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 THE INDEPENDENT ENERGY
PRODUCERS ASSOCIATION ON THE STAFF'S CAPACITY
MARKETS WHITE PAPER

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REPLY COMMENTS OF THE INDEPENDENT ENERGY PRODUCERS ASSOCIATION ON THE STAFF’S CAPACITY MARKETS WHITE PAPER


Rather than respond to the specific items mentioned by the various parties in their comments, IEP will focus its comments on a few key points raised in the comments that the Commission should consider as it deliberates on capacity markets and other matters affecting the evolution of energy markets in California.

I. “DOING NOTHING IS UNACCEPTABLE”

As the California Independent System Operator (“CAISO”) notes, “the current structure of California’s electricity markets is incapable of sustaining the level of
resource adequacy consistent with the State’s traditional reliability standards.”¹ The status quo has not produced the infrastructure investment required to meet growing demand, and as a result California is threatened with the prospect of slim reserve margins or rolling blackouts during times of peak demand. In these circumstances, “long-run reliability can only be sustained by improving the current structure of the market or by carefully designing and implementing additional mechanisms to secure the revenues needed to support the appropriate level of infrastructure development.”²

II. ADMINISTRATIVE ATTEMPTS TO SIMULATE MARKET FORCES CAN HAVE UNEXPECTED EFFECTS

While the current lack of infrastructure compels the Commission to take action, the Commission must also be thoughtful about the actions that it takes. Administrative intervention in markets can have unexpected effects that can thwart achievement of the overall policy goal.

For example, many of the parties support the White Paper’s conclusion that the current mitigated energy market fails to provide sufficient revenues from energy sales to support investment in new resources, leading to proposals for the creation of capacity markets and other mechanisms to provide supplementary revenues to make up for the limitations of energy markets. However, the price signals that the energy market sends to communicate the need for greater investment in generation or increased demand reduction, for example, are dampened as alternative sources of revenues (e.g., capacity

¹ CAISO’s Opening Comments, p. 2.
² CAISO’s Opening Comments, p. 2.
compensation) are developed to compensate for the mitigation of the energy markets.

This example illustrates one of the principles IEP urged the Commission to follow in its efforts to remedy the problems of California energy markets:

Market solutions benefit consumers and should be preferred over administrative solutions wherever feasible. Competitive market solutions are more effective in facilitating the right levels of investment and in keeping costs to consumers lower. However, regulatory intervention begets further regulatory intervention.  

At a more specific level, this illustration shows the need for the Commission to move forward expeditiously to develop a capacity market that is crucial to attracting new investment in capacity in California, while not losing sight of the equally crucial need to improve the price signals coming from energy markets. This is not a case of either/or, where the Commission can choose between progress on capacity markets and improvements to energy markets. Action and progress on both energy and capacity markets are critical if the Commission hopes to achieve the ultimate goal of reforming wholesale markets in order to attract sufficient investment in supply infrastructure. Thus, the Commission must move forward in reforming both capacity and energy markets, while it carefully considers how its actions in one area will affect its goals in another, and how an individual action fits into its long-run plan for improving California’s electric markets.

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IEP’s Opening Comments, p. 4.
III. BILATERAL CONTRACTS SHOULD CONTINUE TO BE THE PRIMARY VEHICLES FOR PROCUREMENT

As IEP and others have repeatedly stated, in the current market environment, long-term power purchase contracts between suppliers and Load-Serving Entities ("LSEs") are the only feasible way to attract investment in new dispatchable capacity resources. Other parties have suggested that a longer-term capacity market could emerge as a prime mechanism for procurement. These conflicting perspectives raise the important issue of the relation between bilateral contracting and the capacity market.

For its part, IEP clearly stated its views in its Opening Comments that "a centralized capacity market should not be conceived of as taking on more than a supporting role."\(^4\) IEP also posed the question that it continues to believe should be central to the Commission’s deliberations on the White Paper and related topics: Does a centralized capacity market help encourage investment?

IEP recognizes that, due to concerns about shifting loads and stranded costs, some LSEs are reluctant to enter into long-term arrangements with suppliers.\(^5\) One of the benefits of a centralized capacity market with a standardized tradable capacity product is that it can provide a mechanism that will allow LSEs to acquire or shed capacity as their loads grow or shrink, respectively. However, it should be apparent that a short-term capacity market, by itself, will not attract investment in new power plants

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\(^4\) IEP’s Opening Comments, p. 5.
\(^5\) See CAISO’s Opening Comments, p. 12.
and will not provide the stability investors require. If LSEs rely exclusively on the centralized capacity market to meet their needs, rather than committing to long-term contracts with suppliers, the capacity market will undermine, rather than further, the Commission’s goal of attracting investment in generation.

For this reason, IEP urges the Commission to clarify that it intends that most transactions will take the form of negotiated bilateral contracts for capacity (and energy), and that the procurement of capacity will take place in an open, transparent, and competitive process. The short-term capacity market will support these bilateral transactions by providing a liquid market for shedding or acquiring incremental capacity as the LSEs’ loads change.

IV. REGULATORY CREDIBILITY AND STABILITY ARE CRUCIAL

None of the comments on the White Paper quibbled with Recommendation No. 8: “Strive for regulatory credibility.” Credibility with investors, however, also requires a form of consistency, so that investors do not have to fear that changes in political administrations or regulatory personnel will lead to changes in market structure. The Commission needs to articulate a plan for how the state will transition from the current unsatisfactory market structure to one that supports adequate investment in infrastructure and meets Californians’ expectations for reliable electric service at competitive prices. As the CAISO’s comments put it, “consideration of a short-term capacity market should be part of a larger effort to define and lay out a longer-term
‘roadmap’ for California,” and IEP agrees that creation of a centralized capacity market may be one of the important first steps along the path outlined in the roadmap.

The need to integrate individual initiatives with a longer-term road map also applies to the Commission’s consideration of other initiatives to improve energy markets. The Commission must necessarily pursue multiple initiatives simultaneously, but it is not always clear to observers how the various initiatives are linked or how they are intended to interact. In the next section, IEP offers its recommendations on how the Commission should proceed to ensure the continued development of competitive wholesale markets.

It is also apparent that the Commission and CAISO need to work together to formulate a single plan for the transition to a stable market structure. The CAISO’s comments demonstrate the need for a closer working relationship with the Commission. Investors and developers cannot and will not invest in California if the entities with the authority to shape energy markets in California do not present a unified vision and plan for the transition to a durable market structure.

V. **RECOMMENDATIONS**

As the CAISO points out, further Commission actions should take place in the framework of a broader roadmap, “a clear outline of the regulatory process to come and how development of a long-term resource adequacy program can or need be staged. It is clear that neither Californians not the market can wait an extended period of time for

6 CAISO’s Opening Comments, p. 15.
the CPUC and others to clarify these issues.”

Within that larger framework, the following actions are the most important for the Commission:

- Support the replacement of the CAISO’s current Must-Offer Obligation and Waiver Denial tariff provisions with the Reliability Capacity Services Tariff provisions proposed by IEP.
- Ensure that the Resource Adequacy Requirement is implemented on June 1, 2006, and is firmly enforced.
- Support the implementation and enforcement of local area requirements that ensure reliability and the development of local reliability pricing mechanisms that signal the need for additional resources in constrained local areas.
- Refine the long-term procurement process so that more resources are secured through long-term bilateral contracts, the key to infrastructure investment in the present circumstances, and so that the process provides greater transparency, which will in turn provide price and structural stability.
- Develop a capacity market structure that enhances and supports bilateral contracting.
- Support continued efforts at the CAISO to improve energy market price signals.

All of these actions should take place within a framework of an overall

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7 CAISO’s Opening Comments, p. 19.
roadmap that articulates how the Commission intends to proceed from current conditions to a more robust electricity market that is able to attract investment in infrastructure that meets California’s increasing demand for electricity.

Respectfully submitted this October 11, 2005 at San Francisco, California.

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CERTIFICATE OF SERVICE

I, Melinda LaJaunie, certify that I have on this 11th day of October 2005 caused a copy of the foregoing REPLY COMMENTS OF THE INDEPENDENT ENERGY PRODUCERS ASSOCIATION ON THE STAFF’S CAPACITY MARKETS WHITE PAPER; R.04-04-003 to be served on all the parties via Electronic Mail and/or Hand Delivery.

I declare under penalty of perjury that the foregoing is true and correct.

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

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(Updated October 6, 2005)

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(Updated October 6, 2005) |
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