



BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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Order Instituting Rulemaking to Consider Refinements to and Further Development of the Commission's Resource Adequacy Requirements Program.

Rulemaking 05-12-013
(Filed December 15, 2005)

**REPLY COMMENTS OF THE BILATERAL TRADING GROUP
ON STAFF REPORT ON PHASE 2/TRACK 2 ISSUES**

On Behalf of
THE BILATERAL TRADING GROUP

KAREN PAULL
Attorney for the Division of Ratepayer Advocates
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102
Phone No.: (415) 703-2630
E-mail: KPP@cpuc.ca.gov

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I. INTRODUCTION

Pursuant to Rule 14.3 of the Commission's Rules of Practice and Procedure, and in accordance with the Administrative Law Judge's Ruling of February 4, 2008, the Bilateral Trading Group (BTG)¹ submits the following reply comments on the Staff Recommendations on Capacity Market Structure (Staff Report).²

The comments show that there is broad support for a bilateral framework for Resource Adequacy (RA). In these reply comments, the BTG briefly comments on the extent of this support and summarizes the principal reasons for it. We then address comments in favor of a Centralized Capacity Market (CCM), chiefly those made by the Centralized Forward Capacity Market Advocates (CFCMA).

¹ The BTG is an *ad hoc* group of consumer organizations and retail and wholesale market participants that includes: APS Energy Services, the California Large Energy Consumers Association (CLECA), the California Manufacturers and Technology Association (CMTA), the City and County of San Francisco (CCSF), Coral Power, LLC, the Division of Ratepayer Advocates (DRA), the Energy Users Forum, J. Aron & Company, The Utility Reform Network (TURN), and Strategic Energy, LLC. For purposes of these comments, the BTG signatories do not include J. Aron & and Coral Power.

² Pursuant to the Commission's Rules of Practice and Procedure, Rule 1.8, I hereby certify that I am authorized to make this filing on behalf of the members of the BTG, with the exception of J. Aron and Coral Power, LLC.

II. Comments of Parties Supporting Bilateral RA Program

A. There is broad support for a Resource Adequacy framework based on the current bilateral capacity market

BTG is pleased that many parties in this proceeding support the current Bilateral RA Program with some modifications. In addition to BTG, these parties include Pacific Gas& Electric (PG&E), California Municipal Utilities Association (CMUA), Alliance for Retail Energy Markets (AREM), and the Coalition of California Utility Employees (CUE).

B. Parties support Bilateral RA because it best serves important State policies

PG&E, for example, believes that Staff’s Recommendation 2 (Modified Bilateral RA) best meets three critical objectives of the RA Program: reliability, customer cost, and consistency with State and Commission environmental and energy policy priorities.³ These are considerations of critical importance for the State and should be central to any decision on modifying the current RA system.

BTG agrees with PG&E’s comment that “The centralized market designs proposed by some parties would completely ignore the Commission’s loading order preferences, procuring generic capacity of the lowest price regardless of the impacts of that capacity on commission policy priorities.”⁴ We agree with PG&E that “the centralized approach creates high risks in return for the uncertain promise of more efficient economic results over time.”⁵

PG&E’s comments provide valuable information on the performance of New England FCM and PJM’s Reliability Pricing Model (RPM).⁶ As stated by PG&E,

³ PG&E’s proposed modifications to the present RA Program include the addition of longer-term forward bilateral requirements, however, which BTG does not support.

⁴ PG&E Comments on Staff Report, p. 6.

⁵ PG&E Comments on Staff Report, p. 7.

⁶ PG&E Comments on Staff Report, p. 19-20.

“Both markets have held successful preliminary forward auctions that procured at least limited amounts of promised new generation. It is unclear whether this new generation will be successfully and timely built, and whether these markets can lead to cost-effective new resource development on a sustained basis.”⁷

PG&E’s information, together with the supplemental information on the Eastern centralized markets provided in BTG’s Opening Comments,⁸ regarding state commission and customer complaints regarding these markets, and the efforts of a major utility to leave PJM due to the high cost of capacity in the PJM market, cast serious doubt on the cost-effectiveness of these markets. The net capacity payment increase for Duquesne Light Co. was approximately \$100 million a year, leading Duquesne to petition to leave PJM.⁹ Duquesne continues to struggle with PJM to avoid what the utility considers to be an unreasonably high capacity charge that is being imposed as a condition of leaving PJM.¹⁰

As discussed in the August 2007 workshops, the BTG has serious concerns over the increased costs for California customers that would result from switching the current RA program to a centralized capacity market, which we estimate to be approximately \$1 billion per year.¹¹

BTG strongly agrees with PG&E’s conclusion that, reliability, the most important of the criteria to be considered, can only be assured through one of the proposals currently before the Commission: The Bilateral Market. Customer cost, and consistency with the full range of the Commission’s policy objectives for California’s energy system, weighs equally in favor of the Bilateral Market.¹²

⁷ PG&E Comments on Staff Report, p. 16.

⁸ BTG Comments on Staff Report, pp. 6-10.

⁹ PG&E Comments on Staff Report, p. 20.

¹⁰ “Duquesne Light CEO Demands PJM Offer ‘Economic’ Answer on RPM,” Restructuring Today, March 12, 2008.

¹¹ See also BTG Pre-Workshop Comments (May 18, 2007) pp. 11-16.

¹² PG&E Comments on Staff Report, p. 24.

CMUA also supports bilateral transactions between willing parties, rather than forced, mandatory markets with artificial price constructs and complex rules.¹³ As CMUA's comments aptly observe that although the analysis in the Staff Report appears to support Bilateral RA, Staff's recommendations do not fully reflect this analysis.¹⁴ BTG's Opening Comments provided a table summarizing Staff's analysis of the Market Design Proposals, which illustrates that the bilateral RA proposals are superior to centralized capacity proposals in satisfying Staff's metrics.¹⁵

BTG strongly agrees with CMUA's observations that,

[W]ith considerable changes and challenges facing the electric utility industry at this time, it would be unwise to fashion a wholly new RA construct with virtually unknown impacts on the industry and consumers. CMUA believes the competing recommendations in the Staff Report are evidence that no compelling reason has been found to change course. As such, CMUA supports emphasis on Bilateral RA mechanisms, and continued refinement of the current RA programs.¹⁶

BTG agrees with CMUA that the Commission should take pride in its achievements on RA, which have resulted in a robust RA program for California, leading CMUA to question why the Commission "would consider moving away so quickly from what must be considered a highly successful policy initiative."¹⁷

The Coalition of California Utility Employees (CUE) in its Comments on Staff Report states that:

To now step away from RA structure and adopt a Centralized Capacity Market risks once again transferring billions of dollars from the pockets of consumers to the pockets of generators, once again no assurance of reliable electricity supplies, and once again having a resource mix that rewards those who make the least effort to develop new renewable resources. And to make matters worse, a Centralized Capacity Market with its all-but-

¹³ CMUA Comments on Staff Report, p. 2.

¹⁴ CMUS Comments on Staff Report, p. 2.

¹⁵ BTG Comments on Staff Report, p. 18.

¹⁶ CMUA Comments on Staff Report, p. 2.

¹⁷ CMUA Comments on Staff Report, p. 3.

inevitable shift to FERC jurisdiction would make it difficult if not impossible for CPUC to control the all-important implementation details.”¹⁸

BTG agrees with CUE’s comment that this is not the time to change the course on current RA and chase the illusion that a Centralized Capacity Market will simultaneously preserve reliability, minimize costs and achieve environmental goals.

CUE correctly states that,

[W]hile the Energy Division has declined to take a position on the ultimate policy choices before the Commission, its analysis clearly shows that Bilateral approaches are superior to Centralized Capacity Market approaches. The Bilateral Trading Group approach, which closely follows current practice, meets all seven metrics. On the key metric of providing least cost electrical service, the BTG approach allows payments to existing generation to be lower than payments to new generation, and thus lower than payments would be under any of the Centralized Capacity Market approaches. This must be recognized as a major virtue of this approach.¹⁹

CUE’s comments state that, “Higher payments to generators under a Centralized Capacity Market approach explains why most generators favor a centralized market and most consumers oppose it.”²⁰

CUE also points out that the Staff’s analysis of CCM proposals shows that they generally fail to satisfy the seven metrics. On the implementation question, CUE states that, CCMs face huge unknowns with regard to the time required for implementation and how they would deal with environmentally preferred resources.²¹

BTG’s analysis shows the same results, and we strongly recommend that the Commission stay the course with Bilateral RA.

¹⁸ CUE Comments on Staff Report, p. 2.

¹⁹ CUE Comments on Staff Report, p. 6.

²⁰ CUE Comments on Staff Report, p. 7.

²¹ CUE Comments on Staff Report, pp. 8-9.

CUE concludes: “The metrics proposed by Staff are, for the most part, the right measures. Using these measures, the Bilateral approaches are far superior”²² and that “the current RA/RPS system isn’t broke – don’t try to fix it by throwing it out.”²³

The Alliance for Retail Energy Markets (AReM) has “grave reservations” regarding the CCM model proposed by Staff in its recommendation No 1, the “Modified Centralized Market.” AReM supports current RA Bilateral Program that has a once-year-ahead RA showing. However, AReM strongly disagrees with the Staff’s recommendation to study the question of imposing a multi-year RA requirement (Staff Recommendation No 2). AReM states that “This is a fundamental market design issue that should not be left to a later decision.”²⁴

C. Backstop mechanism under the Bilateral framework

BTG supports the current one-year-ahead Bilateral RA Program and backstop provided through the Cost Allocation Mechanism (CAM). Under this program, the need for new capacity required for reliability is determined through the LTPP proceeding. The IOUs meet their respective responsibilities for this need by issuing RFOs, selecting counter-parties, and signing the contracts for new generation, subject to the CAM group and Independent Evaluator reviews, and approval by the Commission. BTG believes that the current backstop methodology is a reasonable approach, since the IOUs serve around 90% of the retail load currently. If Direct Access is reopened, then the role of the IOUs in procurement of new generation to meet system reliability needs and recover costs through the CAM can be reviewed. Further, as both BTG and AReM have previously explained, an ability for LSEs to opt out of the CAM would encourage LSEs to make their own arrangements to procure new generation, which should tend to reduce the need for backstop procurement in the first instance.

²² CUE Comments on Staff Report, p. 9.

²³ CUE Comments on Staff Report, p. 9.

²⁴ AReM Comments on Staff Report, p. 3.

Moreover, as the BTG has described, there are alternative approaches for backstop procurement that preserve state jurisdiction. The California Power Authority could be revived to perform this function, or a special purpose entity could be established that would have the backstop responsibility, which would include issuing an RFO for new reliability resources, negotiating with counter-parties, evaluating proposals, and signing necessary agreements. These activities would be subject to CAM group and Independent Evaluator reviews, and the resulting contracts would be submitted to CPUC for approval. Cost allocation would be applied to the net capacity cost of the resources, after energy and other services are auctioned. The cost allocation could be based on forecasted load or actual load.

D. Proposed improvements to current Bilateral market

Meanwhile, as several parties noted in their comments, there are near-term changes to the current RA Program that almost all parties to this proceeding have agreed upon. These include:

1. Establishment of a standard RA Contract and modification of CAISO tariff to reflect such standard.
2. Establishment of an Electronic Bulletin Board (EBB) to provide market liquidity and price transparency.
3. Establishment of registration and tagging system for qualifying RA capacity.
4. Automation of the RA compliance filing process by developing an electronic portal or other computerized methods.²⁵

These measures will improve bilateral markets by increasing transparency and liquidity. BTG urges the Commission to adopt them.

²⁵ AReM Comments in R.08-01-025 (February 7, 2008) pp. 7-8.

III. Comments of Parties Supporting Centralized Capacity Market

A. Parties supporting a CCM are all generation owners or their affiliates

Parties supporting a CCM include the CFCMA (SCE, SDG&E plus 3 generation owners), Mirant, Constellation, Calpine, Sempra Global and the Independent Energy Producers. As noted previously, the supporters of a CCM are all generation owners, affiliates of entities owning generation in California, or trade organization of generators.

There is no doubt that the major beneficiaries of the establishment of a CCM will be the owners of generation, especially existing generators. The transfer of wealth from customers to generators is estimated at over \$1 billion dollars a year, especially in the early years of the market.²⁶ As developments in the New York capacity market illustrate, this wealth transfer would not ensure that adequate generation gets built.²⁷

B. There is limited experience with the Eastern CCMs on which the CFCMA proposal is based

CFCMA's comments consist of a 53 page report and 13 page appendix. The CFCMA claims that its California Forward Capacity Market (CFCM) proposal uses the best practices found in the Eastern U.S. capacity markets, and is best among the proposals in satisfying Staff's evaluation criteria.²⁸

²⁶ CFCMA asserts, at page 6 of its comments, that the "claimed savings of the BTG proposal is achieved *solely* through a perceived ability to price-discriminate between new and existing resources..." (emphasis added). This is incorrect. As set forth in the BTG's May 18 2007 comments, at pages 11-17, the \$1 billion estimate of increased costs is composed of two relatively equal but distinct parts – increased payments to existing units when compared with the current RA program, and *systematic over-compensation* of low heat rate units, such as new combined cycle plants, under a CCM.

²⁷ See *Order Initiating Electricity Reliability and Infrastructure Planning* (Case 07-E-1507 and 06-M-1017 (December 24, 2007), discussed in the BTG's February 29, 2008 Opening Comments at p. 10; see also Motion To Intervene and Comments of the City of New York filed on July 17, 2007 in *New York Independent System Operator, Inc.*, FERC Docket No. ER03-647-009 (asserting that modifications to New York ISO's ICAP market had not resolved problems of economic withholding and rising capacity prices affecting New York City).

²⁸ CFCMA Comments on Staff Report, p. 6.

As stated in previous BTG comments in this proceeding, there is limited experience with the eastern U.S. capacity markets, limited amounts of promised new generation in forward auctions, and no assurance that this new generation will be successfully and timely built and that these markets can lead to cost-effective new resource development on a sustained basis. Furthermore, all detailed reviews of Staff's evaluation metrics show that the Bilateral approaches are superior to CCM approaches.

Therefore, the claim by CFCMA that the CFCM is best among the proposals in satisfying Staff's evaluation must be rejected. Further, the assertion that the CFCM proposal reflects the best practices found in the Eastern U.S. capacity markets does not provide any assurance that the reliability needs of California's electricity system will be satisfied at least cost, or that the environmental objectives set by California's policy makers will be achieved. It is increasingly questionable whether the existing CCMs are achieving their own stated objectives.

C. It is by no means clear that the Eastern CCMs are a "success"

CFCMA claims that the capacity auctions in the NE ISO and PJM have been successful. For example, it states that each of PJM's four auctions "has been successful in securing sufficient resources for the system, and each market monitor's report has declared that the results were competitive. These auctions have secured 4,365 MW of new capacity, including 1,373 MW net increase in demand resource capacity, and prices in the most recent auction were \$5.30/kW-month."²⁹

However, this is not the entire story. CFCMA has not addressed the details of the ISO-NE and PJM auctions, in terms of mix of resources (more demand response than generation for ISO-NE in the near term) or the likelihood that resources will actually come on line as bid. More detailed scrutiny of the results is needed, but a review of the data available to date shows that the results are not quite so rosy, particularly in procurement of *new* generation.

²⁹ CFCMA Comments on Staff Report, p. 37 (footnotes omitted).

The results of PJM's RPM auctions show that, of the 10,051 MW of incremental capacity available to PJM as a result of its four auctions since 2006/2007, the latest of which was for the 2010/2011 time frame, reduction in exports and an increase in imports represented 2,987 MW, withdrawn deactivation requests and postponed or cancelled retirements represented 3,228 MW, and demand response represented 1,373 MW. Thus, the total amount of new generation represents less than a quarter of the total "net increase in installed capacity".³⁰

The NE ISO has had only one FCM auction, for the period 2010/2011, and it was run last month. There is no detailed information about the results available, only that the auction results in 1,813 MW of new supply, of which 1,188 MW were new demand-side projects and 626 MW were "new supply". It was not possible to determine if any of this new supply represents withdrawn deactivation requests or postponed or cancelled retirements.

From the results to date, it is simply too soon to claim that either RPM or FCM has led to significant increases in *new* generation capacity. As PG&E stated, "Both markets have held successful preliminary forward auctions that procured at least limited amounts of promised new generation. It is unclear whether this new generation will be successfully and timely built, and whether these markets can lead to cost-effective new resource development on a sustained basis."³¹

As noted in the Staff Report, various problems in the Eastern CCMs led to changes in the market designs.³² But problems persist, and more market design changes are now being considered. Recently FERC announced that it is convening a technical conference on May 7, 2008 to consider proposals for major design changes to the New England and PJM capacity markets. These proposals were submitted by two associations of industrial customers in FERC's docket on *Wholesale Competition in Regions With*

³⁰ "2010/2011 RPM Base Residual Auction Results" (PJM, Feb. 1, 2008).

³¹ PG&E Comments on Staff Report, p. 16.

³² Staff Report, pp. 27-36.

Organized Electric Markets (RM07-19-000 and AD07-7-000). Of particular interest for purposes of this Commission's decision on resource adequacy is the American Forest & Paper Association's analysis of "the significant economic forces that are currently hindering long term contracting."³³ This organization proposed a significant market modification to address this problem, among others. This proposal will be discussed at the technical conference on May 7, 2008.³⁴

D. CFCMA incorrectly presumes that the Commission has determined that Bilateral RA is not working

CFCMA asserts that a "fundamental starting point for this proceeding is that California requires a better RA mechanism than it currently has."³⁵ BTG is not aware of any such statement by this Commission. The governing statute, Public Utilities Code section 380, *requires* the Commission to establish a resource adequacy program that meets specified objectives, but merely *permits* the Commission to "consider a centralized resource adequacy mechanism among other options" for meeting these objectives.³⁶ A better characterization of the genesis of this proceeding would be that this Commission finally acquiesced to the repeated demands of the generation owner parties that it *consider* a centralized market approach to RA procurement. The generators have been advancing this argument for several years now, and the fact that they have been given a forum to make their case does NOT mean that the Commission has already decided that they are right.

E. CFCMA does not speak for consumers!

CFCMA states that it "...strongly believes that it is in the interest of consumers for the Commission to continue in the direction of transitioning to competitive markets as

³³ See Comments of American Forest & Paper Association filed September 14, 2007 in FERC's *Wholesale Competition* docket.

³⁴ FERC Notice of Technical Conference in *Capacity Markets in Regions With Organized Electrical Markets*, Docket No. AD08-4-000 (February 29, 2008).

³⁵ CFCMA Comments on Staff Report, p. 42.

³⁶ Public Utilities Code § 380 (a)-(h); (i).

soon as practical and to adopt the competitive approach to achieving resources adequacy laid out in the CFCMA proposal.”³⁷ It is interesting that not a single party representing consumer interests in this proceeding is recommending a Centralized Capacity Market.

The statement that a competitive market can only be achieved via the centralized capacity auction proposed by CFCMA is false. Bilateral transactions are the basis for virtually all of the markets in our competitive economy. In the U.S., there are only a few markets, such as treasury bonds, that rely on a centralized auction process. The vast majority of commercial transactions are between willing parties using bilateral transactions to buy and sell everything in the market. Notably, the natural gas market, another recently deregulated industry, relies primarily on bilateral transactions between willing buyers and sellers, informed by privately published commodity price indices and pipeline bulletin boards for posting of capacity transactions.

In fact, the experience of California with a centralized energy market in the form of the Power Exchange did not survive more than a few years. On the other hand, wholesale energy and capacity transactions through the bilateral market have been going on for many years. Buyers have been able to purchase power in the bilateral market and through RFO processes to meet their needs at reasonable prices. The idea that the only way to get a competitive market is through a centralized market is misguided. Furthermore, the proposed CFCM is not based on a competitive framework. It is a designed market with many rules and procedures, such as an administratively-determined demand curve, cap and floor for prices, and many other rules. The CFCM is a micro-managed auction, and BTG believes that it is the CFCM that is not compatible with a true competitive market.

F. A Centralized Capacity Market is not essential to competitive markets

CFCMA asserts that in the Commission’s current Direct Access rulemaking proceeding, the Commission has already decided to embrace competition and is taking

³⁷ CFCMA Comments on Staff Report, p. 8.

steps to deliver the benefits of competition to retail consumers.³⁸ CFCMA then claims that if its proposal for a CCM is not approved, the Commission must be reluctant to relinquish its “central planning authority,” the exercise of which will assertedly preclude the development of competitive retail markets and add significant regulatory intervention and risk. BTG strongly disagrees with the CFCMA’s conclusion that the only way to reach a competitive market is through the establishment of a CCM. Furthermore, what is at stake here is not “state central planning authority” versus markets, as CFCMA suggests. What is at stake is whether the State will adopt an approach to resource adequacy that preserves its long-term ability to make resource planning decisions (its jurisdiction over resource adequacy, if you will) – or an approach that deprives it of the ability to make and implement those decisions. If the state retains this authority, it retains the ability to determine how best to achieve state goals, including the appropriate role for markets.

The CFCMA accuses the Staff Report of “a deep skepticism of the ability of markets to work at all and a preference for administrative solutions.”³⁹ In truth, the reality is precisely the opposite – it is CFCMA that appears to harbor a deep suspicion of the bilateral markets that power the great bulk of the American economy, and strongly prefers a centrally administered, auction-based system.

CFCMA states that “All LSEs including small Direct Access providers, receive benefits from a unified capacity market that neither the MCM (Staff’s option 1) nor the BTG options can offer.”⁴⁰ Despite this claim, it is interesting to note that no LSE or ESP that is not affiliated with a generation owner supports CFCMA’s proposal. Are we to believe that NRG, FPL and Reliant know what is good for consumers, rather than consumer representatives such as CLECA, CMTA TURN, and DRA, all members of BTG? Wouldn’t buyers of power be better off negotiating their own bilateral deals rather

³⁸ CFCMA Comments on Staff Report, p. 13.

³⁹ CFCMA Comments on Staff Report, p. 38.

⁴⁰ CFCMA Comments on Staff Report, p. 16.

than being subject to the uncertain outcome of an administratively-run CCM under FERC regulation?

CFCMA claims that its proposal is a market-based solution, and that what it terms “price discrimination” (a reference to BTG’s proposal to pay existing generation and new generation different prices) cannot persist, since no rational seller will offer capacity at a discount to market. Therefore, CFCMA asserts, in transparent markets there will be a common price for capacity.⁴¹ Yet, the CFCMA proposal recommends that the offer cap for new resources be set at 2.0 CONE, while offers and payments to existing resources will be capped at 1.4 CONE.⁴² Is this not a price discrimination against the existing resources?

A review of CFCMA’s comments on Staff Option 1 (MCM) reveals that CFCMA’s main goal is to increase the revenue of generators. For example, CFCMA suggests setting the price cap for new resources at 2.0 CONE, compared with 1.5 CONE in the MCM Model; CFCMA recommends a price floor set at 0.6 CONE, whereas there is no floor under Staff’s MCM model; and CFCMA recommends calculating the deduction for Peak Energy Rents (PER) on *ex-ante* basis, whereas the Staff recommends an *ex-post* PER deduction in the MCM.⁴³ Although CFCMA asserts in its comments that a “closer analysis” shows that the modification made by Staff in the MCM model would “undermine the legal and economic foundations of the design” of the CFCM,⁴⁴ It is unclear what type of analysis CFCMA used to reach this conclusion. One thing is certain: CFCMA, by setting higher price cap and a price floor, and by asking for an *ex-ante* PER, wants to assure higher profit levels for generator owners.

⁴¹ CFCMA Comments on Staff Report, p. 19.

⁴² CFCMA Comments on Staff Report, p. 20.

⁴³ Under the *ex ante* PER, peak energy rent earnings during periods of high prices are estimated in advance of the energy auction, and may not be entirely accurate, and often are underestimated; the BTG supports the *ex post* PER deduction, as it ensures that all high profits are returned to customers as it is based on actual profits determined after the auction, or *ex post*.

⁴⁴ CFCMA Comments on Staff Report, p. 21.

CFCMA makes the argument that its proposed CFCM adheres to least-cost principles, despite Staff’s position that, with CFCM, there is significant exposure to lack of adherence to least-cost principles.⁴⁵ CFCMA believes that prior experience, expert statements, theory, and impact on incentives support its belief that an auction paying a “uniform price” is better than “paid as bid,” which is the basis for the BTG and one of PG&E’s two proposals.⁴⁶ CFCMA claims that in a “paid as bid” design, resource owners will not offer their resources at their economic costs; instead, that offer price will be guided by their best guess at the market-clearing price. CFCMA further claims that the Revenue Equivalence Theorem⁴⁷ and prior experience strongly suggest that the CFCM, with everyone being paid the same price, rather than their offer price, should not result in higher costs, because the bidding strategy is simpler, and perhaps may result in lower costs due to more information being conveyed in bids.⁴⁸

California’s Power Exchange followed this same theory. Its day-ahead hourly energy auction was based on paying a uniform price to all bidders for each hour. As we all know, due to market manipulation, lack of forward contracting, and a variety of other factors, this experience with a uniform price auction did not last long. The energy crisis was estimated to cost California customers approximately \$40 billion dollars in two years.⁴⁹

The CPUC should not accept CFCMA’s theoretical argument and replace its successful current RA program with an uncertain uniform price auction.

⁴⁵ CFCMA Comments on Staff Report, p. 29.

⁴⁶ CFCMA Comments on Staff Report, p. 30.

⁴⁷ Myerson, R B (1981): “Optimal Auction Design” *Mathematics of Operation Research*, 6, 58-73

⁴⁸ CFCMA Comments on Staff Report, p. 31.

⁴⁹ Attorney General’s Energy White Paper: A Law Enforcement Perspective on the California Energy Crisis – Recommendations for Improving Enforcement and Protecting Consumers in Deregulated Energy Markets (April 2004) p. 6.

G. CFCMA wrongly dismisses staff’s concerns about the feasibility of a Centralized Capacity Market

CFCMA rejects the Staff Report’s concerns regarding the fundamental feasibility of its proposal. CFCMA claims that, given that two markets of similar design and complexity to its proposal have already been implemented and are operating smoothly, the Staff Report’s concerns are not supported by facts.⁵⁰ However, there is still no way to evaluate the success of the ISO-NE and PJM centralized markets, in that neither the actual construction of new generation nor the cost effectiveness of these two Centralized Capacity Markets has been demonstrated.⁵¹ Moreover, both ISO-NE and PJM were building on already-existing capacity markets whose existence preceded industry restructuring. California and the rest of the West, in contrast, have relied upon a bilateral contracting tradition, and a CCM in California would have to begin the development process from scratch, necessarily a much more complex undertaking.

Further, BTG’s Opening Comments have already referenced the challenges to the Eastern markets by entities including the Connecticut Department of Public Utility Control, the New York Public Service Commission, and the Maine Public Utilities Commission, and Duquesne Light Company’s efforts to depart from PJM.⁵²

BTG has presented in its Opening Comments information on the implementation costs of the New England FCM, although we found it difficult to determine the costs of implementing PJM’s RPM.⁵³ On the other hand, CFCMA refers to anecdotal information on the costs of the FCM and RPM, but provides no figures.⁵⁴ In addition, CFCMA

⁵⁰ CFCMA Comments on Staff Report, p. 36.

⁵¹ Questions are being raised about the appropriate criteria for determining whether these markets have “succeeded.” In the comments to FERC cited earlier, the American Forest & Paper Association points out that competition is not a goal in and of itself; rather, competitive markets for electricity were thought to be a better way “to provide safe and reliable service at just and reasonable rates.” AFPA further suggests that the key question for evaluating whether the current markets are “working” is whether they are achieving this goal. Comments of American Forest & Paper Association, *supra* n. 33, at pp. 3, 65.

⁵² BTG Comments on Staff Report, p. 6-10.

⁵³ *Id.*

⁵⁴ CFCMA Comments on Staff Report, p. 38.

certainly has not addressed the enormous litigation costs at FERC of the initial filings, the protests, the settlements, or the continued protests and proposed changes to the FCM or RPM. BTG is also surprised by CFCMA's comment that the first CFCM auction could occur in less than two years.⁵⁵ BTG finds this comment not just wildly optimistic, but hopelessly unrealistic. Based on the experiences of ISO-NE and PJM, BTG submits that the FERC litigation alone will take two to three years.

BTG strongly supports the statement by the Market Surveillance Committee of the CAISO in its final opinion on "Long Term Resource Adequacy Under MRTU." The MSC stated that:

"Given the wide range of uncertainty surrounding the future organization and structure of California's electrical market, as well as the performance of the new capacity-market structure 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."⁵⁶

H. The Bilateral approach is bringing new generation online

CFCMA takes the position that, due to the one-year ahead nature of the current RA program, it does not enable construction of new generation. CFCMA ignores the fact that several thousand MW of new generation have been contracted, some are under construction, and several generation facilities have come online in the last few years. The CAM acts as a backstop to bring online new capacity for reliability if the market does not provide it.

Under the CFCM, the basic concept is an auction for one-year-contracts, four years forward. Based on recent past experience, one can certainly argue that a contract for one year will not support the construction of new generation. The CFCM allows, as a backstop, new generators to propose contracts of up to ten years in length that would be

⁵⁵ CFCMA Comments on Staff Report, p. 36.

⁵⁶ "Final Opinion on Long Term Resource Adequacy under MRTU," (November 5, 2007).

signed by CAISO. CFCMA fails to explain how this approach differs in any fundamental way from the current system.

Basically both the current RA and the CFCM provide one-year contracts, and both have a backstop. The main difference is that currently the IOUs -- through the CAM -- are carrying out the RFOs, conducting contract negotiation and evaluation, and signing long-term contracts that are then approved by the Commission. Under the CFCM, it would be the CAISO that would sign the long-term capacity contracts (up to ten years), subject to FERC approval, with no CPUC review for conformance with state policy objectives. If the current system fails to support “merchant-based investment,” as CFCMA claims,⁵⁷ it is difficult to see how a CCM offering ten-year contracts for new generation would turn out any different, except, of course, that this Commission would lose its oversight over the process, and, the CAISO, an entity with no experience in long-term contracting, would assume responsibility for such long-term contracting in the future.

Currently, the IOUs pay the developers under each contract based on their offer prices, and are able to carry out extensive negotiations to get the best terms and conditions. Contracts are mostly for tolling, and energy and ancillary services are provided for the benefit of the customers. With the CFCM, every existing and new generator would receive the same uniform market clearing price for capacity. Contracts would have to be uniform, and, with an *ex-ante* PER, consumers would not obtain any hedging benefit during high price periods.

CFCMA asserts that its proposal “fully accommodates self-supply of qualified capacity resources by LSEs.”⁵⁸ While the proposal does theoretically *allow* LSEs to submit bilaterally procured resources into the central auction, such resources would have to be procured *more than four years* in advance of the delivery date in order to be submitted into the auction. Such a structure would likely eliminate self-procurement by

⁵⁷ CFCMA Comments on Staff Report, p. 44.

⁵⁸ CFCMA Comments on Staff Report, p. 34.

small LSEs, and would significantly lengthen the time horizon of procurement even for the IOUs, which would add significant costs to cover the required risk premium. These added costs would inevitably be passed on to customers. This is hardly a structure that is friendly toward bilateral procurement and self-supply by LSEs.

I. The CFCM would make implementation of state environmental policies more difficult

CFCMA asserts that its proposal is not antithetical to the State’s environmental policies,⁵⁹ but does not really explain how that can be the case, given that its preference is clearly to *separate completely* the procurement of generic “capacity” from the attainment of RPS and GHG goals. But if the CFCM procures only generic capacity to meet reliability objectives, where will LSEs get the clean *energy* that they will need to meet their RPS and GHG requirements? Clearly new renewable “capacity” will have to be developed somewhere and somehow in order for the renewable “energy” to be available for purchase by LSEs. Thus, there is great risk that LSEs will need to contract for ***duplicate resources*** to meet their RPS requirements,⁶⁰ even as they are forced to pay for the generic capacity – potentially including conventional coal – that is purchased for them through the CFCM. While this may represent the ultimate achievement of a “no generator left behind” policy, it is hardly a cost-effective or consumer-friendly policy for California to adopt.

While asserting that the Staff Report “places too much emphasis” on achieving RPS and GHG standards through the RA mechanism,⁶¹ CFCMA grudgingly acknowledges that “the CFCM design could be adapted to include resource attributes, in addition to location, directly in the auctions.”⁶² However, it is a gross overstatement to

⁵⁹ CFCMA Comments on Staff Report, p. 12-13.

⁶⁰ CFCMA seems to imply that renewable resources provide only *energy* and not *capacity*, yet solar thermal, geothermal and biomass facilities can provide firm capacity to the system, even if the capacity value of wind resources is subject to some question.

⁶¹ CFCMA Comments on Staff Report, p. 12.

⁶² CFCMA Comments on Staff Report, p. 13, fn 6.

suggest, as CFCMA does,⁶³ that it ever actually explained how this could be done. CFCMA’s representative in the workshops may have simply *asserted* as much, but there was never any explanation as to HOW. Moreover, the CFCMA theme that the Commission *could* but *should not* attempt to meet RPS and GHG requirements through a CCM was strongly echoed by the CAISO,⁶⁴ IEP⁶⁵ and Mirant,⁶⁶ each of which argued that the CCM would best focus on procurement of *generic capacity*.

BTG believes that a central issue for the Commission in addressing future capacity procurement is how well the adopted method facilitates the implementation of the loading order and other State energy and environmental policies. The centralized market proposals are all sorely lacking in this regard.

J. CFCMA fails to acknowledge that under its proposal the State would lose its ability to achieve Resource Adequacy in a manner consistent with state priorities

CFCMA is also disingenuous in its attempt to downplay the loss of jurisdiction that this Commission would suffer if a CCM is adopted, asserting that the CPUC would still establish the planning reserve margin (PRM) for its jurisdictional LSEs (as if that were the only issue of concern), even while acknowledging that such a PRM would need to be approved by FERC.⁶⁷ Of course, once an issue becomes subject to a filing at FERC, it will clearly be FERC and *not* the CPUC that makes the final decision, as states in the East have discovered, much to their dismay.

The comments of the CAISO, which has finally stated publicly that it supports a CCM, illustrate this point. CAISO urges this Commission “to narrow the scope of its decision to defer action on certain aspects of CCM design that the CAISO believes would be best addressed in the context of the comprehensive CCM design process rather than

⁶³ *Id.*

⁶⁴ CAISO Comments on Staff Report, pp. 39-40.

⁶⁵ IEP Comments on Staff Report, p. 6.

⁶⁶ Mirant Comments on Staff Report, p. 4.

⁶⁷ CFCMA Comments on Staff Report, p. 33-34.

decided up front.”⁶⁸ What the CAISO is really asking, is not just that the CPUC “defer action,” but that it defer exercise of its own judgment to that of the CAISO. According to the CAISO, “further analysis and deliberation *with stakeholders* is necessary to evaluate alternative approaches on key issues”⁶⁹ (emphasis added). However, in such a process (where owners of generation tend to drown out other voices), the CPUC would be just another “stakeholder” and not a decision-maker, and hence would have no control over the outcome of the process. This very dangerous “offer” by the CAISO should be firmly rejected by this Commission, along with the CCM concept itself.

K. Market power mitigation

CFCMA argues that an administrative price cap in load pockets will lead to the IOUs’ building generation there and LSEs opting out under the waiver.⁷⁰ This ignores the fact that it is very difficult for anyone to build in load pockets, utility or otherwise, even with LMP, and the reality that existing generation in load pockets has market power. FERC recently determined that significant market power mitigation was needed to address the New York city area, where no generation is owned by the local utility. It found that a combination of offer caps and a mitigation reference price level was necessary and appropriate to mitigate market power in the New York City load pocket.⁷¹

It is absurd to suggest that a price cap will lead to IOU construction in such cases. The price cap will either lead to construction, or no construction, period. We note here the following quote from PG&E: “As the Market Surveillance Committee recognized, it is unrealistic to assume new entry in markets that have insufficient load to justify that new entry, or in which the primary barriers to new entry are not price but land use, regulatory, or other factors.”⁷²

⁶⁸ CAISO Comments on Staff Report, p. 34.

⁶⁹ CAISO Comments on Staff Report, p. 6.

⁷⁰ CFCMA Comments on Staff Report, p. 30.

⁷¹ Order Conditionally Approving Proposal in Docket AL07-39 (March 7, 2008).

⁷² PG&E Comments on Staff Report, p. 11.

L. BTG’s proposal is not “the status quo” – it would gradually reduce the role of capacity payments to achieve reliability

Some parties have described the BTG proposal as “status quo” and its backstop mechanism as a utility “control” over the generation market, not allowing the development of “merchant” generators. BTG strongly disagrees with this view of its proposal. BTG’s future view is that California should move toward an energy-based market -- where, as the price cap is gradually moved upward with MRTU implementation, as the CAISO establishes scarcity pricing, and as dynamic demand response becomes available with the installation of advanced metering, the need for capacity payments will decrease and eventually disappear. Developers of new power plants will be able to recover their costs and make reasonable returns on their investment through energy, ancillary services, and fees for call options, as well as long-term energy hedging contracts with LSEs.

In BTG’s view the “merchant generators” will flourish under an energy-based market, without being obliged to sign long-term capacity or tolling contracts with IOUs. On the other hand, if the Commission makes the decision to establish a CCM, California will take a detour from “the gold standard” of an energy-based market, with perhaps no return. Under a CCM new generation will not be developed unless the owners get long-term capacity contracts from CAISO.

BTG believes that proponents of the CCM have a short-term vision of the electricity market. They are interested in making more money from existing generation through a uniform capacity price for old and new resources. They are interested in signing 10-year contracts with CAISO for new power plants to provide capacity, and at the same time keeping the profits from energy production during the high price and scarcity periods with an implicit *ex ante* PER.

A “merchant plant” should be willing to operate in a competitive energy-based market with high price caps rather than in an administratively-run centralized market.

BTG is puzzled that advocates of “merchant plants” are not supporting the long-term view of BTG, which is an energy-based market.

M. CFCMA is correct that California’s Resource Adequacy framework must be consistent with state law

CFCMA would add a new criterion into the Staff-proposed metrics, to include “an assessment of whether a proposal recognizes *statutory* constraints. Several state laws, most notably AB 380, bear directly on resource adequacy and associated requirements on IOUs and other load-serving entities. CFCMA states that, “Any proposal that conflicts with the letter or intent of state law must be rejected or, at a minimum, modified to bring it into conformance.”⁷³ CFCMA is correct that California’s RA framework must meet a number of statutory requirements. We note that there are a variety of statutes and codes that define the state’s energy policy framework as a whole, which must also be considered.

It is not clear that the CAISO’s enabling statute provides authority for the significant expansion of the CAISO’s role being proposed by CFCMA. Section 345 et seq. of the Public Utilities Code describes various duties and authorities of the CAISO to “manage the transmission grid and related energy markets.” The CAISO is required to seek the authority needed to “secure generating and transmission resources necessary to guarantee achievement of planning and operating reserve criteria no less stringent than those established by the Western Electricity Coordinating Council and the North American Electric Reliability Council.”⁷⁴ The CAISO is also required to consult with FERC and various California agencies and report on, among other things, the adequacy of current and prospective institutional provisions for the maintenance of reliability (Pub. Util. Code § 350). But it appears from these code sections that the Legislature neither expected nor intended that the CAISO operate a new and distinct market for capacity with the authority to enter into long-term contracts.

⁷³ CFCMA Comments on Staff Report, p. 17.

⁷⁴ Public Utilities Code §346.

Indeed, subsequent to the creation of the CAISO, and as a result of the 2000-2001 electricity crisis, the Legislature created a state entity expressly “to ensure sufficient power reserves.” Senate Bill 1x 6 created the California Consumer Power and Conservation Financing Authority in 2001⁷⁵. The agency, which was created with much fanfare, was obliged to:

Establish, finance, purchase, lease, own, operate, acquire, or construct generating facilities and other projects and enterprises, on its own or through agreements with public and private third parties or joint ventures with public or private entities, or provide financial assistance for projects or programs by participating parties, to supplement private and public sector power supplies.⁷⁶

The California Power Authority operated briefly, contributing to the development of the Energy Action Plan, but was later defunded by the Governor and Legislature, although the relevant statutes remain on the books.

This Commission has been given the responsibility, under AB 380, for evaluating the reliability benefits, and the reasonableness of the costs inherent in the various resource proposals offered by the various proponents, including Staff’s Alternative Recommendations. AB 380 requires the Commission to take into account a variety of objectives, including the renewable portfolio requirement, fuel diversity, diversity of ownership, equitable allocation of costs, and avoidance of cost shifting. Other relevant statutes, not solely AB 380, are important in guiding the Commission’s decision-making process. The BTG pointed out a number of others in its Opening Comments (including SB 1368, the emissions performance standard statute). The Commission must also keep in mind its fundamental responsibility to ensure that rates are just and reasonable (Pub. Util. Code § 451). As CFCMA states, “Any proposal that conflicts with the letter or

⁷⁵ Chapter 10, First Extraordinary Session 2001

⁷⁶ Public Utilities Code, § 3310(a), et seq.

intent of state law must be rejected or, at a minimum, modified to bring it into conformance.”⁷⁷

IV. CONCLUSION

BTG believes that the importance of capacity market revenues will decline as California moves into MRTU with improvements to its energy market more accurately revealing the underlying value of energy. The desired “end state” should be a competitive energy-based electricity market, relying primarily on revenues from the energy and ancillary service markets and fees obtained from providing call options on energy, as well as long-term energy hedging contracts with LSEs.

As BTG has stated in its Opening Comments on the Staff Report, most of the steps to reach an energy-only market as an “end state” are already in place, underway, or planned for the future.⁷⁸

The creation of a CCM would be an unfortunate, lengthy, and potentially very costly detour on the road to an energy-based market. It would cost millions of dollars and require a great deal of time to design and implement a CCM. Furthermore, it would transfer billions of dollars from consumers to the owners of existing generation, prevent or delay the repowering or retirement of uneconomic generators, and jeopardize the achievement of RPS goal and GHG reduction.

BTG respectfully requests, therefore, that the Commission make the following findings in this proceeding:

1. The Bilateral RA model, with the one-year ahead RA showing, is working and is the most appropriate structure to meet California’s resource adequacy needs.
2. A standardized capacity product that has a day-ahead must-offer obligation and generator performance obligation should be included in the CAISO tariff.

⁷⁷ CFCMA, *Ibid.*

⁷⁸ BTG Comments on Staff Report, p. 21.

3. An Electronic Bulletin Board should be developed for RA capacity to provide liquidity and price transparency.
4. A registration and tagging system should be established for qualifying RA capacity.
5. Automation of the RA compliance filing process should be carried out by developing an electronic portal or other computerized methods.
6. The Commission, as part of the Long Term Procurement Planning process, will determine the need for new resources for each one of the IOUs' service territories.
7. For the present, the IOUs, through the CAM process that is now in place, will provide the backstop for new RA resources if needed. If Direct Access is reopened it may be appropriate to reconsider which entity or entities should perform this function.
8. New resources could be tolling or RA-only contracts. For tolling contracts there will be an energy auction to determine the net cost of RA capacity.

Respectfully submitted on behalf of
The Bilateral Trading Group

/s/ KAREN PAULL

Karen Paull

Attorney for the Division of Ratepayer Advocates
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102
Phone No.: (415) 703-2630
E-mail: KPP@cpuc.ca.gov

March 14, 2008

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of the foregoing document
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REPORT ON PHASE 2/TRACK 2 ISSUES “in R.05-12-013.

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/s/ NELLY SARMIENTO

NELLY SARMIENTO

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SERVICE LIST- R.05-12-013

jmcMahon@crai.com
Kathryn.Wig@nrgenergy.com
rick_noger@praxair.com
keith.mccrea@sablaw.com
ajkatz@mwe.com
myuffee@mwe.com
bblair@thompsoncoburn.com
mmcnaul@thompsoncoburn.com
dbandera@reliant.com
Cynthia.A.Fonner@constellation.com
gschott@reliant.com
boudreauxk@calpine.com
cbanks@complete-energy.com
ej_wright@oxy.com
sisser@goodcompanyassociates.com
stacy.aguayo@apses.com
chilen@sppc.com
curtis.kebler@gs.com
dehling@kling.com

mmazur@3phasesRenewables.com
klatt@energyattorney.com
douglass@energyattorney.com
allwazeready@aol.com
laura.genao@sce.com
michael.backstrom@sce.com
rkmoore@gswater.com
kswitzer@gswater.com
alan.comnes@nrgenergy.com
daking@sempra.com
LURick@sempra.com
DGarber@sempra.com
gbass@semprasolutions.com
skeehn@sempra.com
toberts@sempra.com
tcorr@sempraglobal.com
tbrill@sempra.com
tbrill@sempra.com
liddell@energyattorney.com
rwinthrop@pilotpowergroup.com
tdarton@pilotpowergroup.com
dpapapostolou@semprautilities.com

cneedham@edisonmission.com
kurt.duvall@ci.corona.ca.us
mdjoseph@adamsbroadwell.com
mflorio@turn.org
theresa.mueller@sfgov.org

chh@cpuc.ca.gov
kpp@cpuc.ca.gov
jhendry@sflower.org
ek@a-klaw.com
rsa@a-klaw.com
sls@a-klaw.com
bill.chen@constellation.com
evk1@pge.com
bcragg@goodinmacbride.com
jsqueri@goodinmacbride.com
jwiedman@goodinmacbride.com
jkarp@winston.com
lcottle@winston.com
mday@goodinmacbride.com
edwardoneill@dwt.com
jeffgray@dwt.com
irene@igc.org
ALHJ@pge.com
aweller@sel.com
jchamberlin@strategicenergy.com
ralf1241a@cs.com
alexm@calpine.com
linda.sherif@calpine.com
philm@scdenergy.com
janreid@coastecon.com
bmcc@mccarthyLaw.com
joyw@mid.org
johnrredding@earthlink.net
jweil@aglet.org
cmkehrein@ems-ca.com
cmicsa@caiso.com
CHinman@caiso.com
wamer@kirkwood.com
mary.lynch@constellation.com
abb@eslawfirm.com
mclaughlin@braunlegal.com
braun@braunlegal.com
braun@braunlegal.com
dsandino@water.ca.gov
jluckhardt@downeybrand.com
jjg@eslawfirm.com
kdw@woodruff-expert-services.com
kris.chisholm@eob.ca.gov
www@eslawfirm.com
jdh@eslawfirm.com
lterry@water.ca.gov
hcronin@water.ca.gov
dansvec@hdo.net

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notice@psrec.coop
deb@a-klaw.com
alan.comnes@nrgenergy.com
ryan.flynn@pacificorp.com
jeff.lam@powerex.com
RStoddard@crai.com
chris.ohara@nrgenergy.com
steven.schleimer@barclayscapital.com
steven.huhman@morganstanley.com
michael.gergen@lw.com
jmorrissey@cgs.com
perlism@dicksteinshaprio.com
lisa.decker@constellation.com
jim.mayhew@mirant.com
Bob_Anderson@apses.com
dmcfarlan@mwgen.com
jimross@r-c-s-inc.com
ahendrickson@commerceenergy.com
cweddington@commerceenergy.com
tcarlson@reliant.com
htarpley@complete-energy.com
ptellegen@complete-energy.com
julie.martin@bp.com
steve.koerner@el Paso.com
william.tomlinson@el Paso.com
kesposito@cbcatalysts.com
kjsimonsen@ems-ca.com
jenine.schenk@apses.com
mvillar@nev.com
emello@sppc.com
tdillard@sppc.com
gbawa@cityofpasadena.net
btang@ci.azusa.ca.us
MTENEYCK@CI.RANCHO-
CUCAMONGA.CA.US
akbar.jazayeri@sce.com
Case.Admin@sce.com
david.lloyd@nrgenergy.com
alan.comnes@nrgenergy.com
mshames@ucan.org
kмкиener@fox.net
kмкиener@cox.net
marcie.milner@shell.com
michael.evans@shell.com
centralfiles@semprautilities.com
pmills@semprautilities.com
RNicholson@Semprautilities.com
centralfiles@semprautilities.com
dniehaus@semprautilities.com
jleslie@luce.com
fmason@ci.banning.ca.us

traceydrabant@bves.com
jolko@ci.colton.ca.us
luhler@riversideca.gov
cmartin@calpine.com
dkolk@compenergy.com
lkostrzewa@edisonmission.com
pherrington@edisonmission.com
ssciortino@anaheim.net
sue.mara@rtoadvisors.com
diane_fellman@fpl.com
mramirez@sflower.org
dwang@nrdc.org
filings@a-klaw.com
sdhilton@stoel.com
brbc@pge.com
cbasket@enernoc.com
rcounihan@enernoc.com
sara.oneill@constellation.com
vjw3@pge.com
cem@newsdata.com
jscancarelli@flk.com
jarmstrong@goodinmacbride.com
koconnor@winston.com
vprabhakaran@goodinmacbride.com
judypau@dwt.com
lisa_weinzimer@platts.com
alho@pge.com
bk7@pge.com
ELL5@pge.com
GXL2@pge.com
pcg8@pge.com
RHHJ@pge.com
sscb@pge.com
SEHC@pge.com
svs6@pge.com
S1L7@pge.com
debra.lloyd@cityofpaloalto.org
rwalthers@pacbell.net
c.greif@comcast.net
k.abreu@sbcglobal.net
mark_j_smith@fpl.com
brflynn@flynnrci.com
beth@beth411.com
kerry.hattevik@mirant.com
gblue@enxco.com
kowalewskia@calpine.com
wbooth@booth-law.com
pthompson@summitblue.com
philha@astound.net
dirk.vanulden@ucop.edu

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george.getgen@ucop.edu
matthew.stclair@ucop.edu
john.rolle@ucop.edu
mrw@mrwassoc.com
dmarcus2@sbcglobal.net
rschmidt@bartlewells.com
nrader@calwea.org
carla.peterman@gmail.com
oren@ieor.berkeley.edu
ksims@siliconvalleypower.com
cpechman@powereconomics.com
sberlin@mccarthyllaw.com
rogerv@mid.org
tomk@mid.org
brbarkovich@earthlink.net
demorse@omsoft.com
amckenna@caiso.com
aivancovich@caiso.com
bburns@caiso.com
remmert@caiso.com
dwithrow@caiso.com
grosenblum@caiso.com
jderosa@ces-ltd.com
jmclain@caiso.com
jgoodin@caiso.com
kjohnson@caiso.com
kalmeida@caiso.com
Lkristov@caiso.com
mgillette@enemroc.com
ppettingill@caiso.com
rsmutny-jones@caiso.com
saeed.farrokhpay@ferc.gov
e-recipient@caiso.com
dennis@ddecuir.com
david@branchcomb.com
kenneth.swain@navigantconsulting.com
kdusel@navigantconsulting.com
eolson@navigantconsulting.com
Les.Pereira@ncpa.com
scott.tomashefsky@ncpa.com
Tony.Zimmer@ncpa.com
edchang@flynnrci.com
gdeshazo@caiso.com
jig@eslawfirm.com
Audra.Hartmann@Dynergy.com
brian.theaker@dynergy.com
dcarroll@downeybrand.com
wynne@braunlegal.com
rachel@ceert.org
blaising@braunlegal.com

steven@iepa.com
ferguson@braunlegal.com
www@eslawfirm.com
lmh@eslawfirm.com
hcronin@water.ca.gov
katie@iesolutionsllc.net
karen@klindh.com

californiadockets@pacificorp.com
dws@r-c-s-inc.com
jesus.arredondo@nrenergy.com
gifford.jung@powerex.com
fmobasheri@aol.com
agc@cpuc.ca.gov
sap@cpuc.ca.gov
bbc@cpuc.ca.gov
dbr@cpuc.ca.gov
djh@cpuc.ca.gov
edd@cpuc.ca.gov
eks@cpuc.ca.gov
fxg@cpuc.ca.gov
joc@cpuc.ca.gov
jw6@cpuc.ca.gov
kdw@cpuc.ca.gov
kql@cpuc.ca.gov
kd1@cpuc.ca.gov
lau@cpuc.ca.gov
msw@cpuc.ca.gov
mjd@cpuc.ca.gov
unc@cpuc.ca.gov
ner@cpuc.ca.gov
rmm@cpuc.ca.gov
rls@cpuc.ca.gov
seb@cpuc.ca.gov
skg@cpuc.ca.gov
tbo@cpuc.ca.gov
amckenna@caiso.com
Cleni@energy.state.ca.us
lwong@energy.state.ca.us
lmarshal@energy.state.ca.us
mpryor@energy.state.ca.us
mjaske@energy.state.ca.us
mringer@energy.state.ca.us
jwoodwar@energy.state.ca.us
ntronaas@energy.state.ca.us
cmee@water.ca.gov
ikwasny@water.ca.gov
jgeorge@water.ca.gov
jpacheco@water.ca.gov