

**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)

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

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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 ("Chief ALJ Ruling"), Mirant California, LLC, Mirant Delta, LLC and Mirant Potrero, LLC ("Mirant") submit these reply comments in response to opening comments on the Capacity Markets White Paper ("White Paper") developed by the Energy Division of the California Public Utilities Commission ("Commission").

The opening comments reflect a diversity of views and opinions from parties representing a variety of stakeholders, including wholesale market participants, generators, load serving entities ("LSEs") and consumer advocates. Despite these different perspectives, there appears to be an almost universal recognition that California's current market structure does not provide sufficient incentives to attract investment in new generation, or even to maintain existing levels of generation, and that fundamental reform is needed to ensure reliability and resource adequacy in the State.

Despite this consensus on the need for reform, parties clearly have different views on what the reformed market structure should look like. Many parties, including Mirant, support the development of a capacity market with some type of administratively determined sloping demand curve, consistent with markets adopted or proposed in the East and the recommendation in the White Paper. Others recommend a more purely market-based solution, such as a capacity market that either relies on bids to set the

starting price, or uses an auction involving bids that decline until the necessary amount of capacity is procured to meet the targeted reserve level. Others disagree that a capacity market is needed at all, and suggest that the energy market be modified so that it either provides for scarcity pricing during periods of energy shortages, or has sufficient volatility to encourage demand response and long-term hedging by LSEs. Finally, the California Independent System Operator (“CAISO”) does not endorse any specific form of long-term resource adequacy program, and recommends that a range of options – including an “energy only” approach – be studied in detail before California moves forward with any policy proposal.

It is clear that the development of a capacity market in California will be a complex undertaking that will require disciplined regulatory oversight and decision making to establish the market design and the timetable for implementing it. The lack of consensus among stakeholders with disparate interests demonstrates that regulators will need to make difficult decisions about which market design will best serve California’s reliability needs and the State’s overall interests. Mirant continues to believe that a well-designed capacity market and an effective resource adequacy mechanism will help resolve the problems highlighted in the White Paper. The Commission should remain focused on implementing the resource adequacy requirement (“RAR”) outlined in the recent proposed decision in this proceeding.<sup>1</sup> At the same time, the Commission should move forward quickly to formalize a policy recommendation for a capacity market that facilitates both short- and long-term contracting.

In these reply comments, Mirant does not attempt to address every comment that differs from Mirant’s own recommendations as reflected in its opening comments. Instead, Mirant focuses on a few points that merit attention. Below Mirant explains that (1) contrary to concerns expressed by a few parties, a centralized capacity market will not undermine bilateral procurement, and instead should be viewed as a complement to a strong bilateral procurement program and one part of the equation for encouraging

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<sup>1</sup> The proposed decision contains a few errors that Mirant will address in comments proposing modifications on October 17, 2005.

investment in generation, (2) arguments in favor of relying on energy markets to provide the physical reliability that California needs ignore current political and operational realities in California that make an “energy-only” solution infeasible, and (3) the CAISO’s recommendation that nothing be done now other than undertaking a careful study of all potential market reforms, including a potential “energy-only” solution, is not advisable given the urgent need to implement measures that will ensure the availability of needed resources.

Instead of re-evaluating possible reliance on an “energy-only” market, California should focus on a three-part approach that can and must be done in parallel with each other to create and maintain viable wholesale markets. The first part is a workable energy market with locational pricing and a day-ahead and real-time settlement. The energy market requires reasonable mitigation caps and mitigation based on conduct and impact, rather than simply presuming the existence of market power based on the generation’s location. The second part is a long-term procurement strategy that encourages LSEs to enter into contracts to hedge their energy and capacity requirements. The third part of the approach is a centralized capacity market that provides locational capacity signals on a near- and long- term basis, and that allows participants to settle out different increments of capacity needs. If properly designed and implemented, both the capacity market and the energy market would provide the transparent forward pricing that any commodity market needs to set bilateral pricing requirements. In this way, a centralized capacity market will complement, rather than replace or defer, long-term procurement requirements. Further, this approach will move the State away from non-market mechanisms such as the must offer obligation or reliability must-run (“RMR”) style contracts, and move toward a rational market design that can respond to the economic and societal needs of California.

## *II. Reply Comments*

### **A. A Centralized Capacity Market Will Support Bilateral Procurement And Is One Part Of The Equation For Encouraging Investment In Generation.**

Some parties express concern that a centralized capacity market will be less effective than long-term bilateral contracts for encouraging investment in generation, and even argue that a capacity market could undermine bilateral procurement.<sup>2</sup>

These concerns are contrary to experience in the Eastern markets. Bilateral procurement is a major part of markets in New York and the PJM Interconnection (“PJM”), and also plays a role in New England. While the centralized capacity market in those regions provides a clearing market for short-term monthly settlements, it does not discourage bilateral contracting. To the contrary, several Eastern markets have strong bilateral programs, such as the Basic Generation Service in New Jersey and the Standard Offer Service in Maryland, that help provide for long-term procurement. Also, as noted by the Independent Market Advisor to the New York Independent System Operator (“NYISO”) in its State of the Market Reports for 2003 and 2004, approximately two-thirds of the market in New York City and fifty percent of the market in the rest of New York State is procured bilaterally. The NYISO experience shows that the function of a central capacity auction is to allow the clearing of capacity requirements for balancing and settlement purposes while setting a forward procurement price for the market as a whole. It is this price that market participants look to for assistance in setting forward hedge and bilateral positions.

Concerns about potential impacts on bilateral procurement also overlook the fact that capacity markets will not be the sole driver for new investment in generation and equally do not exist in a vacuum. Rather, capacity markets are part of an overall investment picture that reflects fuel costs, type of generation investment, near and long term forecasts, as well as the shape of the capacity market itself. As reflected in the White Paper, organized capacity markets are initially designed to compensate for the

impact of energy markets that are mitigated to reduce price volatility and potential market power. Equally they are designed to address the need to have physical generation available to meet the overall reserve reliability requirements of the system. Capacity markets provide one part of the investment equation for a generator to decide to invest or remain operating. This equation will include cost recovery afforded through energy markets, as well as capacity markets, and the ability to achieve a sufficient revenue stream to justify the investment costs of the new generation or the retention of the existing unit. For gas peaking units in particular, capacity markets provide the immediate new entrant price signal regarding the forward value of capacity, and are therefore useful in informing a decision about the underlying market fundamentals in the ability to recover long-run marginal costs. Equally, capacity markets provide a signal regarding the value of existing generation, and can inform decisions about whether existing units should remain in service or be retired. They are also a market substitute for RMR contracts, which do not provide a transparent price or a forward locational price signal to the market as a whole.

Much of the criticism leveled at capacity markets in the East either focuses on limitations in existing markets in New England and PJM, or fails to recognize the success of the demand curve in New York and its impact on encouraging investment in generation. Both New England and PJM have taken steps to correct their capacity market in filings before the Federal Energy Regulatory Commission (“FERC”). In the New York market, the demand curve has been shown to attract investment in the areas where it was needed, especially with respect to New York City, and to stabilize generation levels in other areas of the State.

Since enactment of the demand curve in New York City, capacity has increased from 98.5% of the stated reserve when the demand curve was first implemented to 104% of the stated reserve in 2005. The demand curve methodology has proven to be very effective in exposing on a locational basis the underlying reserve requirement and the

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<sup>2</sup> See e.g., comments of the Office of Ratepayer Advocates and comments of the Coalition of California Utility Employees.

value of locational capacity where it is required. If a location is short or near the reserve margin requirement then the demand curve as well as market fundamentals dictate that the value of capacity at that location should signal investment by reflecting a new entrant's long-run marginal costs. Absent a mechanism that provides for cost recovery, investors will not locate generation in a region that is short on capacity.

Parties also complain that the implementation of a capacity market involves a contentious regulatory process, pointing to the Locational Installed Capacity Market ("LICAP") proposal in New England as an example, but much of the dispute over LICAP simply reflects disagreement by interested stakeholders over who should pay for the underlying reliability of the system. Areas that are long in capacity such as Maine and the rest of the New England Pool prefer a locational approach. Areas that are short in capacity naturally prefer a regional non-demand curve approach that will shift or mask the underlying locational capacity requirements. It is not surprising to discover that parties who have not been paying for the underlying value of the generation investment will object when they are asked to start doing so, and that those who are not receiving payment for their investment in generation will support mechanisms that allow for such recovery. This tension is to be expected and should not discourage California from implementing its own capacity market solution.

**B. Energy Markets Alone Will Not Provide The Physical Reliability That California Requires.**

Other parties oppose the idea of establishing a centralized capacity market at all, and instead suggest that an energy market (either alone or in conjunction with long-term bilateral contracts, RMR contracts, local must-offer requirements and other fixes) can be relied on to provide the physical reliability that California needs.<sup>3</sup> As explained below, many arguments in favor of an energy market solution reflect a vision of an energy market that ignores current political and operational realities in California.

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<sup>3</sup> See e.g., comments of Morgan Stanley Capital Group, Inc. and comments of the Alliance for Retail Energy Markets; see also comments of the CAISO recommending that an "energy only" market approach be considered.

Some comments suggest that reforms could be enacted to allow for scarcity pricing and demand responsiveness that will encourage investment in generation when it is needed. Some of the arguments are theoretical and suggest that an all-energy market would be feasible if mitigation measures were modified and if price scarcity could be reflected in prices. These arguments suggest that lifting mitigation caps on a total system basis and enacting changes in the operating reserves methodology could result in higher prices being sustained long enough to encourage new investment and the retention of existing resources as needed for reliability purposes.

What these arguments ignore is that it is highly doubtful that California would tolerate scarcity pricing in the energy market at the levels and for the duration that would be needed to attract and develop new generation. In particular, given the regulatory and political climate of California and FERC, it is extremely unlikely that the wholesale energy market would be allowed to achieve and sustain hourly prices of at least \$5,000 to \$10,000 per megawatt-hour, which are the levels that likely would be needed to attract new investment. The comments also ignore the fact that California has already experimented with an unmitigated wholesale energy market in the service territory of San Diego Gas and Electric Company. As history shows, mitigation was imposed almost immediately once those costs were passed on by the utility and the retail consumers started experiencing scarcity pricing.

The comments also overemphasize the extent to which an “energy-only” solution could be effective. Just as short-term capacity market alone cannot attract new investment without long-term bilateral agreements, it follows that energy markets, particularly those with system or locational price caps, cannot be the only strategy for attracting and retaining the necessary amount of physical generation to meet the overall system requirement. The existing “free ride” nature of California’s energy market also makes the need for a capacity market much more urgent. The ability to have a must-offer call on energy by the CAISO without a corresponding capacity payment, along with extreme mitigation measures, provides no signal to the consumers in California as to the underlying true cost of electricity or the need for new generation in the State.



Arguments in favor of an “all-energy” model also ignore the reality that California requires construction of additional generation resources simply to achieve minimum reserve levels. Many of the markets cited by parties advocating reliance on an energy market, including Texas and the Midwest, are actually long on reserves and can effectively live on a “cushion” of additional generation that dampens the need to have a vibrant capacity market.

**C. The CAISO’s Recommendation Does Not Sufficiently Address The Pressing Need For Market Reforms In California.**

In its opening comments on the White Paper, the CAISO does not endorse any particular long-term resource adequacy program, including the potential implementation of a capacity market in California that uses a short-run demand curve.<sup>4</sup> The CAISO states that its Market Redesign & Technology Upgrade (“MRTU”) project will provide opportunities for additional reliability and market improvement.<sup>5</sup> The CAISO also states that the “energy-only” market solution has not been adequately defined or examined, and that it instead has been dismissed out of hand without exploring whether the issues that make this approach problematic could be resolved more easily than those associated with the implementation of a capacity market.<sup>6</sup> The CAISO also downplays the usefulness of the experience of the Eastern markets, and states that short-run capacity markets remain largely unproven as to whether they will be effective mechanisms to induce resource investment at desired levels. The CAISO recommends that a range of options – including an “energy only” approach – be studied in detail before California settles on any policy proposal.

In focusing on further study without a clear path for moving forward, the CAISO seems to be recommending what amounts to a “do nothing” approach. This approach seems ill-advised in light of the pressing need for market reform in California. Continuing the status quo is simply not supportable given the existing market

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<sup>4</sup> See CAISO comments at 3.

<sup>5</sup> *Id.*

<sup>6</sup> *Id.* at 4.

fundamentals and the reliability crisis in the State, and would be contrary to the Commission's recognition in this proceeding that something must be done to ensure resource adequacy.

No one can credibly ignore the fact that the current market structure has proven to be woefully inadequate to ensure that California has sufficient levels of generation. Despite nearly five years of work on market redesign, the CAISO continues to rely on the draconian administrative approach of the must-offer obligation with short-term RMR contracts to ensure physical reliability in the State. Equally troubling, the CAISO's proposed MRTU is entirely focused on mitigation measures that will dampen any scarcity pricing during peak hours that otherwise could have encouraged new investment. Without a component like a capacity market, this approach seems destined to move the State backward rather than forward along the path toward encouraging investment in generation resources.

The CAISO's emphasis on taking time for further study also ignores the extensive amount of work that the Commission and many parties have done over the last two years to advance the discussion regarding implementation of a capacity market. The CAISO suggests further review of many concepts that have been addressed in the resource adequacy phase of this proceeding, as well as before FERC in proceedings involving the New York demand curve, the New England LICAP proposal and the PJM Reliability Pricing Model. The CAISO acknowledges the need to do something to address pressing issues in California, but nevertheless advocates that the Commission should delay the process to spend more time evaluating an energy-only approach that already has proven to be politically unpalatable in the State. This approach does not seem likely to provide answers in time to enact reforms that will ensure that resources are available when needed.

The CAISO also states on page 5 of its comments that the adoption of a local capacity obligation will give it the tool to address short-term capacity needs while resource adequacy is being explored. Unfortunately, the recently-issued proposed decision on resource adequacy in this proceeding effectively delays and fails to

adequately address the implementation of such a measure. Equally troubling, the CAISO's own methodology suggests a continuation of an RMR approach that does not provide incentives to new generation or transparency to induce new markets.

In sum, instead of re-evaluating possible reliance on an "energy-only" market, California should focus on the three-part approach to creating and maintaining viable wholesale markets that is described in the last paragraph of the introductory section of these comments.

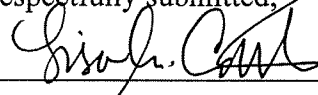
### *III. Conclusion*

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

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## Certificate of Service

I hereby certify that I have this day served a copy of the

***Reply Comments of Mirant California, LLC, Mirant Delta, LLC and Mirant Potrero, LLC on Capacity Markets White Paper***

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Executed on October 11, 2005, at San Francisco, California.

  
Parashita Marschall