



**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**

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Order Instituting Rulemaking to Implement the
Commission's Procurement Incentive
Framework and to Examine the Integration of
Greenhouse Gas Emissions Standards into
Procurement Policies

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Rulemaking 06-04-009
(Filed April 13, 2006)

**ENERGY RESOURCES CONSERVATION
AND DEVELOPMENT COMMISSION
OF THE STATE OF CALIFORNIA**

In the Matter of:

AB 32 Implementation: Greenhouse Gases

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Docket 07-OIIP-01

**OPENING COMMENTS OF THE
LOS ANGELES DEPARTMENT OF WATER AND POWER
ON THE ADMINISTRATIVE LAW JUDGES' RULING REQUESTING COMMENTS ON
ALLOWANCE ALLOCATION ISSUES**

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**OPENING COMMENTS OF THE
LOS ANGELES DEPARTMENT OF WATER AND POWER
ON THE ADMINISTRATIVE LAW JUDGES' RULING REQUESTING COMMENTS
AND NOTICING WORKSHOP ON ALLOWANCE ALLOCATION ISSUES**

In accordance with Rule 14 of the Rules of Practice and Procedure of the Public Utilities Commission ("CPUC" or "Commission") of the State of California, the Los Angeles Department of Water and Power ("LADWP") hereby files the following Opening Comments submitted in response to the "Administrative Law Judges' Ruling Requesting Comments and Noticing Workshop on Allowance Allocation Issues," filed October 15, 2007, in CPUC Rulemaking R.06-04-009 ("Rulemaking") and California Energy Commission (CEC) Docket # 07-OIIP-1.

I. INTRODUCTION

The LADWP appreciates the opportunity to provide preliminary comments on policy issues related to allowance allocations in response to the ALJs' Ruling. We also recognize that the recommendations the CPUC and CEC adopt and forward to the California Air Resources Board (CARB) are intended to help inform, on behalf of the electric sector, the CARB's AB 32 rulemaking process that encompasses many other sectors and sources of greenhouse gas emissions that may likely be included in an CARB greenhouse gas emissions reduction program.

As such, we anticipate this will be an evolving process informed by many stakeholders and sources of information which are critically important, and may not be currently available to us, such as cost and rate impact modeling of various allocation scenarios (intra-sector and inter-sector). Additionally, there are significant policy decisions that are still pending, like the point of regulation (i.e. load-based vs. first-seller), that influence what options are available to consider for allowance allocations.

The comments provided below are preliminary, and may adjust as critical factors evolve.

II. SUMMARY OF OPENING COMMENTS

While LADWP continues to maintain that a direct regulation program which includes emission reduction targets is the most cost effective and efficient method to achieve AB32 goals, we would like to take this opportunity to provide comments on a market-based proposal, particularly given our experience with the Southern California RECLAIM program and the federal Acid Rain program.

At the center of LADWP's position on allowance allocation is our goal to partner with the state to achieve real environmental benefits through greenhouse gas emission reductions, to protect customers from unfair cost burdens and rate spikes and to preserve electric system reliability. We do not support a wealth transfer between regulated entities and the state or among regulated entities, nor do we support creating windfall profits for any entity which will ultimately be subject to compliance under the program or an entity allowed to participate in a greenhouse gas market trading program. A proposed formula for the allocation of emission allowances to significant sources of greenhouse gas emitters must be fair for all entities and direct those with a higher compliance burden (a higher overall emission level) to concentrate their investments in lower emitting and zero emitting resources. To that end, the LADWP supports an administrative allocation of allowances at the program inception date (2012) based on current and accurate emissions levels, with an annual declining cap that ultimately brings each regulated entity in the electric sector to an emission level that reflects best industry practices. The cap-and-trade decline must result in real emission reductions, result in the lowest cost to customers and preserve electric system reliability.

LADWP has an overall carbon intensity of approximately 1300 lbs/MWh, while the average of large utilities in California are much lower, and in some cases less than half of our carbon intensity. LADWP and the City of Los Angeles supported AB 32 during the 2006 legislative session, recognizing that our electric portfolio poses one of the greatest challenges and one of the greatest opportunities for reducing emissions.

LADWP through its board, and in concert with the Mayor, made commitments to targets under the Los Angeles Climate Change program (Green LA) and the California Global Warming Solutions Act (AB 32) and took immediate steps to steer public utility investments toward greenhouse gas reductions. This year, we committed nearly \$2 billion in investments over the next five years to programs that will result in direct greenhouse gas emissions reductions. These investments include:

- New renewable electricity generation and transmission resources for the City of Los Angeles and the Southern California region;
- Tripling funding for our solar installation program;
- Doubling our investments in increased energy efficiency and demand-side management program is for all customers. Creating a LEED standard department to provide assistance city-wide for the development of energy and water efficient construction;
- Redesigned our rate structure and infrastructure improvement for the LA port to shift from bunker fuel to electricity; and
- Increased purchases of alternative fueled vehicles and development of alternative fuel fueling stations for both private fleet and public access.

III. RESPONSE TO SPECIFIC QUESTIONS

3.1. Evaluation Criteria

Q1. Please comment on each of the criteria listed by the MAC:

- a. Reduces the cost of the program to consumers, especially low-income consumers,**
- b. Avoids windfall profits where such profits could occur,**
- c. Promotes investment in low-GHG technologies and fuels (including energy efficiency),**
- d. Advances the state's broader environmental goals by ensuring that environmental benefits accrue to overburdened communities,**

- e. **Mitigates economic dislocation caused by competition from firms in uncapped jurisdictions,**
- f. **Avoids perverse incentives that discourage or penalize investments in low-GHG technologies and fuels (including energy efficiency),**
- g. **Provides transition assistance to displaced workers, and**
- h. **Helps to ensure market liquidity.**

Are these criteria consistent with AB 32? Should other criteria be added, such as criteria specific to the electricity and/or natural gas sectors? In making trade-offs among the criteria, which criteria should receive the most weight and which the least weight?

Answer: The Market Advisory Committee's (MAC) overall fundamental objectives of cost-effectiveness, fairness and simplicity are consistent with California Global Warming Solutions Act (AB 32), assuming the MAC's view is, as AB 32 states, that reducing greenhouse gas emissions is the overall priority. The MAC principles listed above ("a" through "h") are all consistent with the principles of AB 32. However, they do not appear to reflect *all* the principles articulated by the Legislature. For example, AB 32 states it is the intent of the Legislature that the State Air Resources Board design emissions reduction measures in a manner that "***minimizes costs and maximizes benefits for California's economy, improves and modernizes California's energy infrastructure and maintains electric system reliability, maximizes additional environmental and economic co-benefits for California, and complements the state's efforts to improve air quality.***"¹

The Legislature specifically included this language in the bill, recognizing that electric sector investment should be directed toward real environmental benefits that also protect and develop our energy infrastructure in a manner that protects against customer rate shocks. These principles must also be considered by the CEC, CPUC and CARB as the program is developed.

¹ Health and Safety Code, Section 38501(h).

Another important principle to be considered for the electric sector is that the AB 32 program must be designed to compliment and not impede wholesale electric market stability. In the near term, the electric sector, and in particular the public and private utilities will be faced with new and renewed electric market programs as the AB 32 program begins. For example, there may be higher mandates for renewable energy purchases, and a revival of direct retail access. Overall resource adequacy, wholesale market stability and electric system reliability should be given great weight by CEC, CPUC and CARB.

The MAC principles listed in this ruling do not specifically reflect the clear AB 32 principle of investing in California's energy infrastructure and it should be added. The AB 32 program should provide additional incentives to those entities who invest in California's energy infrastructure, including *new* renewables, low and/or zero emission electric generating facilities and transmission infrastructure designed to support these new cleaner resources. The benefits of developing California energy infrastructure are multiple: we will continue to be an economic leader in renewable energy, we can create more electric industry jobs in California, and develop long-term sustainable low carbon and zero carbon resources within California dedicated to serving our region.

Another principle that must be considered by the CEC, CPUC and CARB is that we must work together to design a program that minimizes the potential for gaming and market manipulation. The MAC principle listed as letter "b" discusses avoiding windfall profits, but does not include the other economic risks associated with establishing a market-based system. Proper controls against manipulation must be built into the design, including protecting against the exercise of market power, artificial and

unpredictable price inflators, fraudulent transactions and credit hoarding. The electric sector has the benefit of experience with other emission-based, market-based compliance programs, e.g. RECLAIM and Acid Rain Programs, and with wholesale electric market deregulation. The lessons learned from these experiences should be reflected in the criteria and principles considered by CEC, CPUC, and CARB.

Finally, AB 32 specifically requires the greenhouse gas emission reduction program to “direct public and private investments toward the most disadvantaged communities in California and provide [opportunities] for ...*community institutions*...”² The MAC principle listed as letter “a” covers cost reductions for low-income consumers, it does not also include the broader principle stated above. To the extent feasible, the CEC, CPUC and CARB should look for opportunities to promote investments by electric utilities in their communities, such as reduced electric rates for port interconnection for ships to transition from bunker fuel to electricity, cooperative opportunities to shift vehicle fleets to alternative fuels and cooperative efforts to streamline development and redevelopment using LEED standards.

3.2. Basic Options

Q2. Broadly speaking, should emission allowances be auctioned or allocated administratively, or some combination?

Answer: The LADWP recommends that emission allowances be administratively allocated to entities that have the regulatory obligation to comply with AB 32. In general, the LADWP supports administrative allocation as the least cost approach to reducing emissions under a cap and trade program. The LADWP opposes the auction of emission allowances for several reasons as noted below in greater detail.

² Health and Safety Code, Section 38565.

An auction of emission allowances does not meet the intent of AB 32 to “minimize costs and maximize benefits for California’s economy” and it is questionable whether AB 32 authorizes an auction that collects revenues that are then redistributed to unspecified entities – an approach that looks more like a carbon tax.

There has been much discussion related to a two-step distribution of allowances under the first-seller approach in which allowances are first allocated to retail service providers on behalf of their customers, then followed by an auction to all first-sellers. Other emissions trading programs do not add this unnecessary complexity to their regulatory programs, and the LADWP recommends that the ARB also disregard this approach. It is the LADWP’s position that the first seller approach is more susceptible to legal challenge and market manipulation, as noted in our filings on the first seller in this proceeding.³ While the LADWP supports a source-based GHG program, it is our conclusion that a first-seller approach is fundamentally flawed in that it is not a true source-based approach. As noted below, the LADWP does not believe AB 32 provides CARB with statutory authority to implement an auction, which makes a two-step allowance allocation also fundamentally flawed.

AB 32, in reading the plain language of the statutes, requires CARB to distribute, not auction the authorization to emit, i.e. the allowances. Nowhere does AB 32 authorize CARB to sell or auction allowances nor does AB 32 suggest that an auction shall be a part of the program. In fact, AB 32 requires CARB to distribute allowances in a manner that minimizes cost. An auction, by design, adds costs.

³ LADWP Opening Comments on First Seller, CPUC 06-04-009, August 6, 2007; LADWP Reply Comments on First Seller, CPUC 06-04-009, August 15, 2007.

Some of the specific concerns related to auctions and the distribution of allowances include the following:

- 1) As the MAC acknowledges, there is no experience with a 100 percent auction of allowances in previous emission trading programs. The Acid Rain program allocated almost all of its allowances for free and, as mentioned in Appendix B of the MAC report, was implemented quickly and on schedule and achieved near-100 percent compliance. In addition, electricity sector SO₂ emissions declined 35 percent from 1990 to 2005.
- 2) If a large percentage of allowances are auctioned, there is chance of market manipulation. For example, in the case of the Acid Rain auction this past year and in the RECLAIM program, financial entities' participation has been significant. Entities such as LADWP that need allowances to serve native load may bid into the auction, but may not be awarded sufficient allowances to meet its projected native load and may need to later purchase allowances at significantly higher prices from entities that are speculating (e.g. financial entities).
- 3) An auction is not needed to generate revenues to stimulate development of emerging technologies in the electric sector and may produce the opposite result.

Q3. If you recommend partial auctioning, what proportion should be auctioned? Should the percentage of auctioning change over time? If so, what factors should be used to design the transition toward more auctioning?

Answer: While the LADWP supports administrative allocation of allowances and opposes 100% auction, we previously stated in our comment letter to the MAC that limited auction of allowances similar to the Acid Rain program (10 percent or less of allowances) to accommodate growth is reasonable. However, more recently we have reviewed the statutory authority provided to CARB and have since concluded that such authority does not appear to have been provided in the plain language of the statute.

Q4. How should new market entrants, such as energy service providers, community choice aggregators, or (deliverer/first seller system only) new importers, obtain emission allowances, i.e., through auctioning, administrative allocation, or some combination?

Answer: The LADWP may respond to this question after the workshop in our reply comments.

3.3. Auctioning of Emission Allowances—General Questions

Q5. What are the important policy considerations in the design of an auction?

Answer: The LADWP may respond to this question after the workshop in our reply comments.

Q6. How often should emission allowances be auctioned? How does the timing and frequency of auctions relate to the determination of a mandatory compliance period, if at all?

Answer: The LADWP may respond to this question after the workshop in our reply comments.

Q7. How should market power concerns be addressed in auction design? If emission allowances are auctioned, how would the administrators of such a program ensure that all market participants are participating in the program and acting in good faith?

Answer: Market power, manipulation and/or hoarding are possible outcomes of a cap-and-trade program, and those actions can have rippling effects on the price of electricity. This is a serious concern for entities that have a regulatory compliance obligation in the case that allowances are not readily available if market power and/or manipulation occur. It is also a concern that has recently been studied in relation to the auction design for the northeastern states' Regional Greenhouse Gas Initiative (RGGI)

program⁴. An auction may make it more likely that manipulation will occur, however, without proper market controls, manipulation can also occur with a bilateral trading program.

For example, although South Coast Air Quality Management District RECLAIM program does not conduct an auction of allowances, the exercise of market power is also of great concern in relation to maintaining the stability of the program and allowance prices.⁵

The SCAQMD recently released a preliminary draft report evaluating the RECLAIM program and RECLAIM trading credit (RTC) price reporting. Participants include both RECLAIM facilities subject to compliance and non-RECLAIM facilities, i.e. investors. Theoretically, investors provide capital for installing air pollution control equipment that cost less than the market value of credits, and they can improve price competitiveness. In 2006, investors, not necessarily the entities subject the RECLAIM regulation, were involved in **more than 90 percent** of all infinite year block (IYB) trades, and in all except one of the IYB trades in the first half of 2007. It is possible that when those who are subject to RECLAIM requirements need to expand their operation to serve a growing customer base, those investors and/or traders who hold the surplus credits will stand to gain considerable profits from their purchases of these RTCs. In other words, RECLAIM facility operators have no substitute (i.e. offsets) for RTCs and may be at the mercy of other owners of surplus IYBs or RTCs in the short-term, such as what occurred during the 2000-2001 California energy crisis. In this example, the average

⁴ University of Virginia, Resources for the Future, California Institute of Technology, "Auction Design for Selling CO₂ Emission Allowances Under the Regional Greenhouse Gas Initiative," October 26, 2007. Available at www.rff.org or www.coopercenter.org/econ/rggi_final_report.pdf.

⁵ South Coast Air Quality Management District, "Evaluation and Review of the RECLAIM Program and Assessment of RTC Price Reporting" (Preliminary Draft), September 7, 2007.

price of RTCs for compliance year 2000, sharply increased to over \$45,000.00 per ton compared to the average price of \$4,284.00 per ton traded in the previous year, 1999.⁶

Investors are uniquely situated in that they do not have a regulatory compliance obligation under RECLAIM and therefore can choose to hold their IYBs or RTCs until the price rises to their level of acceptability. The SCAQMD report notes that total RECLAIM NOx emissions during compliance year 2005 were 9,556 tons, and that if total RECLAIM NOx emissions were to remain constant, the NOx RTC surplus in 2011 will only be 120 tons thereby creating much greater demand for the RTCs. Investors have been increasingly active in the RECLAIM trading market, particularly with IYB trades. IYB credits are important to support growth at new and existing facilities. The increased involvement of investors in the RECLAIM market poses a risk of adverse impacts on availability of RTCs and increased compliance costs for RECLAIM facilities.

To the extent a market-based system is developed, LADWP recommends that the CARB establish a market monitoring body to closely monitor transactions, develop a safety valve and identify potential unscrupulous activity.

Q8. What criteria should be used to designate the types of expenditures that could be made with auction revenues (including use to reduce end user rates), and the distribution of money within those categories?

Answer: The LADWP may respond to this question after the workshop in our reply comments.

Q9. What type of administrative structure should be used for the auction? Should the auction be run by the State or some other independent entity, such as the nonprofit organization being established by the Regional Greenhouse Gas Initiative?

⁶ South Coast Air Quality Management District, "White Paper on Stabilization of NOx Prices," January 11, 2001.

The LADWP may respond to this question after the workshop in our reply comments.

3.4. Electricity Sector

3.4.1. Administrative Allocation of Emission Allowances

Q10. If some or all allowances are allocated administratively, which of the above method or methods should be used for the initial allocations? If you prefer an option other than one of those listed above, describe your preferred method in detail. In addition to your recommendation, comment on the pros and cons of each method listed above, especially regarding the impact on market performance, prices, costs to customers, distributional consequences, and effect on new entrants.

Answer: The LADWP supports allocation based on current actual emissions.

A more traditional allocation methodology that is based on emissions has been a successful model in other programs, including Acid Rain and RECLAIM in which real reductions have been achieved over time. This approach places entities on the most level playing field possible.

Concerns regarding over-allocation can be remedied by making sure that allocations are based on actual emissions data from a current year as close to the start of compliance period as possible, rather than estimates that may under or over estimate entity-specific emissions. The AB 32 program will benefit from initiating mandatory reporting requirements on January 1, 2008 before the start of the compliance period (2012-2020). Actual emissions data will be available to determine allocations, providing consistency between allocations and annual compliance if the same methodologies are used for both.

Allocation based on current emissions with a declining annual cap is consistent

with the guiding design principles affirmed by the MAC. This approach reduces cost of the program to consumers and rate shock at the onset of compliance by providing a smooth transition in the early years. It also promotes investment in renewable energy and energy efficiency by providing a reward (i.e. surplus allowances) for reductions made beyond annual cap and a penalty for no action (i.e. allowances surrendered for compliance if reductions are not made).

The concept of “windfall profits” given to generators under an emissions-based approach, such as in the initial phase of the EU program, does not necessarily correlate to, nor would likely occur under AB 32. This is because electric generators in the EU program were over-allocated allowances because distribution was based on inaccurate emission estimates, and not real emissions data.

A hybrid allocation that starts with current emissions in 2012 and ends with a benchmark goal in 2020 is acceptable if certain conditions are included for retail providers. The LADWP can support a transition to an electric sector average benchmark as the 2020 emissions reduction goal. LADWP recognizes that this would result in an overall greater burden for those retail service providers that have high carbon footprints in comparison to those that are relatively cleaner. They would be required to reduce a greater percentage in comparison to retail service providers with low carbon footprints. However, if such approach is adopted, the LADWP believes that other accommodations are necessary, and must be included in order for such a methodology to be feasible. These include a reasonable glide path for high carbon retail service providers in the early years to provide an adequate planning horizon for

new investments in renewable generation and related transmission. This would be followed by a steeper curve in later years until reaching the required reduction levels in 2020.

Pure benchmarking is overly punitive to retail service providers with high-carbon footprints. LADWP does not support a pure benchmarking methodology due to the potential impacts on retail service providers that are dependent on high carboniferous resources and who must make significant changes to their resource mix to reduce emissions over time. Long-term investments in generation resources that were expected to provide economic, low cost electricity will likely become stranded and customers of those entities will not benefit from the full utilization of those resources.

A pure benchmark allocation would immediately cause significant shock to California's electric sector starting in 2012, as retail service providers that have emissions significantly higher than the benchmark would be net buyers of allowances at the onset, and therefore would face the dual burden of trying to invest in low carbon resources, while at the same time shifting scarce resources to the purchase of allowances to cover the shortfall.

Output-Based Allocation (i.e. Retail Sales) is not supported by LADWP and would cause significant harm to many retail service providers that would be net buyers of allowances throughout the entire compliance period, and are likely the same retail service providers that have the greatest emission reductions to contribute to AB 32. Further, output based allocation moves away from the overall program goal of developing a GHG inventory, determining reduction goals and meeting those goals.

The AB 32 program, and particularly any market-based compliance structure must be focused on emissions and emission reduction, not on retail sales or income. Shifting the program focus and designing allocations around retail sales creates a perverse incentive to increase sales and electric generation, and reduces energy efficiency, demand-side management and distributed generation. Such approach has no correlation to major emission sources or the potential for reducing emissions. This approach rewards retail service providers based on their size, and increases transaction costs with no real emission reductions. Emission allowances become available for purchase, not because an entity reduces emissions and thereby creates surplus allowances, but because an entity is overcompensated (i.e. over-allocated) in relation to their compliance burden. Utilities will be forced to purchase credits for the sake of purchasing credits, thereby shifting resources from the true program goals of reducing emissions. A retail based allocation formula has the most potential for market manipulation, creates regional divides, undercuts the policy of this program and unjustly enriches large utilities with legacy investments in nuclear and large hydroelectric systems. There is no rational environmental, economic or consumer-based policy to support a retail based allocation approach and such approach will not position California as a leader, but instead as an example of what should not be done in a climate change program.

Q11. Should the method for allocating emission allowances remain consistent from one year to the next, or should it change as the program is implemented?

Answer: The LADWP may respond to this question after the workshop in our reply comments.

Q12. If new market entrants receive emission allowance allocations, how would the proper level of allocations be determined for them?

Answer: LADWP supports the establishment of a new entrant reserve that provides administrative allocations to new entrants that meet certain criteria, such as meeting best practices for newly installed capacity within the boundaries of the trading program (i.e. in-state generation capacity).

Q13. If emission allowances are allocated based on load/sales, population, or other factors that change over time, how often should the allowance allocations be updated?

Answer: The LADWP does not support an allowance allocation based on load/sales, population, or other similar factors as noted above (see response to Q10). Allocations based on these factors does not provide the appropriate incentives for improved energy efficiency and demand side management, and instead encourages and rewards increased load by adjusting allocations to accommodate that new load irrespective of opportunities that might exist to reduce the impacts associated with population growth. As noted by the State Attorney General⁷ and the CEC⁸, land use planning by local governments and developers plays a critical role in helping the state to reduce energy consumption. Retail service providers should actively engage these

⁷ California Attorney General Edmund G. Brown Jr. reached a settlement with the County of San Bernardino that resolves a lawsuit, filed by the Attorney General in April, contesting the adequacy of San Bernardino's general plan under the California Environmental Quality Act. Brown contended that the plan, a blueprint for the physical development of land until year 2030, did not adequately analyze the effects of development on global warming nor did it identify feasible mitigation measures.
<http://ag.ca.gov/newsalerts/release.php?id=1453>

⁸ California Energy Commission, "The Role of Land Use in Meeting California's Energy and Climate Change Goals," Final Staff Report, August 2007. <http://www.energy.ca.gov/2007publications/CEC-600-2007-008/CEC-600-2007-008-SF.PDF>

other stakeholders through partnerships and other efforts to reduce consumption.

Allocation based on load/sales, population or similar factors would not encourage these types of efforts.

Q14. If emission allowances are allocated based on historical emissions (“grandfathering”) or benchmarking, what base year(s) should be used as the basis for those allocations?

Answer: The LADWP supports allocating allowances based on current emissions using a base period as close to the start of AB 32 compliance period as possible, using real emissions data and not estimates. This would minimize the potential for over-allocation to entities if an earlier period is used that reflects higher emissions levels.

Because electric sector emissions can and do fluctuate significantly from year to year depending on dry/wet hydro years (i.e. available hydroelectric generation) and weather occurrences (prolonged heat waves), it would be appropriate to consider a multi-year base period of 3-5 years, if possible, to normalize for these fluctuations.

For consistency, the LADWP encourages the CARB to use the same emissions reporting methodology for determining allocations as will be used for determining compliance with AB 32 emission caps. Emissions data from the ARB mandatory reporting regulations for 2008 will be reported in 2009 and certified in 2010. However, we recognize that data may not be available for 2009 or 2010 by the time initial allocations are determined.

At the same time, CARB should consider early actions to reduce emissions

through energy efficiency that may not be reflected in an allowance allocation, such as actions taken as early as 2000 when SB 1771 (Sher) was signed into law establishing the Climate Action Registry. At minimum, actions taken at least since the signing of AB 32 (September 2006) should received appropriate consideration and not be penalized by a reduced allocation. CARB can encourage regulated entities to take actions prior to 2012 if guidance is developed that provides entities with confidence that those actions will be recognized and they will not be penalized in the allocation process.

Q15. If emission allowances are allocated based initially on historical emissions (“grandfathering”), should the importance of historical emissions in the calculation of allowances be reduced in subsequent years as providers respond to the need to reduce GHGs? If so, how should this be accomplished? By 2020, should all allocations be independent of pre-2012 historical emissions?

Answer: Please see response to Q10 above regarding a hybrid allocation that starts with current emissions in 2012 and ends with a benchmark in 2020.

Q16. Should a two-track system be created, with different emission allowances for deliverers/first sellers or retail providers with legacy coal-fueled power plants or legacy coal contracts? What are the factors and trade-offs in making this decision? How would the two tracks be determined, e.g., using an historical system emissions factor as the cut-off? How should the allocations differ between the tracks, both initially and over time? What would be the market impact and cost consequences to consumers if a two-track method were used?

Answer: At this time the LADWP may support a hybrid allocation as noted in Q10 above if certain accommodations were made for retail providers that make greater reductions proportionally. The LADWP has not considered a two-track system and would welcome further discussion to determine if such approach achieves the emission reduction goals of AB 32, maintains the state’s electric grid reliability, and minimizes costs to California’s electricity consumers.

Q17. If emission allowances are allocated administratively to retail providers, should other adjustments be made to reflect a retail provider's unique circumstances? Comment on the following examples, and add others as appropriate:

- a. Climate zone weighting to account for higher energy use by customers in inclement climates, and**

Answer: An allowance allocation based on current emissions, using a base period that averages 3-5 years, should accommodate emissions associated with higher energy use by customers in inclement climates. To accommodate annual fluctuations, CARB may want to consider a 3-year compliance period, as opposed to an annual compliance period. Additional adjustments beyond that do not appear to be necessary.

- b. Increased emission allowances if there is a greater-than-average proportion of economically disadvantaged customers in a retail provider's area.**

Answer: The first guiding design principle affirmed by the MAC is to “[avoid] localized and disproportionate impacts on low-income and disadvantaged communities or communities already adversely impacted by air pollution.”⁹ An allowance allocation based on current emissions provides the least-cost approach to reducing emissions to meet the 2020 emission reduction goals. Distributing allowances based on any criteria other than emissions will increase compliance costs for the program overall. An allowance allocation methodology that transfers funds away from direct efforts to reduce emissions will unnecessarily penalize those customers that can least afford the volatility risk to consumer prices.

⁹ Market Advisory Committee, “Recommendations for Designing a Greenhouse Gas Cap-and-Trade System for California: Recommendations of the Market Advisory Committee to the California Air Resources Board,” June 30, 2007, page 11.

Q18. Should differing levels of regulatory mandates among retail providers (e.g., for renewable portfolio standards, energy efficiency investment, etc.) be taken into account in determining entity-specific emission allowance allocations going forward? For example, should emission allowance allocations be adjusted for retail providers with high historical investments in energy efficiency or renewables due to regulatory mandates? If those differential mandates persist in the future, should they continue to affect emission allowance allocations?

Answer: The LADWP may respond to this question after the workshop in our reply comments.

Q19. How often should the allowance allocation process occur? How far in advance of the compliance period?

Answer: The LADWP may respond to this question after the workshop in our reply comments.

Q20. What are the distributional consequences of your recommended emission allowance allocation approach? For example, how would your method affect customers of retail providers with widely differing average emission rates? Or differing rates of population growth?

Answer: LADWP also recognizes that new generation capacity will be needed to meet the state's load growth. We support the establishment of a new entrant allocation that would serve as a reserve to accommodate new entrants and load growth. Please see response to Q3 and Q4.

3.4.2. Emission Allowances with a Deliverer/First Seller Point of Regulation

Q21. Would a deliverer/first seller point of regulation necessitate auctioning of emission allowances to the deliverers/first sellers?

Answer:

For the reasons stated earlier, as a policy matter, an auction of allowances raises a number of issues and would not be LADWP's preferred approach. To the extent that an auction would result in an appropriation of funds, there would appear to be an argument that AB 32 does not authorize any such appropriation. See *California Ass'n for Safety Education v. Brown*, 30 Cal. App. 4th 1264, 1282 (1994) (clear statement of legislative intent required to make an appropriation).

Q22. Are there interstate commerce concerns if auction proceeds are obtained from all deliverers/first sellers and spent solely for the benefit of California ratepayers? If there are legal considerations, include a detailed analysis and appropriate legal citations.

Answer: As LADWP pointed out in earlier comments during this proceeding, the first seller approach raises interstate commerce concerns regardless of whether there is an auction of allowances or whether auction proceeds are spent to benefit California ratepayers. States generally "may not attach restrictions to exports or imports in order to control commerce in other States." *C & A Carbone, Inc. v. Clarkstown*, 511 U.S. 383, 393 (1994) (citing *Baldwin v. G. A. F. Seelig, Inc.*, 294 U.S. 511 (1935)); *Healy v. Beer Inst.*, 491 U.S. 324, 336 (1989). A first seller approach does just that – regardless of how the auction proceeds are used – because requiring allowances attaches a condition to importation (of power generated outside California) for the purpose of controlling commerce in other states (e.g., controlling the method of generation and the amount of emission in the states).

Moreover, a state generally cannot neutralize competitive advantages of other states' products. *Hunt v. Washington State Apple Advertising Comm'n*, 432 U.S. 333, 351 (1977) (invalidating statute because it "has the effect of stripping away from the

Washington apple industry the competitive and economic advantages it has earned”); *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 194 (1994) (invalidating tariff-like scheme because it neutralized advantage held by lower-cost milk producers in other states). Thus, a state, having adopted a law that increases its own producers’ costs, cannot neutralize the resulting cost advantage of out-of-state imports by requiring them to follow the same rule. See *Baldwin v. G. A. F. Seelig, Inc.*, 294 U.S. 511 (1935) (holding that New York, having permissibly set a floor on milk prices charged by New York farmers, could not require out-of-state milk farmers to adhere to the same price to “keep the system unimpaired by competition from afar.” (citation omitted)). To the extent that California requires out-of-state producers to obtain emissions allowances as a way of neutralizing the cost disadvantage posed by in-state emissions limits, interstate commerce concerns arise. These concerns exist regardless of how any potential auction proceeds are spent.

In addition to the underlying legal issues associated with a first seller approach, any auction program could create additional opportunities for legal challenges. To a certain extent, the bases of potential legal challenges will depend on how any auction proceeds are spent. As a general rule, regulations that disadvantage out-of-state businesses, on their face or in practical effect, are *per se* invalid unless the state can prove that it has no other way to advance a legitimate local interest. *C & A Carbone, Inc.*, 511 U.S. at 392. Thus, even if the auction itself treats in-state and out-of-state producers alike, interstate commerce concerns can arise if California directly or indirectly mitigates the effect for in-state producers via the spending mechanism associated with any auction. See, e.g., *New Energy Co. v. Limbach*, 486 U.S. 269

(1988) (evenhanded tax, rebated only to in-state payers, violated Commerce Clause); *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994). *West Lynn Creamery* illustrates this principle. There, state law required both in-state and out-of-state milk retailers and dealers to pay fees for selling milk in the state. The tax itself did not discriminate, but the revenues were distributed only to Massachusetts dairy farmers. 512 U.S. at 188. The Court struck the law down under the Commerce Clause because the overall system neutralized out-of-state producers' cost advantage. 512 U.S. at 196. Though the tax was paid at one point in the distribution chain (dealers and retailers) and the subsidy was paid at a different point (farmers), that fact did not save the system. "Imposition of a differential burden on any part of the stream of commerce – from wholesaler to retailer to consumer – is invalid, because a burden placed at any point will result in a disadvantage to the out-of-state producer." *Id.* at 202-03 (citing cases). Thus, a measure is invalid if it gives an economic benefit to *any* in-state interest in the chain of distribution, if the practical effect is to disadvantage out-of-state producers.

Thus, even using the proceeds to subsidize power generation in California to benefit California ratepayers could implicate these issues. This type of spending could be viewed as charging all generators/deliverers a fee but distributing it only to the in-state competitors, a potential violation of *West Lynn*. Distributing the auction proceeds to other recipients elsewhere in the chain of power distribution, even ratepayers, could also violate *West Lynn* if the practical effect were to favor California-generated power or nullify any cost advantage of out-of-state power.

Q23. If you believe 100% auctioning to deliverers/first sellers is not required, explain how emission allowances would be allocated to deliverers/first sellers. In

doing so, answer the following:

- a. How would the amount of emission allowances given to deliverers/first sellers be determined during any particular compliance period?
- b. How would importers that are marketers be treated, e.g., would they receive emission allowance allocations or be required to purchase all their needed emission allowances through auctions? If allocated, using what method?
- c. How would electric service providers be treated?
- d. How would new deliverers/first sellers obtain emission allowances?
- e. Would zero-carbon generators receive emission allowance allocations?
- f. What would be the impact on market performance, prices, and costs to customers of allocating emission allowances to deliverers/first sellers?
- g. What would be the likelihood of windfall profits if some or all emission allowances are allocated to deliverers/first sellers?
- h. How could such a system prevent windfall profits?

Answer: Please see response to Q21 and Q22. First seller would require 100% auctioning, but AB 32 does not appear to provide statutory authority for auctioning.

Regarding Q23(e), issuing carbon emission allowances (whether under first-seller or load-based) to zero-carbon sources would essentially double-count the environmental benefits and would provide no emissions reduction benefit toward meeting the goals of AB 32.

An allowance, as defined under AB 32, is “an authorization to emit, during a specified year, up to one ton of carbon dioxide equivalent.”¹⁰ A “greenhouse gas emission source” or “source” means:

“any source, or category of sources, of greenhouse gas emissions whose emissions are at a level of significance, as determined by the state board, that its participation in the program established under this division will enable the state board to effectively reduce greenhouse gas emissions and monitor compliance with the statewide greenhouse gas emissions limit.”¹¹

¹⁰ Health and Safety Code, Section 38505(a).

¹¹ Health and Safety Code, Section 38505(i).

AB 32 requires that the CARB to:

“[design] the regulations, including distribution of emissions allowances where appropriate, in a manner that is equitable, seeks to minimize costs and maximize the total benefits to California, and encourages early action to reduce greenhouse gas emissions.”¹²

Based on this, zero-carbon generation does not qualify to receive emission allowances, as it does not meet the definition of a source of significant emissions and would never provide an opportunity for emission reductions, as it is already zero-carbon. Zero-carbon generation resources are already acknowledged in a utility’s resource mix and reduce corresponding compliance burden and cost, under either a source-based or load-based program. Under a load-based program that considers energy consumption, zero-carbon generation (i.e. nuclear, hydro, or renewables) directly reduces a retail service provider’s carbon intensity as measured in pounds/MWh. Under a source-based program, zero carbon generation sources would not be subject emission reduction program and no opportunity would exist to reduce emissions from such sources.

Q24. With a deliverer/first seller point of regulation, should administrative allocations of emission allowances be made to retail providers for subsequent auctioning to deliverers/first sellers? If so, using what allocation method? Refer to your answers in Section 3.4.1., as appropriate.

Answer: The LADWP does not support a first-seller approach. Please see LADWP’s filings in this proceeding for August 5, 2007 and August 15, 2007.

The LADWP does not support a 2-step approach to allowance allocations as described above. Proceeds of an auction under first seller that are returned to retail

¹² Health and Safety Code, Section 38562(b)(1).

service providers whether in advance of or after an auction may pose concerns under the dormant Commerce Clause. See response to Q22 above.

Q25. If you recommend allocation of emission allowances to retail providers followed by an auction to deliverers/first sellers, how would such an auction be administered? What kinds of issues would such a system raise? What would be the impact on market performance, prices, and costs to customers?

Answer: Please see response to Q22 above.

3.5. Natural Gas Sector

Q26. Answer each of the questions in Section 3.4.1. except Q16, but for the natural gas sector and with reference to natural gas distribution companies (investor- or publicly-owned), interstate pipeline companies, or natural gas storage companies as appropriate. Explain if your answer differs among these types of natural gas entities. Explain any differences between your answers for the electricity sector and the natural gas sector.

Answer:

The LADWP may respond to this question after the workshop in our reply comments.

Q27. Are there any other factors unique to the natural gas sector that have not been captured in the questions above? If so, describe the issues and your recommendations.

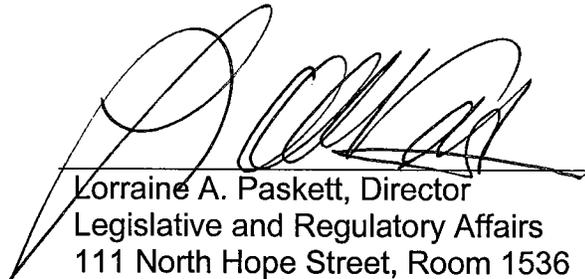
Answer:

The LADWP may respond to this question after the workshop in our reply comments.

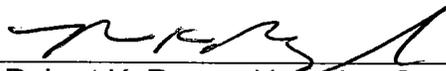
IV. CONCLUSION

The LADWP appreciates the opportunity to provide these opening comments to the CPUC and CEC for your consideration.

Dated: October 31, 2007 Respectfully submitted,



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CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of the attached:

OPENING COMMENTS OF THE LOS ANGELES DEPARTMENT OF WATER AND POWER ON THE ADMINISTRATIVE LAW JUDGES' RULING REQUESTING COMMENTS ON ALLOWANCE ALLOCATION ISSUES

on all known parties to R.06-04-009 by transmitting an e-mail message with the document attached to each party named in the official service list, updated October 29, 2007. See attached service list. I served a copy of the document on those without e-mail addresses by mailing the document by first-class mail addressed as follows:

See attached service list.

I also caused courtesy copies to be delivered as follows:

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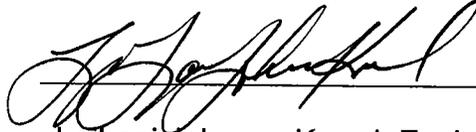
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Executed this 31st day of October 2007, at Los Angeles, California.

A handwritten signature in black ink, appearing to read 'Leilani Johnson Kowal', written over a horizontal line.

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