

**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

**REPLY COMMENTS OF THE
COALITION OF CALIFORNIA UTILITY EMPLOYEES
ON THE
STAFF CAPACITY MARKETS WHITE PAPER**

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Pursuant to the Chief Administrative Law Judge's August 25, 2005 Ruling, the Coalition of California Utility Employees offers these reply comments on the Staff "Capacity Markets White Paper."

In our opening comments, we identified a host of reasons why the Commission should not proceed with the proposed capacity markets. Rarely has CUE found its comments on a major public policy question in harmony with such a large and diverse set of parties who make the same points in their comments. Even parties that ostensibly support or are neutral on the merits of creating a new centralized capacity market have identified the same troubling issues which CUE raised in our opening comments. Given the depth and breadth of opposition to rapidly plunging ahead, the Commission should seriously consider whether proceeding with the Staff's recommendations would do more harm than good.

In these reply comments we summarize the many points of agreement that counsel extreme caution or, as we described in our initial comments, humility.

I. GO SLOWLY – OTHER OPTIONS MAY BE BETTER

CUE’s opening comments began by asking, “do we have to go through this all over again?” and concluded that “the issue before the Commission is not how to construct a capacity market but whether to” Even generation companies and marketers, not to mention the CAISO, suggest that the answer is “maybe not.”

Calpine, the largest independent generation company in the nation, correctly warns the Commission that the “need for new capacity” is “more pressing” than the need for a new capacity market, and that attempting to develop a new capacity market “may distract stakeholders and policy makers.”¹ Calpine, like CUE, prefers that the Commission “start with the bilateral market for now” and get its LSE-based resource adequacy requirements (RAR) working “before the Commission embarks on yet another major market structure activity.”²

The CAISO is also strikingly cautious about the major new market-maker role which the Energy Division appears to contemplate for it. The CAISO’s discussion of “retail tariff structures” suggests that the

¹ Calpine, Comments of Calpine Corporation on Capacity Markets White Paper, p. 1.

² Calpine, p. 9.

Commission’s demand-side initiatives with critical peak pricing (CPP) may bring the demand response the White Paper says is lacking.³ The CAISO also “recommends that more attention be paid to a range of alternative capacity mechanisms,” calls for the CPUC to “move cautiously” and, overall, pointedly declines to endorse “any specific form of long-term resource program.”⁴

Morgan Stanley is more upfront. It calls the Energy Division’s proposal “a fundamentally flawed proposal” and says that the existing PJM capacity market “has resulted in the worst possible outcome for consumers.”⁵

AReM also sees that the Energy Division’s proposed capacity market as a recipe for trouble: “demand-curve based capacity markets are an attempt to remedy the consequences of a distortionary policy with another distortionary policy.”⁶

Consumer groups share the concerns of marketers, generators and the CAISO. ORA calls on the Commission to “step back”⁷ and lists a variety of actions that may obviate any need for a capacity market: MRTU, bid cap increases, LMP, renewable procurement, and DSM,⁸ as well as demand

³ CAISO, Opening Comments of the California Independent System Operator Corporation on the California Public Utility Commission’s Capacity Markets White Paper, p. 3.

⁴ CAISO, pp. 1, 4, 14.

⁵ Morgan Stanley, Comments of Morgan Stanley Capital Group Inc. on Staff Capacity Markets White Paper, pp. 11, 8.

⁶ Lynne Kiesling, An Analysis of Electricity Capacity Markets in California, p. iii.

⁷ ORA, Comments of the Office of Ratepayer Advocates on the California Public Utilities Commission Energy Division Staff Capacity Markets White Paper, p. 1.

⁸ ORA, pp. 1-2.

response through AMI/ CPP⁹ and RAR non-performance penalties.¹⁰ Indeed, ORA is so troubled by the White Paper’s single-minded focus on a particular kind of capacity market that it writes, “[t]his evolving rationale is somewhat troubling as it indicates that we sometimes do not know what problem we are trying to solve.”¹¹

TURN, the major consumer group involved in CPUC activities, puts its call to slow down right in its title: “Don’t Rush to Judgment!”¹² TURN subsequently lists a variety of alternatives to the capacity market described in the White Paper “in order to demonstrate that there is no clear ‘state of the art’ in capacity market design, despite some of the implications to the contrary in the WP. ... There is simply not a clear ‘correct’ answer that this Commission could rationally decide to implement on an accelerated basis in the near term.”¹³

Finally, the major regulated electric utilities also express caution about the proposed capacity market. SDG&E presents a completely different alternative involving 4-year forward call options and fixed energy prices.¹⁴ PG&E warns about the existing U.S. capacity markets that “[n]o Eastern

⁹ ORA, p. 12.

¹⁰ ORA, p. 14.

¹¹ ORA, p. 17.

¹² TURN, Comments Of The Utility Reform Network On The Energy Division’s Capacity Markets White Paper, Title page.

¹³ TURN, p. 8.

¹⁴ SDG&E, Opening Comments of San Diego Gas & Electric Company (U 902 E) on the Capacity Markets White Paper, p. 5.

market has a proven, thoroughly successful track record.”¹⁵ And SCE “cannot support a capacity market construct that does not *fully replace* the Commission’s current resource adequacy requirements.”¹⁶

II. A CAPACITY MARKET WILL NOT PRODUCE NEW GENERATION

Virtually every policymaker and participant in the electric utility industry is concerned about the need to construct new generation in the next few years. Thus the key question is, will the proposed capacity market help solve this problem? Our opening comments explained why it would not help get new generation built. Generators, utilities and other market participants all agreed with us.

PG&E says a capacity market won’t result in new generation “for the foreseeable future.”¹⁷

Morgan Stanley also says that capacity payments to generators in existing capacity markets have not led to new construction, and are not “bankable.”¹⁸

Calpine says that 7-10 year power purchase agreements, not short term capacity market contracts, are needed to justify new construction,¹⁹

¹⁵ PG&E, Comments of Pacific Gas and Electric Company (U 39 E) on the California Public Utility Commission Energy Division Capacity Markets White Paper, p. 8.

¹⁶ SCE, Comments of Southern California Edison Company (U 388-E) on Capacity Markets White Paper, p. 2, n.1 (emphasis added).

¹⁷ PG&E, p. 3.

¹⁸ Morgan Stanley, pp. 2, 4.

¹⁹ Calpine, p. 3.

while SCE suggests that a “backstop mechanism” such as 15-year contracts (entered into by whom? SCE doesn’t say) may be needed.²⁰

IEP, speaking for many generators, endorses capacity markets but not because of their ability to facilitate new generation construction: “...near term new investment ultimately requires long-term bilateral contracting In the near term, however, new investment almost certainly will be driven by bilateral contracting.”²¹

Williams confirms that “short term capacity markets – a month or a year in advance of the need ... are not sufficiently forward to allow new investment to compete....”²²

Thus, if the Commission focuses on designing a new capacity market, it would divert resources from the real problem, and fail to ensure a reliable generation supply for the latter half of this decade. But it is even worse than that.

III. A CAPACITY MARKET MAY *IMPEDE* NEW GENERATION

Capacity markets as proposed by the Energy Division not only fail to drive new generation investments, they may interact with existing bilateral markets so as to reduce the attractiveness of bilateral contracting and

²⁰ SCE, p. 5 and fn. 4.

²¹ Comments of the Independent Energy Producer’s Association on the Staff’s Capacity Markets White Paper, p. 9.

²² Williams, Comments of Williams Power Company, Inc. on Capacity Markets White Paper, p. 4.

therefore reduce the amount of new generation built. Several parties pointed out ways in which this could occur.

The CAISO warned that a capacity market could act as a cap on bilateral prices,²³ and of course any price cap is a disincentive for investment, while Duke warns more generically that a capacity market should not “interfere with bilateral contracts.”²⁴

Constellation discusses at some length ways in which bilateral contracting could be reduced with a multi-year-forward capacity market.²⁵ Morgan Stanley flatly asserts that “long-term capacity markets eliminate or curtail bilateral, forward contracting....”²⁶

But with a short-term capacity market, Williams indicates a similar risk that LSEs could stop procuring bilaterally and “default to centralized procurement, to the detriment of existing supply and new investment” if they are allowed (or required) to procure via a capacity market.²⁷

SCE’s comments show that the risk raised by Williams is not just hypothetical. SCE explains that it believes the existence of a capacity market would relieve LSEs of any obligation to procure bilaterally.²⁸ Thus SCE concludes that it is “not clear whether the existence of a capacity market

²³ CAISO, p. 9.

²⁴ Duke, Comments of Duke Energy North America on Capacity Markets White Paper, p. 11.

²⁵ Constellation, Comments of Constellation Energy Commodities Group, Inc. and Constellation NewEnergy Group, Inc. on Capacity Markets White Paper, pp. 8-12.

²⁶ Morgan Stanley, p. 8.

²⁷ Williams, p. 4.

²⁸ SCE, pp. 3-4.

would assist LSEs in their attempts to bilaterally procure capacity if they so choose.”²⁹

In the face of widespread warnings that a capacity market could impede new generation, it would be irresponsible for the Commission to put future reliability at risk by proceeding with the capacity market proposal.

IV. A CAPACITY MARKET CONFLICTS WITH THE COMMISSION’S MANDATE THAT LSEs HAVE AT LEAST A 15% RESERVE MARGIN

CUE’s opening comments warned that “the proposed capacity market, rather than providing a means to comply with the [15-17% reserve] resource adequacy requirement, provides a means not to comply.”³⁰ The opening comments of both PG&E and SCE confirm our warning.

PG&E warns that a capacity market is inconsistent with the Commission’s resource adequacy requirement of 15-17% reserves: “It is very important to recognize that a capacity market using a NYISO-type demand curve would not set the reserve margin at some pre-specified level, such as the 15-17% approved by the CPUC ... [R]eserve levels can either exceed, fall within, **or fall below** the desired reserve margin range.... A critically important question for the Commission is how its resource adequacy requirements, particularly the planning reserve margin, **could or should** coexist with a capacity market.”³¹

²⁹ SCE, p. 4.

³⁰ CUE, p. 13.

³¹ PG&E, p. 3 (emphasis added).

SCE goes farther than PG&E, and concludes that existing resource adequacy requirements cannot coexist with capacity markets and would thus have to be scrapped:

a capacity market completely replace[s] LSE-based resource adequacy requirement obligations.... SCE cannot support a capacity market construct that does not fully replace the Commission's current resource adequacy requirements.³²

Having worked so hard to implement the RAR, it would not serve California well to have the Commission now abandon that requirement.

V. LOCATIONAL ISSUES NEED TO BE ADDRESSED FIRST, REQUIRING MULTIPLE CAPACITY MARKETS, NOT JUST ONE, WITH DIFFERENT PRICES

CUE's comments pointed out that the White Paper concedes that capacity markets must be locational. Many commenters, including ORA, CAISO, TURN, Constellation, Calpine and SCE, agreed on the necessity for locational capacity markets.³³

VI. A CAPACITY MARKET WOULD BE OPERATED BY THE CAISO, MAKING IT FERC JURISDICTIONAL AND THUS CEDING CPUC AUTHORITY

CUE's opening comments pointed out the risks of ceding yet more CPUC authority to FERC. But many commenters indicated that any new

³² SCE, p. 3, fn. 1.

³³ ORA, pp. 2, 15, 20; CAISO, pp. 8, 11, 16; TURN, p. 9; Constellation, p. 17; Calpine, p. 6; SCE, p. 10, endorsing "reasonable LICAP requirements with locally varying demand curves" while warning that implementation will be "potentially complex...difficult...will require careful planning...will not fully meet all of the CAISO's reliability constraints...."; see also Morgan Stanley; IEP; Williams; SDG&E; PG&E; West Coast Power (West Coast Power Comments on Staff Capacity Markets White Paper); and Sempra (Comments of Sempra Global on Capacity Markets White Paper).

capacity market would be operated by the CAISO, which would make it subject to FERC's jurisdiction.³⁴ Some went further and called for the CAISO to design as well as operate the new markets.³⁵ PG&E specified its belief that the CAISO should be responsible for defining the local areas covered by each locational capacity market, should operate the markets, and should serve as the entity actually collecting capacity payments from LSEs and then disbursing those payments to generators.

It was left to SCE to make explicit the *de facto* abdication of authority by the CPUC which capacity markets would entail: "If the CAISO must request FERC approval for a detailed capacity market design, ... the [CPUC] seems left with the same recourse as any other party before FERC and no specific authority"³⁶

Again ceding CPUC authority to FERC is not a wise move for California.

VII. THE DEVIL WILL BE IN THE *YEARS* OF DETAILS

CUE's opening comments warned that "nothing is as simple as it first appears."³⁷ Since then, TURN has warned the Commission elsewhere that "[a]s much as we might like the world to be simple, it simply is not."³⁸

Looking at the overall issue of capacity markets, AReM warned that

³⁴ Mirant (Comments of Mirant California, LLC, Mirant Delta, LLC, and Mirant Potrero, LLC, on Capacity Markets White Paper); West Coast Power; Williams; Constellation.

³⁵ IEP; Duke; Sempra.

³⁶ SCE, p. 16.

³⁷ CUE, p. 2.

³⁸ TURN, post-workshop comments, A. 05-04-015 (DPV2), 10/6/05.

“capacity market design is incremental and costly,” and the White Paper ignores the cost to set up a “well-designed” capacity market, or the costs that will result if a poorly designed market is set up,³⁹ while SCE warned that “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.”⁴⁰

Some particular areas where the comments of parties other than CUE show that there are likely to be long, difficult disputes are described below.

A. Time scale of the market

TURN, SDG&E, and Sempra all endorsed long-term markets,⁴¹ and SCE wanted a long-term market considered, but Morgan Stanley warned that long-forward markets cause decisions based on “inherently increasingly inaccurate data.”⁴²

B. Treatment of existing vs. new generation

The White Paper contemplates paying a single clearing price for all capacity procured in each particular market, subject to performance adjustments. But both ORA and Morgan Stanley asserted that such a capacity market will overpay existing generation,⁴³ implying that perhaps existing generation should not be allowed to participate in a capacity market.

³⁹ AReM, Comments of the Alliance for Retail Markets on the Capacity Market White Paper, p. 21.

⁴⁰ SCE, p. 7.

⁴¹ TURN, pp. 4, 8; SDG&E; Sempra; SCE, p. 7.

⁴² Morgan Stanley, p. 3.

⁴³ ORA, p. 2; Morgan Stanley, p. 4.

C. Ex post vs. ex ante vs. no mitigation for high energy prices

The question of how much to pay for capacity from generation which is already making a substantial operating profit from its energy sales brought a wide range of responses. This is just the sort of subtle but complex market design issue, with millions of dollars at stake, where the Commission is unlikely to be able to find the “right” answer even if one exists.

TURN and SCE proposed ex post mitigation for high energy prices, while Constellation, Mirant and West Coast Power said ex ante, IEP said ex ante or not at all, Duke said full netting of energy profits from capacity payments would just be wrong, and Sempra called for no mitigation at all.⁴⁴

Morgan Stanley says **any** method will be “difficult” and “administratively complex,” and the Electricity Oversight Board (EOB) says mitigation will be hard to calculate. Mirant raises the possibility that the mitigation offset could be bigger than the capacity payment itself, and asks, what happens then?⁴⁵

D. Interactions with LMP

ORA raised the possibility that interactions between regional capacity markets (even a locational capacity market would still have flat prices across some fairly large geographical region, perhaps as large as all of SP15 and certainly as large as, say, San Diego County) and the nodal energy prices due

⁴⁴ TURN, p. 8; SCE, pp. 6, 9-10; Constellation; Mirant; West Coast Power; Duke, p. 5; Sempra, pp 8-9.

⁴⁵ Morgan Stanley; EOB, Comments Of The California Electricity Oversight Board On The CPUC Energy Division Capacity Markets White Paper, p. 2; Mirant, p. 14.

in 2007 under the ISO's LMP proposal would have the effect of muting the very locational prices that have been the object of years of market-design efforts.⁴⁶

E. Seams issues

In its comments on the White Paper, Powerex warned the Commission that there will be a “multitude of seams issues.” In other comments, CERS and Morgan Stanley specifically raised the issue of how liquidated damages (LD) contracts involving imports into California will be treated. The issue is huge because of the large number of MW under contract with CERS in the form of LD imports. Calpine flatly opposed any LD contracts being allowed to participate in capacity markets.⁴⁷

In a completely different set of seams issues, California utilities have historically engaged in large exchange contracts with Pacific Northwest (PNW) utilities in which California sold winter *energy* to the PNW in exchange for summer *capacity*. Such contracts have been mutually beneficial to the tune of hundreds of millions, if not billions, of dollars. Indeed, it was the opportunity for exchanges between the PNW and California which was the basis for building all the large transmission lines between the PNW and California. But a money-for-capacity market would do nothing to facilitate such exchanges in the future, and might even block them from occurring because they would not fit into standard product definitions. SCE's

⁴⁶ ORA, pp. 12-13.

⁴⁷ Calpine, p. 6.

comments emphasized that “a capacity market structure with rules that appropriately recognize the need to encourage exchanges with the Pacific Northwest...will be essential...,”⁴⁸ but provided no ideas as to what such a structure might look like.

F. Slope of the administratively determined demand curve

The White Paper described a simple demand curve shape: horizontal on the left, then linearly declining to the X-axis. But the White Paper comments show that implementation would not be so simple as all that.

The Electricity Oversight Board proposed that the slope of the demand curve should be low, which means that small differences in price would correspond to large differences in reserve margin – sure to be a controversial result. But on the other extreme, SCE called for the demand curve to be related to “loss of load probability and the level of capacity in the system,” which implies a strongly non-linear curve quite unlike the curves portrayed in the White Paper.⁴⁹ Meanwhile, Sempra was unsure if there should be CPUC-determined demand curve at all, and AReM said that any demand curve would be totally artificial and it would be cheaper to reduce demand by 2000 MW in the 32 hours with highest loads than to build 2000 MW of peakers that each run no more than 32 hours per year.

⁴⁸ SCE, p. 9.

⁴⁹ EOB; SCE, p. 15.

G. Performance issues

Parties had many ideas about how performance should affect payments in capacity markets, and how performance should be measured. The obvious problem is that since LSEs already have bilateral contracts for generator output with differing performance obligations, there will need to be some way to take those differences into account when bidding those contracts into the proposed capacity markets. So even if a “standard” set of performance requirements can be decided upon, there will still be performance issue problems to resolve.

In addition, since all generating plants are not created equal, this problem will continually reoccur.

H. Residual or full market

The White Paper contemplates a market in which all capacity is obtained via the capacity market. But as PG&E points out, if the capacity market is for all MW, then bilateral contracts become only financial instruments. And if bilateral contracts are just financial hedges, it is not obvious why utilities will be particularly motivated to enter into them, or why they will devote the care and attention to operational issues which they are currently devoting with bilateral contracts. Perhaps in recognition of this prospective problem, Calpine says any capacity market should just be for otherwise unmet residual needs.⁵⁰

⁵⁰ Calpine, p. 3.

The decision as to whether any future capacity markets should be for all capacity or only for residual capacity needs not yet met through other mechanisms is a key decision whose potential for controversy the Commission has not yet recognized.

VIII. REGULATORY STABILITY

Regulatory stability is like apple pie – who could be against it? But CUE’s opening comments pointed out that the CAISO has been anything but stable in its rules since 1998. “Capacity market design with regulatory stability” may well turn out to be one of the greatest oxymorons in the history of the CPUC.

The signs are already apparent in the opening comments on the White Paper. Mirant says that market design will have to change over time, but also calls for “certainty in the rules once set.” IEP says “...stuttering progress may also be California’s experience” because of a continuing need to fix problems with each successive iteration of market design. AReM says market design will be “incremental,” meaning multiple changes and hence no regulatory stability. And finally, SCE would have a capacity market *replace* current RAR obligations, a major change in regulatory policy.⁵¹

⁵¹ SCE, p. 7 and p. 3, fn. 1.

IX. CONCLUSION

With a multitude of parties asking the Commission to go slowly, while warning that the proposed capacity markets may discourage, not promote, new generation, will conflict with the Commission's 15-17% resource adequacy requirement, does not address locational issues first, will cede CPUC authority to FERC, will be bedeviled with years of struggle with complex details and will create continuing regulatory *instability*, the Commission should have the wisdom to put the capacity market aside.

Instead, the Commission should finish implementing its resource adequacy requirement and apply it to all LSEs.

If the Commission wants to explore further regulatory changes, it should consider moving toward the model that has never had a generation-based blackout of its own making, has ample reserve margins, and has lower rates than any market based system: the regulated, cost-of-service generation of California's publicly-owned utilities.

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I hereby certify that I have this day caused the foregoing **REPLY COMMENTS OF THE COALITION OF CALIFORNIA UTILITY EMPLOYEES ON THE STAFF CAPACITY MARKETS WHITE PAPER** to be served upon all parties to Rulemaking 04-04-003 via email, mail or messenger pursuant to the Commission's Rules of Practice and Procedure.

Dated at South San Francisco, California, this 11th day of October, 2005.

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