

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

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

R.06-04-009
(Filed April 13, 2006)

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**COMMENTS OF CALPINE CORPORATION ON
THE MARKET ADVISORY COMMITTEE RECOMMENDATION FOR
DESIGNING A GREENHOUSE GAS CAP-AND-TRADE SYSTEM FOR CALIFORNIA**

Avis Kowalewski
Director, Western Regulatory Affairs
CALPINE CORPORATION
3875 Hopyard Road, Suite 345
Pleasanton, CA 94588
Tel. (925) 479-6640
Fax. (925) 479-7303
Email: kowalewskia@calpine.com

Jeffrey P. Gray
DAVIS WRIGHT TREMAINE LLP
505 Montgomery Street, Suite 800
San Francisco, CA 94111
Tel. (415) 276-6500
Fax. (415) 276-6599
Email: jeffgray@dwt.com

Attorneys for Calpine Corporation

Dated: August 6, 2007

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STATE OF CALIFORNIA**

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Pursuant to the July 19, 2007 ruling of Administrative Law Judges TerkKeurst and Lakritz ("ALJ Ruling"), Calpine Corporation ("Calpine") submits these comments on the Market Advisory Committee ("MAC") recommendation of a "first seller approach" for designing a greenhouse gas ("GHG") cap-and-trade system for California (the "MAC Report"). The MAC's objective is to design a cap-and-trade program that will result in cost effective GHG emissions reductions consistent with the goals of Assembly Bill ("AB") 32. The first seller approach represents an alternative to the load-based approach jointly being studied by the California Public Utilities Commission ("CPUC") and the California Energy Commission ("CEC") for regulating GHG emissions in the electricity sector.

I. INTRODUCTION

As Calpine has discussed in previous comments filed in this proceeding, it strongly supports the GHG emission reduction goals established in AB 32 and the efforts of the CPUC, CEC, MAC, and the Air Resources Board ("ARB") to design and implement a fair, workable, market-based approach to meet these goals. Calpine believes both the first seller and load-based approaches have inherent strengths and weaknesses. Whether one approach or the other is

ultimately successful in reducing GHG emissions, however, will depend, in large part, on implementation details yet to be formulated and adopted.

Given current unknowns, Calpine's comments do not take a position as to which approach is superior or should be adopted; but rather, generally address the issue areas identified in the ALJ Ruling.¹ In addressing these issue areas, Calpine focuses on a few "core concepts" that it believes are critical components to a successful cap-and-trade program and should inform the decision making process in general, and consideration of the specific issues raised in the ALJ Ruling in particular. These core concepts include:

- Clear and enforceable emissions caps where emissions are fully verifiable;
- Strong reporting, tracking, and verification mechanisms that will minimize the need for emission proxies;
- An approach to distributing emissions allowances (whether by allocation or auction) that minimizes significant adverse economic impacts and "links" allowances to the entities responsible for GHG emissions compliance; and
- A liquid, transparent and administratively efficient market for emissions allowances that recognizes and rewards early actors and technical innovation.

While these core concepts do not represent a definitive and complete list of components necessary to develop a successful cap-and-trade program, Calpine believes they are integral to achieving the emissions reduction goals set out in AB 32.

II. DISCUSSION

A. Basic Definitions (Questions 1-8)²

The description of the first seller approach used in the ALJ Ruling appears to be consistent with the definition used in the MAC Report. Specifically, for in-state resources, the

¹ Calpine generally supports the comments being filed by the Western Power Trading Forum ("WPTF"). WPTF provides responses to specific questions contained in the ALJ Ruling.

² Section headings (including numbering) correspond to section headings in the ALJ Ruling. Calpine has not included section headings for issues in which it is not providing comments.

first seller is the generator in all cases and, for imports, the first seller is the entity that first delivers electricity at a point of delivery within California – in other words, the Purchasing/Selling Entity (“PSE”) listed on the NERC E-tag at the first California point of delivery. With respect to imports, this PSE could be the generator, a marketer, or some other entity, such as a retail provider that has taken title to the power out-of-state.

In cases where the PSE is not the actual generator, or the source of the power is not known (*i.e.*, an “unspecified” source), it may be necessary to assign a “proxy” emission level under both the first seller and load-based approaches, notwithstanding the use of E-tags. This would be the case because, in some instances, E-tags only track back to a control area and not the specific generating source, making it nearly impossible to determine actual emission levels for use in determining compliance with an AB 32 cap-and-trade system. In addition, under a load-based approach, greater use of proxies may also be needed for certain in-state power deliveries because, unlike the first seller approach, the point of regulation under a load-based system is not at the generator.

As discussed in more detail below, the widespread use of emission proxies can undermine efforts to achieve long-term emissions reductions. Thus, accurate emissions tracking will be critical to the success of either a first seller or load-based approach. Accordingly, Calpine supports the adoption of strong and accurate reporting and tracking protocols, as well as policies that minimize the use of emission proxies.

B. General Policy Issues (Questions 9-16)

Leakage and contract shuffling are a concern under both the first seller and load-based approaches. With respect to leakage, under either approach, the use of emission proxies (or default emission rates) for any out-of-state power provides an opportunity for entities to shift from lower emitting in-state sources to higher emitting out-of-state sources, potentially resulting

in increased emissions associated with California energy use. One possible way to discourage such leakage would be to adopt high emission proxy rates for unspecified sources. Adopting high proxy rates should encourage lower emitting sources to identify and report emissions associated with energy production and help prevent higher emitting sources from gaming the system by marketing their power as “unspecified.” Under this approach, actual emission levels can be more accurately tracked and reported for AB 32 compliance purposes.

Contract shuffling is also a problem under either approach. Contract shuffling refers to a situation where an entity “shuffles” contract commitments so that higher emitting resources are used to serve load outside California and cleaner resources are used to serve demand in California. “Shuffling” contracts may provide a way for regulated entities to be “technically” in compliance with California’s cap-and-trade program notwithstanding that there would be no “net” reduction in emissions.

In addition, unlike leakage, contract shuffling could become more pervasive as policies result in an increased use of specified sources. Specifically, to maximize the value of their portfolios, power importers will have an incentive to specify low-emitting sources of power for import into California (in order to meet cap-and-trade obligations) and market higher-emitting power in other states. This would be the case because, under a single-state cap-and-trade program, there is no effective way to dictate or regulate the dispatch of out-of-state generation. As a result, contract shuffling can occur whenever power is imported into California and the potential for it will likely exist under any California only approach to emissions reductions.

Irrespective of the approach (first seller or load-based), leakage and contract shuffling are problems inherent in single-state cap-and-trade programs. Both of these problems, however, can be effectively addressed through robust regional or national programs that include strong reporting and tracking requirements.

E. Reporting, Tracking, and Verification (Questions 26-31)

Irrespective of whether a first seller or load-based approach is adopted, strong reporting, tracking, and verification mechanisms will be necessary if mandated GHG emissions reduction is to be achieved. AB 32 requires ARB to develop reporting protocols that will “[a]ccount for greenhouse gas emissions from all electricity consumed in the state.”³ At a minimum, accurate accounting of emissions requires source identification and tracking. Absent initial identification of the source providing power, it will be nearly impossible to determine and verify associated emissions for AB 32 compliance purposes. Given the role played by marketers, title to power can often change hands multiple times before entering the State (which is relevant under a first seller approach) or reaching end-use customers (which is relevant under a load-based approach). Thus, once a source is specified, it is equally important that the power be carefully tracked as new entities acquire title, or it moves across the grid.

Requiring that all sources of electricity be specified would be the most effective and accurate way to account for emissions. Nevertheless, there will likely be a continued need for some unspecified resources to ensure reliability under California’s current market structure. As a result, some type of emission proxy will need to be developed.

By their nature, emission proxies are problematic in the context of cap-and-trade programs because they do not directly link a source with its assigned emissions. As a result, if a proxy is lower than the actual emissions of the source to which the proxy is applied, accounting protocols will necessarily understate actual emissions. Moreover, under such circumstances, higher emitting sources will have an incentive to market themselves as unspecified resources to take advantage of the lower emissions proxy level. The net effect is that *actual* emissions may

³ Cal. Health and Safety Code §38530(b)(2).

be higher than reported emissions, notwithstanding that all responsible entities are in compliance with their respective obligations under an AB 32 cap-and-trade program.

To better ensure the goals of AB 32 are met, Calpine supports the adoption of strong reporting, tracking, and verification mechanisms that minimize the need for emissions proxies. Calpine firmly believes that such mechanisms will be critical to the success of either a first seller or load-based cap-and-trade program.

F. GHG Emissions Allowance Allocation Issues (Questions 32-34)

Emissions allowances could be auctioned or directly allocated under either the first seller approach or the load-based approach. If adopted, an auction approach should contemplate a phase-in period that would include the direct allocation of allowances to some sources in order to mitigate potential adverse economic impacts associated with increased capital costs necessary to comply with emission reduction requirements and/or energy contracts that do not contemplate emission reduction costs. Under this approach, allocations should be based on electricity output - that is, based on energy produced or sold - and updated on a regular basis to account for changes in production and contracting. Basing allocations on electricity sales will make it possible to directly allocate allowances to any entity, whether a physical generating source or a marketer selling under energy contracts. In addition, regularly updating allocations should result in the better matching of allowances with allowance requirements, and will create incentives for efficient, lower emitting resources to operate more which will, in turn, reduce overall GHG emissions. This approach to allocation (energy output with regular updating) should also reduce the risk of windfall profits by reducing the chances of over allocation of allowances.

Calpine does not support any allocation scheme that would be limited only to retail providers and require other first sellers to acquire allowances via auction. To the extent allowances are allocated, retail providers should not be treated differently than other entities

subject to the cap-and-trade program. Specifically, allowances should be allocated to all entities who are regulated under the program, whether a generator, marketer, or retail provider.

Allocating allowances in this way provides an incentive for those subject to the cap-and-trade program to reduce emissions.

Furthermore, under the first seller approach, retail providers would be subject to the cap and trade program for only a small fraction of sales, if at all.⁴ If these entities are over allocated allowances, they could control a large portion of the allowance market with little incentive to make those allowances available to the market. Giving a retail provider more allowances than which it would otherwise qualify for as the first seller could reduce liquidity in the allowance market and, thus, reduce the ability of the market to find the most cost effective means for achieving the state's emission reduction goals. Liquidity and transparency are critical to an efficient market, and allocating allowances only to retail providers under a first seller approach is counter to that goal.

In addition, since some retail providers also own generation, allocating allowances to them and not other entities subject to the cap-and-trade program raises serious competitive concerns. Under both the first seller and load-based approaches, retail providers will potentially be subject to AB 32 compliance requirements at some level. However, given that they compete in the market with other generators and marketers, it would be patently unfair to allow retail providers to manage the auction or allocation process. Liquidity and transferability should be a fundamental principle of the market. Giving allowances to the retail providers for future allocation to other entities, subject to the cap-and-trade program, may jeopardize this principle.

⁴ This would be the case because retail providers generally contract for a significant portion of the energy needed to serve their loads.

H. Relationship to a Multi-State System Such as the Western Regional Climate Action Initiative (Questions 36-39)

Whether there is a risk of double counting the emissions from imported power is dependent on the specific type of cap-and-trade programs involved. For example, should California adopt the first seller approach, the point of regulation for all in-state sources will be the generator. However, if the generator exports power to a state that also employs a first seller or load-based cap-and-trade program, then there is the potential for the emissions associated with the imported power to be double counted – once in California and, then again, when the power is first sold in the other state (if the state employs a first seller approach) or when acquired by a retail provider to serve load (if a load-based approach is used). Given the risks of double counting emissions, it is critical that the most accurate reporting and tracking mechanisms be employed. Accurately reporting and tracking emissions should help identify power that has already been “counted” for compliance purposes in one state so that other states could exempt such power from cap-and-trade compliance requirements.

I. Interaction with Potential Federal Regulation (Questions 40-42)

Whether a first seller or load-based approach can be easily “scaled or linked” to a regional or national GHG emissions program will depend, in large part, on the type of regional or national program being contemplated. For instance, the first seller approach functions similar to a source-based program, particularly with respect to in-state sources (*i.e.*, the point of regulation is at the generator/source). Thus, it is reasonable to assume that the first seller approach would be more easily linked than a load-based program to regional or national source-based systems. By the same token, a load-based program should be more easily linked to any regional or national load-based system.

III. CONCLUSION

Calpine supports the efforts of the CPUC, CEC, MAC, and ARB to design and implement a fair, workable, and market-based cap-and-trade program that will result in cost effective GHG emissions reductions consistent with the goals of AB 32. To accomplish this goal, it will be critical that strong reporting, tracking, and verification mechanisms be adopted that will minimize the need for emission proxies; emissions allowances be distributed in a way that minimizes adverse economic impacts and links allowances to entities subject to emissions compliance obligations; and a liquid, transparent, and administratively efficient emissions allowance market be established.

Respectfully submitted,

Avis Kowalewski
Director, Western Regulatory Affairs
CALPINE CORPORATION
3875 Hopyard Road, Suite 345
Pleasanton, CA 94588
Tel. (925) 479-6640
Fax. (925) 479-7303
Email: kowalewskia@calpine.com

/s/ Jeffrey P. Gray
Jeffrey P. Gray
DAVIS WRIGHT TREMAINE LLP,
505 Montgomery Street, Suite 800
San Francisco, California 94111
Tel. (415) 276-6500
Fax. (415) 276-6599
Email: jeffgray@dwt.com
Attorneys for Calpine Corporation

Dated: August 6, 2007

CERTIFICATE OF SERVICE

I, Judy Pau, certify:

I am employed in the City and County of San Francisco, California, am over eighteen years of age and am not a party to the within entitled cause. My business address is 505 Montgomery Street, Suite 800, San Francisco, California 94111.

On August 6, 2007, I caused the following to be served:

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via electronic mail to all parties on the service list R.06-04-009 who have provided the Commission with an electronic mail address and by First class mail on the parties listed as "Appearance" and "State Service" on the attached service list who have not provided an electronic mail address.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct, and that this declaration was executed on the date above at San Francisco, California.

/s/ Judy Pau

Judy Pau

cc: Commissioner Michael R. Peevey (via U.S. Mail and Email)
ALJ Charlotte TerKeurst (via U.S. Mail and Email)
ALJ Jonathan Lakritz (via U.S. Mail and Email)
ALJ Meg Gottstein (via U.S. Mail and Email)

CALIFORNIA PUBLIC UTILITIES COMMISSION

Service Lists

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Appearance

STEVEN S. SCHLEIMER
DIRECTOR, COMPLIANCE & REGULATORY AFFAIRS
BARCLAYS BANK, PLC
200 PARK AVENUE, FIFTH FLOOR
NEW YORK, NY 10166

STEVEN HUHMAN
MORGAN STANLEY CAPITAL GROUP INC.
2000 WESTCHESTER AVENUE
PURCHASE, NY 10577

RICK C. NOGER
PRAXAIR PLAINFIELD, INC.
2711 CENTERVILLE ROAD, SUITE 400
WILMINGTON, DE 19808

KEITH R. MCCREA
ATTORNEY AT LAW
SUTHERLAND, ASBILL & BRENNAN, LLP
1275 PENNSYLVANIA AVE., N.W.
WASHINGTON, DC 20004-2415

ADAM J. KATZ
MCDERMOTT WILL & EMERY LLP
600 13TH STREET, NW.
WASHINGTON, DC 20005

CATHERINE M. KRUPKA
MCDERMOTT WILL AND EMERY LLP
600 THIRTEEN STREEET, NW
WASHINGTON, DC 20005

LISA M. DECKER
CONSTELLATION ENERGY GROUP, INC.
111 MARKET PLACE, SUITE 500
BALTIMORE, MD 21202

CATHY S. WOOLLUMS
MIDAMERICAN ENERGY HOLDINGS COMPANY
106 EAST SECOND STREET
DAVENPORT, IA 52801

KEVIN BOUDREAUX
CALPINE POWER AMERICA-CA, LLC
717 TEXAS AVENUE, SUITE 1000
HOUSTON, TX 77002

THOMAS DILL
PRESIDENT
LODI GAS STORAGE, L.L.C.
1021 MAIN ST STE 1500
HOUSTON, TX 77002-6509

E.J. WRIGHT
OCCIDENTAL POWER SERVICES, INC.

PAUL M. SEBY
MCKENNA LONG & ALDRIDGE LLP

5 GREENWAY PLAZA, SUITE 110
HOUSTON, TX 77046

1875 LAWRENCE STREET, SUITE 200
DENVER, CO 80202

TIMOTHY R. ODIL
MCKENNA LONG & ALDRIDGE LLP
1875 LAWRENCE STREET, SUITE 200
DENVER, CO 80202

STEPHEN G. KOERNER, ESQ.
EL PASO CORPORATION
WESTERN PIPELINES
2 NORTH NEVADA AVENUE
COLORADO SPRINGS, CO 80903

JENINE SCHENK
APS ENERGY SERVICES
400 E. VAN BUREN STREET, SUITE 750
PHOENIX, AZ 85004

JOHN B. WELDON, JR.
SALMON, LEWIS & WELDON, P.L.C.
2850 EAST CAMELBACK ROAD, SUITE 200
PHOENIX, AZ 85016

KELLY BARR
MANAGER, REGULATORY AFFAIRS & CONTRACTS
SALT RIVER PROJECT
PO BOX 52025, PAB 221
PHOENIX, AZ 85072-2025

STEVEN S. MICHEL
WESTERN RESOURCE ADVOCATES
2025 SENDA DE ANDRES
SANTA FE, NM 87501

ROGER C. MONTGOMERY
VICE PRESIDENT, PRICING
POWER
SOUTHWEST GAS CORPORATION
PO BOX 98510
LAS VEGAS, NV 89193-8510

RONALD F. DEATON
LOS ANGELES DEPARTMENT OF WATER &
111 NORTH HOPE STREET, ROOM 1550
LOS ANGELES, CA 90012

SID NEWSOME
TARIFF MANAGER
SOUTHERN CALIFORNIA GAS COMPANY
GT 14 D6
555 WEST 5TH STREET
LOS ANGELES, CA 90051

DAVID L. HUARD
ATTORNEY AT LAW
MANATT, PHELPS & PHILLIPS, LLP
11355 WEST OLYMPIC BOULEVARD
LOS ANGELES, CA 90064

CURTIS L. KEBLER
J. ARON & COMPANY
SUITE 2600
GRAHAM
2121 AVENUE OF THE STARS
LOS ANGELES, CA 90067

DENNIS M.P. EHLING
ATTORNEY AT LAW
KIRKPATRICK & LOCKHART NICHOLSON
10100 SANTA MONICA BLVD., 7TH FLOOR
LOS ANGELES, CA 90067

GREGORY KOISER

NORMAN A. PEDERSEN

CONSTELLATION NEW ENERGY, INC.
350 SOUTH GRAND AVENUE, SUITE 3800
LOS ANGELES, CA 90071

ATTORNEY AT LAW
HANNA AND MORTON, LLP
444 SOUTH FLOWER STREET, NO. 1500
LOS ANGELES, CA 90071

MICHAEL MAZUR
CHIEF TECHNICAL OFFICER
3 PHASES ENERGY SERVICES, LLC
2100 SEPULVEDA BLVD., SUITE 38
MANHATTAN BEACH, CA 90266

TIFFANY RAU
POLICY AND COMMUNICATIONS MANAGER
CARSON HYDROGEN POWER PROJECT LLC
ONE WORLD TRADE CENTER, SUITE 1600
LONG BEACH, CA 90831-1600

GREGORY KLATT
ATTORNEY AT LAW
DOUGLASS & LIDDELL
411 E. HUNTINGTON DRIVE, STE. 107-356
ARCADIA, CA 91006

MAUREEN LENNON
CALIFORNIA COGENERATION COUNCIL
595 EAST COLORADO BLVD., SUITE 623
PASADENA, CA 91101

RICHARD HELGESON
SOUTHERN CALIFORNIA PUBLIC POWER AUTHORITY
225 S. LAKE AVE., SUITE 1250
PASADENA, CA 91101

DANIEL W. DOUGLASS
ATTORNEY AT LAW
DOUGLASS & LIDDELL
21700 OXNARD STREET, SUITE 1030
WOODLAND HILLS, CA 91367

PAUL DELANEY
AMERICAN UTILITY NETWORK (A.U.N.)
10705 DEER CANYON DRIVE
ALTA LOMA, CA 91737

AKBAR JAZAYEIRI
DIRECTOR OF REVENUE & TARIFFS
SOUTHERN CALIFORNIA EDISON COMPANY
2244 WALNUT GROVE AVE. ROOM 390
ROSEMEAD, CA 91770

ANNETTE GILLIAM
ATTORNEY AT LAW
SOUTHERN CALIFORNIA EDISON COMPANY
2244 WALNUT GROVE AVENUE
ROSEMEAD, CA 91770

CATHY A. KARLSTAD
SOUTHERN CALIFORNIA EDISON COMPANY
2244 WALNUT GROVE AVE.
ROSEMEAD, CA 91770

LAURA I. GENAO
ATTORNEY
ELECTRIC
SOUTHERN CALIFORNIA EDISON
2244 WALNUT GROVE AVENUE
ROSEMEAD, CA 91770

RONALD MOORE
GOLDEN STATE WATER/BEAR VALLEY

630 EAST FOOTHILL BOULEVARD
SAN DIMAS, CA 91773

DON WOOD

. AIMEE M. SMITH

PACIFIC ENERGY POLICY CENTER
4539 LEE AVENUE
LA MESA, CA 91941

ATTORNEY AT LAW
SEMPRA ENERGY
101 ASH STREET HQ13
SAN DIEGO, CA 92101

ALLEN K. TRIAL
SDGE&SCG
HQ-13
101 ASH STREET
SAN DIEGO, CA 92101

ALVIN PAK
SEMPRA GLOBAL ENTERPRISES
101 ASH STREET
SAN DIEGO, CA 92101

DAN HECHT
SEMPRA ENERGY
101 ASH STREET
SAN DIEGO, CA 92101

DANIEL A. KING
SEMPRA ENERGY
101 ASH STREET, HQ 12
SAN DIEGO, CA 92101

SYMONE VONGDEUANE
SEMPRA ENERGY SOLUTIONS
101 ASH STREET, HQ09
SAN DIEGO, CA 92101-3017

THEODORE ROBERTS
ATTORNEY AT LAW
SEMPRA GLOBAL
101 ASH STREET, HQ 13D
SAN DIEGO, CA 92101-3017

DONALD C. LIDDELL, P.C.
DOUGLASS & LIDDELL
2928 2ND AVENUE
SAN DIEGO, CA 92103

MARCIE MILNER
DIRECTOR - REGULATORY AFFAIRS
SHELL TRADING GAS & POWER COMPANY
4445 EASTGATE MALL, SUITE 100
SAN DIEGO, CA 92121

REID A. WINTHROP
PILOT POWER GROUP, INC.
8910 UNIVERSITY CENTER LANE, SUITE 520
SAN DIEGO, CA 92122

THOMAS DARTON
PILOT POWER GROUP, INC.
9320 CHESAPEAKE DRIVE, SUITE 112
SAN DIEGO, CA 92123

STEVE RAHON
DIRECTOR, TARIFF & REGULATORY ACCOUNTS
SAN DIEGO GAS & ELECTRIC COMPANY
8330 CENTURY PARK COURT, CP32C
SAN DIEGO, CA 92123-1548

GLORIA BRITTON
ANZA ELECTRIC COOPERATIVE, INC.
58470 HWY 371
PO BOX 391909
ANZA, CA 92539

LYNELLE LUND
COMMERCE ENERGY, INC.

TAMLYN M. HUNT
ENERGY PROGRAM DIRECTOR

600 ANTON BLVD., SUITE 2000
COSTA MESA, CA 92626

COMMUNITY ENVIRONMENTAL COUNCIL
26 W. ANAPAMU ST., 2/F
SANTA BARBARA, CA 93101

JEANNE M. SOLE
DEPUTY CITY ATTORNEY
CITY AND COUNTY OF SAN FRANCISCO
1 DR. CARLTON B. GOODLETT PLACE, RM. 234
SAN FRANCISCO, CA 94102

JOHN P. HUGHES
MANAGER, REGULATORY AFFAIRS
SOUTHERN CALIFORNIA EDISON COMPANY
601 VAN NESS AVENUE, STE. 2040
SAN FRANCISCO, CA 94102

LAD LORENZ
V.P. REGULATORY AFFAIRS
SOUTHERN CALIFORNIA GAS COMPANY
601 VAN NESS AVENUE, SUITE 2060
SAN FRANCISCO, CA 94102

MARCEL HAWIGER
THE UTILITY REFORM NETWORK
711 VAN NESS AVENUE, SUITE 350
SAN FRANCISCO, CA 94102

NINA SUETAKE
ATTORNEY AT LAW
THE UTILITY REFORM NETWORK
711 VAN NESS AVE., STE 350
SAN FRANCISCO, CA 94102

DIANA L. LEE
CALIF PUBLIC UTILITIES COMMISSION
LEGAL DIVISION
ROOM 4300
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3214

F. JACKSON STODDARD
CALIF PUBLIC UTILITIES COMMISSION
LEGAL DIVISION
ROOM 5125
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3214

AUDREY CHANG
STAFF SCIENTIST
NATURAL RESOURCES DEFENSE COUNCIL
111 SUTTER STREET, 20TH FLOOR
SAN FRANCISCO, CA 94104

EVELYN KAHL
ATTORNEY AT LAW
ALCANTAR & KAHL, LLP
120 MONTGOMERY STREET, SUITE 2200
SAN FRANCISCO, CA 94104

MICHAEL P. ALCANTAR
ATTORNEY AT LAW
ALCANTAR & KAHL, LLP
120 MONTGOMERY STREET, SUITE 2200
SAN FRANCISCO, CA 94104

SEEMA SRINIVASAN
ATTORNEY AT LAW
ALCANTAR & KAHL, LLP
120 MONTGOMERY STREET, SUITE 2200
SAN FRANCISCO, CA 94104

WILLIAM H. CHEN
CONSTELLATION NEW ENERGY, INC.
SPEAR TOWER, 36TH FLOOR
ONE MARKET STREET
SAN FRANCISCO, CA 94105

BRIAN K. CHERRY
DIRECTOR REGULATORY RELATIONS
PACIFIC GAS AND ELECTRIC COMPANY

EDWARD G POOLE
ANDERSON DONOVAN & POOLE
601 CALIFORNIA STREET SUITE 1300

77 BEALE STREET, B10C
SAN FRANCISCO, CA 94106

SAN FRANCISCO, CA 94108

ANN G. GRIMALDI
MCKENNA LONG & ALDRIDGE LLP
101 CALIFORNIA STREET, 41ST FLOOR
DAY
SAN FRANCISCO, CA 94111

BRIAN T. CRAGG
ATTORNEY AT LAW
GOODIN, MACBRIDE, SQUERI, RITCHIE &
505 SANSOME STREET, SUITE 900
SAN FRANCISCO, CA 94111

JAMES D. SQUERI
ATTORNEY AT LAW
GOODIN MACBRIDE SQUERI RITCHIE & DAY LLP
DAY LLP
505 SANSOME STREET, STE 900
SAN FRANCISCO, CA 94111

JEANNE B. ARMSTRONG
ATTORNEY AT LAW
GOODIN MACBRIDE SQUERI RITCHIE &
505 SANSOME STREET, SUITE 900
SAN FRANCISCO, CA 94111

KAREN BOWEN
ATTORNEY AT LAW
WINSTON & STRAWN LLP
101 CALIFORNIA STREET
SAN FRANCISCO, CA 94111

LISA A. COTTLE
ATTORNEY AT LAW
WINSTON & STRAWN LLP
101 CALIFORNIA STREET, 39TH FLOOR
SAN FRANCISCO, CA 94111

SEAN P. BEATTY
ATTORNEY AT LAW
COOPER, WHITE & COOPER, LLP
201 CALIFORNIA ST., 17TH FLOOR
SAN FRANCISCO, CA 94111

JOSEPH M. KARP
ATTORNEY AT LAW
WINSTON & STRAWN LLP
101 CALIFORNIA STREET
SAN FRANCISCO, CA 94111-5802

JEFFREY P. GRAY
DAVIS WRIGHT TREMAINE, LLP
505 MONTGOMERY STREET, SUITE 800
SAN FRANCISCO, CA 94111-6533

CHRISTOPHER J. WARNER
PACIFIC GAS AND ELECTRIC COMPANY
77 BEALE STREET, PO BOX 7442
SAN FRANCISCO, CA 94120-7442

SARA STECK MYERS
ATTORNEY AT LAW
122 28TH AVENUE
SAN FRANCISCO, CA 94121

LARS KVALE
CENTER FOR RESOURCE SOLUTIONS
PRESIDIO BUILDING 97
PO BOX 39512
SAN FRANCISCO, CA 94129

ANDREA WELLER
STRATEGIC ENERGY

JENNIFER CHAMBERLIN
STRATEGIC ENERGY, LLC

3130 D BALFOUR RD., SUITE 290
BRENTWOOD, CA 94513

2633 WELLINGTON CT.
CLYDE, CA 94520

BETH VAUGHAN
CALIFORNIA COGENERATION COUNCIL
4391 N. MARSH ELDER COURT
CONCORD, CA 94521

KERRY HATTEVIK
MIRANT CORPORATION
696 WEST 10TH STREET
PITTSBURG, CA 94565

AVIS KOWALEWSKI
CALPINE CORPORATION
3875 HOPYARD ROAD, SUITE 345
PLEASANTON, CA 94588

WILLIAM H. BOOTH
ATTORNEY AT LAW
LAW OFFICES OF WILLIAM H. BOOTH
1500 NEWELL AVENUE, 5TH FLOOR
WALNUT CREEK, CA 94596

J. ANDREW HOERNER
REDEFINING PROGRESS
1904 FRANKLIN STREET
OFFICE
OAKLAND, CA 94612

JANILL RICHARDS
DEPUTY ATTORNEY GENERAL
CALIFORNIA ATTORNEY GENERAL'S
1515 CLAY STREET, 20TH FLOOR
OAKLAND, CA 94702

CLIFF CHEN
UNION OF CONCERNED SCIENTIST
2397 SHATTUCK AVENUE, STE 203
BERKELEY, CA 94704

GREGG MORRIS
DIRECTOR
GREEN POWER INSTITUTE
2039 SHATTUCK AVENUE, STE 402
BERKELEY, CA 94704

R. THOMAS BEACH
CROSSBORDER ENERGY
2560 NINTH STREET, SUITE 213A
BERKELEY, CA 94710-2557

BARRY F. MCCARTHY
ATTORNEY AT LAW
MCCARTHY & BERLIN, LLP
100 PARK CENTER PLAZA, SUITE 501
SAN JOSE, CA 95113

C. SUSIE BERLIN
ATTORNEY AT LAW
LLC
MC CARTHY & BERLIN, LLP
100 PARK CENTER PLAZA, SUITE 501
SAN JOSE, CA 95113

MIKE LAMOND
ALPINE NATURAL GAS OPERATING CO. #1
PO BOX 550
VALLEY SPRINGS, CA 95252

JOY A. WARREN

BALDASSARO DI CAPO

ATTORNEY AT LAW
MODESTO IRRIGATION DISTRICT
1231 11TH STREET
MODESTO, CA 95354

151 BLUE RAVINE ROAD
FOLSOM, CA 95630

JOHN JENSEN
PRESIDENT
AFFAIRS
MOUNTAIN UTILITIES
GROUP
PO BOX 205
KIRKWOOD, CA 95646

MARY LYNCH
VP - REGULATORY AND LEGISLATIVE
CONSTELLATION ENERGY COMMODITIES
2377 GOLD MEDAL WAY, SUITE 100
GOLD RIVER, CA 95670

LEONARD DEVANNA
EXECUTIVE VICE PRESIDENT
CLEAN ENERGY SYSTEMS, INC.
11330 SUNCO DRIVE, SUITE A
RANCHO CORDOVA, CA 95742

ANDREW BROWN
ATTORNEY AT LAW
ELLISON, SCHNEIDER & HARRIS, LLP
2015 H STREET
SACRAMENTO, CA 95811

BRUCE MCLAUGHLIN
BRAUN & BLAISING, P.C.
915 L STREET, SUITE 1270
SACRAMENTO, CA 95814

GREGGORY L. WHEATLAND
ATTORNEY AT LAW
ELLISON, SCHNEIDER & HARRIS, LLP
2015 H STREET
SACRAMENTO, CA 95814

JANE E. LUCKHARDT
ATTORNEY AT LAW
DOWNEY BRAND LLP
555 CAPITOL MALL, 10TH FLOOR
SACRAMENTO, CA 95814

JEFFERY D. HARRIS
ATTORNEY AT LAW
ELLISON, SCHNEIDER & HARRIS LLP
2015 H STREET
SACRAMENTO, CA 95814

VIRGIL WELCH
CLIMATE CAMPAIGN COORDINATOR
ENVIRONMENTAL DEFENSE
1107 9TH STREET, SUITE 540
SACRAMENTO, CA 95814

WILLIAM W. WESTERFIELD, 111
ATTORNEY AT LAW
ELLISON, SCHNEIDER & HARRIS L.L.P.
2015 H STREET
SACRAMENTO, CA 95814

DOWNEY BRAND
JANE E. LUCKHARDT
555 CAPITOL MALL, 10TH FLOOR
SACRAMENTO, CA 95814-4686

RAYMOND J. CZAHAR, C.P.A.
CHIEF FINANCIAL OFFICER
WEST COAST GAS COMPANY
9203 BEATTY DRIVE
SACRAMENTO, CA 95826

STEVEN M. COHN
ASSISTANT GENERAL COUNSEL
SACRAMENTO MUNICIPAL UTILITY DISTRICT
PO BOX 15830
205
SACRAMENTO, CA 95852-1830

ANN L. TROWBRIDGE
ATTORNEY AT LAW
DAY CARTER & MURPHY, LLP
3620 AMERICAN RIVER DRIVE, SUITE
SACRAMENTO, CA 95864

DAN SILVERIA
SURPRISE VALLEY ELECTRIC CORPORATION
PO BOX 691
ALTURAS, CA 96101

JESSICA NELSON
PLUMAS-SIERRA RURAL ELECTRIC CO-OP
73233 STATE ROUTE 70, STE A
PORTOLA, CA 96122-7064

DONALD BROOKHYSER
ALCANTAR & KAHL
1300 SW FIFTH AVE., SUITE 1750
PORTLAND, OR 97210

CYNTHIA SCHULTZ
REGULATORY FILING COORDINATOR
PACIFIC POWER AND LIGHT COMPANY
825 N.E. MULTNOMAH
PORTLAND, OR 97232

KYLE L. DAVIS
PACIFICORP
825 NE MULTNOMAH,
PORTLAND, OR 97232

RYAN FLYNN
PACIFICORP
825 NE MULTNOMAH STREET, 18TH FLOOR
PORTLAND, OR 97232

TARA KNOX
AVISTA CORPORATION
PO BOX 3727
ASSN.
SPOKANE, WA 99220

IAN CARTER
POLICY COORDINATOR-NORTH AMERICA
INTERNATIONAL EMISSIONS TRADING
350 SPARKS STREET, STE. 809
OTTAWA, ON K1R 7S8
CANADA

JASON DUBCHAK
ASSOCIATE GENERAL COUNSEL
WILD GOOSE STORAGE, LLC
1200 855 2ND STREET, S.W.
CALGARY, AB T2P 4Z5
CANADA