

**BEFORE THE PUBLIC UTILITIES COMMISSION
AND THE ENERGY RESOURCES CONSERVATION
AND DEVELOPMENT COMMISSION
OF THE STATE OF CALIFORNIA**

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

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

Order Instituting Informational Proceeding – AB 32.

CEC Docket No. 07-OIIP-01

**SOUTHERN CALIFORNIA PUBLIC POWER AUTHORITY
REPLY TO COMMENTS ON
MARKET ADVISORY COMMITTEE REPORT**

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In accordance with the July 19, 2007 Administrative Law Judge's Ruling Requesting Comments and Legal Briefs on Market Advisory Committee Report and Notice of En Banc Hearing ("Ruling") in the captioned proceedings, the Southern California Public Power Authority ("SCPPA") respectfully submits this Comment. In accordance with the Ruling, this Reply Comment is being submitted to both the California Public Utilities Commission ("CPUC") and the California Energy Commission ("CEC") (jointly, "Commissions").

I. OVERVIEW OF OPENING COMMENTS: FIRST SELLER AND THE ACHILLES HEEL.

The opening comments address a central issue confronting the Commissions: What should be the point of regulation of greenhouse gas ("GHG") emissions for the electric sector? The choices available to the Commission have been defined by a central desideratum: California seeks to reduce the GHG emissions that are caused by generating electricity to serve California

electricity consumers, regardless of whether the electricity was generated inside or outside of California.

About a quarter of the electricity that is delivered to serve load in California comes from out-of-state resources, and about half of the emissions associated with serving California load are associated with that out-of-state generation. In an effort to impose GHG emissions regulation on all electricity that is delivered to California consumers, the CPUC has proposed a “load-based” approach under which retail providers would be the point of California GHG regulation. *See Assigned Commissioner’s Ruling and Phase 2 Scoping Memo at 1 (February 2, 2007) (“Scoping Memo”).* Alternatively, the Commissions are considering a “first-seller” approach that was suggested by the Market Advisory Committee (“MAC”) in its Recommendations for Designing a Greenhouse Gas Cap-and-Trade System for California (“Recommendations”) (June 30, 2007). The MAC proposes that both California in-state generators and importers should be points of regulation to capture all of the emissions associated with serving California electricity consumers. *See Recommendations at 42.* After reviewing the opening comments, SCPPA is persuaded that the load-based approach is the better option.

Both the retail provider approach and the first-seller approach pose problems. On one hand, establishing retail providers as a point of regulation under the load-based approach could lead to greater reliance on using default factors to attribute GHG emissions to electricity that retail providers deliver to consumers, particularly electricity purchased through the Integrated Forward Market (“IFM”) proposed by the California Independent System Operator (“CAISO”), and it could affect bidding into the IFM as explained by Southern California Edison Company (“SCE”). *See SCE Comment at 19-23.* On the other hand, by imposing GHG regulation on importers, the first-seller approach could discourage importers from selling into the California

market. That could reduce market liquidity, increase wholesale electricity prices, and decrease reliability. *See PacifiCorp Comment at 7-8.*

There is a decisive defect in the first-seller approach, however. The first-seller approach would result in the State of California attempting to directly regulate wholesale sales into California. Wholesalers would be required to obtain GHG emission allowances in order to sell electricity into California. California GHG regulation would determine who is authorized to sell into the state and how much each wholesaler may sell. *See PacifiCorp Comment at 13.* Furthermore, the requirement that wholesalers must buy allowances as a condition for selling electricity into California would directly affect the wholesale price of electricity. Indeed, the intended purpose of extending GHG regulation to importers would be to internalize the cost of GHG emissions into the wholesale price that is charged by the importers. *See Recommendations at 46.*

The extension of GHG regulation to the wholesale sale of electricity is a fatal flaw in the first-seller approach. Wholesale sales of electricity are within the exclusive jurisdiction of the Federal Energy Regulatory Commission (“FERC”). The extension of California GHG regulation to wholesale sales of electricity is preempted by the Federal Power Act and would be unlawful. The direct application of California regulation to imported wholesale energy makes the first seller approach an unacceptable option. “The great Achilles heel of the Market Advisory Committee’s first seller approach is imported energy.” Green Power Institute (“GPI”) Comment at 4.

As generally recognized in the opening comments, the load-based approach would not raise preemption problems. “The load-based approach, which regulates only retail sellers, does

not face the same potential preemption problems.” Natural Resources Defense Council (“NRDC”) Legal Brief at 3.

A. The Load-Based Approach Would Be Consistent with Providing Leadership for the Region and Nation.

California seeks to have its program become the model for other states and the nation. Development of a load-based GHG regulatory program for the electric sector could provide a valuable model for states to use in forging GHG regulatory programs prior to development of a federal program.

It appears that a number of western states are interested in instituting GHG regulatory programs ahead of implementation of a federal program. Certainly, the states that have joined California in the Western Regional Climate Action Initiative (Arizona, New Mexico, Oregon, Utah and Washington) are interested. The states that are considering GHG regulatory programs are likely to share California’s concern about avoiding “leakage” and will want to reduce the GHG emissions associated with electricity delivered from out-of-state generation as well as the GHG emissions associated with electricity delivered from in-state generation. Also, those other states will most likely be interested in establishing a regulatory program that would not be subject to federal preemption challenges.

Establishing a load-based program in which retail providers are the point of regulation can resolve leakage problems and preemption problems simultaneously. Thus, it is likely that those states that are interested in pursuing GHG regulatory programs will consider a load-based program for their electric sectors. That is what Oregon is doing. *See* Energy Producers and Users Coalition and Cogeneration Association of California (“EPUC/CAC”) Comment at 51-52.

California could provide a valuable service for other states if it would develop a sound load-based GHG regulatory program for its electric sector. The establishment of a sound and

legally sustainable California program would be likely to encourage other states to do the same. That would expand the reach of GHG regulation so as to reduce global greenhouse gas emissions, and it would result in other states instituting programs that would be compatible with rather than conflict with the California program.

B. A Load-Based Approach Would Facilitate Efficient GHG Reduction in the Electric Sector.

A load-based program for the electric sector would maximize efficiency in reducing GHG emissions in the electric sector. Unlike generators, retail providers have available to them a wide range of tools to use to reduce the GHG emissions associated with electricity delivered to the retail providers' consumers. Most notably, they can use a judicious mix of energy efficiency programs, renewable resource programs, re-powering of existing generation facilities, revised dispatch protocols, and, for some, participation in land-use decision-making to develop a comprehensive strategy for achieving the greatest amount of GHG reductions at the lowest possible cost. Individual generators or "independent power producers" could take advantage of, at most, one or two of those tools for achieving GHG emissions.

The CPUC clearly supports developing a comprehensive strategy that utilizes all tools available to retail providers in order to achieve GHG reduction goals. *See* Scoping Memo at 9. Adopting the load-based approach would be consistent with achieving the goal of maximizing GHG reductions most efficiently.

C. The Load-Based Approach Would Avoid Double Regulation of Emissions from Generators.

It appears that the MAC developed the first-seller approach on the assumption that California would be the only western state that would seek to establish a GHG regulatory program. If that assumption were wrong and various states were to implement GHG regulatory programs that were based on the first-seller approach, there would be clear likelihood of double

regulation of GHG emissions. For example, if both California and Arizona implemented GHG regulatory schemes based on the first-seller approach, a generator that is located in Arizona but which exports electricity to California would be regulated both at the source of emissions by Arizona and at the first California point of delivery (“POD”) by California.

Double regulation would not result if multiple states adopted the load-based approach to GHG regulation. For example, if both California and Oregon were to adopt load-based programs for their electric sectors (as may, in fact occur), an Oregon generator that produces electricity for delivery to California would not be regulated by Oregon. Instead, the emissions associated with electricity transmitted by the Oregon generator for delivery to California load would be the responsibility of the California retail provider that serves the load. Thus, while instituting first-seller programs across the western region would result in double regulation, instituting load-based programs would not. The fact that multiple state adoption of load-based programs would avoid double regulation is a key reason for California to develop a load-based approach as a model for the western region rather than the first-seller approach.

D. The Load-Based Approach Would be Consistent with the MAC’s Objective of “Simplicity” and Would Reduce Administrative Burdens.

The MAC proposed several fundamental objectives for designing a GHG regulatory program. One was “simplicity,” which the MAC defined as “a program that is easily communicated and administered.” Recommendations at 18. The load-based approach would achieve the MAC objective of simplicity and minimization of administrative burden better than the first-seller approach.

PacifiCorp calculates that currently there are five investor-owned utilities, twenty-six municipal electric utilities, three rural cooperatives, seventeen state and federal agencies and irrigation districts, and approximately seventeen registered electric service providers that would

be subject to GHG regulation in the electric sector under a load-based approach. PacifiCorp at 2-3. Thus, less than seventy entities would be points of regulation under the load-based approach. *Ibid.* By contrast, under the first-seller approach, the number of entities that would become subject to regulation by California would increase “exponentially.” *Ibid* at 2. Every generation source of emissions in California plus all importers, even those who import infrequently, would be subject to the California first-seller regulatory scheme. A dramatic increase in the number of entities that would become subject to regulation would dramatically increase the gross administrative burden of the program on the electric sector.

The exponential increase in administrative burden that would result from adoption of the first-seller rather than the load-based approach is illustrated by the increased complexity of allocating GHG emission allowances. Under the load-based approach, by PacifiCorp’s calculation, less than seventy entities would need to receive allowances. Under the first-seller approach, there would need to be an allocation and distribution of allowances to hundreds and probably thousands of regulated entities. *See* EPUC/CAC at 21.

E. The Load-Based Approach Would Reduce the Potential for a GHG Regulatory Program to Negatively Affect Wholesale Prices.

If California were to institute a first-seller program, generators in other states would take into account the need to buy allowances in deciding whether to sell electricity to California. A wholesaler might be deterred from selling into California by uncertainty about the availability and price of allowances. Salt River Project (“SRP”) Comment at 6. Even if a wholesaler could get certainty about availability and price, if the wholesaler had an option to sell electricity into a state such as Oregon that had a load-based program or to a state that had no GHG regulatory program at all, the wholesaler would tend to sell to the non-California market unless the

California price were so high that it was the most attractive price after taking into account the cost of California allowances.

A decline in wholesale sales into the California market could reduce the liquidity of the market and raise prices. *See PacifiCorp* at 8. Ultimately, requiring wholesalers to acquire allowances could deter wholesale sales into California so much as to diminish reliability of service to California load.

By contrast, the load-based approach would not make wholesale sales a point of regulation. The cost of allowances would not be reflected in wholesale prices. Wholesale sellers would not be deterred from selling into the California market. The result would be lower wholesale prices than under the first-seller approach and a greater prospect that California would be able to consistently attract wholesale sales of electricity.

SCE was concerned about the impact that a load-based program could have on bidding into the CAISO's IFM under the Market Redesign Technology Update ("MRTU"). SCE at 18. While SCE may be correct that a load-based program would affect the *pattern* of bidding, the load-based approach would not substantially affect the *quantity* of electricity that would be available to serve California load. By contrast, the first-seller approach would have the potential to reduce the quantity, absent a significant wholesale price escalation.

F. The Load-Based Approach Would Reduce Disputes About Allowance Allocation.

Adopting a load-based approach would tend to reduce nettlesome GHG allowance allocation issues. First, it would tend to eliminate all issues involving allocation of allowances to generators. Some independent power producers complained to the MAC that they operate under long-term fixed price contracts which prohibit them from passing through costs until the

contracts expire. The MAC observed: “Whether these producers should receive a free allocation in the interim should be evaluated carefully.” Recommendations at 56.

Other independent power producers seek a free allocation of allowances that would exceed their actual emissions. If their requests for excessive allowances were granted, they would be able to sell the excess and retain the resulting revenue. For example, CalEnergy Operating Corporation (“CalEnergy”) contends that it has geothermal plants that have “GHG emissions below the level of significance.” CalEnergy Comment at 3. Nevertheless, CalEnergy says that it and other renewable energy generators should receive free allowances based upon their “historic output of energy.” *Ibid.* at 8. CalEnergy reasons that this would give renewable energy generators excess allowances so that they could “sell a portion of their allocations (since their GHG emissions are insignificant)... to make their energy more cost competitive with other energy, and to invest in new and more efficient technologies.” *Ibid.* at 8.

Calpine joins CalEnergy in seeking free allocations of allowances based on “energy output with regular updating.” Calpine Comment at 6. EPUC/CAC argues that cogenerators should get a free allocation of allowances based on a “double benchmark” approach so as to provide allowances in excess of actual emissions. EPUC/CAC Comment at 12. Neither CalEnergy, Calpine, nor EPUC/CAC deign to address the MAC’s concern that giving free allowances to independent power producers could result in windfall profits. Recommendations at 48 (“When allowances are given out for free to generators, generators capture those rents”). Nevertheless, all issues that would arise under the first seller approach about allocating allowances to generators would disappear under the load-based approach insofar as retail providers rather than generators would be the point of regulation.

Second, adopting a load-based approach would address at least in part a proposal by Pacific Gas and Electric Company (“PG&E”) for load-serving entities (“LSEs”) to get free allowances in excess of their actual emissions. PG&E proposes that the Commission adopt a first-seller approach and that *all* electric sector allowances should be allocated to the LSEs, most likely on the basis of their retail load. LSEs that receive the allowances would then reallocate the allowances “to first sellers as complying entities through an auction or some other approach....” PG&E at 35.

As SCPPA explained in its opening comment, PG&E’s proposal would expose some retail providers to cross subsidizing other retail providers. If the allowances were allocated among retail providers on the basis of load as apparently assumed by PG&E, retail providers that have a more carbon-intensive resource mix such as the SCPPA members may receive fewer allowances than they need to cover actual emissions while lower emission retail providers such as PG&E would tend to receive many more allowances than they need to cover their emissions. That could result in an inequitable wealth transfers among retail providers. Also, it would contradict the repeated statements by the MAC as well as the Commissions about maintaining a strong incentive for retail providers to pursue energy efficiency aggressively, insofar as any decline in load would result in the decline in carbon allowances.

PG&E’s proposal for LSEs to receive allowances and then to resell allowances to generators as the point of regulation would be eliminated if the Commission were to adopt the load-based approach: First sellers would not be a point of regulation and thus, would not constitute a market for the allowances that would be resold by LSEs under PG&E’s proposal.

G. The Load-Based Approach Would Eliminate the Reporting and Tracking Problems Posed by the First-Seller Approach.

The opening comments make it clear that E-tags are insufficient to meet the GHG emission tracking and reporting needs of the first-seller approach. Although completed E-tags identify a “source,” that source is not always a specific generation unit. E-tags are not generated for intra-balancing authority deliveries. As a result, there are no E-tags at all for deliveries in which both the source and the sink are within the same balancing authority. E-tags carry no information about GHG attributes of reported electricity deliveries. Lastly, even if E-tags were generated for all deliveries from source to sink, E-tags are confidential. Thus, if the Commissions decided to pursue the first-seller option, the Commissions would be confronted with difficult reporting and tracking issues.

By contrast, a reporting protocol is already being developed for retail providers. AB 32 requires the CARB to adopt regulations by January 1, 2008 to “account for greenhouse gas emissions from all electricity consumed in the state, including transmission and distribution line losses from electricity generated within the state or imported from outside the state.” California Health and Safety Code § 38530(b)(2). A draft reporting protocol has already been proposed by the staffs of the Commissions. A draft decision regarding the reporting protocols is expected to be issued shortly in this docket, R.06-04-009.

Although SCPPA has raised issues about the reporting protocols that have been proposed by the Commissions’ staffs, SCPPA is confident that those issues will be satisfactorily resolved. The result would be a reporting protocol that would be adequate for implementation of the load-based approach. Indeed, it is apparent from AB 32 that the Legislature assumed that the reporting protocol which CARB is required to develop under AB 32 would be used for that purpose. Thus, if the Commissions were to adopt the load-based approach, they would avoid the

host of reporting and tracking issues that they will have to confront if they opt to pursue the first-seller approach.

II. THE EPUC/CAC “HYBRID” PROPOSAL SHOULD BE REJECTED FOR THE SAME REASONS AS THE FIRST-SELLER APPROACH.

EPUC/CAC propose a “hybrid approach” in which the point of regulation would be the emitting resource for in-state resources and the LSE for imports. EPUC/CAC Comment at 17. The hybrid approach is unworkable. In-state electricity would be commingled in the CAISO IFM and real time markets. If a default factor were adopted for deliveries from the IFM and real time markets to LSEs, in-state generation emissions would be double regulated. First, the emissions would be regulated at the in-state source of generation. Second, the emissions would be regulated upon the delivery of electricity to LSEs for redelivery to load. Furthermore, as with the first-seller approach, inadequate information is available for imported electricity. As discussed above, there is no available reporting protocol to identify the information that would be needed about imports in order to make LSEs responsible for the emissions associated with imports. Just as imports are the Achilles heel of the first-seller approach, they are the Achilles heel for the hybrid approach proposed by EPUC/CAC.

III. RESPONSES TO COMMENTS REGARDING QUESTIONS.

SCPPA provides the following responses to various comments that were submitted to parties in response to questions that were presented in the Ruling.

A. Basic Definitions (Questions 1 through 8).

The Division of Ratepayer Advocates (“DRA”) points out in response to Question No. 8 that the Los Angeles Department of Water and Power (“LADWP”) is a balancing authority and that the LADWP control area extends to the Intermountain Power Project (“IPP”) in Utah. DRA

Comment at 5. Insofar as transmission from IPP to the LADWP load center is entirely within the LADWP control area, LADWP is not required to generate E-tags. *Ibid.* DRA is correct.

DRA's response to Question No. 8 highlights a central problem with the first-seller approach. E-tags are the only mechanism that any party has proposed to track GHG attributes of imported electricity from source to sink, and E-tags are inadequate for that purpose. As DRA's example shows, for some imports there are no E-tags whatsoever.

The fact that E-tags are not required for deliveries within a balancing authority also creates problems for some of the definitions of "first-seller" that are proposed by advocates of the first-seller approach. The Commission required supporters of the first-seller approach to provide definitions of "first-seller." Ruling at 2, 4. In response to Question No. 1, SCE defines the first seller for imported power as being "the entity that first delivers electricity at a point of delivery within a California balancing authority (also commonly referred to as a 'control area')." SCE Comment at 3. However, insofar as E-tags are not required for deliveries within a control area, it would not be possible to consistently identify the first seller as defined by SCE.

B. General Policy Issues (Questions 9 through 16).

Morgan Stanley Capital Group, Inc. ("Morgan Stanley") contends in response to Question No. 13 that the load-based approach would be more complex than the first-seller approach and that such complexity could have an impact on power prices. Morgan Stanley Comment at 9. In fact, the reverse is true. The load-based approach would be much less complex than the first-seller approach. Far fewer entities would be involved, and the load-based approach does not present the reporting and tracking dilemmas that are raised by the first-seller approach. There is no complexity that would result in the load-based approach having an effect on wholesale markets.

C. Interaction with Energy Markets (Questions 17 through 19).

In response to Question No. 17 about the impact of the first-seller approach and the load-based approach on existing wholesale energy markets, DRA recommends that “some research and analysis could be done to better understand behavior in these markets and best possible outcomes.” DRA Comment at 12. As explained above, the load-based approach would be unlikely to have any substantial effect on wholesale markets. Conversely, however, the first-seller approach could have major negative effects on price, liquidity, and reliability of the wholesale market. If the Commission opts to proceed with consideration with the first-seller approach, SCPPA joins DRA in urging the Commission to fully model the effects that the first-seller approach would have on the wholesale market.

D. Interaction with Existing Programs and Policies (Questions 20 through 25).

PG&E claims in response to Question No. 21 that LSEs would have the same incentive under a first-seller approach as they would have under a load-based approach to pursue energy efficiency programs “because electricity prices will be higher due to the internalized cost of AB 32 compliance....” PG&E Comment at 29. PG&E made the same claim in response to Question No. 14 about the effect the first-seller approach would have on LSE long-term investments in low GHG emitting generation technologies. PG&E Comment at 23. In fact, however, the higher electricity cost that would result from adopting the first-seller approach and having the cost of allowances “internalized” in the price of electricity would provide no incentive for PG&E to pursue either energy efficiency or low-GHG generation technologies. All of the increase in the price of electricity would be passed through to PG&E consumers with none of the increase being borne by PG&E shareholders.

Under a load-based approach, however, PG&E as a retail provider would be responsible for obtaining allowances that would be sufficient to cover emissions. If PG&E were negligent in

pursuing low-GHG alternatives or energy efficiency, the Commission would be well positioned to assess whether some portion of the cost of allowances should be borne by shareholders rather than completely recovered from ratepayers. PG&E would have more of an incentive to pursue energy efficiency and low-GHG alternatives aggressively under the load-based approach in which PG&E would be a point of regulation than under any approach such as first seller which would permit PG&E to avoid being a point of regulation.

In response to Question No. 21, Morgan Stanley contends that only the first-seller approach can result in price signals to “industrial and large commercial facilities” about emissions costs. Morgan Stanley Comment at 15-16. Morgan Stanley’s contention is incorrect. If a load-based approach were adopted and retail providers were required to buy allowances, the utilities would pass through the cost of the allowances. That would result in a price signal about emissions costs being sent to industrial large commercial customers

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

In response to Question No. 27, PG&E proposes that the Staff proposed reporting protocol that was circulated on June 12, 2007 in this proceeding “should be revised to place the reporting responsibility on first sellers, rather than on the LSEs.” PG&E Comment at 32. PG&E ignores the fact that AB 32 requires that CARB develop mandatory greenhouse gas emissions reporting requirements by January 1, 2008 to, among other things, “account for greenhouse gas emissions from all electricity consumed in the state, including transmission and distribution line losses from electricity generated within the state or imported from outside the state.” California Health and Safety Code § 38530(b)(2). The reporting requirement shall apply “to all retail sellers of electricity, including load-serving entities... and local publicly owned utilities....” *Ibid.* Thus, CARB is required by statute to develop a reporting protocol that applies to retail providers.

CARB does not have discretion to abandon the effort to develop mandatory reporting requirements for retail providers and to shift to developing reporting protocols that would apply to first sellers. CARB must develop the reporting protocols that will apply to retail providers regardless of whether the Commissions adopt a first-seller approach or a load-based approach to establishing the point of regulation for the electric sector. If the first-seller approach were to be adopted, there would need to be *two* protocols, one for reporting by retail providers as required by AB 32 and another for purposes of implementing the first seller approach.

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

In responding to Question No. 32, PG&E proposes to distribute all of the electric sector allowances to “load serving entities.” PG&E Comment at 35. PG&E does not define “load serving entities,” but presumably the scope of the term extends beyond California investor owned utilities to publicly owned utilities (“POUs”) and energy service providers (“ESPs”). Presumably the allowances would be allocated among the LSEs on the basis of their retail electrical loads. Under PG&E’s proposal, the allowances that would be received by the LSEs would then be redistributed to the first sellers who would be the point of regulation in the electric sector “through an auction or some other approach....” *Ibid.*

PG&E’s proposal would be unfair to retail providers that have a more carbon intensive electrical generation resource mix than does PG&E or similarly situated utilities that enjoy the benefits of a substantial component of hydroelectric generation and nuclear generation in their resource mix. As explained in SCPPA’s opening comment (at 39), SCPPA members are substantially reliant upon coal-fired resources, primarily the Intermountain Power Project in Utah and the San Juan Project in New Mexico as a legacy of resource development decisions that were made in accordance with state and national policies as they existed in the 1970’s. As a result, under a first-seller program, SCPPA members and similarly situated retail providers would need

to obtain allowances to cover emissions that would be proportionately much greater than the allowances that PG&E or similar situated utilities would need.

Under PG&E's proposal, the retail providers that have a more heavily carbon intensive resource mix would face a prospect of having to buy allowances from PG&E or other similarly situated retail providers. The result would be a wealth transfer from consumers of retail providers that have a more heavily carbon intensive resource mix to the consumers of retail providers that have a lower carbon intensive resource mix. Accordingly, SCPPA strongly opposes PG&E's proposal.

If a GHG regulatory program were adopted which requires retail providers to obtain allowances to cover their emissions, SCPPA recommends that allowances be distributed so that the consumers served by retail providers will not have to bear the full cost of buying allowances in addition to bearing the costs of reducing the carbon intensity of their retail providers' fuel mix. Ratepayer dollars should be used for funding activities that actually contribute to reducing their retail providers' greenhouse gas emissions. The Ratepayers should not also be required to bear the full burden of purchasing allowances, particularly if the revenues that are generated by such purchases would be channeled to other retail providers or to purposes other than funding the GHG reduction efforts of the ratepayers' retail provider.

PG&E is not the only one to propose that it receive allowances for free that would be substantially in excess of any actual need to cover the cost of emissions. As discussed above, CalEnergy is an operator of geothermal plants that have "GHG emissions below the level of significance." CalEnergy Comment at 5. However, CalEnergy seeks to receive free allowances based upon its "historic output of energy." *Ibid* at 8. That would result in CalEnergy and

similarly situated renewable resource operators receiving allowances far in excess of their need for allowances.

CalPine joins CalEnergy in seeking a free allocation of allowances on the basis of “energy output” without regard to the actual level of emissions in need for allowances. Similarly, EPUC/CAC propose that co-generators get an allocation of allowances based on a “double benchmark” approach which would result in co-generators receiving allowances substantially in excess of their actual emissions. EPUC/CAC Comment at 12.

None of the generators that seek an allocation of allowances in excess of their emissions address the MAC’s concern that “when allowances are given out for free to generators, generators capture these rents.” Recommendations at 48. Nor do they provide any justification for the windfall that they would get if they got allowances in excess of their actual need to cover emissions. Both the PG&E proposal and proposals by generators to receive excess allowances beyond any level that might be justified by a need to cover actual emissions should be rejected as leading to cross-subsidization and unjust enrichment.

G. Relationship to Other Sectors Under AB 32 in California (Question 35).

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

Adoption of a load-based program by California could provide a model for other western states that desire to pursue GHG regulation of their electricity sectors prior to the implementation of a nationwide program. Further, to the extent to which there were a uniform adoption of load-based programs on the state-by-state basis in the west, double regulation of emissions associated with electricity that is traded in the western wholesale market would be avoided.

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

In response to Question No. 42, Morgan Stanley contends that if California were to adopt a load-based program for the electric sector, California's program would be unlikely to "attract much emulation." Morgan Stanley Comment at 26. In fact, a California load-based program for the electric sector would be likely to be emulated by other jurisdictions that are closest to California, the Western states. To the extent to which other western states including those in the Western Regional Climate Action Initiative are interested in implementing GHG reduction programs before a national program is adopted, those states would likely be interested in programs which can simultaneously address leakage issues while avoiding federal preemption issues. Thus, it would be valuable for the western region to have California develop a load-based electric sector regulatory program which other states could follow as a model.

Morgan Stanley points to the fact the European Union ("EU") adopted a source-based program, The Emissions Trading System ("ETS"). Morgan Stanley Comment at 26. However, the EU was implementing a continent-wide program, so the EU did not need to address leakage issues such as those that are likely to concern individual western states that elect to proceed with GHG regulatory programs in advance of implementation of a federal program. Morgan Stanley also points to the fact that the Regional Greenhouse Gas Initiative ("RGGI") that has been adopted by a group of northeastern states is a source-based program. *Ibid.* However, it seems that the RGGI states elected not to address leakage at the formative stage of their program. The RGGI states adopted GHG emission reduction targets that were substantially less aggressive than California's, which may have been a factor that contributed to reduced concerns about leakage issues. It is unlikely that the Western states are likely to be so sanguine about leakage issues.

Lastly, Morgan Stanley points to the fact that any federal program is likely to be a source-based rather than load-based program. *Ibid.* However, leakage (except across

international borders) is unlikely to be a major concern for a federal program insofar as that program will be nationwide. Further, federal preemption would not be a problem for a federal program. Thus, although a source-based program may be appropriate at the national level, the load-based model is more appropriate for western states that elect to proceed with GHG reduction initiatives in advance of the implementation of a federal program.

The contexts in which the EU ETS and RGGI programs were fashioned in the context and which a national program might be fashioned are different from the context in which California and other western states are attempting to develop GHG regulatory programs for their electric sectors in the advance of the development of a federal program. The load-based approach is the most appropriate for California and the western states, given their uniform need to address leakage, to avoid inter-program conflicts, and to avoid federal preemption issues.

J. Questions for Legal Briefing (Questions 43 through 53).

By Ruling dated August 8, 2007, the Administrative Law Judge raised the additional question for legal briefing:

54. To what degree if any, does the following line of cases suggest that a deliverer/first seller approach is more likely than a load-based approach to be subject to preemption under the Federal Power Act? *Northern Natural Gas Co. v. Kansas*, 372 U.S. 84 (1963); *Transcontinental Gas Pipe Line Corp. v. Mississippi*, 474 U.S. 409 (1986); *Northwest Central Pipeline Corp. v. Kansas*, 489 U.S. 493 (1989). Please consider these cases in light of *Calif. ex rel. Lockyer v. Dynegy, Inc.*, 375 F.3d 831, 842 n8 (2004) (finding that the Federal Power Act and the Natural Gas Act are similar statutory schemes and therefore case law for the two Acts is often interchangeable). Please provide a detailed analysis.

This line of cases suggests that the deliverer/first seller approach would almost certainly be subject to preemption under the Federal Power Act (“FPA”) whereas the load-based approach would not.

1. Analysis of the Cited Cases.

As recognized by the Commissions, the *Dynegy* case stands for the proposition that case law involving specific provisions of the Natural Gas Act may be applied to parallel provisions of the Federal Power Act and vice versa. In this case involving the Commission's proposed deliverer/first seller approach, the provision at issue is FPA § 201(b), 16 U.S.C. § 824(b) insofar as certain first sales into California would be sales at wholesale in interstate commerce. The parallel provision under the Natural Gas Act is § 1(b), the subject of the cases cited. Both provisions give FERC the authority to regulate sales of electricity or natural gas at wholesale (*i.e.* for resale) in interstate commerce.

Northern Natural involved a Kansas State Corporation Commission order requiring all purchasers of natural gas, including interstate pipeline companies, "to purchase gas ratably from all wells connecting with its pipeline system in each gas field within the State." 372 U.S. at 85. The Supreme Court determined that the order was preempted by FERC's authority under NGA § 1(b) over wholesale sales of natural gas in interstate commerce. The Court found that

The federal regulatory scheme leaves no room either for direct state regulation of the prices of interstate wholesales of natural gas . . . or for state regulations which would indirectly achieve the same result.

Id. at 91. The Court further found that

The danger of interference with the federal regulatory scheme arises because these orders are unmistakably and unambiguously directed at *purchasers* who take gas in Kansas for resale and transportation in interstate commerce. In effect, these orders shift to the shoulders of interstate purchasers the burden of performing the complex task of balancing the output of thousands of natural gas wells within the State . . . a task which would otherwise presumably be the State Commission's. Moreover, any readjustment of purchasing patterns which such orders might require of purchasers who previously took unratably could seriously impair the Federal Commission's authority to regulate the intricate relationship between the purchasers' costs structures and eventual costs to wholesale customers who sell to consumers in other states.

Id. at 92. The Court then noted that while the purpose of the ratable take order was to conserve natural resources, the problem with the particular order was that it directly interfered with the prices of natural gas in wholesale sales in interstate commerce. *Id.* at 93. The Court noted that, even if there were no other alternative means for Kansas to achieve such conservation of natural gas, the method at issue would still fail. *Id.* at 94.

The *Transco* case involved a nearly identical order issued by the State Oil and Gas Board of Mississippi as the order issued by the Kansas Commission, which the Supreme Court also struck down. The difference in the two cases is that the Mississippi Supreme Court had upheld the Mississippi regulation on the grounds that the Natural Gas Policy Act of 1978 effectively nullified the *Northern Natural* holding. The Mississippi Supreme Court noted that the NGPA had removed FERC's jurisdiction over the "high cost" gas at issue in the case.

The Supreme Court found that although FERC no longer had jurisdiction over first sales of natural gas, Congress had determined to give market forces a more significant role in supply, demand and pricing issues and did not intend to give to the States the power it had denied FERC. In so finding, the Court relied on a prior case that found that a "'federal decision to forgo regulation in a given area may imply an authoritative federal determination that the area is best left unregulated, and in that event would have as much pre-emptive force as a decision to regulate.'" 474 U.S. at 422 (citing *Arkansas Electric Cooperative Corp. v. Arkansas Public Service Comm'n*, 461 U.S. 375 at 384 (1983)). The Court found that the relationship between the purchasers' costs structures and eventual costs to wholesale customers was "is still a subject of deep federal concern." *Id.* at 422. In determining that the Mississippi Board's order was preempted, the Court found that the order "directly undermines Congress' determination that the supply, the demand, and the price of high-cost gas be determined by market forces." *Id.* at 422.

In addition, in reviewing the Mississippi order, the Supreme Court noted that *Northern Natural* rested on a presumption that

in the absence of ratable-take requirements, purchasers would choose a different, and presumably less costly, purchasing pattern. By requiring pipelines to follow the more costly pattern, Kansas' order conflicted with the federal interest in protecting consumers by ensuring low prices.

Id. at 420.

Northwest Central involved Kansas' attempt to get around the *Northern Natural* decision by promulgating an order providing that producers' rights to extract assigned quantities of natural gas from a particular field would be permanently cancelled if production was delayed beyond allotted time periods. The Supreme Court upheld the regulation. The Court found that the regulation of producers was specifically reserved to the States and that the regulation does not conflict with the federal scheme regulating interstate purchasers' costs structures and thus, there was no federal preemption. The Court noted that the appellant pipeline company did not assert any conflict that was so direct that it would be impossible to comply with both the Kansas regulation and the federal regulations involving purchasing and pricing practices.

The Court also found that the Kansas regulation did not *per se* violate the Commerce Clause because it is neutral on its face, providing for cancellation of producers' rights regardless of whether they supply the interstate or intrastate market, and was not promulgated for the purpose of economic protectionism. In addition, the Court found that the regulation passed the balancing test set forth in *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142, since it was neutral in its application and was an exercise of Kansas' traditional and congressionally recognized power over gas production.

Taken together, what these cases suggest is that any regulation that *directly* impacts the *sale* (not merely the cost and price) of electricity for sale in interstate commerce runs the risk of being preempted by the FPA, particularly where Congress has given FERC the authority to regulate or where Congress has purposefully determined to leave the area unregulated. *See, e.g.*, 375 U.S. at 851, (“our cases specifying the nature and scope of exclusive FERC jurisdiction make clear that the interstate ‘transmission’ or ‘sale’ of wholesale energy pursuant to a federal tariff -- not merely the ‘rates’ -- falls within FERC's exclusive jurisdiction. States do, of course, have jurisdiction over certain sales, but we have enunciated a bright-line distinction between wholesale sales, which fall within FERC's plenary jurisdiction, and retail sales, over which the states exercise jurisdiction”). Furthermore, a regulation that *indirectly* impacts the price of wholesale sales of electricity would also be preempted. *See, e.g.*, 375 U.S. at 851, n. 17 (citing *Northern Natural* as discussed above). Finally, it would not matter whether the sale price were a tariff-based rate or a market-based rate. Both types of rates are within FERC’s exclusive jurisdiction to determine.¹

A regulation that indirectly impacts the sale of wholesale sales of electricity may avoid violating the Commerce Clause so long as the regulation is neutral on its face *and in its application* and is within the States’ traditional areas of regulation, such as environmental law. However, any discriminatory effect in the way the regulation is applied to various types of entities (as opposed to any specific company) may still violate the Commerce Clause.

2. The First Seller Approach is Preempted by the FPA.

¹ *See Market-Based Rates For Wholesale Sales Of Electric Energy, Capacity And Ancillary Services By Public Utilities*, 119 FERC ¶ 61,295 at P 7 (2007) (establishing new rules for determining whether entities qualify for charging market-based rates and recognizing that existing market-based rate policy was developed through FERC’s decision of individual proposals for market-based rates).

The deliverer/first seller approach runs afoul of the FPA simply because requiring certain sellers of electricity at wholesale to purchase emissions allowances as a condition to selling electricity into California would *directly* impact the sale (and the cost) of electricity sold at wholesale in interstate commerce, whether such sale was at a tariff rate or market-based rate. For instance, although not adequately defined, the description of the deliverer/first seller approach includes a deliverer/first seller “that first delivers electricity at a point of delivery within California.” Ruling at 3. This definition would include entities such as power marketers, other public utilities, out-of-state generators, and any other entity with excess power that sell electricity at wholesale in interstate commerce. Under the first seller approach, these entities would need to purchase emissions allowances in order to deliver into and sell their electricity into California. Such a condition on the ability to sell power into California clearly and directly impacts the terms and conditions of the sale itself as well as the wholesale price.

In a case involving FERC’s treatment for ratemaking purposes of SO₂ emissions allowances created by the Environmental Protection Agency under the Clean Air Act, FERC determined that the costs associated with such emissions allowances are within its jurisdiction under FPA § 205. *Edison Electric Institute*, 69 FERC ¶ 61,004 (1994). FERC made clear that any impact on the cost of electricity sold at wholesale in interstate commerce is exclusively within its jurisdiction:

The sale or transfer of an emissions allowance may "affect" the rates a utility charges "for or in connection with" jurisdictional service. Thus, if a wholesale sale of electric energy by a public utility requires the use of an emissions allowance, that sale, and the cost of allowances in connection with it, is subject to review under section 205. Similarly, the Commission will consider the justness and reasonableness of costs for emissions allowances when a public utility seeks to flow through its costs in wholesale rates. Such costs, as all other costs, may be disallowed if they are not reasonable or are imprudently incurred.

Id. at 61,289. The cost of emissions allowances that are not directly related to the use of generating facilities, such as emissions allowances associated with wholesale sales (rather than the generation itself) into a state, would be subject to FERC jurisdiction because the directly affect the sale of electricity for resale in interstate commerce.

Conversely, to regulations limiting generators' emissions, the load-based approach, which would require the retail providers to keep their electricity portfolios within certain emissions limits, is squarely within the State's authority. Any affect on the cost or price of electricity sold at wholesale in interstate commerce would be indirect and unavoidable. Although a retail provider may make different purchasing decisions in order to meet its emissions portfolio limits and that could affect the cost of various types of generation, the retail provider would still pay the FERC-approved rate (whether tariff- or market-based) for any purchases of electricity at wholesale.

3. **The PURPA Cases.**

Several parties argue that because the first-seller approach is an environmental regulation and that such regulations are within the traditional police powers of the state, it would not be preempted by the FPA. For instance, in arguing that the deliverer/first seller approach would not likely be preempted, EPUC/CAC and PG&E rely on cases involving PURPA and electric generators for the proposition that FERC's authority under the FPA does not preempt environmental regulations. Such cases are inapposite and do not address the issue that has been directly addressed by the Supreme Court in the cases cited by the Commission in this question, *i.e.*, that any state regulation that *directly* impacts wholesale sales of electricity in interstate commerce is preempted.

EPUC/CAC relies on a recent FERC case involving renewable energy credits ("RECs") and PURPA for the proposition that the first seller approach would not face preemption

problems. EPUC/CAC Comment at 34. *See American Ref-Fuel Company, et al.*, 105 FERC ¶ 61,004 (2003). However, that case involved a narrow issue and is distinguished from the issues presented by the first seller approach.

First, the RECs at issue were part of a state program regulating the resource portfolios of retail suppliers, *i.e.*, it was a load-based program.

Second, the question before FERC was whether PURPA determined the ownership of RECs if the actual QF contract was silent on the issue – an issue that is not relevant to whether the first seller approach is preempted by the FPA. FERC found that RECs were created by state law and that the avoided cost rules and regulations promulgated pursuant to PURPA did not contemplate RECs and that the avoided costs rates for capacity and energy do not convey the RECs in the absence of express contractual provision. *Id.* at 61,007, at 18. FERC noted that its regulations set forth the factors to be considered in determining what the “avoided cost” rate should include and that environmental attributes are not included. *Id.* at 21-22. FERC found this appropriate since the purpose of using avoided costs was to put the purchasing utility in the same position when purchasing QF capacity and energy as it would have been had the utility generated the electricity itself or purchased it from another source. *Id.* at 22. Thus, the avoided cost paid to the QF does not depend on the type of QF, *i.e.*, fossil-fuel or renewable energy. The RECs, whether they passed to the purchasing utility or not, do not change the rate to be paid by the utility to the QF.

Finally, the FERC was careful to narrowly define the issue it addressed, making the distinction between RECs and other possible types of tradable credits that could impact the price of electricity within FERC’s jurisdiction. *Id.* at 24 (“We thus grant Petitioners’ petition for a declaratory order, to the extent that they ask the Commission to declare that contracts for the sale

of QF capacity and energy entered into pursuant to PURPA do not convey RECs to the purchasing utility . . .”).

The case cited by PG&E regarding FERC’s determination that qualifying facilities are not exempt from state environmental laws provides no useful precedent. *See* PG&E Comments, Attachment 1 at 2 (citing *Small Power Production and Cogeneration Facilities – Environmental Findings*, 10 FERC ¶ 61,314 at 61, 632 (1980)). The FPA is an entirely different regulatory scheme than PURPA. The FPA involves FERC’s plenary authority over “sales of electricity at wholesale in interstate commerce” rather than the development of alternative fuel sources and the use of renewable generation. In addition, unlike the FPA, PURPA lists specific laws or types of laws from which QFs may be exempt. 16 U.S.C. § 824a-3(e)(1) (“ . . . qualifying cogeneration facilities, and qualifying small power production facilities are exempted in whole or part from the Federal Power Act [16 U.S.C. 791a et seq.], from the Public Utility Holding Company Act [15 U.S.C. 79 et seq.], from State laws and regulations respecting the rates, or respecting the financial or organizational regulation, of electric utilities, or from any combination of the foregoing . . .”). In the FERC order, FERC merely acknowledged the fact that environmental laws were excluded from the list of the types of laws from which qualifying facilities may be exempt under PURPA.

PG&E also cites a case involving FERC’s determination that generators would not have to comply with the must run requirement if doing so would cause them to violate their certificates or permits. The case is inapplicable. The FERC merely determined that a generator could be exempted from the “must run” requirement if it could “demonstrate that running its unit violates a permit, would result in a criminal or civil violation or penalties, or would result in QF units violating their contracts or losing their QF status.” *See San Diego Gas & Electric Co. v.*

Sellers of Energy and Ancillary Service Into Markets Operated by the California Independent System Operator Corporation and the California Power Exchange, 96 FERC ¶ 61, 117 at 61, 448 (2001).

The numerous other cases cited by EPUC/CAC regarding preemption fail to take into account the cases noted by the Commission, in Question No. 54. EPUC/CAC Comments at 31-34. Notwithstanding the various cases laying out the tests for determining whether a field is preempted, the cases cited in Question No. 54 clearly show that the Supreme Court has already addressed the kinds of state regulations that are preempted by the Natural Gas Act and, by extension, the FPA and that those regulations include environmental and conservation laws that directly impact the price of wholesale sales of electricity.

Nearly all of the initial comments acknowledge that the first-seller approach is the approach that is most likely to face preemption issues. *See* EPUC/CAC Comment at 37.

The cases cited by those who claim that the first-seller approach would survive an attack on the grounds of preemption are not applicable to the regulatory scheme under the FPA. The cases addressed by the Commission in Question No. 54 are precisely on point. Thus, the first-seller approach fails under a preemption analysis.

4. Commerce Clause Issues

As discussed above, *Northwest Central* indicates that a regulation that indirectly impacts the sale of wholesale sales of electricity may avoid violating the Commerce Clause so long as the regulation is neutral on its face *and in its application* and is within the States' traditional areas of regulation, such as environmental law. In its initial comments, PacifiCorp states that "[i]f California were to direct revenues from GHG allocation sales to in-state first sellers, in essence returning to them some of their own payments for such GHG allowances, that would discriminate against out-of-state first sellers, who had to purchase GHG allowances, but got none

of such payments back through “assistance” from California. PacifiCorp Comment at 14. Given that regulations must be neutral in their application and must not disadvantage out-of-state sellers as compared to in-state sellers, PacifiCorp is likely to be correct that the allocation of revenues from the sale of GHG allowances could result in the first seller approach violating the Commerce Clause.

5. Alternatives for Addressing Preemption Issue

In its brief on legal issues, NRDC states that California should “ensure that the cost of complying with California’s GHG regulations ... is included in the usual FERC rate-making process.” NRDC Legal Brief at 6. NRDC does not explain which agency or how that agency should go about accomplishing this. Given that individual sellers of electricity at wholesale in interstate commerce must file a tariff, either a traditional rate tariff or a market-based rate tariff, a California agency would appear to have to intervene in each rate proceeding involving each of those sellers.

However, NRDC also suggests that California could file a petition for a declaratory order. NRDC Legal Brief at 11. The Commissions could file a petition pursuant to 18 C.F.R. § 385.207(a)(2), which permits a person to petition for a “[d]eclaratory order or rule to terminate a controversy or remove uncertainty.” Interested parties would have an opportunity to comment. However, SCPPA believes that the Commissions would need to better define “deliverer/first seller” and otherwise refine the first-seller approach to ensure that their petition for declaratory order would have sufficient detail for FERC to make a determination on the issue of preemption.

IV. CONCLUSION.

As discussed, SCPPA is persuaded by the arguments submitted in the opening comments that the load-based approach to establishing a point of regulation for the electric sector would be

far superior to the first-seller approach in meeting California's objectives for GHG regulation of the electric sector. Moreover, the first-seller approach is affected by a fatal flaw in that it is

preempted by the Federal Power Act. Accordingly, SCPPA recommends that the Commissions adopt the load-based approach as proposed by the CPUC in the Scoping Memo.

Respectfully submitted,

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PUBLIC POWER AUTHORITY**

Dated: August 15, 2007

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of the **SOUTHERN CALIFORNIA PUBLIC POWER AUTHORITY REPLY TO COMMENTS ON MARKET ADVISORY COMMITTEE REPORT** on the service list for CPUC Docket No. R.06-04-009 and CEC Docket No. 07-OllP-01 by serving a copy to each party by electronic mail and/or by mailing a properly addressed copy by first-class mail with postage prepaid.

Executed on August 15, 2007, at Los Angeles, California.

/s/ Sylvia Cantos

Sylvia Cantos

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