

October 11, 2005

BY HAND DELIVERY

Docket Office
State of California Public Utilities Commission
505 Van Ness Avenue, Room 2001
San Francisco, CA 94102

Re: Order Instituting Rulemaking to Promote Policy and Program Coordination and Integration in Electric Utility Resource Planning - Rulemaking 04-04-003

Dear Sir/Madam:

Enclosed for filing is an original and five copies of the **REPLY COMMENTS OF PACIFIC GAS AND ELECTRIC COMPANY (U 39 E) ON THE CALIFORNIA PUBLIC UTILITY COMMISSION ENERGY DIVISION CAPACITY MARKETS WHITE PAPER** issued in connection with the above-referenced proceeding.

Please file the original and return the stamped copy in the envelope provided. Thank you for your assistance with this matter.

Very truly yours,

/s/

Edward V. Kurz

EVK/dl

Enclosures

cc: President Michael R. Peevey
ALJ Mark S. Wetzell
Jack Fulcher, Energy Division (five copies)
Official Service List for R-04-04-003

**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

U 39 E

**REPLY COMMENTS OF PACIFIC GAS AND ELECTRIC COMPANY (U 39 E)
ON THE CALIFORNIA PUBLIC UTILITY COMMISSION ENERGY DIVISION
CAPACITY MARKETS WHITE PAPER**

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INTRODUCTION

Pursuant to 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 (“Chief ALJ Ruling”), Pacific Gas and Electric Company (“PG&E”) submits these reply comments on the Capacity Markets White Paper (“White Paper”) developed by Energy Division Staff of the California Public Utilities Commission (“CPUC”). PG&E again thanks the Energy Division for the substantial work that went into the White Paper, and acknowledges the thoughtful and wide-ranging comments of market participants in response to the White Paper. PG&E appreciates this opportunity to provide its reply to the comments filed on the White Paper, and to place this effort in perspective.

Three conclusions clearly emerge from the White Paper and the comments on it: currently, there is insufficient investment in new and existing resources needed to meet California’s growing demand; a capacity market, or an alternative mechanism designed to achieve similar objectives, may well contribute towards a long-term solution to the lack of investment and provide other benefits; and the development of a capacity market or alternative mechanism will, and should, take both time and serious deliberation. While efforts have begun to examine and design California’s future market structures, urgent attention is needed now to

spur the investment California requires in the near-term. The stability of our energy market, and California's economy, will remain at risk until interim measures are deployed.

I. THE NEED IS CLEAR: THE PATH TO A LONG-TERM SOLUTION IS NEITHER CERTAIN NOR CLOSE AT HAND

The White Paper and the vast majority of the comments acknowledge that the disruptions of California's energy crisis, the failings of today's energy market and uncertainty as to future market structures are jointly responsible for the investment deficiencies in today's and tomorrow's energy markets. In the coming years, and likely sooner for southern California, that lack of investment will translate into capacity shortages that will destabilize California's energy market, threatening intolerable price surges. Certain requisite qualities of the long-term solution are beyond dispute: a stable regulatory and market environment in which investors can be reasonably assured of an appropriate long-term return on their investments in existing and new resources.

The comments on the White Paper, however, reveal that a tremendous amount of work is needed before stakeholders' disparate visions of that regulatory and market environment are brought into an implementable focus. When serious commenters cannot agree as to fundamental questions (*i.e.*, whether an energy-only or a capacity-based market is preferable, whether a centralized market or central purchaser is necessary or desirable and, if so, what role discretion should play; what time period should be addressed by the mechanism; and whether the mechanism should complement, or supersede, resource adequacy requirements), we can be assured that the process of resolving these basics and the details that must follow will take considerable time. Caution is urged by the majority of commenters, as the potential costs are great and, the continuing experiments of the Eastern markets tell us, results are often far from expectations. The Commission should take the time needed to clearly identify the goals of the long-term solutions and assure that our collective steps towards them are reasonably likely to succeed.

II. AS LONG-TERM SOLUTIONS WILL NOT MEET IMMEDIATE NEEDS, THE COMMISSION SHOULD FOCUS ON NEAR-TERM SOLUTIONS WHILE EVALUATING THE LONG-TERM OPTIONS

While the commenters are deeply divided on the best long-term market structures for California, stakeholders from across the full spectrum of market participants agree with the White Paper's conclusion that such long-term structures must be in place and remain stable for a significant period of time before there will be any likelihood that investors will have sufficient confidence in them to support new resources. See, e.g., Opening Comments of the California Independent System Operator Corporation ("CAISO") on the California Public Utilities Commission's Capacity Markets White Paper at 5; Comments of the Independent Energy Producers Association on the Staff's Capacity Markets White Paper at 4-5, 9; Comments of The Utility Reform Network on the Energy Division's Capacity Markets White Paper at 2-3 ("TURN Comments"). In short, even upon adoption, a long-term solution cannot be counted upon to spark investment in new resources. TURN captured the concern concisely: "TURN believes that California cannot afford to wait to design, implement and "get the kinks out" of a new market design before it secures new investment. The exact time frame in which new capacity is required, while somewhat uncertain, is clearly not that far away." TURN Comments at 3. PG&E agrees, and, like TURN, strongly recommends a two-tiered approach: a fast track to ensure needed new resources are built and their costs are equitably allocated, and a more deliberate track that allows a careful, well-tailored design for a California capacity market or alternative mechanism.

The Fast Track: New Resources & Fair Allocation of Costs. For the foreseeable future, new resources will be built only on the basis of long-term contracts with credit-worthy counterparties. One means of achieving this is to extend the newly-emerging Resource Adequacy program to include multi-year requirements, as suggested by TURN in its comments, id., and as PG&E has long maintained. Other mechanisms are also worthy of consideration, but no mechanism should require investor-owned utilities to undertake investment on behalf of others without an appropriate allocation of the concomitant costs and risks. The burdens associated with building new resources to fill gaps in California's projected resource needs must be spread to all of those who will benefit from them, particularly those who have not conducted

long-term plans nor made long-term commitments. PG&E joins TURN in asking the Commission to immediately engage in an effort to ensure resources needed in the near term can be, and will be, built.

The Measured Path: Monitoring Eastern Developments & Adapting Proven Concepts. While interim measures, which are necessary under the rosier of scenarios, are designed and implemented, the Commission should begin a stakeholder process with the CAISO and other stakeholders to clearly identify the goals to be achieved by a capacity market or alternative mechanism. As many commenters noted, including the Office of Ratepayer Advocates (“ORA”), the CAISO and TURN, the Eastern markets and Texas’ ERCOT are actively engaged in experimentation with capacity markets and energy-only alternatives. None of these mechanisms can be said to have been successful to date. A deliberate and careful approach will enable California to gain from these efforts, allowing time to determine how to adapt elements of these experiments that achieve their aims to the special needs of California, as well as time to learn from the pitfalls that are certain to emerge. As ORA noted, the potential costs of these mechanisms are not insubstantial, and California must be careful not to heedlessly add to the costs of its already-high energy bills. The Commission, the CAISO, and all market participants must work conscientiously, but carefully, to build the mechanisms that will form the foundation of the future market. In so doing, elements must be chosen that are closely targeted on the goals identified through the stakeholder process, and metrics must be built into the mechanism to monitor whether California is truly reaping the intended rewards of its efforts, and not paying too much for them.

CONCLUSION

PG&E again commends the Commission’s Energy Division for providing such a strong start to this crucially important discussion on California’s energy future. PG&E asks that the Commission begin immediate efforts to fashion, with market participants, an equitable effort to provide for the near-term while working on a careful, more deliberate pace towards the long term. PG&E continues to look forward to participating in the development of the interim measures and long-term market structures needed to keep California’s energy market, and its economy, competitive and healthy.

Respectfully submitted,

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By: /s/
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October 11, 2005

CERTIFICATE OF SERVICE BY ELECTRONIC MAIL OR U.S. MAIL

I, the undersigned, state that I am a citizen of the United States and am employed in the City and County of San Francisco; that I am over the age of eighteen (18) years and not a party to the within cause; and that my business address is Pacific Gas and Electric Company, Law Department B30A, 77 Beale Street, San Francisco, CA 94105.

I am readily familiar with the business practice of Pacific Gas and Electric Company for collection and processing of correspondence for mailing with the United States Postal Service. In the ordinary course of business, correspondence is deposited with the United States Postal Service the same day it is submitted for mailing.

On the 11th day of October, 2005, I served a true copy of:

**REPLY COMMENTS OF PACIFIC GAS AND ELECTRIC COMPANY (U 39 E)
ON THE CALIFORNIA PUBLIC UTILITY COMMISSION ENERGY DIVISION
CAPACITY MARKETS WHITE PAPER**

[XX] By Electronic Mail – serving the enclosed via e-mail transmission to each of the parties listed on the official service list for R.04-04-003 with an e-mail address.

[XX] By U.S. Mail – by placing the enclosed for collection and mailing, in the course of ordinary business practice, with other correspondence of Pacific Gas and Electric Company, enclosed in a sealed envelope, with postage fully prepaid, addressed to those parties listed on the official service list for R.04-04-003 without an e-mail address.

I certify and declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Executed on this 11th day of October, 2005, at San Francisco, California.

/s/

DONNA LEE