WPTF
Western Power Trading Forum

DOCKET	
09-IEP-1A	
DATE	NOV 16 2009
RECD.	NOV 16 2009

November 16, 2009

The Honorable Jeffrey D. Byron
Chairman and Presiding Member
2009 Integrated Energy Policy Report Committee
California Energy Commission
1516 Ninth Street, MS-29
Sacramento, CA 95814-5512

RE: Docket No. 09-IEP-1A -- Draft 2009 IEPR

Dear Commissioner Byron:

Many thanks to you and your staff for meeting with us last week to discuss issues associated with California's hybrid market. The purpose of this letter is to provide some specific written comments to you about these issues, in the context of the 2009 Integrated Energy Policy Report – Draft Committee Report, issued in September 2009 ("Draft IEPR Report").

What is the hybrid market? The Draft IEPR Report states on page 198:
The hybrid electricity market established through Assembly Bill 1890 (Brulte *et al.*, Chapter 854, Statutes of 1996) created multiple entities that invest in and operate specific facilities that are part of the overall electricity infrastructure in California. Merchant generation has a strong position in California.[1]

This statement may be true if the hybrid generation market is defined as traditional cost-of-service investment undertaken by vertically integrated Investor-Owned Utilities ("IOUs") prior to AB 1890 supplemented by investment by non-IOU entities pursuant to long term contracts with the IOUs. However, the statement is, unfortunately, wholly inaccurate if one defines "merchant generation" as investment in new generation in California that did not rely on either utility rate base or long term cost pass-through contracts with the utilities. The undersigned refer to this form of investment, where the risks of investment are actively managed by investors, as merchant investment – and it is nowhere to be seen in California.

Why is merchant generation absent in California? The CPUC has already acknowledged that incentives for merchant generation, as defined above, are undermined when the market price signals are compromised by investment that is granted long term regulatory guarantees for cost recovery and when existing market structures do not

[1] See Draft IEPR report, page 198.

provide tools to manage the risks associated with those investment. As WPTF stated in its October 30, 2009 letter to you:

> [the] position that continued reliance on UOG (and ratepayer-backed PPAs) is incompatible with the development of a competitive market model that stimulates private investment is consistent with basic economic theory. The Commission is taking measured, cautious steps in the direction of this end-state, and a number of programs and security measures must be developed and tested before California relies on competitive markets to provide this critical resource to our state. D.06-07-029 stated that we were in a transitional period, and this remains the case. Anticipated rulings on forward RA requirements (and the market structures for acquiring these resources) in Phase 2 of the RA proceeding and the development of a transparent PRM methodology in the PRM rulemaking are key steps in this process.[2]

At the October 14 hearing, these issues were brought into sharp focus by the comments of Mr. Todd Strauss of Pacific Gas & Electric. In his comments, Mr. Strauss urged that utility-owned generation projects should be allowed to bid into utility RFOs. Mr. Strauss claimed that allowing this to occur would promote a higher level of competition in the RFO process. Quite the contrary is true, however. As has already been fully vetted at the CPUC, there is simply no way to meaningfully compare a "life of asset" utility owned project to a 10 year power purchase agreement and for that reason, the CPUC has determined that such projects should not be allowed to participate in the RFOs.[3] Moreover, a policy that would "allocate" 50% of new generation to utility owned investment and another 50% to merchant investment, a position that PG&E has promoted in the past, would do nothing to address the fundamental flaws of the hybrid market. Basic questions regarding how this allocation would be determined (e.g., by location, timeline, technology and under what terms and conditions it would be applied) show the extent of the controversy, and demonstrate that the idea of "dividing up the market" between utilities and non-utilities is fatally flawed.

What would it take for merchant generation to re-emerge in California? Again, the answer is fairly simple. First and foremost, there must be a clear recognition by policy makers that California's hybrid market has demonstrated that merchant generation cannot co-exist with the utility procurement paradigm that allows the regulated utility to build, own and/or control resources. The risks associated with merchant generation in this environment are simply too high and completely unmanageable. Second, there must be proactive steps taken to ensure that merchant investment can re-emerge in the California markets. Establishing robust markets for energy, capacity, ancillary services tradeable renewable energy credits and market based emission reduction mechanisms are critical in this regard. Third, utility procurement must undergo a paradigm shift away from its current focus on asset ownership and control and toward procurement practices that support competitive wholesale and retail markets, rather than thwart them.

---

[2] See Decision 07-12-052 issued in R.06-02-013, page 200.

[3] The CPUC rules for utility run RFOs does permit projects referred to as "build-own-transfer" to compete directly in the RFOs

How can the California Energy Commission help effectuate these changes? The Draft IEPR Report acknowledges the interrelationship between the work of the CEC on the IEPR and the CPUC's Long Term Procurement Proceedings ("LTPP"). The CEC could fulfill an important role in promoting greater understanding of hybrid market issues and setting the stage for addressing these important issues by modifying the Draft IEPR Report Recommendations to include the following new section:

Recommendations for the Energy Sector: Evaluating and Addressing Hybrid Market Structure Flaws

Issues associated with the hybrid market have not been adequately addressed in this year's IEPR analysis, and we remain concerned that utility domination of infrastructure investment is potentially detrimental to competitive wholesale and retail markets, and therefore potentially detrimental to technological innovation necessary to achieve our environmental goals. Moreover, competition at the wholesale and retail levels creates downward pressure on prices. Finally, the existing hybrid market structure requires ratepayers to bear the financial and operational risks associated with new investment, and ignores the market's capabilities to actively manage and hedge those risks. We believe that these issues need a fuller vetting and evaluation, and intend to invite the California Public Utilities Commission to participate in a more complete evaluation of the existing hybrid market structure in the next IEPR update, to identify possible market enhancements and changes to utility procurement practices that would facilitate the re-emergence of merchant investment.

WPTF again thanks you and appreciates your attention to this important topic.

Respectfully submitted,

Gary B. Ackerman

Gary B. Ackerman
Executive Director
Western Power Trading Forum
3527 Mt. Diablo Blvd #338
Lafayette, CA 94549
Tel: 925-299-9271

CC: The Honorable James D. Boyd
Vice Chair and Associate Member
2009 Integrated Energy Policy Report Committee
California Energy Commission