



**FILED**

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

Rulemaking Regarding Whether, or Subject to What Conditions, the Suspension of Direct Access May Be Lifted Consistent with Assembly Bill 1X and Decision 01-09-060.

Rulemaking 07-05-025  
(Filed May 24, 2007)

**ASSIGNED COMMISSIONER  
AND ADMINISTRATIVE LAW JUDGE'S RULING  
REGARDING IMPLEMENTATION MEASURES  
FOR PHASE II (A)(2)**

In Decision (D.) 08-11-056, the Commission adopted measures to expedite the phase-out of the California Department of Water Resources (DWR) from its role of supplying electric power to retail customers. The implementation of this phase-out will be accomplished in Phase II (a)(2) of this proceeding. By ruling dated December 17, 2008, comments were solicited on implementation issues in Phase II (a)(2). This ruling provides guidance to implement the measures adopted in D.08-11-056, as discussed below.

**1. Establishment of a Working Group**

As authorized by D.08-11-056, a Working Group is hereby established to develop protocols and strategies for negotiating replacement power contracts to substitute DWR with the Investor-Owned Utilities (IOUs). Based upon the nominations submitted by parties on December 30, 2008, the Working Group membership roster is established as set forth in Appendix 1 of this ruling. The initial meeting of the Working Group shall be conducted telephonically. The

Commission's staff will provide separate notice to the Working Group members of the time for the first meeting and the call-in telephone number.

## **2. Role of Working Group in Contract Negotiations**

Based on parties' comments, some clarification is warranted for a proper understanding of the role of the Working Group, and how it will interact with other parties and the Commission. The Working Group will consist of representatives of DWR, the IOUs, and the Commission's advisory staff. The Working Group will develop protocols and strategies for prioritizing and scheduling of negotiations for replacement contracts in accordance with the principles and priorities adopted in D.08-11-056. The Working Group, however, will not engage in the actual negotiations with counterparties for individual replacement contracts. Each IOU (along with DWR) will be responsible for the actual negotiation of replacement agreements for the DWR contracts that have been allocated to that respective IOU.

The Consumer Federation of California (CFC) argues that by creating the Working Group, the Commission "ceded its discretionary power to determine what constitutes a reasonable replacement contract to a group with a pecuniary interest in the outcome." Based on this erroneous premise, CFC claims that "the Working Group will be making decisions which are statutorily required to be made by the Commission." (CFC Comments at 6.) CFC is incorrect. The Working Group has *not* been authorized to determine what constitutes a reasonable replacement contract. The Working Group's purpose instead is to merely develop protocols for the prioritizing and scheduling negotiation of replacement agreements to make the process as efficient and successful as possible. The Working Group role is in no way intended to replace, or limit the due process rights of parties to participate in the "just and reasonable" contract

review process. The replacement agreements will not become effective until or unless they are approved by the Commission. The Commission retains full authority to determine whether a replacement contract is “just and reasonable.” That authority has not been ceded to the Working Group.

CFC also claims that:

“participation by Commission staff in the Working Group may create an appearance of bias if the staff members, and those with whom they discuss working group activities, also advise the Commission. Staff people who have been intimately involved in guiding the negotiation process will have acquired information that is not readily available to the public or the parties to the consequent ratemaking proceeding. It would be unfair for them to intentionally or inadvertently pass on to the Commission. . . information discovered during working group activities when they are advising the Commission.” (CFC Comments at 8.)

Based on this claim, CFC argues that a “firewall” should be erected between Commission staff participating in the Working Group and Commission staff advising the Commission. CFC is incorrect in claiming that participation by Commission staff in the Working Group may create an appearance of bias if they also advise the Commission.

Any representatives of the Commission’s advisory staff that participate in the Working Group are not “parties” to the proceeding. The role of the technical staff is not to sponsor or support a particular advocacy position, but rather, to facilitate the procedural process. Thus, there is no basis for CFC’s allegations that advisory staff’s involvement could create an appearance of bias. The Commission’s Rules of Practice and Procedure already set forth appropriate provisions and restrictions governing ex parte communications between parties and Commission decision makers. CFC’s proposal for additional restrictions in

the form of a Commission staff “firewall” would unreasonably hinder the Commission from carrying out its responsibilities, and would serve no valid purpose. The CFC proposal is rejected.

### **3. Working Group Progress Reports**

D.08-11-056, Ordering Paragraph 3 states that: “A process will be established for periodic progress reports on negotiation efforts by the Working Group for assessing the prospects for agreement on acceptable new contracts, with the goal being to curtail unproductive negotiation efforts before they result in the expenditure of unnecessary costs or time.” Comments were solicited on the appropriate processes for adequate notice to – and input from – interested parties not represented on the Working Group, with respect to the review of replacement contracts subject to Commission approval pursuant to Pub. Util. Code § 451.

AReM and Reliant propose that the Working Group submit two types of ongoing progress reports – (1) a confidential detailed progress report for use by the Commission and (2) a publicly available distilled report to allow interested parties to assess whether progress is being made. SCE objects, arguing that the Working Group should be allowed the flexibility to carry out its responsibilities without reporting to outside parties. SDG&E likewise objects, arguing that communicating progress reports to other parties will add unnecessary complexity. SDG&E argues that parties will be provided a fair and full opportunity to review and comment on replacement contracts when they are submitted for Commission approval.

DRA recommends that the Working Group progress reports be placed on the Procurement Review Group (PRG) agendas for each IOU, and that PRG participants have the opportunity to provide input on the negotiation goals and

framework. DRA argues that the PRG is the proper forum to determine whether the replacement contracts meet energy needs consistent with Commission's policy. PG&E likewise believes that replacement contracts be reviewed with each utility's PRG before submission for formal Commission approval. PRG participants are bound by confidentiality agreements, so the discussions would be protected from public disclosure.

Reliant and AReM object to PRG review or feedback on contract negotiations prior to a formal submission of a contract for Commission review and approval. Reliant argues that the negotiation of replacement agreements does not fit into the overall construct of the PRG which is tasked with reviewing the overall long term procurement strategy of the IOUs.

## **Discussion**

The Working Group will be required to submit periodic progress reports to the Assigned Commissioner and ALJ. The status reports will be the vehicle through which the Working Group will advise the Assigned Commissioner and ALJ as to whether, or to what the extent, it is proposed that negotiations on a given contract be discontinued, that priorities be redirected, or that negotiating strategies be revised. In response to any such proposals by the Working Group, the Assigned Commissioner and ALJ will provide additional guidance by written ruling. Prior to such a ruling taking final effect, parties will be provided an appropriate opportunity to comment.

To the extent that a progress report contains information deemed confidential or proprietary, the status report shall be filed under seal. A copy of the unredacted report shall be provided to the Assigned Commissioner and ALJ. Parties that are not market participants and that enter into an appropriate nondisclosure agreement may receive a copy of the unredacted progress report.

There is no reason, however, to involve the PRG in a separate formal review of Working Group activities. The roles and responsibilities of the PRG are separately defined and circumscribed within the LTTP framework. It would unduly complicate the contract novation/negotiation process to introduce an additional layer of PRG review. Interested parties, including those with members on the PRG, will be kept apprised of the progress of contract negotiations through progress reports filed by the Working Group. Also parties will have an opportunity to participate in the “just and reasonable” review process once the IOU submits a replacement contract for Commission approval.

A separate redacted version of the progress report shall be made publicly available. The Working Group should discuss at its initial meeting what information could be made publicly available in redacted form without compromising contract negotiations.

The question of the timing and frequency of periodic progress reports is also a matter to be discussed within the Working Group. Within 10 working days after the first meeting is held, the Working Group shall formally file and serve a proposed schedule for providing periodic progress reports, including contents that can be made publicly available in redacted form. The proposed schedule for submitting progress reports will be subject to approval by the Assigned Commissioner and ALJ. Reports shall be presented in sufficient detail to support an assessment of whether to continue with contract negotiations based on the priorities set forth in D.08-11-056 or whether to redirect priorities.

#### **4. Standards for Review and Approval of Replacement Contracts**

D.08-11-056, Ordering Paragraph (OP) 11 stated, in part: “As a priority, Phase II (a)(2) of this proceeding shall address the appropriate ‘just and reasonable’ standards to be used in the review and approval of any replacement

agreements, in order to ensure consistency with the applicable requirements of Section 451.” The point of this directive is not to prejudge or preapprove replacement contracts before they have been formally submitted for Commission approval, or to interfere with efforts to secure negotiated agreements that are in ratepayers’ best interests.

As stated in D.08-11-056, the more explicit guidance that the Commission can provide early in the negotiation process as to how the “just-and-reasonable” standard will be applied, the more likely it is that any replacement contract presented for approval can meet this standard without being sent back for additional negotiations. In their comments, parties express conflicting views as to the threshold requirements that a replacement contract should satisfy to sustain a finding that it is “just and reasonable.”

DRA argues that, at a minimum, any replacement contract should produce an improvement in rates over the existing DWR contract, particularly for the contracts which the Commission is challenging as unjust and unreasonable (Sempra, Coral and PacifiCorp contracts). DRA argues that the Commission should also consider the costs of renegotiating and reviewing the contracts (including Commission staff and participating parties’ time and resources), as well as the IOU’s debt equivalency, cost of capital and credit collateral costs. Moreover, if the total estimated savings to ratepayers under the terms of a contract are only “modest,” but do not compensate for the additional costs of the renegotiation process (offset by any ratepayer savings realized by DWR), then DRA argues that such contract replacement should not be approved.

DRA argues that all replacement contracts should be evaluated subject to the same principles and standards that have been established in the LTPP process. For example, DRA argues that utilities stepping into the shoes of DWR

to renegotiate a contract should at least be required to use an Independent Evaluator as currently required in the competitive Request-For-Offer (RFO) process. This will also help to ensure that utilities maintain the required resource mix over the long term timeframe.<sup>1</sup> DRA argues that the just and reasonableness determination should take into account the results of the existing competitive procurement process.

PG&E proposes that the Commission utilize a similar standard of review as is currently used when evaluating contracts arising from bilateral negotiations. In particular, PG&E proposes that the review should be “based on available and relevant market data” that “may include showing competing price offers, results of market surveys, brokers and online quotes, and/or other sources of price information such as published indices, historical price information for similar time blocks ...” and comparison to recent RFOs.<sup>2</sup> PG&E argues that although this standard was adopted for short-term bilateral transactions, the Commission has also allowed long-term bilateral transactions,<sup>3</sup> and this standard can be equally applicable to longer-term transactions, such as a novated or renegotiated DWR contract.

SCE argues that DRA’s proposal to apply LTPP principles to the review of replacement contracts is overly broad and offers little practical guidance. Instead

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<sup>1</sup> The merits of coordinating with the LTPP Process were addressed in DRA’s Opening Comments on Phase II(a)(1), pp. 3-6.

<sup>2</sup> D.03-06-067 at 20 (adopting standard for review of short-term bilateral transactions).

<sup>3</sup> D.03-12-062 at 26 (adopting short-term bilateral standards) and 39 (allowing longer-term bilateral transactions); D.04-12-048 at 117 (reaffirming utility authority for bilateral transactions).

of adopting a blanket policy that all contracts and negotiations comport with LTTP “principles and standards.” SCE argues that the Commission should evaluate each contract on its own merits to determine if ratepayers will benefit from the new contract. Reliant likewise argues that the replacement contracts will not be the product of the LTTP process insofar as they merely replace DWR contracts that are already accounted for in the IOUs’ resource mix. As such, Reliant argues that there is no basis for replacement contracts to undergo the lengthy review process that applies to contracts that are newly initiated as part of an IOU’s LTTP. AReM argues that for contracts that are novated “as is,” the determination that the contract is “just and reasonable” should be a straight forward matter since the ratepayer would be subject to the same costs and terms as under the predecessor DWR contract.

CFC argues that it would be counterproductive to prescribe detailed criteria in advance of contract negotiations as to what the Commission would deem to meet the “just and reasonable” standard of Sec. 451. CFC expresses concern that parties negotiating replacement agreements would merely seek to satisfy those predetermined minimum standards, rather than negotiate more aggressively for more favorable prices or terms that could benefit ratepayers.

## **Discussion**

In order to avoid unduly limiting possible negotiations or prejudging Commission deliberations that can only be made once specific contracts are presented for approval, this ruling is limited to broad principles that should guide negotiations.

As stated in D.08-11-056, “the resulting ‘Replacement Agreement’ must, at a minimum be at least as beneficial as the existing contract.” Based upon the principles established in D.08-11-056, an “as is” novation would be pursued

where “seeking expanded modifications in contract terms or prices is likely to result in protracted delays or disputes...” (D.08-11-056 at 74). In order to support a finding that a particular contract is “just and reasonable,” there should be a showing that an “as is” novation was pursued after considering the potential for protracted delays or disputes resulting from more expanded contract negotiations. (Decision at 75).

At the same time, merely because a novated contract may continue the same prices and terms as the underlying DWR contract, that does not mean that the novated contract will automatically be found “just and reasonable.” Although the Commission is required by law to pass through DWR contract power costs to ratepayers, the Commission has never made a finding that the DWR contracts are “just and reasonable.” In fact, the Commission has legally challenged certain DWR contracts as unjust and unreasonable under the Federal Power Act. As stated in D.08-11-056, each replacement contract must be reviewed on its own merits, independent of the underlying DWR contract, to determine if it is “just and reasonable” based on:

“the conditions, including market conditions, at the time of negotiation, and based on expectations of market conditions in effect during the period that such replacement agreement would be in effect. As such, the review of those contracts will be separate and distinct from the setting in which the previously executed DWR contracts were negotiated and subsequently litigated” (D.08-11-056 at 67.)

As a general principle, each replacement contract will be reviewed on its own merits as a bilateral contract. In this regard, the standard of review for bilateral transactions, as noted above by PG&E could prove useful in evaluating replacement contracts. DRA’s recommendation is not adopted to evaluate replacement contracts based on a competitive RFO standard. As noted in

D. 08-11-056, Commission-approved IOU procurement plans do not require that power be procured solely via a competitive RFO process. While the Commission has stated a preference that long-term procurement be conducted via competitive procurement mechanisms, the IOUs are allowed flexibility to use bilateral contracts to meet residual net short positions. (See D.08-11-056 at 52.)

To the extent that a replacement agreement merely replaces an existing DWR contract with no other substantive changes, the replacement would not necessarily affect the IOU's LTTP. On the other hand, "any replacement agreement that would extend the term of a contract should also be reviewed by the Commission for consistency with the long-term procurement planning criteria, pursuant to Section 454.5." (Decision at 81.)

## **5. Consideration of Natural Gas Hedging Master Agreements**

In its comments, SCE notes that DWR has master agreements with numerous counterparties that have been put in place for the sole purpose of hedging the natural gas requirements of the DWR contracts. These master agreements have been used by the IOUs, as DWR's agent, to hedge significant volumes of natural gas. SCE believes that these master agreements should follow the DWR contracts to the IOUs. DWR also believes that the evaluation of potential benefits from novation of an individual DWR contract may need to include analysis of DWR's program to hedge its gas risk exposure and fuel procurement agreements. If the master agreements for hedging and the related transactions under them are assigned or novated to the IOUs, SCE states that the IOUs would likely be required to post additional collateral.

In view of the noted connection of DWR's natural gas hedging master agreements and related hedging transactions to the novation or other replacement of DWR contracts, the Working Group should incorporate

consideration of the effects of – and appropriate disposition of-- the DWR master agreements for natural gas hedging in their overall planning process for replacement contract negotiations. The Working Group should provide an updated analysis of the implications of this issue in reference to the development of a plan for replacement contract negotiations as an element of its progress reports to the Assigned Commissioner and ALJ.

## **6. Procedural Rules for Review of Replacement Contracts**

Parties disagree as to the procedure that should be used for formal Commission review and approval of replacement contracts.

In order to support a finding that such contracts are “just and reasonable”, AReM proposes that the IOU simply file an advice letter certifying that the terms and conditions of the novated contract are substantively the same as before the novation. SCE proposes contracts be submitted for approval either through application or a Tier 3 advice letter filing.<sup>4</sup> PG&E also proposes that contract approval be processed via advice letter. DRA and SDG&E argue that contract approval should be through a formal application process. DRA argues that consumers will not be served by a hasty contract review process, and that a formal application process is necessary to provide for an adequate review.

### **Discussion**

The process for Commission review of replacement contracts must provide adequate opportunity to determine whether each of the contracts presented for approval is “just and reasonable.” The Commission cannot automatically

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<sup>4</sup> Tier 3 advice letters concern matters whose disposition is expected to require action by the Commission. As with Tier 2 advice letters, the initial review period is 30 days,

*Footnote continued on next page*

presume that novated contracts are “just and reasonable” merely because the replacement contract does not change the prices or terms of the existing contract. Interested parties must be provided a fair opportunity to participate in any Commission review of the replacement agreements to determine if they are “just and reasonable.”

The review process should also be performed in a procedurally efficient manner, taking into account that there are 26 separate DWR contracts subject to novation or other negotiated replacement, each of which may involve varying complexity or controversy. On the one hand, an expedited Tier 1 advice letter process would not provide sufficient opportunity to review replacement contracts, particularly contracts with modifications beyond novation “as is.” On the other hand, processing 26 separate replacement contracts through a formal application process would add more procedural complexity, particularly where contracts may be submitted for approval at different times. As noted in D. 08-11-056, the review of replacement contracts will occur promptly for each replacement contract as negotiation is completed, but *before* the replacement contract becomes effective. The review will get underway for certain contracts while others may still be in negotiation.

An approach is needed that provides both administrative efficiency and procedural due process. These goals can both be achieved by requiring that the replacement contracts be submitted for approval through the Tier 3 advice letter process. The Tier 3 advice letter approach will allow for more streamlined processing than would be possible under a formal application. A Tier 3 advice

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but unlike Tier 2, a Tier 3 advice letter may not be deemed approved. D.07-01-024 prescribes the procedures for Tier 3 advice letters in further detail.

letter filing, however, will also provide ample opportunity for parties to comment on proposed contracts before the Commission rules upon them. As with Tier 2 advice letters, the initial review period is 30 days, but unlike Tier 2, a Tier 3 advice letter may not be deemed approved without formal Commission action. Rather, contracts submitted through a Tier 3 advice letter will require a formal Commission resolution. The Commission may choose to consolidate the consideration of multiple advice letters in a single resolution. D.07-01-024 prescribes the procedures for Tier 3 advice letters in further detail.

## **7. Scheduling of Subsequent Phases**

By ruling dated March 28, 2008, Phase II was bifurcated into a Phases (a) and (b). D.08-11-056 adopted a plan to conclude remaining Phase II (a) issues by implementing replacement contracts to remove DWR from its role as power supplier. Phase II(b) will address the public policy merits of lifting the Direct Access suspension, including the applicable wholesale market structure and regulatory prerequisites for lifting the suspension. In my ruling dated April 18, 2008, the setting of a schedule for Phase II(b) was deferred. As stated in the ruling: "As Phase II (a) progresses, we will be better positioned to formulate an appropriate schedule for Phase II (b)." In opening and reply comments filed on January 14, and 28, 2009, respectively, parties addressed whether Phase II (b) scheduling should continue to be deferred, or should move forward concurrently with Phase II(a)(2).

AReM and Reliant propose moving forward immediately with Phase II(b), to proceed concurrently with contract novation negotiations in Phase II (a)(2). Most of the other parties, however, argue that Phase II(b) should be postponed until progress of the replacement contract negotiations can be assessed. In the meantime, DRA argues, there remain many other high-priority proceedings

involving procurement planning, resource adequacy, renewable resources, clean distributed generation, and energy efficiency, all of which require substantial Commission resources.

DRA states that if the Commission is inclined to consider overlapping schedules for Phase II(a)(2) and Phase II(b), however, the Phase II(b) schedule should be deferred at least until contract negotiations are completed for the four prioritized DWR contracts without novation clauses, as directed in Ordering Paragraph 6 of D.08-11-056. The outcome of those negotiation efforts would provide the Commission with a better sense of the earliest date that direct access could be reinstated, and thus, how best to schedule Phase II(b) issues.

CFC argues that the sequence of Phase II(a)(2) and II(b) should be reversed, and that Phase II(b) should proceed forward now, with a suspension of the Phase II(a)(2) program for contract novation. CFC believes that the Commission should first consider whether conditions necessary for the proper functioning of a competitive market, consistent with the public interest, now exist.

## **Discussion**

Although the Commission set a target goal of January 1, 2010 for completing the process of implementing replacement contracts to remove DWR from its role as power supplier, uncertainties remain as to how quickly this goal will be realized. In view of the uncertainties as to how quickly replacement contracts can be implemented, it is premature to set a schedule for Phase II(b) at this time. A more efficient approach is to allow parties to focus their resources on resolving Phase II(a) issues for now.

The proposal of CFC to reverse the sequence of the proceeding--with Phase II(b) to go forward while Phase II(a)(2) is suspended--contradicts the

directives of D.08-11-056. The Commission has already determined in D. 08-11-056 that the program for DWR contract novation should be implemented now based on the record that has already been developed. Accordingly, the reversal of direction proposed by CFC is procedurally improper.

SCE raises a concern as to whether direct access will automatically reinstate upon novation or assignment of the last DWR contract. In this regard, however, D.08-11-056 expressly states: "While January 1, 2010 is the target date for removing DWR from supplying power, we clarify that this is not the target date for reopening direct access." (See D.08-11-056 at 3, footnote 4). Accordingly, completing the removal of DWR from supplying power will not automatically reinstate direct access. The Commission must resolve issues in Phase II (b) and III of this proceeding prior to any possible reinstatement of direct access.

As the prospects for successful negotiation of replacement contracts are assessed, particularly for the Sempra and Coral contracts, the timing of the Phase II(b) schedule can be further considered based on a more accurate assessment as to the earliest possible date that retail competition could be reinstated.

## **8. Treatment of Early Release of Operating Reserves**

Pursuant to OP 4, comments were also solicited concerning how to allocate the early release of DWR reserves to ratepayers resulting from the termination of DWR contracts through novation. Various parties commented on this issue. SDG&E recommends that disposition as to how to allocate the early release of operating reserves is an issue that should be addressed through the annual proceedings to determine and allocate the DWR revenue requirement. This is a

reasonable recommendation. Accordingly, any further determinations as to specifically how to allocate the early release of operating reserves will be taken up in the next DWR revenue requirement proceeding.

**IT IS RULED** that:

1. The membership roster of the Working Group is hereby adopted, as set forth in Appendix 1 hereto, to develop protocols and strategies for negotiating power contracts to replace California Department of Water Resources (DWR) with the Investor-Owned Utilities (IOUs) in accordance with the principles and directives set forth in Decision (D.) 08-11-056.

2. The Commission staff shall schedule an initial telephonic meeting of the Working Group and notify members of the time and the call-in phone number for the meeting.

3. Within 10 working days after its first meeting, the Working Group shall formally file and serve a proposed schedule for providing periodic progress reports, including contents that can be made available publicly in redacted form. The proposed schedule for submitting progress reports will be subject to approval by the Assigned Commissioner and Administrative Law Judge.

4. Negotiations for replacement agreements should be conducted in conformance with the priorities and principles established in D.08-11-056, as further explained in the discussion above.

5. The Working Group should also incorporate consideration of the effects of –and disposition of – DWR master agreements for natural gas hedging as an element of its progress reports.

6. Replacement contracts shall be submitted for Commission review and approval, utilizing the Tier 3 advice letter process.

7. Disposition as to how to allocate the early release of DWR operating reserves is an issue that shall be addressed through the annual proceedings to determine and allocate the DWR revenue requirement.

8. The scheduling of Phase II(b) will be deferred until after a further assessment has been made as to the prospects and timing of successful negotiation of replacement contracts.

Dated February 4, 2009, at San Francisco, California.

/s/ MICHAEL R. PEEVEY  
Michael R. Peevey  
Assigned Commissioner

/s/ THOMAS R. PULSIFER  
Thomas R. Pulsifer  
Administrative Law Judge

## APPENDIX 1

### Membership Roster for the Working Group Established Pursuant to D.08-11-056

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(From December 29, 2009 until February 23, 2009) \*

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\*Due to a Family Leave absence, Mr. Pena will substitute for Ms. Foley from December 29, 2008 until February 23, 2009.

**(END OF APPENDIX 1)**

**INFORMATION REGARDING SERVICE**

I have provided notification of filing to the electronic mail addresses on the attached service list.

Upon confirmation of this document's acceptance for filing, I will cause a Notice of Availability of the filed document to be served upon the service list to this proceeding by U.S. mail. The service list I will use to serve the Notice of Availability of the filed document is current as of today's date.

Dated February 4, 2009, at San Francisco, California.

/s/ SANDRA M. JACKSON

Sandra M. Jackson