UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Compensation for Generating Units Subject to Local Market Power Mitigation In Bid-Based Markets PJM Interconnection, L.L.C.	Docket No.	EL03-236-000 PL04-2-000

POST-TECHNICAL CONFERENCE COMMENTS OF CALPINE CORPORATION

Calpine Corporation ("Calpine") commends the Federal Energy Regulatory Commission ("Commission") for providing market participants with this much-needed opportunity to submit comments on the technical conferences held in this proceeding on February 4 and 5, 2004.[1] While the Commission has entertained separate sets of comments under the two dockets, Calpine found that many of the same issues that exist in PJM also exist in the other RTO's and ISO's. Calpine has therefore consolidated its general comments and those specific to PJM in this single set of comments. Although this consolidation has extended the time slightly for submitting comments in the PJM docket, Calpine believes such an extension efficiently allowed for the development of consistent comments applicable to both dockets in one filing. Accordingly, Calpine respectfully requests that the comments be accepted out of time in the PJM docket. Calpine offers the following comments regarding local market power mitigation policy.

I. Introduction

The current forms of market mitigation being proposed, whether at PJM or the California ISO, are simply regulation without the reasonable opportunity to recover

[1] The Commission's Notice of February 6, 2004, set a February 20, 2004 date for comments in EL03-236-000 and a February 27, 2004 comment date in PL04-2-000.

capital costs and earn a return. To date the focus of ISO and RTO Market Monitors has been too focused on the use of mitigation (or the threat of mitigation) to achieve desired price results. In the eyes of the specific beholder (the local market monitor) mitigated prices reflect competitive outcomes. In practice, however, all that can be said is that mitigation (or the threat of mitigation) assures that wholesale prices will not exceed competitive levels. What buyers and Market Monitors generally leave unsaid is that it may also prevent prices from ever reaching competitive levels. Moreover, mitigation is a self-fulfilling prophecy. The more intrusive mitigation gets, the more likely the result will be less competitive entry and increasingly greater need for mitigation.

An alternative does exist. If the objective is to achieve greater competition, then by definition, the only mitigator that is consistent with competition is requiring market buyers to self provide energy price hedges through forward contracts. In order for buyers to assure adequate competitive choices and competitively procured forward hedges for themselves, this must occur on a lead-time that is sufficient to allow new entry. This requires fundamental change in the focus of mitigation, *e.g.* requirements on load serving entities ("LSEs") to cover their forward exposure as part of the market design. This means providing LSEs with incentives to enter into long-term supply contracts with generators. In order to provide some incentive for buyers (loads) to enter into long-term contracts, they must be held accountable where they "choose" not to self-hedge.

Unfortunately, this does not exist today. The current approach to mitigation sends all the wrong signals. It rewards LSEs for deferring purchase decisions by delivering mitigated price levels (whether through mitigation intervention or simply the threat of such intervention) after they let options for competing alternatives such as new resource entry expire (these require a multi-year lead time for siting, permitting and construction). It is far easier for a buyer to sit idle waiting for the ISO or RTO market monitor to step in to mitigate prices or, through the use of a must-offer obligation, lean on capacity. However, this is a very short-sighted policy and dangerous to the future reliability of the grid.

While case specific auctions such as that proposed by the PJM Market Monitor might offer incremental improvement over the more intrusive form of mitigation referenced above, it is both too much and too little. First, the auction process goes too far in requiring a life (of resource) contract term. While the investment in new generators in the current environment necessitates a five - ten year initial contract term, terms beyond this time frame should not be decided on behalf of load (by the PJM Market Monitor). Second, the PJM auction proposal is too little. As described by a participant in the Technical Conference, it is akin to buying an automobile insurance policy after the car has hit the tree. By waiting until the lead time for new entry has elapsed and only triggering an auction once the market monitor blows the whistle, mitigation or some other form of price administration is still needed in the period prior to the in service date of the winning bidder's new resource. This approach does nothing to change the general buy-side market behavior and may do more harm than good.

In the following comments, Calpine suggests a plan that could achieve competitive prices through competition and over time diminish reliance on local market power mitigation. This approach would hold LSEs responsible for meeting <u>their</u> reliability obligations on behalf of <u>their</u> loads and hold them accountable if they "choose" not to pursue competitive alternatives and instead let those options expire. Calpine does recognize that adopting any new approach will undoubtedly require a transition period. The options that LSEs have been conditioned (by existing market mitigation policy) to let expire over the past few years means that in the short run, there is insufficient time for new entry in the areas currently experiencing or about to experience local supply concentrations. By virtue of LSEs' inactions, some level of mitigation may be necessary in the transition, but even here, resulting price levels should neither be a reward for prior inaction by LSEs nor a penalty for those new resources that were developed to increase competition.

Specifically, the fundamental basis for post-1996 generator investments cannot now be revoked. These investments were undertaken by companies with the intent and effect on increasing competition in the respective market. Penalizing them for increasing competition would send the wrong message to the supply side of the market and the financial community. The PJM Market Monitor's requested uniform removal of the mitigation waiver for post-1996 units should be denied. Moreover, the must offer (or flexible offer) obligation ("MOO" or "FOO") and the Residual Unit Commitment ("RUC") proposed in the California ISO's comprehensive market re-design must similarly exempt all post-1996 units.

II. Ultimate Remedy of Market Power is Long Term Contracting

For a variety of policy reasons at both the state retail level[2] and FERC regulated wholesale market level, existing markets do not sufficiently encourage LSEs to enter into longer term contracts with both new and existing generating resources. Existing markets actually encourage LSEs not to hedge forward enough to assure competitive prices for themselves. As a consequence, there has been a persistent reliance on shorter-term purchases. Meanwhile loads have let options for alternative supplies through new development expire. If this were a conscious decision to buy from one or more existing resources going forward, prudent business practice would suggest that these LSEs should have properly hedged their future energy price uncertainty. Such a hedge was available from existing resources through a bilateral contract which minimally would have covered the period required for new supply entry. This has not happened. While some forward interest proposals under certain state retail programs present as much as a three year purchase term, lead time for the start of those purchases is measured in months, in contrast to the multiple years required for new entry. Furthermore, those RFP processes do not necessarily result in procurement of generating capability required to physically hedge those forward obligations.

In order to restore competitive market function, two key principles must be enforced. First, as simple as it sounds, load must be held accountable to satisfy "its" obligation to assure adequate future resources. Current market policy in all of the ISO's and RTO's has this somewhat inverted[3]. Second, in the event that a load does not take adequate actions to hedge their own price exposure, load should bear the accountability for their decisions and face exposure to potentially much higher price volatility. Where that level of price volatility is not acceptable at a state or regional level, the supply

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[2] Under some state's retail wheeling designs, default service or provider of last resort services commit to relatively short durations and on a relatively short lead time, albeit longer in both duration and lead time than the underlying requirements in the capacity markets of the respective ISO or RTO.

[3] Through numerous provisions in the respective market rules and tariff provisions, existing set of generators are required to provide certain reliability services whether or not the market price offered for the service is sufficiently compensatory for assuming such obligations.

choices of LSEs must be constrained further and a certain quantity of forward purchases must be required of them.

Based on Calpine's observations in ISO and RTO stakeholder processes, much of the debate on the need for mitigation is driven by the absence of these principles in market policy, including mitigation policy, in the existing ISO and RTO markets. The natural inclination of market buyers is to pay as little as they can to get as much as they can. While the opposite can be said for market sellers (in the long term market really only asset owners), asset owners do not have a controlling vote in stakeholder governance and cannot require changes to be made from the flawed status quo. The specifics of why this is true are immaterial to this discussion. However, the simple matter is that prevailing market policy does not hold load sufficiently accountable for its own fate and mitigation measures through price caps, bid caps and other forms instead suppress price, provides a regulatory hedge to load and discourages new entry. Further, the Commission cannot rely on these ISO and RTO governance processes or the Market Monitors themselves to voluntarily get this job done. Specific direction is required.

III. Symmetry Needed Between Forward Procurement and PJM Regional Transmission Expansion Plan "Reliance" on New and Existing Generators

While it is often said that "a plan not executed is no plan at all", the absence of execution of the generator portion of the PJM Regional Transmission Expansion Plan ("RTEP") by LSEs is not necessary under current mitigation and market policy in PJM. By virtue of reliance on mitigation and other rules which forceably require generator owners to provide reliability services in PJM and other RTO's and ISO's, the plan is automatically executed and action by LSEs is disincentivized. The PJM RTEP is built upon all existing and new infrastructure and thus the system comes to "rely" upon then existing resources whether or not load or transmission customers have purchased the right to rely upon any individual generator. It is obvious that this does not lead to a market outcome, but to a future debate that one or more generators are the only choice (in the short run) to meet specific reliability needs. This recipe has prepared the way for the local market power mitigation debate that precipitated the Reliant Complaint (EL03-116-000) and the PJM filing (EL03-236-000) and ultimately this technical conference. Load should only "rely" upon the capacity (generating or transmission capability) for which it has committed to pay for the related services in those period(s). Further, generating resources not so purchased should by definition be dispositively determined not to possess market power (they are not pivotal) and should not be subject to mitigation. While the specifics in this filing are focused on PJM, the same infirmities exist in other ISO's as well. Commission direction is needed here. PJM should be required to modify its resource adequacy procurement process in a way that requires LSEs to purchase the capacity services on a lead time and contract duration necessary to fulfill the RTEP. Capacity not so purchased should not be relied upon to meet future reliability criteria. The PJM MMU should further distinguish between resources sold as capacity under this framework and that which is not. In the latter case, such resources should not be subject to mitigation.[4]

[4] Calpine recognizes that in the transition to longer lead time generator capacity procurement, there may be a period of 1-3 years in which some form of mitigation might be needed to protect against withholding of capacity (i.e., refusing to sell that capacity at a competitively reasonable price). Even here, however, mitigation should neither be a reward to buyers nor penalty to owners of those assets. A generator subject to mitigation should not be precluded from a reasonable opportunity to recover its capital through its energy bid prices. The capacity markets do not reflect the locational capacity value that exists in local sub-markets

IV. Post-1996 New Resource Entry Increased Competition: This Desired Market Behavior Should Not Be Punished by Pulling The Rug Out After The Investment is Sunk

When post-1996 units were built, they increased the competitive choices. By definition, they were not at that time "pivotal". The system and market previously ran without them. To the degree load has grown around them, planners have since come to "rely" on them to meet, in some cases, unique reliability needs without LSEs having purchased reliability (capacity) services from these resources consistent with that planning reliance. Even if the "specific" circumstances could result in monopoly rents, this simply means that LSEs have not planned the resources to meet their obligation to assure reliable electric service to their customers. It is inappropriate to invert this reliability responsibility through removal of the mitigation waiver with the intent of requiring such resources to meet the LSEs' reliability obligations at curbed prices. That will not be the right direction if competitive markets are the objective.

So what can be done that is fair to all parties? The correct remedy here is the same as above. Certainly do not wait for future circumstances to arrive (do not wait for another car to hit the tree). Require the LSEs to cover their resource needs on a planning horizon basis now. This is the only long-term mitigator that is consistent with a market. Require the LSEs to assure resource adequacy on the same lead time that the system planning process relies on those underlying resources to support those LSEs' reliability obligations. At that time, LSEs can choose the degree to which they wish to self-hedge their exposure to short-term energy price volatility. After they choose their desired level of self-hedge, let market price volatility happen.

If, prior to implementing this market-wide reform, individual post-1996 units present specific market power concerns, any mitigation authority must be limited to a period not to exceed 60 days for any individual resource. Where any extension of that interim mitigation authority is deemed necessary on such a post-1996 unit, the respective market monitor should be required to submit a filing (within ten days of mitigating the unit) to request specific interim authority with respect to that unit beyond the 60 day period. The threshold for getting approval of that extended authority should be high and any such filing should demonstrate why interim authority is necessary, what market shortfalls led to the situation and what market reforms will be pursued to remedy the underlying market flaw. Further, the design of any interim measures should be done with the objective of minimizing interference with the competitive market and minimizing harm against investors. If the ISO fails to seek such authority or the Commission denies that authority, mitigation authority over that resource would expire 60 days from the date mitigation was first applied.

V. Any Transitional Mitigation Should Be Designed to Do The Least Harm To the Market

A. Local, One-off Auctions Suggested By PJM Are Not the Answer

PJM Market Monitor has suggested that local market power issues could possibly be resolved through ad hoc local auctions where the winning bid(s) receive a life of resource contract (or in the case of transmission, rolled in status). While the idea of event specific local auctions may be palatable as a transition (assuming the more permanent solutions will be implemented on a well defined schedule), the purchase duration need not be as long as PJM Market Monitor suggests. Particularly given the interim nature of such a solution, the duration should be long enough to facilitate financing of a new project, but should not exceed that duration. ISO's and RTOs should limit their role in purchasing hedges for loads. After the transition, the objective is to hold the LSEs feet to the fire on this responsibility.

B. Market Participants Should Be Afforded A Process To Seek Direct Assistance From FERC in Getting Bid Cap Relief

The authority to interfere in the market and the risk of limiting a resource's opportunity to recover capital costs and earn a return should not occur solely at the ISO or RTO level. While it is true that the Market Monitors must seek approval of their underlying authority through Section 205 filings, much discretion remains with Market Monitors. Given the significant impact any exercise of this discretion may have on resource owners, a more efficient means of seeking relief than the current Section 206 complaint process should be developed.

VI. CONCLUSIONS

Calpine thanks the Commission for this opportunity to provide these comments. We look forward to working with the Commission, Commission Staff, and all other market participants throughout this proceeding.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that the foregoing document has been served upon each person designated on the official service list compiled by the Secretary in this proceeding.

Dated at Boston, MA this 27th day of February 2004.

By: /s/ Richard A. Kanoff

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