

**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 SOUTHERN CALIFORNIA EDISON COMPANY (U 338-E) ON
CAPACITY MARKETS WHITE PAPER**

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Comments Of Southern California Edison Company (U 338-E) On Capacity Markets White Paper

TABLE OF CONTENTS

<u>Section</u>	<u>Title</u>	<u>Page</u>
I.	COMMENTS ON POLICY QUESTIONS FOR CALIFORNIA FROM THE EXPERIENCES OF OTHER STATES AND ISO/RTOS	2
A.	Question 1: Would A Downward Sloping Demand Curve Capacity Market Construct, Similar To The New York Approach, Be An Appropriate Mechanism To Support California’s Resource Adequacy Program?	2
B.	Question 2: Would A Capacity Market, Such As In New York, Assist LSEs To Make Adjustments By Being Able To Sell Excess Capacity Or Buy It When They Are Short?	3
C.	Question 3: Would This Mechanism Assist California In Meeting Its Goals To Be Resource Adequate And Reach A Minimum Of 15-17% Reserve Margins?.....	4
D.	Question 4: To Address Deliverability Concerns And Meet The CAISO’s Requirements, Is It Appropriate To Investigate Solutions For Local Areas As A First Step?	5
E.	Question 5: Do Capacity Markets In Local Areas That Are Designed With Downward Sloping Demand Curves Significantly Mitigate Energy And Capacity Market Power Concerns? What Are Other Appropriate Steps (e.g., Subtraction Of Peak Energy Rents)?	5
II.	COMMENTS ON ENERGY DIVISION RECOMMENDATIONS	6
A.	Recommendation 1: Adoption Of A Short-Run Organized Capacity Market Approach With A Downward Sloping Capacity-Demand Curve For The CAISO.....	6
B.	Recommendation 2: Further Investigation Of Alternative Availability Metrics And Ensuring Of Development Of An Availability Metric That Is Applicable To Hydro, Wind, Thermal And Other Generation Technologies, And To Appropriate Demand Response Products	7
C.	Recommendation 3: Consideration Of Subtraction Of Peak Energy Rents From The Capacity Payment	8
D.	Recommendation 4: Adoption Of Reasonable Locational Installed Capacity Requirements With Locally Varying Demand Curves	9
E.	Recommendation 5: Consideration Of Protection Against Capacity Exports During Times Of Tight Supply Through The Use Of Capacity Prices That Fluctuate Seasonally	9

TABLE OF CONTENTS (CONTINUED)

Section		Page
F.	Recommendation 6: Investigation Of The Dependability Of Capacity Import Contracts During Times Of High West-Wide Load	10
G.	Recommendation 7: Make The Fixed-Cost Recovery Curve Explicit	11
H.	Recommendation 8: Strive for Regulatory Credibility	14
III.	COMMENTS ON THE ROLES OF THE CPUC AND CAISO.....	14
IV.	CONCLUSION.....	15

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Pursuant to the schedule set out in 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, Southern California Edison Company (“SCE”) provides the following comments on the Capacity Markets White Paper (“White Paper”) produced by the California Public Utilities Commission’s (“Commission’s”) Energy Division.

I.

COMMENTS ON POLICY QUESTIONS FOR CALIFORNIA FROM THE EXPERIENCES OF OTHER STATES AND ISO/RTOS

A. Question 1: Would A Downward Sloping Demand Curve Capacity Market Construct, Similar To The New York Approach, Be An Appropriate Mechanism To Support California's Resource Adequacy Program?

A downward sloping demand curve capacity market construct, similar to the approach used in New York, or that which is proposed for use in New England, could be an appropriate mechanism to replace the resource adequacy construct currently being discussed as part of R.04-04-003. A demand curve capacity market construct will more efficiently assure that resource adequacy targets are achieved than current resource adequacy requirements. It will also assure that the costs associated with reliability are borne equitably by all load. Further, the demand curve construct may also mitigate capacity market power, while assuring that a non-zero value is attributed to capacity in excess of target reserve levels. This additional capacity provides increased reliability, and, as such, has value. Additionally, the use of the downward sloping demand curve should result in more stable capacity prices. These stable prices, along with alleviated reliability concerns, will provide increased certainty to investors with stakes in new or existing plants. In sum, a capacity market structure reduces risks and properly allocates reliability costs in the presence of customer migration. For these reasons, SCE generally supports the use of a downward sloping capacity market structure as a complete replacement for current resource adequacy requirements.¹ Such a market structure will be far more effective in

¹ SCE notes that its support for such a capacity market requires such a structure to completely replace LSE-based resource adequacy requirement obligations. Currently, the White Paper implies that any capacity market in California will be a complement to the LSE-based resource adequacy requirement imposed by the Commission. SCE cannot support a capacity market construct that does not fully replace the Commission's current resource adequacy requirements. See White Paper at 2, 3, 4.

assuring resource availability and adequacy than any Load Serving Entity (“LSE”) based resource adequacy requirement.²

B. Question 2: Would A Capacity Market, Such As In New York, Assist LSEs To Make Adjustments By Being Able To Sell Excess Capacity Or Buy It When They Are Short?

A capacity market structure, such as that in place in New York, or that proposed for New England, may facilitate the sale of excess capacity by providing an accessible market structure into which excess capacity can be sold.³ Furthermore, the stable pricing of capacity anticipated from a capacity market structure may help mitigate the effect of stranded costs from excess capacity.

With regards to “buying” capacity, it is not entirely clear whether a capacity market structure would facilitate the “buying” of capacity. For example, under the New England Independent System Operator (“NEISO”) Locational Installed Capacity (“LICAP”) proposal, there is no need for an LSE to buy capacity, because the amount of capacity required to be purchased by an LSE is pre-determined by the market. Although an LSE may choose to purchase additional capacity through bilateral contracts in order to hedge its risk against capacity market prices, it would not be required to do so. In other words, an LSE can either choose to be short and rely on the market’s capacity procurement and allocation of costs associated with that procurement or contract bilaterally to hedge its allocated share of capacity market costs. In such circumstances, it is not clear whether the existence of a capacity market would assist LSEs in their attempts to bilaterally procure capacity if they so choose. Therefore, the presence of a visible capacity price from year to year may facilitate such buying, but that outcome is unclear.

² One way in which a capacity market construct would assure resource availability is by including a tariff obligation (with an availability component) on all generators who wished to be qualified to receive a capacity payment.

³ However, although an LSE may hedge its future capacity needs, and therefore hold capacity in excess of its needs at some point, the capacity market will not, in general, ensure that the cost of such hedges can be fully recovered.

C. Question 3: Would This Mechanism Assist California In Meeting Its Goals To Be Resource Adequate And Reach A Minimum Of 15-17% Reserve Margins?

A capacity market mechanism such as that used in New York, or that which has been proposed for New England, should assist California in achieving a 15-17% reserve margin; however, it does not guarantee that this result will be achieved every year. The demand curves used in New York, and proposed for New England, are designed so that capacity payments, at or below a target level of reserves, meet or exceed the fixed cost requirements of a new combustion turbine. As such, it is anticipated that all existing generators should be able to cover their fixed-costs requirements—and the addition of new generation should be economic—if reserve levels are at or below target levels. However, a one-year stream of payments, even at levels exceeding fixed-cost recovery requirements for that year, may not result in new generation additions due to the risks and uncertainties facing investors over the life of the investment. If new generation investment does not occur, then it may be possible for reserves to fall short of target levels. This would result in high capacity market prices.

The Commission and other entities, such as the California Energy Commission (“CEC”) and the California Independent System Operator (“CAISO”), may wish to consider alternative means of attracting new capacity investment to California if such circumstances are foreseen. For example, a backstop mechanism could ensure that investment in new generation occurred in advance of projected reserve deficiencies.⁴ This would allow California to confidently assert its ability to reach minimum reserve margins of 15-17%.

⁴ An example of such a mechanism is the Pennsylvania, New Jersey, and Maryland System Operator RPM proposal for 15-year backstop contracts.

D. Question 4: To Address Deliverability Concerns And Meet The CAISO's Requirements, Is It Appropriate To Investigate Solutions For Local Areas As A First Step?

Yes, it is appropriate to investigate solutions for deliverability concerns in local areas. Furthermore, there is no apparent reason why a capacity market structure would not be able to effectively address these concerns.

In the current resource adequacy process, taking place in R.04-04-003, three deliverability concerns have been identified. First, due to transmission constraints, generation pockets exist where only a limited amount of generation in an area is capable of serving system load. Second, sufficient generation capacity should exist for all load pockets to assure that load within the pockets can be served, regardless of transmission or other grid reliability constraints. Third, whether there should be restrictions on import capability.

It is possible that a capacity market structure would be able to address these issues in the following manner. For generation pockets, limitations on the level of capacity that can be bid from generation within load pockets should be considered to ensure deliverability. For load pockets, locational capacity markets large enough to be competitive should be utilized in order to minimize any remaining local area capacity needs after capacity markets have cleared. For import capability restrictions, the counting of import capacity in capacity markets should be restricted based on the capabilities of the transmission system.

E. Question 5: Do Capacity Markets In Local Areas That Are Designed With Downward Sloping Demand Curves Significantly Mitigate Energy And Capacity Market Power Concerns? What Are Other Appropriate Steps (e.g., Subtraction Of Peak Energy Rents)?

Capacity markets in local areas, designed with downward sloping demand curves can substantially mitigate capacity market power and mitigate some energy market power. However, one cannot conclude that all market power concerns are eliminated as a result of capacity

markets. Additionally, the degree of market power mitigation may depend substantially on the details of the capacity market design.

For example, if demand curve levels are set too high, sellers with market power can bid so as to raise capacity prices in these markets to excessive levels. This market power may be mitigated by subtracting peak energy rents based on actual observed prices (*ex post* true-up), thereby curtailing these sellers' incentive to raise energy prices. However, if the energy output of a unit selling capacity has been sold bilaterally to a third party, the third party may continue to have an incentive to profit from higher energy prices. Further, if *ex ante* measures of peak energy rents are used as subtractors, as they are in New York, sellers of capacity would still have an incentive to exercise energy market power. Thus, capacity market structures can help mitigate energy and capacity market power, but the degree of such mitigation depends on the details of the market design, and, in any case, cannot be considered capable of fully mitigating market power concerns.

II.

COMMENTS ON ENERGY DIVISION RECOMMENDATIONS

In the White Paper, the Energy Division makes several recommendations for a possible capacity market. SCE addresses each of these below.

A. Recommendation 1: Adoption Of A Short-Run Organized Capacity Market Approach With A Downward Sloping Capacity-Demand Curve For The CAISO

SCE supports the adoption of an organized capacity market approach with a downward sloping capacity demand curve for the CAISO as a replacement for existing resource adequacy requirements. However, there are a myriad of design details that need to be worked out, and SCE's support for an organized capacity market is contingent on a reasonable resolution of those details.

One important example would be the defining of the tenure of the capacity market, currently described in the recommendation as "short-term." Pennsylvania, New Jersey, and

Maryland System Operator recommends a four year-ahead capacity market (for a one year payment commitment). Such a system has merit for the additional revenue stability that it provides and the associated improved investment decisions for new and existing generation. If the Energy Division recommendation is intended to preclude the consideration of use of a four-year-ahead market, because it does not consider it “short-run,” then SCE cannot support this recommendation.

B. Recommendation 2: Further Investigation Of Alternative Availability Metrics And Ensuring Of Development Of An Availability Metric That Is Applicable To Hydro, Wind, Thermal And Other Generation Technologies, And To Appropriate Demand Response Products

The issue of measuring and providing incentives for performance should continue to be examined as part of capacity market development and implementation in California. SCE is concerned that the sole use of Unforced Capacity (“UCAP”) as both a metric for capacity (*i.e.*, the capacity available for sale into CAISO is the qualified capacity, as defined in the current resource adequacy requirements process, discounted by the unit’s availability factor to reflect forced outages) and a measure of performance (*i.e.*, the incentive to perform is tied to the potential for reduced capacity eligible to be sold into the capacity market in future years) provides inadequate performance incentives.

The proposal currently in place in New England appears to have solved this problem by providing payments based on performance at time of capacity need (*e.g.*, low reserve periods). This framework offers benefits both in terms of a capacity metric (qualified capacity can be used eliminating the need for tracking and reporting of forced outages),⁵ and as a performance

⁵ Forced outage reporting and actual forced outage durations involve discretion on the part of the plant operators, and thus could lead to problems if used as a metric for eligible capacity. For example, the economics of quickly returning a unit from a forced outage will vary between low demand, low price seasons and high demand, high price seasons. Yet, the duration of the outage will have an equal effect on the calculation of forced outage rates. Therefore, it would be inefficient to encourage overtime expenses during low load seasons just to reduce forced outage reporting.

measure (the consequences of failure to perform at critical times provide a much sharper incentive than the potentially *de minimus* reduction of future eligible capacity). However, it is not apparent that further investigation into metrics associated with wind, hydro, or demand-side resources are necessary, given the extensive evaluation and debate that occurred during the resource adequacy workshops. If it is determined that different metrics are required for participation in capacity markets for these resources—an outcome that does not appear to be consistent with eastern capacity market approaches—then further investigation could be conducted.

Additionally, the treatment of imports is a critical issue associated with the development of capacity markets for California. Given California’s dependence on imports, it would be prudent to inquire whether the accounting of imported capacity has been properly performed. Furthermore, a capacity market structure with rules that appropriately recognize the need to encourage exchanges with the Pacific Northwest, by recognizing their value as capacity while allowing for return energy during low capacity need periods, will be essential to achieving efficient and reliable outcomes for California consumers.

C. Recommendation 3: Consideration Of Subtraction Of Peak Energy Rents From The Capacity Payment

SCE supports the consideration of subtraction of actual rents from the capacity payment. This method, as proposed in New England’s LICAP proposal, provides additional incentives for performance during high priced periods,⁶ and, as noted in the White Paper, helps mitigate energy market power of sellers of capacity. Furthermore, if the capacity market is designed to ensure that a new combustion turbine would at least fully recover its fixed and variable operating costs over the course of a year when reserve margins are at or below target levels, then energy revenues in addition to capacity revenues must be considered in this calculus. Therefore, if any

⁶ High prices are highly correlated with periods of capacity need.

new resource can be brought into the system at a cost equal or lower than the proxy combustion turbine, then the price signal for investment would be at a sufficient level (though, as noted previously, the one year tenure of the financial commitment may be wholly inadequate to attract long term investment in new generation).

D. Recommendation 4: Adoption Of Reasonable Locational Installed Capacity Requirements With Locally Varying Demand Curves

SCE agrees with the White Paper’s recommendation of adopting reasonable LICAP requirements with locally varying demand curves. As noted in the White Paper, there are several potentially complex issues associated with properly defining the parameters of the locational element of the capacity market design. For example, if the number of local areas is too great (which would create local areas that are too small) the market construct will not be competitive. Furthermore, defining the proper areas, transmission constraints, cost variations between local areas to the extent they exist, requirements for each defined area, and overall reserve margin targets, will be a difficult task that will require careful planning. Accordingly, in defining local areas and local markets, there must be allowance for the likelihood that capacity market outcomes will not fully meet all of the CAISO’s reliability constraints, and that it may not be possible to completely eliminate unit specific contracts, such as the current Reliability Must Run (“RMR”), as a backstop to the capacity market process.

E. Recommendation 5: Consideration Of Protection Against Capacity Exports During Times Of Tight Supply Through The Use Of Capacity Prices That Fluctuate Seasonally

The aforementioned LICAP considerations involve various capacity design elements that need to be investigated. For example, will the capacity market auction process that establishes prices for capacity, prior to the *ex post* peak energy rents adjustment, be run on a monthly or annual basis? Will payments be shaped over the course of the year or the seasons to reflect differences in expected reliability needs (and thus capacity values) or will prices be shaped by

monthly changes in the capacity supply offers and target reserve margin parameters (load dependent)? Questions such as these must be answered at a basic level before establishing the rules for treatment of exports. In addition, California must also consider, when setting rules for exports, its dependence on imports at critical times, and its need to provide return energy for exchange agreements.

F. Recommendation 6: Investigation Of The Dependability Of Capacity Import Contracts During Times Of High West-Wide Load

SCE agrees that recognizing California's dependence on imports to meet load and reliability requirements is critical. The degree to which imported power will help meet future loads cannot be overestimated. Similarly, the degree to which imported power will be used cannot be ignored. Accordingly, SCE supports the investigation, on a regular and continuous basis, of the capacity of import contracts during time of high west-wide load, and, as a more general matter, SCE supports determining the degree to which import power is assumed to be delivering to meet capacity obligations in a capacity market, and how that participation can be accomplished.

For example, bilateral contracts with California LSEs, assuming appropriate deliverability and performance criteria are met, should be eligible to be bid into the capacity market auction process by those LSEs. The appropriate deliverability and performance criteria would be established by the existing resource adequacy requirements process. It is important to note, however, that the performance and delivery obligations of external entities who bid import power directly into capacity markets have not been discussed in the current resource adequacy requirements process taking place in R.04-04-003. Such obligations must be established in any new capacity market structure.

In addition, some import capacity has been used historically to meet reliability needs without contracts well in advance of delivery (*e.g.*, sold a year or more ahead of the delivery date). This has been possible because of the ability to depend on acquisition of import capacity

over available transmission on a shorter lead time basis. Under a capacity market paradigm, a question arises about whether some of the resources needed should be assumed to be available to meet California's peak demand based on historical performance, even in the absence of LSE specific contracts or bid participation in the capacity market auction by the importer. Failure to recognize the presence of capacity that has been historically available, but not contracted, well in advance of delivery, will result in a level of reliability that will generally be above target reserve levels and more costly than what was historically required.

For example, consider a capacity market design in which the auction process takes place four years in advance of delivery. In such an auction, supply may be available from not-yet built generation, but there may be severely limited import capacity participating in the auction. Therefore, only to the degree importers are willing to commit capacity through contracts or bids four years in advance of delivery would they be eligible to be counted in such a process. The result of their exclusion would be inflated capacity prices, and more capacity than is needed to meet reliability targets. Accordingly, it will be necessary to find a capacity market design approach that does not build in such inefficiencies.

G. Recommendation 7: Make The Fixed-Cost Recovery Curve Explicit

Adoption of an explicit fixed-cost recovery curve is impossible in light of currently available information and should be rejected as a goal of capacity market design. The White Paper describes the fixed-cost recovery curve, shown illustratively in Figure 2 of the White Paper, as a reflection of what is required for generators to reach a "normal" profit level for peakers. While it is true that a downward sloping relationship exists between the level of fixed-cost recovery, the existence of such a curve does not lead to the conclusion that one can, or should, establish a specific fixed-cost recovery curve for a new capacity market.

For any specific generator, the amount of cost recovery it can expect from the energy market that can be applied to fixed-cost recovery is the difference between its variable cost and the market clearing price. Since the market clearing price is reduced as supply is increased, for a

given downward sloping demand curve the depiction of a downward sloping fixed-cost recovery curve is reasonable. However, despite this conclusion, the fixed-cost recovery curve should not be made explicit for several reasons. First, the fixed-cost recovery curve is different for every generator and the variable costs of each generator are not publicly known. Second, the level of fixed-cost recovery necessary for each generator to earn “a normal profit level for peakers” is unknown, because the level of sunk investment and the amount of fixed operations and maintenance costs are unknown. Finally, the appropriate profit level for generators has not been defined. In any event, it should not be the purview of the Commission to establish target profit levels for generators unless those generators are subjected to cost of service regulation. Accordingly, it would not be prudent to make a fixed-cost recovery curve explicit in any new capacity market design.

SCE does not dispute the possibility that existing generators may be receiving less fixed-cost recovery from the current energy market than they need to fully recover their fixed-costs and earn a return on investment. If the market is to be sustainable over time, generators that are needed for reliability should be able to earn sufficient revenues to cover their costs and earn an appropriate risk-adjusted rate of return on their investment. However, the information from which to establish any of these target levels is not currently available.

For example, if generators that are needed for reliability are incapable of earning enough to keep operating (*i.e.*, such generators shut down existing resources needed to maintain grid reliability), it can be assumed that insufficient revenue is available from the market to recover fixed-costs. Additionally, in such a situation it can be assumed that current revenues from the market are not sufficient for a new generator to cover its investment cost.⁷ If such a situation occurs, even though the system’s reserve margin has fallen to near target levels necessary to maintain desired levels of reliability, then it is safe to assume that energy revenues are too low for fixed-cost recovery to be sustainable. It is not unreasonable to infer each of these

⁷ A new generator is defined as a peaker or a combustion turbine, or whatever the least cost new entries may be.

conclusions from the recent history of California's energy markets, and, therefore, SCE does not dispute the need for an additional revenue stream beyond current energy market revenues to contribute to generator fixed-cost recovery.

Nevertheless, it is not possible, or desirable, to attempt to define the level of fixed-cost recovery that should be achieved through a capacity market mechanism. If the White Paper intends to state that the demand curve, when at, or slightly above, target reserve margin levels should result in sufficient revenue for a new combustion turbine to fully cover its fixed and operating costs and earn a reasonable, risk adjusted, return on investment, then SCE would agree. However, if the full set of parameters for the downward sloping demand curve is intended to be derived from some broader calculation of a theoretical fixed cost recovery curve, then SCE would disagree.

The slope of the demand curve should be designed to reflect the relationship between the cost of achieving reliability, and the reliability achieved. In other words, as a "demand curve" for reliability, it should reflect the fact that there is a diminishing value for reliability as reserve margins increase. When reserve margins are very low, the value of additional supply in maintaining reliability is great, and, therefore, one would expect the demand curve slope to be high. Conversely, as target reserve levels increase—even though there continues to be some value of increased reliability from increased capacity—the value diminishes, and, therefore, a gradually declining demand curve is implied. In fact, reliability analysis can be used to establish the functional relationship between the loss of load probability and the level of capacity in the system. It is this curve that provides insight into the appropriate shape of the demand curve (as explained in the LICAP proposal in New England). If it is desirable for California to establish a specific foundation for the demand curve and the ultimate parameters to be adopted for that demand curve, it should be these principles, and not the fixed-cost recovery curve (as implied in the White Paper) that would provide the appropriate foundation.

H. Recommendation 8: Strive for Regulatory Credibility

Striving for regulatory credibility is an appropriate goal, though no decision this Commission makes will be binding on future Commissions. Therefore, this Commission should set forth the value of a stable regulatory paradigm and describe the limited conditions under which regulatory changes may be warranted. By sending and reiterating the message regarding the importance of avoiding unnecessary changes with the construct and rules of a capacity market, this Commission sets forth the foundation necessary to avoid instability in the capacity market.

III.

COMMENTS ON THE ROLES OF THE CPUC AND CAISO

SCE agrees that the Commission and the CAISO have key roles in the policy development and implementation of any capacity market considered in California. Additionally, stakeholders at both the Commission and the CAISO must be given opportunity for input on the specifics of any capacity market that may be developed. However, while the White Paper invites parties to comment on the likely roles the CAISO and Commission can play in the development and implementation of a capacity market, at this time, given the vagueness of the White Paper with regard to an actual capacity market proposal, it is difficult to be able to comment on the specific roles to be played by the two entities. This question is especially difficult considering the fact that while the Commission may wish to be involved in the development of a capacity market, if the CAISO must request Federal Energy Regulatory Commission (“FERC”) approval for a detailed capacity market design, and FERC can modify the design elements in a decision, the Commission seems left with the same recourse as any other party before FERC and no specific authority over such changes. This fundamental question of jurisdiction over any capacity market that may develop will affect any discussion of the roles of the Commission and CAISO.

Additionally, SCE recommends that the Commission look to the experience of the New York Independent System Operator (“NYISO”) for direction in determining the roles which should be played by the Commission and the CAISO. Since the NYISO is also a single-state jurisdiction involved with a rate commission, like California, examining the division of responsibility in that system’s capacity market is likely to be useful to the Energy Division’s efforts here.

IV.

CONCLUSION

SCE respectfully submits the foregoing comments on the White Paper and looks forward to future discussion of capacity markets constructs for California.

Respectfully submitted,

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September 23, 2005

CERTIFICATE OF SERVICE

I hereby certify that, pursuant to the Commission's Rules of Practice and Procedure, I have this day served a true copy of COMMENTS OF SOUTHERN CALIFORNIA EDISON COMPANY (U 338-E) ON CAPACITY MARKETS WHITE PAPER on all parties identified on the attached service list(s). Service was effected by one or more means indicated below:

- Transmitting the copies via e-mail to all parties who have provided an e-mail address. First class mail will be used if electronic service cannot be effectuated.
- Placing the copies in sealed envelopes and causing such envelopes to be delivered by hand or by overnight courier to the offices of the Commission or other addressee(s).
- Placing copies in properly addressed sealed envelopes and depositing such copies in the United States mail with first-class postage prepaid to all parties.
- Directing Prographics to place the copies in properly addressed sealed envelopes and to deposit such envelopes in the United States mail with first-class postage prepaid to all parties.

Executed this **23rd day of September, 2005**, at Rosemead, California.

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September 23, 2005

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RE: R.04-04-003

Dear Docket Clerk:

Enclosed for filing with the Commission are the original and five copies of the **COMMENTS OF SOUTHERN CALIFORNIA EDISON COMPANY (U 338-E) ON CAPACITY MARKETS WHITE PAPER** in the above-referenced proceeding.

We request that a copy of this document be file-stamped and returned for our records. A self-addressed, stamped envelope is enclosed for your convenience.

Your courtesy in this matter is appreciated.

Very truly yours,

Laura I. Genao

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Enclosures

cc: All Parties of Record
(U 338-E)

