

**BEFORE THE
CALIFORNIA ENERGY COMMISSION**

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In the Matter of:)
)
Proposed Adoption of Regulations)
Establishing a Greenhouse Gases)
Emission Performance Standard)
For Baseload Generation of Local)
Publicly Owned Electric Utilities)

Docket 06-OIR-1

**COMMENTS OF
BARCLAYS CAPITAL
J. ARON & COMPANY
MORGAN STANLEY CAPITAL GROUP INC.
ON PROPOSED REGULATIONS**

Michael A. Yuffee
Erin M. Murphy
McDERMOTT WILL & EMERY LLP
600 Thirteenth Street, NW
Washington, DC 20005
Tel: 202.756.8000
Fax: 202.756.8087
Email: emmurphy@mwe.com

Attorneys for
BARCLAYS CAPITAL
J. ARON & COMPANY
MORGAN STANLEY CAPITAL GROUP INC.

January 9, 2007

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**COMMENTS OF BARCLAYS CAPITAL, J. ARON & COMPANY, AND MORGAN
STANLEY CAPITAL GROUP INC.ON PROPOSED REGULATIONS**

Barclays Capital, J. Aron & Company, and Morgan Stanley Capital Group Inc. (collectively “Filing Parties”) respectfully submit these comments on the “Staff-Proposed Regulations for Implementing the Greenhouse Gases Emissions Performance Standard for Local Publicly Owned Electric Utilities” (“Proposed Regulations”) posted January 3, 2007, in the above-captioned Docket pending before the California Energy Commission (“CEC”).

Filing Parties file these comments in response to § 2908 of the Proposed Regulations, which states that “[a] contract of five years or more for unspecified baseload power is not compliant with the [emissions performance standard].”¹ As a result, such a prohibition requires that all long-term commitments be with specified sources in order to demonstrate compliance with the emissions performance standard (“EPS”). Filing Parties believe that such a restriction:

- is not based on the spirit or letter of Senate Bill (“SB”) 1368;²
- could result in significantly increased costs for rate-payers; and
- could significantly impede reliability.

¹ “Staff-Proposed Regulations for Implementing the Greenhouse Gases Emission Performance Standard for Local Publicly Owned Electric Utilities” at 6.

² Stats. 2006, ch. 598, approved Sept. 29, 2006.

For the reasons described below, the Filing Parties urge the CEC to reconsider the proposed regulatory text that states that a contract for five years or more for unspecified baseload power is not compliant with the EPS.

The Filing Parties are concerned that proposed § 2908 could have long-term detrimental effects on wholesale power markets in California and the West. The Filing Parties strongly believe that the best way to create a robust and viable long-term GHG market structure is to make it source-based, not load-based. The Filing Parties look forward to working with the CEC in this proceeding to develop a comprehensive record that addresses and makes clear the implications of this most fundamental market design issue.

I. COMMENTS

A. Unspecified Long-Term Contracts Comport With SB 1368

The Proposed Regulations as drafted advance the assumption that the objectives of SB 1368 cannot be accomplished without requiring long-term contracts to be tied to specific generation sources.³ The Filing Parties respectfully state that this is an overly broad and potentially damaging reading of SB 1368.

SB 1368 provides, in relevant part, that:

[i]n developing and implementing the greenhouse gases emission performance standard, the commission shall address long-term purchases of electricity from unspecified sources in a manner consistent with this chapter.⁴

The Proposed Regulations construe this provision in a similar manner as the Proposed Decision recently issued by the California Public Utilities Commission (“CPUC”). The CPUC’s Proposed Decision construes this provision to mean that “(1) LSEs only enter into long-term financial

³ CPUC’s Proposed Decision at 117.

⁴ § 8341(d)(7).

commitments with baseload generation that comply with EPS, and (2) EPS compliance cannot be achieved in a manner that would yield a contrary result, i.e., that permits a load-serving entity (“LSE”) to enter into long-term commitments with high-emitting sources.”⁵ Neither the CPUC’s Proposed Decision, nor the Proposed Regulations, however, support this construction of the statute.

The only section of SB 1368 that mentions unspecified contracts is the provision cited above.⁶ That provision in no way requires a prohibition on unspecified long-term contracts as the Proposed Regulations apparently assume. Rather, that provision requires the CEC to address long-term purchases from unspecified sources “in a manner consistent” with the rest of the statute. The Proposed Regulations include rules for implementing SB 1368 for specified resources. To be in accord with the clear language of SB 1368, the Proposed Regulations must now work out the rules to implement SB 1368 for unspecified resources.

In sum, SB 1368 could have expressly banned any contracts five-years or longer with unspecified resources. It did not. As a result, the CEC need not prohibit unspecified contracts as is currently recommended in the Proposed Regulations.

The Filing Parties recognize that the statute requires that all LSEs who enter into long-term financial commitments for baseload generation must ensure that the generation supplied “complies with the greenhouse gases emission performance standard *established by the commission*.”⁷ Numerous parties suggested a variety of approaches to assign long-term contracts with unspecified resources an appropriate proxy or composite emissions standard that would meet both the spirit and the letter of the statute. Nevertheless the Proposed Regulations

⁵ CPUC’s Proposed Decision at 117.

⁶ *Id.* at n149.

⁷ § 8341(a).

apparently reject all of these alternatives, in an attempt to “follow the [P]roposed [D]ecision as closely as possible.”⁸ The Filing Parties respectfully suggest that SB 1368 obligates both the CEC and the CPUC to consider a less draconian method for treating unspecified long-term contracts other than requiring their complete prohibition.

As described in greater detail below, the recommendations included in the Proposed Regulations are apparently based on the CPUC’s Proposed Decision, which is based solely on hypothesized possible outcomes without giving due consideration to the adverse implications of such a ban on long-term contracts going forward.⁹ Because of the significant harm associated with prohibiting unspecified long-term contracts, and because designing a proxy emissions standard does not violate the language or intent of SB 1368, the CEC should reconsider the Proposed Regulation’s prohibition. To that end, the Filing Parties urge the CEC to closely examine this issue in the upcoming workshops scheduled to examine the Proposed Regulations. Numerous proposals have been suggested to-date and these proposals could use further vetting and consideration during these workshops. Developing a more appropriate method for considering unspecified long-term contracts at this phase would better serve the rate payers and the entire greenhouse gas initiative. Undeniably, such an approach comports with the language and intent of SB 1368.

B. Requiring Only Unit-Specific Contracts Is Uneconomic For Rate Payers

Requiring that all long-term commitments be with specified sources has the potential to cause economic harm to the ratepayers. The Proposed Regulations rely on the CPUC’s Proposed

⁸ Proposed Regulations, Introduction at 1.

⁹ The CPUC’s Proposed Decision maintains that because attendees at the workshops indicated that the LSEs would be “entering into very few, if any, new contracts or contract renewals with unspecified contracts with a term of five years or longer,” banning such contracts would not have a significant, impact on resource procurement flexibility. CPUC’s Proposed Decision at 122.

Decision where it maintains that the general design goals for the EPS include protecting California ratepayers from exposure to: (1) “the high costs of retrofits [to facilities] . . . under future emission control regulations;” and (2) “potential supply disruptions when these high-emitting facilities are taken off line for retrofits, or retired early, in order to comply with future regulations.”¹⁰ However, the Proposed Regulation’s prohibition on long-term transactions with unspecified sources does not comport with this goal.

First, ratepayers bear no such economic risk from unspecified resource contracts. Under such fixed-price contracts, the supplier necessarily bears all of the economic risks associated with the resources that underlie its supply. Additionally, the supplier has no mechanism for passing on any future compliance-related costs other than as may have been bilaterally negotiated.

Second, suppliers of unspecified contracts with terms of more than five years, and not the ratepayers, bear all of the “disruption” risk under the contract. Simply stated, if an unspecified unit is unavailable for any reason, including retrofitting, early retirement, or compliance with future regulations, the supplier would be required to find power supply from an available unit, and bear all of the economic and performance risk under the contract.

As such, there is no logic behind limiting contracts with unspecified resources to protect ratepayers, because such contracts in fact provide the HIGHEST level of protection, and provide the best hedge against the very risks that SB 1368 aims to address.

Furthermore, by requiring that Publicly-Owned Utilities (“POUs”) effectively can only enter into unit-contingent contracts after implementation of the Proposed Regulations, the CEC effectively eliminates a whole class of supply contracts that could help reduce power costs for

¹⁰ *Id.* at 3.

ratepayers. Suppliers that do not specify resources are taking an approach to the market that emphasizes system knowledge, nimbleness, flexibility, intermediation, and risk management in an effort to always use the best available source to meet a contractual obligation in a complex, ever-active, creative and flexible manner. In some instances it may seem counterintuitive that an entity that does not own physical generation units could supply power at a lower price than a company that owns and operates actual generation resources. However, it is the case that power marketers may offer the cheapest source of supply, as evidenced by the fact that power marketers have successfully bid for contracts to supply power to load serving entities. By arbitrarily eliminating power marketers from competition, California consumers are deprived of the benefits of their lower cost options.

Finally, the Proposed Regulations again follow the CPUC's Proposed Decision and maintain that a ban on long-term unspecified resource contracts greater than five years will not adversely affect the requisite flexibility that a POU needs, because POUs would be entering into very few, if any, new contracts or contract renewals with unspecified contracts with a term of five years or greater. The Proposed Regulations, along with the CPUC's Proposed Decision takes this data on its face without understanding why LSEs might have avoided entering into such contracts in the current environment. What the Proposed Regulations and the CPUC's Proposed Decision fail to consider is that LSEs may very well have avoided entering into *any* long-term contracts, pending the finality of the CPUC's rules for procurement that will result from the Long-Term Procurement rulemaking. In fact, careful review of the recently filed Long-Term Procurement Plans by the LSEs with the CPUC reveals that all three LSEs are planning to enter into new contracts to replace their California Department of Water Resources ("CDWR") contracts that are terminating at the end of the decade. Each of the LSEs has specified that they

plan on replacing the CDWR contracts with contracts from the market or from existing generation. Furthermore, the Proposed Regulations completely disregard the fact that POUs regularly use long-term contracts with marketers or portfolio managers to meet their small baseload acquisitions. The adverse implications of proposed § 2908 will be significant for POUs.

C. Prohibiting Unspecified Long-Term Contracts Threatens System Reliability

If the Proposed Regulations are adopted as proposed, the prohibition on unspecified long-term contracts will effectively force all long-term supply contracts to become unit-specific supply contracts. There is, however, an unintended consequence for system reliability that will result from relying on such unit-specific long-term contracts. The CEC should consider this adverse impact on system reliability before effectively requiring all long-term contracts to be unit-contingent arrangements as the Proposed Regulations ostensibly endorse.

As the Filing Parties discussed in their comments to the CPUC, they recognize that Section 2908's prohibition on unspecified long-term contracts also has parallels to the recent proposal by the Federal Energy Regulatory Commission ("FERC") to revise their regulations governing network resources under the *pro forma* Open Access Transmission Tariff ("OATT"). There, FERC proposed to require that for a power purchase agreement to qualify as a network resource under the OATT, it must specify a single source of supply. FERC received numerous comments on this issue advising that flexibility is necessary on this matter, for the same reasons that flexibility is necessary in the EPS for unspecified long-term contracts.

In the FERC proceeding, Arizona Public Service Company ("APS") filed detailed comments on the network resource issue, citing various reliability concerns that are particularly

relevant in the instant proceeding.¹¹ All of the concerns for system reliability cited by APS are analogous here. For example, APS noted the need for flexibility when a firm power purchase agreement with delivery at a liquid trading hub could be sourced from several different units, without impacting the firmness of the resource. APS also noted the role of non-utility market participants, like Barclays, J. Aron, and MSCG, who may not have a “system” or own generating resources, but have solid credit.¹² In this circumstance, a financial institution can enter into a long-term sale arrangement with a POU and meet the supply requirements under the agreement by purchasing a variety of resources that would not otherwise be available to a POU due to credit matters. Although that long-term agreement may not be able to specify a generating unit on a long-term forward basis,¹³ it ensures system reliability at least as well as any unit-contingent contract.¹⁴

As APS also noted in its comments to FERC, requiring sellers to unnecessarily commit specific resources long before delivery is required will reduce market liquidity and reliability. Specifically, unspecified resource liquidated damages contracts are critical to POUs, so long as they are physically firm, because they allow parties to settle on damages without litigation. As a result, those contracts historically are the most reliable. For example, APS states that firm power purchase agreements typically have the highest availability of any network resource; indeed, APS experienced a 100% physical delivery rate for firm power purchases in the twelve months ending in June 2006, compared with an average availability of approximately 92.5% for owned

¹¹ An excerpt of APS’s comments is attached hereto as Exhibit A.

¹² Exhibit A at 36.

¹³ All “unspecified contracts” become “specified” in the Day-Ahead timeframe, through the resource scheduling and tagging process.

¹⁴ *Id.* at 37.

generation, and a 76.8% rate for unit-contingent contracts.¹⁵ As is evident by APS's data, unit-contingent contracts are the least reliable arrangement, as compared with long-term unspecified power purchase agreements, which are the most reliable. It only follows, then, that the Proposed Regulation's prohibition on such contracts could serve to negatively impact reliability in the California markets.

II. CONCLUSION

For all of the aforementioned reasons, the Filing Parties respectfully request that the CEC reconsider the proposed § 2908 in the Proposed Regulations prohibiting unspecified long-term contracts greater than five years.

Respectfully submitted,

/s/

Michael A. Yuffee
Erin M. Murphy
McDERMOTT WILL & EMERY LLP
600 Thirteenth Street, NW
Washington, DC 20005
Tel: 202.756.8000
Fax: 202.756.8087
Email: emmurphy@mwe.com

Attorneys for
BARCLAYS CAPITAL
J. ARON & COMPANY
MORGAN STANLEY CAPITAL GROUP INC.

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¹⁵ *Id.* at 38.