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

RESPONSE OF SOUTHERN CALIFORNIA EDISON COMPANY (U 338-E) TO COMMENTS ON CAPACITY MARKETS WHITE PAPER

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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 Comments on the Capacity Markets White Paper ("Comments") received by several parties. As 23 parties responded to most of the five policy questions and eight recommendations set out in the Capacity Markets White Paper ("White Paper"), SCE limits its comments here to the issue of why a centralized capacity market should be designed to completely replace California Public Utilities Commission ("CPUC") Resource Adequacy Requirements ("RAR"), and not simply as a "complement" or "backstop" when load-serving entity ("LSE")-based RAR procurement is not enough, or results in excess resources for individual LSEs. SCE reserves its right to comment on parties' positions with regard to other issues, as appropriate, in future consideration of capacity market structures.

I.

USE OF CAPACITY MARKETS TO "BACK UP" AN LSE-BASED RAR FAILS TO RECOGNIZE THE VALUE OF A CENTRALIZED, REPLACEMENT CAPACITY MARKET

In comments on the White Paper, several parties argue that a capacity market should be introduced as a complement to the existing LSE-based RAR. For example, Williams Power Company, Inc. ("Williams") asserts:

> [B]ilateral contracts should remain the primary means by which LSEs meet their Resource Adequacy Requirement. That is, capacity markets should serve as a complementary backstop role to bilateral procurement. If not...LSEs have an incentive to default to centralized procurement to the detriment of existing supply and new investment.[1]

Similarly, Duke Energy North America ("DENA") contends:

> [A] formalized capacity market structure will be an important tool for LSEs to satisfy their RAR procurement obligation. It is important that the structure not interfere with bilateral contracts as those contracts are likely to be the primary means of supporting new infrastructure development. The "backstop" role of the capacity market may also support development, but it will more likely provide a means for LSEs to acquire smaller increments of capacity and suppliers to sell "odd lots" of capacity not acquired under whatever standardized products develop in the bilateral markets.[2]

As these statements make clear, some parties believe that California should develop a capacity market that merely complements LSE-based RAR imposed by the CPUC.[3] Such a view of capacity markets fails to recognize that making capacity markets nothing more than a "backstop" to LSE-based RAR procurement may ultimately undermine the value of a capacity

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[1] Williams at 4.

[2] DENA at 11.

[3] Other parties seemingly agree with the idea that the CPUC's LSE-based RAR would not be supplanted by a capacity market, rather it would be complemented by it. For example, West Coast Power states, "resource adequacy needs will be best met if private bilateral contracts are accompanied by a centralized capacity market." *See* West Coast Power at 3.

market, eliminating some of the capacity market's positive attributes, such as, mitigation of market power; increased stability upon which investment can be based; and, the equitable treatment of all market participants.

A. Merely Using Capacity Markets As Backstops For LSE-Based RAR Could Undermine the Value of Capacity

Allowing a capacity market to be the backstop for an LSE-based RAR could be seen as similar to allowing the California Independent System Operator ("CAISO") real-time market to be the backstop to day-ahead scheduling. As such, prices in the forward market (in this case the LSE-based RAR) could be established in large part by the opportunity cost associated with the market of last resort – the backstop capacity market.

For example, assume that some LSEs have an obligation to procure bilaterally at some time in advance of the capacity market auction. Knowing that a demand curve will set the price that is available to the seller if it withholds its power from the bilateral market to meet RAR, the seller will never offer power at a price below that which it expects to receive from the demand curve.[4] If, however, the forward obligation requires LSE-buyers to purchase in advance of the capacity market or face stiff penalties for non-compliance with their RAR, then it is likely that these LSE-buyers could be forced to pay higher than demand curve prices. Additionally, because the cost of economically withholding capacity from forward bilateral sales is only the opportunity cost associated with the capacity market backstop demand curve, the risk of holding out for high price by sellers is minimal.[5]

The "second bite at the apple" feature of a capacity market designed solely as a "backstop" to the CPUC's RAR encourages withholding and manipulation, not the stability

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4 For purposes of this example, SCE assumes that a demand curve would be used in this "backstop" capacity market, as the White Paper specifically asks parties to comment on issues with the use of a demand curve and none of the parties advocating a "backstop" capacity market disagree that a demand curve capacity market structure would be wrong for California. *See e.g.*, Williams at 6; West Coast Power at 5; DENA at 3.

5 As the Commission is aware, similar situations led to economic withholding from the Power Exchange during the energy crisis (through strategies such as hockey stick bidding).

required to ensure necessary infrastructure investment and reliability. Because a touted feature of capacity markets is their effective market power mitigation through administratively set demand curves, as opposed to LSE-based bilateral obligations for which no effective market power mitigation exists, the CPUC should not consider any capacity market structures that eviscerate the consumer protection associated with market power mitigation. Accordingly, the Commission should reject the notion of capacity markets as "complementary" rather than "replacements for" the CPUC's LSE-based RAR.

B. <u>A Centralized, Replacement Capacity Market Would Provide Critical Benefits to California</u>

As pointed out above, a "backstop" capacity market could have consequences which could diminish the value of such a market. A centralized, replacement capacity market, on the other hand, would have benefits such as ensuring that market power is mitigated on the supply side; providing for stable, transparent, and predictable capacity values which can be the basis for investment; and, aligning cost responsibility among LSEs.

First, as noted in Section I.A, above, a replacement, capacity market with a demand curve could help mitigate market power on the supply side. The administratively determined demand curve would eliminate the degree to which sellers could drive up prices in such a market as well as any market power which exists in bilateral contracting situations. Additionally, models for such markets already exist. Models for an LSE-based RAR with a backstop capacity market do not. For this reason alone, it is imperative that the CPUC give great weight to the idea of a capacity market that completely replaces the LSE-based RAR.

Second, a replacement, capacity market would provide a stable mechanism upon which investment can be based by providing revenue stability that leads to improved investment decisions. As SCE has previously noted, this result can best be achieved if a demand curve is used in an organized capacity market similar to the four-year-ahead market used by the

Pennsylvania, New Jersey, and Maryland System Operator.[6] Such time horizons tend to stabilize revenues over time, a result that increases the climate for investment.

Lastly, a replacement, capacity market would ensure that responsibility for resource procurement is equally borne by all LSEs in an easy-to-implement manner. A replacement capacity market ensures the fair allocation of responsibility for resource adequacy to all load because it bills the cost of capacity procurement directly to LSEs. It does not rely on LSEs themselves to track load and procurement, another entity to determine what the appropriate level of procurement is, and then upon another entity to track compliance. Instead, a capacity market that replaces LSE-based RAR relies only on the capacity market to determine what level of resources are needed and each LSEs' share of the cost of such resources. The efficiencies gains inherent in such a system cannot be overlooked in the CPUC's study of capacity markets.

II.

CONCLUSION

For the foregoing reasons, SCE encourages the CPUC to reject consideration of capacity market mechanisms that merely serve as a backstops to the CPUC's LSE-based RAR.

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[6] *See* SCE at 7.

Respectfully submitted,

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October 11, 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 RESPONSE OF SOUTHERN CALIFORNIA EDISON COMPANY (U 338-E) TO COMMENTS 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 **11th day of October, 2005**, at Rosemead, California.

Lizette Vidrio
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October 11, 2005

Docket Clerk
California Public Utilities Commission
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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 **RESPONSE OF SOUTHERN CALIFORNIA EDISON COMPANY (U 338-E) TO COMMENTS 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

LIG:smb:LAW#1254939
Enclosures

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