

**Ensuring Resource Adequacy in California:
An Alternative to Centralized Capacity Markets**

**Presentation to the
CAISO Independent Market Surveillance Committee
by the Bilateral Trading Group**

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Bilateral Trading Group

These comments are submitted on behalf of the Bilateral Trading Group, an *ad hoc* group of consumer organizations and retail and wholesale market participants. The Bilateral Trading Group has engaged in periodic discussions regarding resource adequacy mechanisms and long-term market issues. While each of the participants shares a common view with regard to concerns about centralized capacity markets, we have not, individually or collectively, reached any final conclusions regarding a preferred alternative resource adequacy mechanism for California.

- California Large Energy Consumers Association
- California Manufacturers and Technology Association
- City and County of San Francisco
- Coral Power, L.L.C.
- Division of Ratepayer Advocates
- Energy Users Forum
- J. Aron & Company
- Strategic Energy, L.L.C.
- The Utility Reform Network

Background

- The CPUC has committed to undertake a comprehensive examination of alternative resource adequacy mechanisms as part of its ongoing Rulemaking proceedings (R. 05-12-013 and R. 06-02-013).
- The Bilateral Trading Group has serious concerns with proposals calling for adoption of an eastern-style, centralized capacity market for California.
- We encourage the CPUC to develop a complete record that thoroughly examines the costs and benefits of alternative resource adequacy mechanisms.
- The purpose of this presentation is to outline one such alternative to a centralized capacity market, with the aim of encouraging further discussion of such alternatives among interested parties.

Summary of Position

- The Bilateral Trading Group favors a market structure in which:
 - Consumption and investment decisions are driven by robust energy price signals;
 - Forward hedging contracts are used to protect consumers from volatile prices and the potential exercise of market power, and to facilitate financing of new generation resources; and
 - Capacity payments are determined bilaterally and are viewed as a source of supplemental revenues targeted to specific generators, particularly peaking units that operate infrequently, that are not able to fully recover their fixed costs through the energy markets.
- We do not favor:
 - Creating a centralized capacity market that relies on administrative mechanisms to establish a single market clearing price that is based on the hypothetical net costs of a new peaking resource, and is paid to all generation resources, regardless of whether a unit is a peaker or a baseload resource.

Concerns with a Centralized Capacity Market

- Requires development of significant institutional infrastructure and reliance on complex, administratively-driven processes.
- Providing new entry-based capacity payments to all generation, including baseload units with variable operating costs significantly below the market price of energy, will reduce energy price signals and increase costs for consumers.
- Supposed benefits are either unproven or can be achieved more simply and effectively through a bilateral trading approach that is already occurring and is compatible with the emphasis on creating robust energy markets.
 - Centralized capacity markets may be effective at keeping existing generation in service, but they have not been proven effective in encouraging efficient investment in new generation.
 - While proponents claim centralized markets facilitate customer choice and prevent free-rider issues, these objectives can be addressed through development of bilateral trading platforms and transaction reporting systems that facilitate liquidity and promote price transparency.

Ambiguity Over Long-term Design Objectives

- Advocates are divided over the long-term design objective of centralized capacity markets:
 - Some advocates view capacity markets as a permanent institutional feature that allows generators to recover all or most of their fixed costs.
 - Other advocates believe capacity markets should be designed explicitly to diminish over time as energy markets mature and demand response improves, thus enabling a greater proportion of generators' total fixed costs to be recovered through the energy market rather than administratively-determined capacity payments.
- The notion of a centralized capacity market as permanent institutional feature is incompatible with the vision of a decentralized, innovation-driven electricity market that allows consumption and investment decisions to be driven by robust energy price signals.
- Even if expected to diminish over time, institutional dominance and inertia make it difficult to eliminate centralized capacity markets once they've been created.

Views on Resource Adequacy

We favor...

- Market-based solutions, not administratively-determined capacity payments.
- Targeted capacity payments based on technology (baseload vs peaker); not a single clearing price for all capacity that distorts existing energy markets.
- LSE-based resource adequacy obligation, not a centrally-administered obligation.
- A jurisdictional balance that keeps the State in control of its own energy future and preserves the State's flexibility in implementing RA policy.
- Increasingly robust and well-functioning energy markets that allow intermediary hedging contracts to support financing of new generation.
- Market structures allow demand resources to compete effectively with supply-side resource in meeting reserve capacity and peaking energy needs.
- Utility tariff reform that allows retail consumers to voluntarily "see" and respond to wholesale spot market prices and benefit from the demand reduction services they provide.
- Standardized, tradable capacity products and price transparency.

Alternative Proposal

1. Retain the existing LSE-based resource adequacy framework with a forward reserve margin obligation.
2. Continue to implement a bilateral-based capacity market using standardized capacity products with locational attributes.
3. Encourage development of bilateral trading platforms and transaction reporting systems to facilitate liquidity and promote price transparency.
4. Implement wholesale market design changes to improve the performance of existing energy and ancillary services markets and reduce the need for separate capacity payments.
5. Rely on RCST (Reliability Capacity Services Tariff), or similar mechanisms, to mitigate market power in RA markets and provide uncommitted generators, which are not otherwise receiving capacity payments through bilateral contracts, with appropriate compensation for capacity value and compliance with must-offer obligations.
6. As a backstop measure, authorize a designated entity to enter into multi-year forward procurement contracts to ensure adequate new generation is built, with associated costs allocated to loads that do not satisfy the forward reserve margin obligations.