Initial Comments on Capacity Market Proposals
CAISO Department of Market Monitoring
August 29, 2007

The Department of Market Monitoring (DMM) offers these initial comments on market power mitigation features or provisions of various capacity pricing and procurement proposals, as outlined in written submissions to the CPUC and subsequent discussion and clarifications provided at the August 21, 2007 CPUC workshop session on market power issues.

As a general comment, DMM notes that many of the proposals need significantly more detail on how they address potential market power concerns associated with physical and economic withholding of capacity. DMM encourages each group to give further consideration to this issue and provide additional details on potential market power mitigation mechanisms that could be included in their proposal. Specifically, DMM would like each group to consider the following:

Competition from New Resources – To what extent does the proposal allow new investment to compete to meet capacity requirements?

Local Market Power Mitigation - DMM notes that significant barriers to entry may exist in may load pockets that make installation of large amounts of new capacity infeasible or extremely costly. For these reasons, DMM believes that any proposal should include additional provisions to explicitly mitigate local market power. It is preferable to develop such market power mitigation provisions in advance in order to ensure that the provisions may be objectively applied by the CAISO. Effective local market power mitigation would need to address both physical and economic withholding through clear ex-ante market rules. Under approaches based on administratively set demand curves, the elasticity of demand (or slope of the demand curve) may provide limited protection against local market power. Thus, DMM believes additional market power mitigation provisions made be necessary under such approaches. Additionally, simply relying on DMM and FERC to monitor for the exercise of market power is not an effective mitigation strategy.

CAISO Backstop Provisions - Virtually all proposals appear to rely in varying degrees on some sort of backstop contracting authority by the CAISO. DMM notes that such backstop provisions can play an important role in mitigation (both supply and demand), by ensuring that capacity requirements can ultimately be met at prices that are within the range of "just and reasonableness". However, in order to effectively mitigate market power without undermining incentives for participants to participant in the primary capacity procurement mechanism, payments terms of such backstop contracting authority should comparable to the payment provisions incorporated into the capacity pricing and procurement design. All proposals need additional details on the assumptions about the backstop pricing and procurement mechanism of the CAISO and how this would interact with the proposed primary capacity procurement and pricing mechanism.

Performance Incentives – To what extent does each proposal create incentives for generation to perform during critical peak periods? In previous comments in the context of RCST and Resource Adequacy provisions, DMM has consistently advocated placing a heavier weight on generation unit availability during more critical peak hours, as an incentive for improved generator performance and to deter potential physical withholding.

Long-term Energy Contracting –As a final comment, DMM notes that while the focus of these proposals is on the procurement and pricing of capacity, it is critically important that the CPUC and parties to this proceeding not lose sight of the essential role that long-term energy contracting plays in mitigating market power in the short-term energy markets. The best designed long-term capacity procurement and pricing structure will not prevent another energy crisis (even under a 15% planning reserve margin), if it is not coupled with large amounts of long-term energy contracting. At the end of the day, Californians consume energy not capacity and if this energy is not adequately hedged through long-term contracts, the market will be ripe for significant market power abuse. With this in mind, each proposal should explain how it will impact or co-exist with long-term energy contracting.