Comments of Constellation Energy Commodities Group, Inc., Constellation NewEnergy, Inc., and Mirant California

on

Opinion on "Long-Term Resource Adequacy under MRTU" by Frank A. Wolak, Chairman James Bushnell, Member Benjamin F. Hobbs, Member Market Surveillance Committee of the California ISO

Submitted to kperez@caiso.com

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Constellation and Mirant appreciate the opportunity the submit these comments on the *Opinion on Long-Term Resource Adequacy under MRTU* issued by the Market Surveillance Committee of the California Independent System Operator ("CAISO") on November 5, 2007 ("MSC Opinion"). Constellation and Mirant's comments reflect a strong concern that MSC's recommendation to defer efforts to design and implement a centralized capacity market will impede the formation of competitive markets in California. Adopting the "wait and see" approach offered in the MSC Opinion will serve only to ensure that investment in California's energy infrastructure is accomplished via regulatory intervention, such as the costly and inefficient approaches mandated by the CPUC for Southern California last summer.[1] Furthermore, it will stymie the development of a competitive investment environment that fosters technological innovation that will be needed to address greenhouse gas reductions and renewable resource challenges. Finally, it ensures that consumers in California continue to directly bear the risks of new investment.

While consideration of the overarching investment framework is lacking in the MSC Opinion, the MSC also fails to address the commercial and risk management issues that capacity market advocates have stated are reasons for developing a centralized market. LSEs are currently obligated by regulators and state law to procure capacity reserves to meet the resource adequacy requirement. A number of market participants have identified problems that exist due to the lack of a centralized market that would enable LSEs and suppliers to more efficiently meet their obligations. Some of the problems identified over the past year include lack of price discovery and transparent pricing, market illiquidity, inefficient market monitoring, and a minimal role for

[1] See October 25, 2007 *August – September Status Report on SCE Peakers* served on parties to CPUC Dockets R.05-12-013/R.06-02-013, wherein SCE notes that four of the five peakers authorized by the CPUC became operational, representing 180 MWs of capacity at a current forecast capital costs of $245 million, or $1.36 million / MW.

market intermediaries. Indeed, the problems that exist in managing the existing RA obligation, in addition to a number of problems that have been widely acknowledged in the utilities' procurement proceeding is what prompted the State's consideration of a centralized capacity market. The proceeding started out with market participants joining together to list the problems that exist in the current investment and resource adequacy structure and why a capacity market remedies those concerns. The proceeding in more recent months has focused on design details if a capacity market were to be adopted. The MSC's option in dismissing the need for a capacity market should, at a minimum, address how the problems identified in the existing framework should be resolved, if not by a centralized capacity market. In addition, The MSC should also explain how its advocacy for investment via utility rate-based investment, either through contracts or ownership, is consistent with a market based investment paradigm.

It would also helpful for the MSC to explain its understanding of how ratebased investment participates in the energy markets since there appears to be a misunderstanding of how rate-based investments participate in the market.

A brief examination of statements contained in MSC Opinion directly highlights its flawed reasoning.

1. **"[G]iven the wide range of uncertainty surrounding the future organization and structure of California's electricity market, as well as the performance of new capacity-market structures in eastern markets, it appears to us to be a singularly inappropriate time for California to commit to a new resource adequacy mechanism with potentially significant cost consequences. In short, we believe there is substantial value to deferring any major overhaul of the Resource Adequacy structure until California's specific needs for such a LT-RA product are known with greater clarity."[2]**

A failure at this time to implement market mechanisms that support new investment will ensure that when the need for new investment arrives, it will require regulatory intervention in the form of regulatory guarantees (rate-based or long term utility-backed power purchase agreements) to pay for that investment – a paradigm that requires consumers to directly bear all the risks of that new investment.

2. **"Further, many are concerned that the current RA paradigm is too dominated by the procurement plans of the regulated utilities. We share those concerns. However, given the status of several other policy initiatives currently underway in California, it is difficult to see how establishing a centralized capacity market would alter this in the near term"[3]**

The MSC is mistaken in its apparent belief that the utility procurement plans are directly linked to the current RA paradigm. They are not. Under the Long-Term Procurement Proceeding ("LTPP" R.06-02-013), the IOUs are required to submit procurement plans pursuant to Public

[2] MSC Opinion, page 1

[3] MSC Opinion, page 1-2

Utilities Code § 454.5 to the CPUC every two years. As has been made abundantly clear in the current proceeding, the IOUs' LTPP needs assessment with respect to new capacity resources bears little relationship to the planning criteria employed in RA. Thus, investment in new generation that occurs as a result of the LTPP will, and is, undermining the effectiveness of the RA program, inhibiting market price signal formation, and imposing cost responsibility risks on consumers that should and could be more actively managed by supplier and market intermediaries.

The MSC also appears to suggest that direct regulatory intervention to secure investment is consistent with other policy initiatives. That also is inaccurate. The CPUC has adopted policies that seek to transition away from regulatory guarantees to support investment, and the CAISO's mission is to administer ***competitive markets***, not direct regulatory intervention, that ensure reliability. For the CPUC policies and the CAISO markets to be successful, the MSC's concern about the dominance of utility-based investment must be addressed and quickly. While perhaps not perfect, centralized capacity market implementation is the next best step, and is certainly better than the alternative of ceding investment management to continued direct regulatory intervention under a command and control structure.

3. **"Without retail choice, much of the rationale for FERC-based LT_RA policies goes away because the vast majority of load will continue to be served by CPUC-jurisdictional entities."[4]**

The fact that the majority of load is currently served by the IOUs is no excuse to continue the IOUs dominance in infrastructure investment. In the absence of open retail competition, even more attention should be paid to increasing wholesale competition, especially with respect to investment in new resources, in order to minimize the potential for new stranded costs.[5]

4. **"An LMP market for energy with more granular pricing of ancillary services can provide greater transparency to all parties about the economic and reliability benefits that a specific generation unit provides to electricity consumers."[6]**

This statement suggests that the LMP prices for energy and well-defined ancillary services that are expected to come to fruition with MRTU can and will provide sufficient transparency about the economic benefits of generation. They will not. MRTU is an important step in the evolution of energy and ancillary service pricing that will facilitate competition, and the implementation of subsequent improvement in scarcity pricing and convergence bidding will continue that evolution. However, there is no current trajectory in this evolution that indicates a possibility that bid mitigation or local market power mitigation measures will be modified in ways that allow energy and ancillary service pricing alone to support new investment. The existence of bid caps at the levels that will be in effect in California provide a regulatory hedge for load that

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[4] MSC Opinion, page 2.

[5] Constellation and Mirant note that the MSC appears to suggest that if all utility ratepayers could get only hourly priced generation service that would provide the necessary incentives for them to forward contracts with alternative suppliers. Forcing hourly priced service on all customer classes, especially smaller energy users and especially in advance of widespread availability of advanced metering, is unnecessary and risky, and in any event, would likely be much more difficult to implement than a centralized capacity market.

[6] MSC Opinion, page 3

largely eliminates any need for them to seek hedges in the market place through forward contracting. Accordingly, it is appropriate and necessary to reform the existing out of market mechanisms with a well designed product —RA Capacity—that will assure revenues are provided to maintain generation availability.

The MSC appears to recognize this when they suggest that load serving entities should be *REQUIRED* to enter into forward energy supply contracts. There is only a need for such a *REQUIREMENT*, because the current market design is not capable of providing the right incentives for that type of hedging on a voluntary basis. The forward energy contract that the MSC seems to favor is essentially an option contract that requires the supplier to provide energy at a specific price. Pricing the option embedded in the forward energy contract is no different than pricing capacity. The price of the option will take into account all the other revenues and opportunity costs available to the energy resource, and price the option accordingly. A centralized capacity market can and will provide additional structure and transparency to that option pricing that is simply not available in a capped energy-only market.

5. "It is important to recognize that the RA paradigm need not be focused on investment to meet load growth for more than a decade."[7]

The MSC Opinion suggests that the commitment to new renewable resources and energy efficiency preclude the need for new non-renewable resources, and therefore preclude the need for any additional improvements or modification to the existing RA paradigm. The MSC appears to predicate this statement on a presumption that all renewable and efficiency investment will be achieve by direct utility investment, and that since utility investment is achieved without regard to broader market impacts, there is no need to implement markets to support that form of wholesale investment. The MSC is correct in its recognition that continued investment through mandated utility investments precludes the need for a capacity market and the competition it would engender. However, Constellation and Mirant urge the MSC to recognize that continued mandated utility investments also preclude any real need for MRTU's LMP pricing improvements, improvements to ancillary services, scarcity pricing, convergence bidding, and backstop procurement. Indeed, all the short term market design improvements recommended by the MSC in lieu of a centralized capacity market are rendered moot if investments are going to be managed through resource planning at the CPUC, rather than through wholesale markets. Moreover, simple reliance on energy efficiency and increased renewables penetration may not assure the minimal levels of high availability capacity needed for system reliability, particularly given California's exposure to hydro availability, regulatory disincentives to use of high GHG emitting imports, and growth rates of peak demand levels due to increased loads in arid areas. Given that the RA policies California has adopted are intended to provide insurance for supply sufficiency, it makes little sense to reject a tool that can help support competition for a basic capacity product.

The MSC correctly notes throughout the opinion that there are significant regulatory, commercial and physical uncertainties that exist concerning how new resources will need to perform, about what type of ancillary services are required to ensure that renewables contribute meaningfully to system reliability, and about how our environmental goals will change the way

[7] MSC Opinion, page 4.

we think about our capacity requirements. But to decide now to simply defer the implementation of market mechanisms that will allow market participants to analyze and manage those risks and uncertainties will leave in place the costly regime of command and control responses. Constellation and Mirant believe that consumers would benefit if we continue to reform and improve the investment paradigm so that it focuses on managing those risks rather than simply passing through those risks and cost responsibilities to ratepayers.

Conclusion:
In summary, the MSC should further evaluate the conundrum that its Opinion creates for the California markets. If California continues to defer implementing markets that support investment outside the direct-control regulatory regime that is currently the sole mechanism for investment, that deferral will simply ensure that a transition away from the reliance on that regulatory regime is unachievable.

The conclusion of the MSC Opinion states: "We can imagine future system conditions and features of a centralized capacity market that would fit the California market."[8] However, the MSC fails to provide any description of what those imaginary future system conditions might be that would cause MSC to support centralized capacity markets. What is clear, however, is that while it waits for those future system conditions to unfold, the MSC is content to allow direct regulatory intervention--rather than market mechanisms--provide the necessary investments, whether that investment is in renewables, fossil generation, or other technological innovations. Such a posture is likely to be a bad deal for consumers, as our experience with stranded costs has taught us, and therefore the suggestion that we have the luxury of time to wait to implement sound, competitive, market designs should be rejected.

Respectfully submitted,

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[8] MSC Opinion, page 10.