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 (Filed April 1, 2004)

REPLY COMMENTS OF CALPINE CORPORATION ON CAPACITY MARKETS WHITE PAPER

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Pursuant to the August 25, 2005 Chief Administrative Law Judge's Ruling, Calpine Corporation ("Calpine") submits these reply comments on the California Public Utilities Commission's ("Commission") Capacity Markets White Paper ("White Paper"). Calpine believes that the development of a centralized capacity market along the lines outlined in the White Paper should be pursued and notes that the White Paper has generated a significant amount of serious, diverse comments on the future market structure for California. However, as Calpine stated in its Comments on the White Paper, the development of such a capacity market should *not* take priority over the urgent need to ensure that existing generation required to meet expected demand is provided just and reasonable compensation for the services it provides and that new capacity needed by California is being built. Many of the comments submitted by parties echo these key points made by Calpine.

1. The Commission and California Independent System Operator ("CAISO") must give their highest priority to transition mechanisms that will ensure that existing generation needed to meet expected demand is provided just and reasonable compensation for the services it provides and that needed new generation is built.

Calpine believes that establishing a capacity market will take years; thus, action must be taken during the transition period to ensure needed capacity is available to meet expected demand**.** Many parties agree that a properly functioning capacity market (or other properly functioning market structure) will likely take years to develop and implement.[1] Most of these parties acknowledge that during this transition period to a properly functioning capacity market, it is critical that the Commission and the CAISO ensure that needed existing generation is provided the proper price signals to ensure continued operation and that needed new generation is developed and built.

One of the best ways to establish an effective transition mechanism is through the Technical Conference proposed by the Independent Energy Producers Association ("IEP") as part of its Reliability Capacity Services Tariff ("RCST") proposal, which is presently before the Federal Energy Regulatory Commission ("FERC"). The RCST would replace the CAISO's current Must Offer Obligation for generators. Several parties presented ideas on transition mechanisms that could be considered as part of this Technical Conference.[2] Thus, IEP's RCST filing would seem to be the best near-term opportunity to ensure a functioning and effective energy market during the transition period. The Commission should support the use of the RCST Technical Conference to identify and implement a transition mechanism that can replace the current Must Offer Obligation.

The need for new generation also needs to be addressed as a top priority by the Commission. Parties as diverse as the CAISO, TURN, WCP, and PG&E recognize the need for new generation. As Calpine stated in its Comments, the Commission must resolve the procurement, retail, and cost allocation rules in a manner that will allow Investor Owned Utilities

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[1] *See* Comments of CAISO, The Utility Reform Network ("TURN"), Alliance for Retail Energy Markets ("AReM"), Pacific Gas and Electric Company ("PG&E"), San Diego Gas & Electric Company ("SDG&E"), The Office of Ratepayer Advocates ("ORA"), Sempra Global ("Sempra"), West Coast Power ("WCP"), Duke Energy North America ("DENA"), and Morgan Stanley Capital Group, Inc. ("MSCG").

[2] Several comments provided concepts that deserve consideration. The CAISO proposes a "transitional program" for the next several years for needed existing plants. TURN proposes an resource adequacy requirement ("RAR") that is 100% for three years out and 80% for five years out. AReM proposes that Capacity Call Option be used in the transition. DENA proposes an "interim contracting approach."

("IOUs") or other entities capable of procuring long-term electric resources to acquire additional new capacity under long-term Power Purchase Agreements ("PPA").

In addition, the Commission should consider MSCG's proposal to have power marketers enter into these long-term contracts. Marketers, such as MSCG, have the financial profile, as well as the business model, to enter into the long-term PPAs that are necessary to get new generation built. Calpine supports the Commission's consideration of approaches that rely on non-IOUs to enter into long-term PPAs for needed new generation.

The CAISO, AReM, SDG&E, IEP, Constellation and MSCG strongly put forth the case to raise the current price caps and take other actions (in combination with more forward contracting) to improve the current energy and ancillary services markets. Highly respected economists provide detailed analysis on this issue in the comments submitted by the CAISO and AReM. Calpine agrees with this approach. There are several actions the Commission can take during the transition period (and beyond) to help relax the CAISO's unnecessary price mitigation policies and ensure that needed resources are available. Specifically, the Commission should support action by FERC to remove impediments in the energy market that distort the market and are not needed to reasonably constrain market power, including:

- Removal of the Must Offer Obligation and its replacement with the interim RCST, as proposed by IEP.
- An increase in price caps to the industry standard level of $1,000 MWh.
- Removal of Automatic Mitigation Procedure ("AMP").

Implicit in all of the above recommendations is that the Commission must ensure that *all* new supply will be procured through open and fair competitive solicitations, consistent with the policies established by the Commission in Decision 04-12-048. If IOUs are given the opportunity to procure IOU-owned resources outside of the competitive framework, the credibility and usefulness of a capacity market will be completely undermined.[3]

2. The Commission and the CAISO must proceed carefully with the structuring of a capacity market.

The development and implementation of a properly functioning capacity market will take a significantly amount of effort, expertise and time, and a wide range of options must be considered. As a result, the development and implementation of a properly functioning capacity market should be a lower priority than the need to take immediate action to ensure new generation is developed and built and that existing generation needed to meet expected demand is provided just and reasonable compensation for the services it provides.

As the CAISO, AReM, Constellation, ORA, TURN and others note in their respective comments, markets in other regions are still evolving and California can learn from the experience in these regions. Calpine agrees and further supports the following recommendations:

- The CAISO recommends a careful and thorough evaluation of major options, including ones that are more "energy-only." Calpine concurs with the need to carefully develop the new market structure and to move toward improvement of the energy market. The CAISO approach should be considered in a joint effort by the Commission and the CAISO.

- MSCG proposes that load serving entities ("LSEs") be required to enter into long-term PPAs while, at the same time, removing the energy market price cap. Calpine supports the consideration of this concept. It is similar to what is being done by the Electric Reliability Council of Texas ("ERCOT") and the Midwest ISO ("MISO"). While complete lifting of price caps is likely not feasible, the raising of caps well above the $1,000 norm (*e.g.*, $5,000 to $10,000) is feasible and should be considered. This approach would encourage LSEs to forward contract and, thus provide the incentives needed for investment in new generation resources. Long-term contracts will mitigate the risk to consumers posed by higher caps. MSCG's proposal is a relatively simple approach that could be implemented in a short period of time.

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[3] *See e.g.*, Constellation's Comments at 5.

- AReM proposes having a strong demand response system combined with a robust energy market.
- Sempra and SDG&E propose a four years out capacity auction.

Calpine appreciates the opportunity to submit these reply comments on the White Paper and looks forward to working with the Commission and other stakeholders to ensure the needs of California's electric customers are met and that any future energy crisis is avoided.

Respectfully submitted,

/s/ Linda Y. Sherif

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Dated: October 11, 2005

CERTIFICATE OF SERVICE

I, Judy Pau, certify:

I am employed in the City and County of San Francisco, California, am over eighteen years of age and am not a party to the within entitled cause. My business address is One Embarcadero Center, Suite 600, San Francisco, California 94111-3834.

On October 11, 2005, I caused the following to be served:

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enclosed in a sealed envelope, by first class mail on the parties listed as "Appearance" and "State Service" on the attached service list who have not provided an electronic mail address, and via electronic mail to all parties on the service list who have provided the Commission with an electronic mail address.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct, and that this declaration was executed on the date above at San Francisco, California.

/s/ Judy Pau
Judy Pau

Service List R.04-04-003
Jack Fulcher, Energy Division