many multiple-states independent system operators do not have. The Commission (as the agency responsible for ensuring the adequacy of utility service in California) and the CAISO (as the entity responsible for ensuring the reliable operation of the State's transmission system) have the ability to work together to develop a resource adequacy and capacity market construct that best suits California's needs. The Commission and the CAISO can work together to craft a proposal that is submitted to FERC for ultimate approval and implementation.

A distinction should be made, however, between the Commission's policy oversight role and the CAISO's role in operating the system and administering wholesale electricity markets. The Commission has a key role to play in overseeing and establishing regulatory policy for the State's load serving entities, including by developing and implementing the resource adequacy requirements that are being considered in this docket. The Commission also has an important role to play in developing policy recommendations for the parameters of a capacity market.

On the other hand, the CAISO should be responsible for designing the market and for implementing and administering it, based on the Commission's policy recommendations and with the benefit of the Commission's active participation in the FERC review and approval process. As the entity responsible for system operation and administration of wholesale markets in California, the CAISO is better suited in terms of expertise and personnel to be responsible for designing and implementing detailed pricing and demand curve parameters and market rules. In contrast, the Commission does not possess authority or the day-to-day operational expertise needed to oversee or implement capacity markets. The CAISO is also better suited to this role given that it will be responsible for operating the capacity market in conjunction with the tariff rules as ultimately approved by FERC.

The Commission therefore should follow New York's example. In New York, the NYISO developed the business rules for its capacity market, while the NYPSC identified the parameters it supported and voiced that support in the proceeding before FERC. Similarly, the Commission should develop the broad parameters of a capacity market and formulate the relationship between the capacity market and the state's resource adequacy requirements. The Commission should take the lead in articulating the need for a capacity market in California, establishing the requirements applicable to all load serving entities for resource adequacy to fit into the capacity construct, and creating a general policy outline regarding the preferred capacity market design. The Commission also should provide policy recommendations to the CAISO as to recommended design features such as the adoption of a downward sloping demand curve.

Utilizing the Commission's policy recommendations, the CAISO should be responsible for developing the business rules, tariff provisions and design features for implementing the capacity market. The CAISO would develop detailed rules and tariff mechanisms dictating how the market will operate to support the Commission's recommended policy design. The Commission and the CAISO then could file the proposal with FERC and jointly request FERC authorization for the new market rules.

4. Other Significant Issues

Working with the CAISO, the Commission should establish forward goals and timelines for developing and implementing a capacity market in California. Although the White Paper is a good first step in the process, there clearly is much work to be done before a formal policy recommendation can be issued. It will be important for the Commission to establish a clear framework and path for how that decision will be developed in order to send the signals needed to bring investment into California's generation market.

III. Conclusion

Mirant appreciates the opportunity to present these comments. Mirant looks forward to continuing to work with Staff and the Commission to design a proposal for implementing a capacity market in California that is in the best interest of energy consumers.

Respectfully submitted,

Vincent J. Novak, for Lisa A. Cottle

James Mayhew
Director RTO Coordination and
Commercial Liaison
Mirant Corporation
1155 Perimeter Center West
Atlanta, Georgia 30338
Telephone: (678) 579-3421
Facsimile: (678) 579 7726

jim.mayhew@mirant.com

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Lisa A. Cottle
White & Case LLP
4 Embarcadero Center, 24th Floor
San Francisco, California 94111
Telephone: (415) 544-1100
Facsimile: (415) 544-0202
lcottle@whitecase.com

Attorneys for Mirant California, LLC,
Mirant Delta, LLC and Mirant Potrero,
LLC

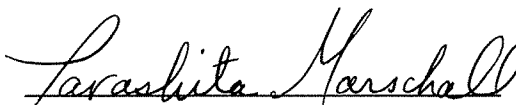
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on all known parties to R.04-04-003 by sending a copy via electronic mail and by mailing a properly addressed copy by first-class mail with postage prepaid to each party named in the official service list without an electronic mail address.

Executed on September 23, 2005, at San Francisco, California.


Parashita Marschall