

**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 Constellation Energy Commodities Group, Inc.
and Constellation NewEnergy, Inc.
on Capacity Markets White Paper**

September 23, 2005

Lisa M. Decker, Esq.
Counsel

Constellation Energy Group, Inc.
111 Market Place, Suite 500
Baltimore, Maryland 21202
Phone: (410) 468-3792
Fax: (410) 468-3499
Email: Lisa.Decker@constellation.com

*On behalf of Constellation Energy
Commodities Group, Inc. and Constellation
NewEnergy, Inc*

Andrew B. Brown

Ellison Schneider & Harris L.L.P.
2015 H Street
Sacramento, CA 95814
Tel: (916) 447-2166
Fax: (916) 447-3512
Email: abb@eslawfirm.com

*Attorneys for Constellation Energy
Commodities Group, Inc., and Constellation
NewEnergy, Inc.*

**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 Constellation Energy Commodities Group, Inc.
and Constellation NewEnergy, Inc.
on California Public Utilities Commission Capacity Markets White Paper
Issued by the CPUC Energy Division, Sean Gallagher Director**

I. Introduction and Summary

On August 25, 2005, Chief Administrative Law Judge Angela Minkin issued a Ruling Providing Notice of Availability of Staff Capacity Market White Paper (“White Paper”) and Providing for Comments by interested market participants. Constellation Energy Commodities Group, Inc. and Constellation NewEnergy, Inc. (collectively, “Constellation”) commends the Staff of the Energy Division (“Staff”) of the California Public Utilities Commission (“CPUC”) for the thoughtful and comprehensive work that is represented in the White Paper, and welcomes this opportunity to provide comments.

Constellation believes that the White Paper forms a very solid foundation upon which the Commission can proceed to direct the implementation of sound capacity market design that will not only help to ensure that there are sufficient and efficient capacity resources to meet California’s energy needs, but that will also ensure that the benefits of truly competitive markets are achieved.

Constellation’s comments are structured to simultaneously address the Staff’s central recommendations and discuss Constellation’s views regarding “lessons learned” from existing markets, consistent with the request in the ALJ ruling. This is followed by a short discussion

concerning interagency implementation. Some of the most salient points discussed below can be summarized as follows:

- California should adopt the NY-ISO Capacity Market structure because it contains the best set of elements proven to encourage capacity development.
- The capacity market design must include a local reliability area procurement obligation.
- The regulatory community needs to articulate a commitment to competitive markets in order to foster better confidence in market participants and to signal regulatory certainty to investors.

II. Constellation Comments

A. Constellation Supports Use of the NY-ISO Capacity Markets Approach as the Appropriate Conceptual Framework That Should be applied for California's Capacity Market Design

Constellation agrees with Staff's ultimate conclusion that a short term capacity market design with the demand curve feature similar to the system that has been implemented by the NY-ISO will provide an important tool to support LSEs' compliance with the Commission's Resource Adequacy Requirements ("RAR") procurement obligation and, in turn, induce new investments to provide needed supply capacity. Moreover, Staff's conclusions that implementation of well-structured capacity markets are the right administrative response to address the blunting of price signals caused by mitigation measures are fundamentally sound and accurate, and Constellation supports these conclusions.

However, Constellation has some serious reservations as to the underlying rationale which led Staff to this correct conclusion. Namely, the premises for Staff's adoption of a capacity market structure is the fact that there is inadequate demand response and the inability to selectively interrupt customers whose LSEs do not secure the resources necessary to serve their load. In selecting these premises, Staff has ignored the negative effect that mitigated energy prices have on demand response by blunting the price signals that would otherwise encourage consumers to conserve, because Staff has assumed that demand is inelastic. In addition, the issue

of “free-ridership” is a red-herring. The NY Demand Curve addresses free-ridership in that all load that is served through the demand curve pays for capacity. If LSEs do not demonstrate that they have acquired adequate reserves in the month-ahead, the LSE will pay for its reserve requirement based upon the actual clearing price of the capacity market. The risk for the LSE is the price risk that the capacity price may clear at the upper limit of the price curve, instead of at a lower price if they had contracted bilaterally. Therefore, all load pays for capacity either through their own bilateral contracting efforts or through the clearing of the capacity market. Under the CPUC resource adequacy requirement, LSEs are required to secure resources to meet the reserve requirement for their load. Thus, while Staff reaches the right conclusions about the need for a capacity market, Constellation feels that it is important to clearly acknowledge that it is price mitigation that leads to the need for a capacity market structure.

In Constellation’s experience, all forms of energy price mitigation, including safety net bid caps and local market power mitigation measures, whether applied on an *ex ante* or *ex post* basis, seriously blunt the energy price signals that would otherwise encourage new investment. The strong link between existing forms of price mitigation in all the organized wholesale energy markets and the direct limitations that this mitigation places on new capacity investment—both in new and existing generating resources and in demand response—cannot be overstated.

Mitigation of energy prices provides consumers with a “free” regulatory hedge against high price signals from the market. Access to the “free” regulatory hedge precludes the development of market-based hedges that buyers and sellers would otherwise pursue to manage their price risks. Unfortunately, however, the “free” regulatory hedge is not really free at all, because it creates future cost impacts in terms of insufficient generation supply and demand response investment that ultimately requires some additional action by regulators to make up for

the price signal mitigation. In the absence of market-based signals to increase capacity resources before a reliability crisis, regulators must anticipate those reliability issues that arise and respond with more market intervention in the form of mandated, rate regulated responses because those are the only tools they have once a reliability crisis looms.

Rather than relying upon additional market intervention during periods of crisis, there are two potential market-based frameworks that can work to resolve the lack of investment that price mitigation causes. The first is an “energy only market” structure with no forms of energy price mitigation where the risk of high scarcity-driven prices incent infrastructure development as a form of physical hedging. An energy only market structure requires the following:

1. In an energy only market, energy market mitigation shifts away from *ex ante* or *ex post* mitigation of energy bids and other forms of price caps and instead uses mitigation measures that are solely focused on identifying and addressing instances of market power abuse.
2. In a workable energy only market, investors must have confidence that the energy only market will be politically durable over the long run and that market structure disruptions are minimized. That is, the industry needs greater regulatory certainty that provides confidence that market rules and structures will not be significantly changed and confidence that when market clearing prices begin to become volatile or high, that regulators will allow those price signals to emerge rather than attaching new forms of *ex ante* or *ex post* price mitigation. Policy makers must be prepared to resist the urge to call for mitigation in response to instances of high prices.
3. Energy only markets must be sufficiently transparent for all market participants to see and respond to price signals through the frequent posting of energy prices (not bids). Market participants need to face exposure to this natural short term volatility in the market, and be provided a variety of hedging tools, including bilateral contracts, to enable market participants to hedge their exposure to volatility in the short term markets.
4. Monitoring for market power is absolutely necessary and should continue to play an important oversight role. However, policy makers must develop clear policies that differentiate problems associated with the abuse of market power from high price signals associated with scarcity. Market power should be defined as the ability to intentionally increase prices, at

will, over a sustained period of time. Any actions taken in response to abuse of market power should be designed to remedy the specific abuse and any necessary changes to market rules should be adopted prospectively. Market monitoring should be performed by an independent entity with a regional perspective. Monitoring should focus on individual remedies rather than market wide remedies.

Thus far, there have been no organized wholesale electric markets that have eliminated safety net bid caps and other forms of local mitigation measures, although all other markets set their “damage control caps” at or upwards of \$1000/MWh rather than California’s current \$250/MWh cap. Constellation expects that given various political pressures, it is unlikely that any state or federal regulatory authority could ensure that such mitigation measures would not be re-introduced even if they were eliminated. Nevertheless, the energy only market structure should remain as the ultimate desired market end-state, and all proposed market design changes or refinements should be evaluated in terms of how those revisions help advance realization of a fully competitive energy only market.

The critical goal of finding a capacity market structure that promotes, rather than impedes, the development of competitive markets is particularly relevant. As the Staff has correctly noted, the need for a capacity markets construct is to remedy the harm and dysfunction that energy price mitigation causes in the current market design. Therefore, the keystone is a capacity market design that ensures continued progress toward the goal of a fully competitive wholesale and retail energy-based market. To further this goal, Constellation believes that the following four principles must be followed when deciding on the capacity market design:

1. There must be a stated commitment on the part of the regulatory community in favor of the creation, improvement and maintenance of competitive markets because competitive markets will provide better, more efficient, and competitively priced service for ratepayers than will rate regulation. A clear commitment that stable, competitive markets environment can and should work to solve capacity resource requirements

(both generation development and demand response) is the cornerstone to providing regulatory stability.

2. The capacity market design should be focused on creating *forward price signals* that, together with price signals from the existing energy and ancillary services markets, provide assurance to the investment community that there is a reasonable expectation of adequate revenues to support investment.
3. Capacity market design *should not* be focused on *forward price setting* mechanisms that use a centralized agency (whether the regulated utilities or the CAISO) in the role of procuring capacity resources on behalf of load.
4. There should be an understanding that continuous improvement of energy market structures is laudable and to be pursued so that energy markets can assume an increasing proportion of the value of resources that serve the market. To begin those evolutionary improvements, policy makers should be willing to consider a phased increase to the level of today's bid caps on a regular, periodic (perhaps annual) basis, in order to stimulate increased levels of demand response. In addition, there is a need to phase out other extra-market mitigation measures that lead to out-of-merit dispatches and the prohibition on the truly marginal resource in setting the market clearing price. These reforms must occur so that the energy price signals improve. Suppliers must be allowed to bid at rates that reflect scarcity, risk, and opportunity costs - and demand must also be allowed to set market-clearing prices. As extra-market mitigation measures are reformed over time, energy revenues will increase and capacity markets will become increasingly less significant in driving investment decisions.

With these principles as the backdrop, attached are the features of a well-designed capacity market that Constellation recommends for adoption by the Commission:

1. Capacity markets should be designed so that market participants are given three to four year forward information as to what the reserve requirements (15-17%) are and what the forward curve will be for procurement planning purposes, but the LSEs' RAR procurement compliance demonstrations should be no more than one month in advance to ensure the maximum level of bilateral contracting and to minimize (if not eliminate) the role of the CAISO or any other entity in procuring "backstop" capacity that requires socialization of costs. Constellation refers to these concepts separately as the *forward planning* aspects of capacity market design, which are helpful and necessary for prudent procurement and the *forward obligation/compliance demonstration*

aspects of capacity market design, which need be no more forward than one month.

2. The capacity market should incorporate demand curve price signals and methodology to provide assurance of energy market revenue adequacy and to ensure that all resources willing and able to commit their capacity to the CAISO markets can do so, whether or not they are bilaterally contracted with a LSE.
3. The capacity market must incorporate locational components to ensure that capacity is added when and where it is needed, but the locations should be defined as broadly as possible to maximize market liquidity and minimize creation of market power concerns.
4. Capacity markets should treat all qualified resources – generation and demand response – equivalently.

Constellation believes that the White Paper recommendations, with their support for the New York demand curve approach, fundamentally reflect these principles and incorporate the important key features described above, and thus Constellation strongly supports the direction the White Paper charts for the Commission.

B. Comments on Staff's Eight Recommendations

Below, Constellation addresses each of the Staff's specific Recommendations and provides some comments on associated discussions from the "lessons learned" section.

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

Constellation agrees that the New York style demand curve approach is a well-designed and successful capacity market structure. California would be well-served to implement the New York demand curve. The New York market design features best achieve the goals of encouraging efficient investment and **ensuring** that the resources are available when needed. Constellation notes, however, that several of the modifications that PJM and ISO-NE are each proposing in their designs represent mechanisms that diverge from the successful New York

model and thus will somewhat compromise progress toward robust competition (both wholesale and retail) compared to the New York model.

For example, the four-year forward commitment process PJM proposed in its Reliability Pricing Model (“RPM”) filing fundamentally differs from the New York capacity market model. The four-year mechanism is an interventionist device intended to anticipate system capacity needs by placing PJM—rather than the LSEs—in a direct procurement role. Constellation does not support those design changes in California because having the control area operator (such as CAISO) contract directly on a forward basis undermines LSEs’ perception of market risks and moves the responsibility for prudent procurement planning from the LSEs to the control area operator. Accordingly, a market structure similar to that now proposed by PJM in the RPM would actually undermine forward bilateral contracting and frustrate the timely development of new capacity.

Although PJM currently proposes that capacity procurement obligation requirements be articulated a full four years in advance of the planning year, the reality is that under the PJM RPM design, LSEs may—but are not required to—demonstrate to PJM that they have secured their share of the capacity requirements on the four year advance timeline. Should LSEs make a four year ahead commercial commitment, they may apprise PJM of their capacity position. But LSEs are not required to take positions that far forward. Instead, the LSE can rely upon PJM to secure capacity for its benefit when it conducts the demand curve auction four years before the planning year. All resources (existing or planned) may compete in this auction. All units offering capacity that clears below the demand curve price would contract directly with PJM and be assured a one year capacity payment made four years hence, equal to the demand curve clearing price established during that planning year.

Constellation understands that the stated intention behind the four year forward procurement approach is to allow new resources to participate in the capacity selection process. Constellation also understands that using a four year forward auction mechanism with PJM “standing in the middle” of the capacity procurement through its direct contracting could be seen as desirable in light of uncertainties surrounding potential retail load migration. However, Constellation simply does not agree with the premise that it is necessary for the control area operator to take a market position or for the capacity demonstration to occur any sooner than the one month time horizon that New York employs, for the following reasons:

- The most crucial elements for successful capacity market design that will avoid the need for an extra-market “backstop” entity are: (1) forward planning, (2) forward price signals, and (3) differentiation of price by location. Specifically, Constellation believes that a four year forward *planning* element can provide market participants with specific information about critical capacity needs throughout the system. Providing this information, including needs within specific local reliability areas, is precisely the type of information that market participants—including capacity owners, developers, and load serving entities (“LSEs”)—must have to make informed decisions about how to meet their capacity requirements.
- The demand curve feature provides capacity resource owners and LSEs with important information on the range of price signals that will apply to capacity resources in the event those parties do not enter into bilateral contracts to meet their capacity requirements. The demand curve provides market participants with the range of prices that will apply in the spot market, where the range is

dependent upon the actual depth of the capacity resource base. Constellation believes that the combination of the *forward planning information*, including information about *locational capacity requirements*, along with the *demand curve price signals* will provide the needed incentive for market participants to make rational decisions about their capacity requirements obligations and procurement risks, and for resource owners and developers to understand the value that the market will provide for their resources. Having PJM function as the capacity middleman serves to make PJM a market participant, rather than the market administrator, a role that should be avoided.

- Under PJM's proposed RPM, LSEs are not required to make any direct forward commitment to capacity resources. PJM makes those commitments directly with suppliers on behalf of the LSEs and allocates the costs to the LSEs in real time. Constellation is concerned that any similar design element in California will reduce, if not eliminate, the incentives for direct forward contracting between resource owners and LSEs because this procurement role essentially moves certain procurement risks over to the control area operator. Just as ISOs do not make forward energy purchases on behalf of load, there is no compelling reason why an ISO should undertake a multi-year forward capacity procurement on behalf of load.
- California has undertaken a number of efforts to secure supplies for loads through forward contracting, rather than the troublesome over-reliance by the IOUs on the real-time market seen during the energy crisis. Constellation views a robust bilateral contract market as essential for continued market

development. If the ISO is put in a position of taking on a direct procurement role like the one PJM has proposed, there could be similar unintended consequences, including the erosion of value for existing bilateral contracts to the participants that made those forward commitments. Under such a structure, bilateral contracts would become less than a “perfect” hedge against supply sufficiency and pricing risks, and thus market participants are less likely to enter into bilateral contracts when another entity will assume those risks without a premium.

- Constellation is concerned that if an ISO “stands in the middle” by directly participating in long forward contracts, then the most efficient, competitive responses to capacity needs may be compromised, leading to the possibility of new stranded cost creation. In such conditions, it may be difficult for the ISO to maintain its “independence” with respect to the market.
- Furthermore, the forward approach advocated in the PJM RPM model may undermine California’s efforts to develop more demand response programs that can influence the wholesale markets. Put simply, demand resources are not well-suited to a four year forward commitment (particularly where the programs remain in a state of flux and rapid evolution). Constellation firmly believes that robust demand response is a critical wholesale and retail market design element that will allow the energy markets to become increasingly competitive and less dependent on excessive mitigation measures. Accordingly, Constellation does not support market designs that would

undermine the ability of demand response to fully integrate into the CAISO markets.

In summary, Constellation believes that while the four year *forward planning* and demand curve elements like those seen in PJM's RPM proposal *will provide* the forward price signals necessary to incentivize capacity resource owners and load serving entities to make rational, appropriate capacity resource decisions that will ensure reliable operations and address the revenue sufficiency issues. However, the PJM proposal concerning of the four year *forward resource commitment* through a centralized ISO procurement mechanism is a design flaw that will have the unintended consequence of compromising forward contracting by buyers and sellers of capacity, and undermine the value of the hedged positions parties may have already taken on a bilateral basis.

In the White Paper, Staff correctly acknowledges that a sloped demand curve approach for capacity market design serves to strongly mitigate power. It does so because withholding of a small amount of resource does not raise the demand curve pricing; in other words, it takes a significant amount of withholding of resources to impact the overall clearing price. Staff also recognizes that deducting net revenues from the cost of new entry in establishing the demand curve pricing reduces any incentive to try and drive energy prices up since such increases will, when the capacity pricing is re-set, cause the capacity price to decrease. Both of these are powerful features of the demand curve that provide structural means to limit the abuse of market power. There is one comment, however, that Staff has made with respect to market power that Constellation must respond to, and that is with respect to virtual bidding. Staff has said that a must bid requirement on capacity resources can be fairly ineffective in limiting market power

because “suppliers may bid high and may export with impunity through virtual bids.”¹ This Statement mischaracterizes the impact that virtual bidding can have, because virtual bidding is not limited to supply bids only. Load may submit virtual bids as well, and thus an increase in virtual bids that serves to increase prices can be offset by virtual load bids that will have the opposite effect and bring prices back down.

Recommendation 2: Further investigate alternative availability 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.

With respect to performance standards, Constellation favors the New York approach because it has adopted a rational, fair, and time-tested method for ensuring that capacity resources are fully incented to maintain their availability and produce power during peak demand periods. In New York, each capacity resource is required to report all forced outages to the ISO as they occur and also give a monthly outage report so that the NYISO can compile its 12 month rolling average equivalent forced outage rate (“EFORd”). This approach is essentially similar to the capacity counting conventions developed in the RAR effort (D.04-10-035).

EFORd measures the equivalent forced outage rate for generation based on analysis approaches used by NERC for this GADS program, and which are the basis for qualifying capacity measurement under California’s RAR.² The 12 month rolling average EFORd is the NY’s version of “qualifying capacity”, namely the capacity level that a specific unit may offer its capacity into the demand curve auction. Under this New York approach, a unit that fails to deliver on the energy that it has committed to make available to the market will be prospectively “punished” by the availability-adjusted amount of capacity it can subsequently sell.

¹ See White Paper, page 22.

² See, e.g., Appendix C of the June 15, 2004 Workshop Report on RAR issues prepared by ALJ Cooke and adopted by the Commission in D.04-10-035.

Thus, Constellation would not support, and recommends that the Commission not adopt, the draconian measures proposed by ISO-NE, as it is patently unfair and counterproductive to base a capacity resource's capacity payments on its performance at particular moments in time. California does not need such a device given its extraordinary regulatory efforts over non-public utility wholesale generators in the form of General Order 167 (implementing SB 39xx) and its RAR policy decisions to insure against future supply problems by requiring reserve levels above the WECC's approximately 107% of load Minimum Operating Reserve Criteria. Moreover, imposing such a performance standard within the capacity market structure implies that a generation owner can completely avoid forced outages during times of peak need, notwithstanding the fact that the ISO typically imposes "no touch" periods during the peak season and that equipment can and does unexpectedly fail notwithstanding any reasonable level of predictive or preventative maintenance.

Clearly any resource owner would want its unit to perform well during peak demand periods, but the fact of the matter is that peak periods are when the most acute stresses occur on both the transmission system and on capacity resources. Any market system that proposes to take away the capacity revenue stream based solely on a transient event that may occur during the peak demand periods will increase market risks for generation and therefore undermine investments by taking away the revenue stream that is essential to make sure that needed supplies are available to avoid supply shortfalls in the future. This is particularly the case where parties may enter a bilateral transaction that contains availability and performance elements that provide strong incentives to be productive during peak periods. Imposing an additional penalty layer in the context of the capacity market would be counter productive. Constellation believes that the EFORd approach to performance metrics (which is essentially reflected in the existing

RAR counting rules is an equitable way to incent performance by capacity resources.

Constellation emphatically urges the CPUC to reject any set of performance standards similar to those under consideration in ISO-NE, and instead adopt the more tested, rational, and fair performance standards utilities in New York.

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

Constellation agrees that the cost of new entry demand curve pricing should be offset by forecast expected net revenues. However, the net revenue deduct must be done on an *ex ante* basis in order to avoid disruptions to bilateral trading transactions. Constellation believes that the New York approach to the deductions of net revenues provides greater price certainty to the demand curve structure than will the ISO-NE approach, although either approach is workable.

The demand curve pricing for capacity, developed on the cost of new entry should be offset by net revenues from energy and ancillary service markets. The theoretical purpose for this type of adjustment is to ensure that the capacity market design functions provide a source of revenue that “makes up” for the revenue that is otherwise missing due to over-mitigation in the energy and ancillary service markets. Under the New York approach, all aspects of the demand curve pricing are reviewed (pursuant to the NYISO tariff) on a three year cycle. This review covers not only the full scope of applicable cost for new supply entry, but also the anticipated energy and ancillary service revenue offsets. Once these components of the demand curve are reviewed and approved by FERC, they remain in place without change until the next review cycle three years later. In this manner, market participants have assurance that the demand curve pricing is providing a stable set of price signals.

The stability of the demand curve pricing is an important design element. A recent FERC ALJ Decision in the ISO-NE case, however, undermines the stability. That proposed decision

calls for ISO-NE to calculate on a monthly basis, the peak energy rents that the proxy unit would have earned during the prior 12 months. Under this design, the net revenue offset in New England (if this method is ultimately approved by FERC) would result in demand curve pricing that changes every month, injecting uncertainty on the capacity revenue stream. Accordingly, the proposed ISO-NE demand curve pricing will be much less stable than its New York counterpart.

Constellation believes that California will be much better served by adopting the more stable New York framework because the need for revenue certainty is absolutely critical to reviving lagging capacity investments in California. Nevertheless, if the CPUC decides to adjust the demand curve based on the 12 month rolling average forecast peak energy rent deductions approach proposed for New England, Constellation urges that method be applied only on an *ex ante* basis to provide better forward price signals.

Parenthetically, Constellation notes that at one point in its long-litigated history, the ISO-NE proposed that the net revenue offsets be done on an *ex post* basis, meaning that capacity resources would be required to retroactively return capacity payments back to the ISO based on some after-the-fact calculation. New England abandoned that approach in favor of the forecast 12-month rolling average net revenue offset because it recognized that the uncertainty associated with *ex post* adjustments to the capacity price would create havoc in the capacity market. In the interest of clearer market-based price signals and greater investment certainty, Constellation respectfully requests that the CPUC Staff clarify that it is recommending the New England approach based upon the *ex ante* 12-month rolling average concept and not the abandoned *ex post* approach.

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

Constellation wholeheartedly supports Staff’s position that “a locational capacity market (one that includes locational demand curves) can complement and reinforce the locational energy price signals to ensure generation locates where it is needed and not in areas that are inaccessible to load.”³

The local areas discussed in the RAR workshops were defined in the CAISO LARS process, which reviews 10 different load pockets. The feasibility of combining some of the load pockets for purpose of developing demand curves should be evaluated. Once the load pockets are defined, the demand curve capacity pricing must be tailored to specifically ensure that the two pricing components of the demand curve—the cost of new entry and the net revenue offsets—reflect the economic realities of the locations. However, the more narrowly defined the load pocket, the fewer capacity resources can meet the locational requirements, raising concerns about the creation of conditions that could create potential market power. Thus, the locations should be defined and the demand curve pricing developed across the broadest possible geographic area so as to minimize market power concerns and ensure market liquidity and to maximize competitive conditions.

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

Although this Staff Recommendation is focused on the issues of exported power, Constellation’s concerns here run to both exports and imports. Put succinctly, if resources are not selected or contracted to provide resource adequacy capacity, then the resources should be free to enter into any transaction. Resources secured to provide RA capacity would have the corresponding availability obligation that essentially commits that capacity to the CAISO.

³ See White Paper, page 24.

Accordingly, the concern about “excess” exports should not arise if the LSEs’ RAR procurement obligation is fulfilled.

With respect to whether capacity markets should be designed so that the demand curve pricing reflects a higher value in the peak summer to discourage exports, Constellation does not believe that such a design element is necessarily advantageous, particularly during the initial incarnations of the capacity market structure. Better price signals would exist if the focus of the capacity market is the demand curve associated with peak demand periods and the appropriate LRAs. The pricing for capacity should naturally reflect LSEs’ demand for the product, which will vary by season. Accordingly, during the non-summer periods there should be a surplus of capacity available (either already secured under a bilateral, or supplies not contracted during the non-peak periods) which could be offered in a secondary market or through the formal capacity market. It is important to be mindful that California has seen (especially prior to the implementation of generator outage coordination protocols) high demand for capacity during non-peak periods. Rather than mitigating or augmenting market structures in anticipation of ordinary demand cycles, the capacity market should be designed to encourage supplies whenever and wherever needed.

Lastly, in light of California’s reliance on imports and the regional desire to minimize “seams issues”, it may lead to inefficiencies if California develops any rules that hinder exports during any point of time. Other areas that currently carry surplus capacity may take a similar “protectionist” stance, resulting in balkanization of the grid rather than the elimination of seams.

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

In the White Paper, Staff reflects a concern about whether imports can reliably meet the capacity requirements of California and whether demand curve pricing needs to reflect seasonal

differences to ensure that California capacity remains committed to California during its peak summer season. While the issue of whether imports should be allowed to meet the capacity resource needs of California is a crucial question given California's historic reliance on external sources for its energy needs, the answer to that question is not particularly relevant to the design of the capacity market with regional participation.

For instance, the market rules with respect to whether market participants may contract with resources outside the state to demonstrate their compliance with resource adequacy procurement obligations must be very clear, but once those rule is established, the market should be indifferent to how resources from inside or outside the state compete to provide the capacity. As an example, assume that a LSE contracts with a provider that qualifies as an import resource based on the Commission's October 2004, *Interim Decision Regarding Resource Adequacy* (D.04-10-035) and the LSE has been allocated CAISO-verified intertie capacity sufficient for that resource. If the LSE demonstrates that it has secured its imports from an external resource that has met all the RAR qualifying capacity and deliverability requirements, then those resources must be treated comparably to internal capacity resources, especially when it comes to performance and availability requirements.

California relies upon imports to meet up to 20-25% of its peak demand. System reliability would be seriously threatened if these contracts were disallowed in terms of meeting a resource adequacy requirement. The Commission has already determined that imports will count toward resource adequacy in D.04-10-035. This decision will determine the process for allocating available intertie capacity. So long as entities have import contracts that meet the criteria articulated in D.04-10-035 and have intertie capacity, the import should count toward the capacity requirements in California.

Moreover, as noted above, the implementation of RAR and a capacity market structure should aim to avoid or eliminate seams issues, not exacerbate them. Unfairly penalizing imports when the quantity that can be relied upon is already limited under the RAR policy's implicit preference for internal generation makes little sense.

Recommendation 7: Make the fixed-cost recovery curve explicit.

By recommending a capacity market structure that has pricing based on the cost of new entry reduced by a proxy for energy and ancillary services, Staff has appropriately recognized that a capacity market construct is necessary when energy prices are prevented, due to mitigation measures, from reflecting the full value of capacity resources. However, Constellation believes, as explained in response to Recommendation 1 above, that the capacity market design must anticipate a need for continual improvement in the competitiveness of the energy markets that will lead to a reduction in the importance of the capacity market over time in terms of the amount of overall revenue that capacity resources earn.

Recommendation 8: Strive for regulatory credibility.

From Constellation's perspective, the stability and success of the marketplace, and therefore the ability to timely and efficiently address resource needs, is highly dependent upon the leadership and credibility of the regulatory community. As noted in the response to Recommendation 1, there needs to be a clear commitment from the regulatory community in support of competitive market structures if market participants and investors are going to make serious investments of time and capital.

California currently needs a clear articulation of the "end state" and commitment to stick with the path despite the bumps that can come along the way. Otherwise California will

continue its reputation as a highly uncertain regulatory environment and investments will be made less efficiently.

The need for regulatory stability and commitment to markets should not read to infer that incremental changes will not be needed. Instead, the critical point is that those changes should be known, understood and telegraphed as far in advance as possible so as not to cause market disruptions.

C. Interagency Implementation

Interagency coordination and cooperation is critical if real progress is to be made toward market-based infrastructure development and provision of energy. Constellation believes that the interactions between the CPUC, CAISO, CEC, LSEs and suppliers should focus on the various entities' core competencies and areas of responsibility.

In this context, Constellation believes that the CPUC should articulate the general policy directivities with regard to RAR and the general design of the "end state" capacity market. The CPUC, in conjunction with the CEC, CAISO and stakeholders, would develop the appropriate RAR procurement obligation for all LSEs. The CPUC, along with the CEC, CAISO and stakeholders would develop the capacity demand curve slope.

The markets would then be implemented, operated and enforced by CAISO pursuant to tariff provisions and established protocols. Those elements would need to be incorporated into the CAISO's market redesign efforts, much as the current RAR policies are being integrated. The market-based structure would be subject to FERC tariff review and adoption. It would apply to all entities using the CAISO Controlled Grid and those entities would be subject to the CAISO enforcement protocols. In this way a broader set of entities would be subject to the RAR policies and could avail themselves to the capacity market to satisfy their procurement obligations.

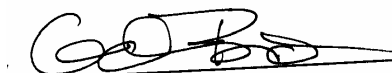
Because the CPUC has its traditional responsibility for oversight and enforcement over the public utilities' procurement practices and RAR compliance, there would in effect be two sets of eyes on the utilities' RAR procurement compliance efforts—one by the CPUC through the review and approval of submitted procurement plans, and a second by the CAISO in terms of compliance with the capacity market structure. Accordingly, the CPUC will have direct oversight over the majority of capacity secured under the capacity market structure.

III. Conclusion

Constellation applauds the Energy Division's report examining capacity market design issues that would support the implementation of the RAR policies. As noted throughout these comments, Constellation urges the Commission to adopt a short-term capacity market structure like that used by the NY-ISO. That design creates the proper balance of incentives for development of capacity when and where needed, and the need for good planning information and price signals in the marketplace.

September 23, 2005

Respectfully submitted,



Lisa M. Decker, Esq.
Counsel

Andrew B. Brown

Constellation Energy Group, Inc.
111 Market Place, Suite 500
Baltimore, Maryland 21202
Phone: (410) 468-3792
Fax: (410) 468-3499
Email: Lisa.Decker@constellation.com

Ellison Schneider & Harris L.L.P.
2015 H Street
Sacramento, CA 95814
Tel: (916) 447-2166
Fax: (916) 447-3512
Email: abb@eslawfirm.com

*On behalf of Constellation Energy
Commodities Group, Inc. and Constellation
NewEnergy, Inc.*

*Attorneys for Constellation Energy
Commodities Group, Inc., and Constellation
NewEnergy, Inc.*

CERTIFICATE OF SERVICE

I, Eric Janssen, am over the age of 18 years and employed in the City and County of Sacramento. My business address is 2015 H Street, Sacramento.

On September 23, 2005, I served the within document, **Comments Of Constellation Energy Commodities Group, Inc. and Constellation NewEnergy, Inc. On Capacity Markets White Paper**, in R.04-04-003, with electronic and mail service as prescribed in R.04-04-003 and the August 25, 2005 ALJ Ruling, and personal service on the Assigned Commissioner and Assigned Administrative Law Judge, at San Francisco, California.

Executed on September 23, 2005, at Sacramento, California.

Eric Janssen

Service List
R.04-04-003
Sept. 23, 2005

abb@eslawfirm.com
aclark@calpine.com
ajo@cpuc.ca.gov
alan.comnes@dynegey.com
amabed@semprautilities.com
andrew@simpsonpartners.com
annette.gilliam@sce.com
aorchar@smud.org
armi@smwlaw.com
aweller@sel.com
ayk@cpuc.ca.gov
bcragg@gmssr.com
bcragg@gmssr.com
bds@cpuc.ca.gov
berj.parseghian@sce.com
beth.fox@sce.com
bfranklin@eob.ca.gov
bill.chen@constellation.com
bill@jbsenergy.com.
bjones@mjbradley.com
blaising@braunlegal.com
bmcc@mccarthy.com
bpowers@powersengineering.com
brbarkovich@earthlink.net
brflynn@flynnrci.com
brian.theaker@williams.com
bsk@cpuc.ca.gov
cab@cpuc.ca.gov
cabaker906@sbcglobal.net
car@cpuc.ca.gov
carlo.zorzoli@enel.it
case.admin@sce.com
cem@newsdata.com
centralfiles@semprautilities.com
ceyap@earthlink.net
chris@emeter.com
chrishilen@dwt.com
chrism@mid.org
ckmitchell1@sbcglobal.net
cleni@energy.state.ca.us
clyde.murley@comcast.net
cmkehrrein@ems-ca.com
cmlong@earthlink.net
cpe@cpuc.ca.gov
cpuccases@pge.com
craigtyler@comcast.net
ctoca@utility-savings.com

curtis.kebler@gs.com
daking@sempra.com
dbachrach@nrdc.org
dcarroll@downeybrand.com
ddowers@sfwater.org
dgarber@sempra.com
dgeis@dolphingroup.org
dhuard@manatt.com
diane_fellman@fpl.com
dickerson05@fscgroup.com
djh@cpuc.ca.gov
dkates@sonic.net
dkk@eslawfirm.com
dks@cpuc.ca.gov
dmahmud@mwdh2o.com
dmarcus2@sbcglobal.net
don.winslow@ppmenergy.com
douglass@energyattorney.com
dsandino@water.ca.gov
dsaul@solel.com
dsh@cpuc.ca.gov
dwood8@cox.net
dws@r-c-s-inc.com
edchang@flynnrci.com
edwardoneill@dwt.com
ehull@ci.chula-vista.ca.us
eleuze@caiso.com
ell5@pge.com
elvine@lbl.gov
e-recipient@caiso.com
eric@strategyi.com
evk1@pge.com
eyussman@knowledgeinenergy.com
fdeleon@energy.state.ca.us
filings@a-klaw.com
fortlieb@sandiego.gov
frank.cooley@sce.com
freedman@turn.org
garson_knapp@fpl.com
gbaker@sempra.com
gbrowne@smud.org
george.hanson@ci.corona.ca.us
ghinners@reliant.com
gig@cpuc.ca.gov
glw@eslawfirm.com
gmorris@emf.net
greg.blue@dynegey.com
grosenblum@caiso.com
gtholan@caiso.com
gumbrelli@cs.com

gxl2@pge.com
hchoy@isd.co.la.ca.us
info@tobiaslo.com
irene.stillings@sdenergy.org
j0b5@pge.com
jackp@calpine.com
james.booth@hklaw.com
janet.combs@sce.com
janreid@coastecon.com
jarmstrong@gmssr.com
jay.bhalla@intergycorp.com
jbradley@svmg.org
jcervantes@sandiego.gov
jeanne.sole@sfgov.org
jef@cpuc.ca.gov
jeffgray@dwt.com
jennifer.holmes@itron.com
jesus.arredondo@nrgenergy.com
jf2@cpuc.ca.gov
jgalloway@ucsusa.org
jimross@r-c-s-inc.com
jkarp@whitecase.com
jkloberdanz@semprautilities.com
jkloberdanz@semprautilities.com
jleslie@luce.com
jlm@pge.com
jmcArthur@elkhills.com
JMcMahon@navigantconsulting.com
joe.como@sfgov.org
johnrredding@earthlink.net
joyw@mid.org
jpacheco@water.ca.gov
jskillman@prodigy.net
jsqueri@gmssr.com
jtachera@energy.state.ca.us
jweil@aglet.org
karen@klindh.com
kdg@cpuc.ca.gov
kduggan@capstoneturbine.com
kdw@woodruff-expert-services.com
keith.fuller@itron.com
keith.mccrea@sablaw.com
keithwhite@earthlink.net
kena@calpine.com
kglick@eob.ca.gov
kgriffin@energy.state.ca.us
kjk@kjkammerer.com
kl1@cpuc.ca.gov
klatt@energyattorney.com
kmcspadden@milbank.com

KMelville@sempra.com
kmelville@sempra.com
kmills@cfbf.com
kmorton@sempra.com
kms@cpuc.ca.gov
knotsund@uclink.berkeley.edu
kpp@cpuc.ca.gov
l_brown123@hotmail.com
LAdocket@cpuc.ca.gov
laura.genao@sce.com
lcasentini@drintl.com
lcottle@whitecase.com
liddell@energyattorney.com
linda.sherif@calpine.com
lisa.decker@constellation.com
lisa_weinzimer@platts.com
lkaye@ka-pow.com
lmh@eslawfirm.com
lp1@cpuc.ca.gov
lrm@cpuc.ca.gov
lscott@landsenergy.com
lurick@sempra.com
magq@pge.com
map@cpuc.ca.gov
marks@alohasys.com
mary.lynch@constellation.com
matt@bradylawus.com
mclaughlin@braunlegal.com
mcmannes@aol.com
mdbk@pge.com
mdjoseph@adamsbroadwell.com
meb@cpuc.ca.gov
mecsoft@pacbell.net
meg@cpuc.ca.gov
meg@cpuc.ca.gov
mflorio@turn.org
michael.backstrom@sce.com
michael.crumley@elpaso.com
michaeledwardboyd@sbcglobal.net
mjaske@energy.state.ca.us
mjaskowronski@inlandenergy.com
mlennon@whitecase.com
mlgillette@duke-energy.com
Mmesseng@energy.state.ca.us
mona.tierney@constellation.com
moxsen@calpine.com
mpa@a-klaw.com
mrh2@pge.com
mrw@mrwassoc.com
mrw@mrwassoc.com

mschmidt@semprautilities.com
mshames@ucan.org
msnow@manatt.com
msw@cpuc.ca.gov
mtrexler@climateservices.com
mts@cpuc.ca.gov
mzr@cpuc.ca.gov
nao@cpuc.ca.gov
nes@a-klaw.com
nil@cpuc.ca.gov
npedersen@hanmor.com
nrader@calwea.org
ntoyama@smud.org
pcmcdonnell@earthlink.net
pduvair@energy.state.ca.us
petertbray@yahoo.com
pha@cpuc.ca.gov
philm@scedenergy.com
ppettingill@caiso.com
psd@cpuc.ca.gov
pucservice@manatt.com
puma@davis.com
rae@cpuc.ca.gov
ramonag@ebmud.com
rberliner@manatt.com
rejohnson@att.com
rhoffman@anaheim.net
rhwiser@lbl.gov
rick_noger@praxair.com
rliibert@cfbf.com
rmd@cpuc.ca.gov
rmiller@energy.state.ca.us
roger.pelote@williams.com
rru@sandag.org
rsa@a-klaw.com
rschmidt@bartlewells.com
rsparks@caiso.com
rwalther@pacbell.net
rwethera@energy.state.ca.us
samuel.r.sadler@state.or.us
sarveybob@aol.com
sberlin@mccarthyllaw.com
scarter@nrdc.org
scasey@sfwater.org
sed@cpuc.ca.gov
service@spurr.org
sia2@pwrval.com
sjl@cpuc.ca.gov
sscb@pge.com
sschleimer@calpine.com

ssmyers@att.net
sst@cpuc.ca.gov
stevegreenwald@dwt.com
steven@iepa.com
susan.freedman@sdenergy.org
tam@cpuc.ca.gov
tcarlson@reliant.com
tcorr@sempra.com
tcx@cpuc.ca.gov
tdp@cpuc.ca.gov
tglaviano@energy.state.ca.us
tim.hemig@nrgenergy.com
tomb@crossborderenergy.com
toms@i-cpg.com
trf@cpuc.ca.gov
troberts@sempra.com
vhconsult@earthlink.net
vjb@cpuc.ca.gov
vjw3@pge.com
vwood@smud.org
wbooth@booth-law.com
william.tomlinson@elpaso.com
wkeilani@semprautilities.com
WKeilani@semprautilities.com
woodrujb@sce.com
wsm@cpuc.ca.gov
wwwesterfield@stoel.com
ygross@sempraglobal.com
ztc@cpuc.ca.gov

ENERGY AMERICA, LLC
ONE STAMFORD PLAZA,
8TH FLOOR
263 TRESSER BLVD.
STAMFORD CT 06901

OCCIDENTAL POWER
SERVICES, INC.
5 GREENWAY PLAZA,
SUITE 110
HOUSTON TX 77046

BP ENERGY COMPANY
501 WESTLAKE PARK BLVD
HOUSTON TX 77079

APS ENERGY SERVICES
COMPANY, INC.
400 E. VAN BUREN STREET,
SUITE 750
PHOENIX AZ 85004

NEW WEST ENERGY
CORPORATION
MAILING STATION ISB 665
PO BOX 61868
PHOENIX AZ 85082-1868

CONSTELLATION
NEWENERGY, INC.
350 SOUTH GRAND AVE.,
SUITE 2950
LOS ANGELES CA 90071

MICHAEL MAZUR
3 PHASES ELECTRICAL
CONSULTING
2100 SEPULVEDA BLVD.,
SUITE 15
MANHATTAN BEACH CA
90266

QUIET ENERGY
QUIET LLC
3311 VAN ALLEN PL.
TOPANGA CA 90290

AMERICAN UTILITY
NETWORK (A.U.N.)
10705 DEER CANYON DRIVE
ALTA LOMA CA 91737

SEMPRA ENERGY
SOLUTIONS
101 ASH STREET, HQ09
SAN DIEGO CA 92101

CORAL POWER, LLC.
4445 EASTGATE MALL,
SUITE 100
SAN DIEGO CA 92121

PILOT POWER GROUP, INC.
9320 CHESAPEAKE DRIVE,
SUITE 112
SAN DIEGO CA 92123

ELECTRICAMERICA
COMMERCE ENERGY, INC.
600 ANTON BLVD., SUITE
2000
COSTA MESA CA 92626

COMMERCE ENERGY, INC.
600 ANTON BOULEVARD,
STE 2000
COSTA MESA CA 92626

AOL UTILITY CORP.
12752 BARRETT LANE
SANTA ANA CA 92705

CITY OF CORONA
DEPARTMENT OF WATER &
POWER
730 CORPORATION YARD
WAY
CORONA CA 92880

CALPINE POWERAMERICA-
CA, LLC
4160 DUBLIN BLVD.
DUBLIN CA 94568