

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

Order Instituting Rulemaking to Promote)	
Policy and Program Coordination and)	R.04-04-003
Integration in Electric Utility Resource)	
Planning)	
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**REPLY COMMENTS OF THE
CALIFORNIA INDEPENDENT SYSTEM OPERATOR TO
ADMINISTRATIVE LAW JUDGE'S RULING REQUESTING
ADDITIONAL COMMENTS ON RESOURCE ADEQUACY ISSUES**

Charles F. Robinson, General Counsel
Anthony J. Ivancovich, Senior Regulatory Counsel
Grant A. Rosenblum, Regulatory Counsel
California Independent System Operator
151 Blue Ravine Road
Folsom, CA 95630
Telephone: 916-351-4400
Facsimile: 916-351-2350

Attorneys for the
California Independent System Operator

Dated: July 29, 2004

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The California Independent System Operator (“CAISO”) respectfully submits these reply comments in response to the Administrative Law Judge’s Ruling Requesting Additional Comments on Resource Adequacy Issues mailed on July 8, 2004 (“ALJ Ruling”) in this proceeding.

I. INTRODUCTION

The ALJ Ruling requested comments on the following resource adequacy issues:

- (1) Whether to accelerate the phase-in of the full planning reserve margin from January 1, 2008 to June 1, 2006;
- (2) How the year-round 15-17% reserve requirement and the seasonal 90% forward contracting requirement interact, including (1) when to fill-in the remaining 10% for reserves procured for the summer months, and (2) when load serving entities (“LSEs”) must demonstrate the full 15-17% in the non-summer months. In particular, comments should address whether LSEs should be required to procure and demonstrate the remaining 10% of

their summer resource adequacy requirement and their full non-summer reserve margin one month ahead; and

- (3) Whether future Commission approved contracts intended to comply with resource adequacy requirements should include terms and conditions requiring that resources secured to meet the LSE's resource adequacy requirement be available to LSEs to schedule in the day-ahead time frame.

In addition to the CAISO, eight other parties filed initial comments on the aforementioned issues.¹ In the instant Reply Comments, the CAISO responds to other parties' initial comments regarding the issues raised in the ALJ Ruling. The CAISO notes that its Reply Comments will not address issues that were not expressly raised in the ALJ Ruling (*e.g.*, the "counting" of liquidated damages contracts for purposes of satisfying the resource adequacy obligation and the merits of a capacity tagging proposal). These issues are addressed in the CAISO's comments on the resource adequacy Workshop Report and therefore are not repeated herein.

The CAISO submits that none of the parties' comments pose a legitimate barrier to implementing the 15-17% planning reserve margin by June 1, 2006. Further, the opposition to a requirement that the full non-summer planning reserve margin, as well as the remaining 10% of the summer reserve margin, be procured one-month ahead is limited, and the objections to such a requirement are without merit. Finally, no party has raised valid arguments in opposition to a

¹ Initial comments were filed by the following parties: Alliance for Retail Energy Markets ("AREM"); Western Power Trading Forum ("WPTF"); Silicon Valley Manufacturing Group ("SVMG"); Pacific Gas & Electric Company ("PG&E"); Southern California Edison Company ("SCE"); Office of Ratepayer Advocates ("ORA"); Independent Energy Producers Association ("IEP"); San Diego Gas & Electric Company ("SDG&E"); and The Utility Reform Network ("TURN").

requirement that resources procured to meet a load serving entity's ("LSE") resource adequacy obligation must be available to the LSE and the CAISO in the day-ahead time frame.

II. WAITING UNTIL 2008 TO FULLY IMPLEMENT THE RESERVE REQUIREMENT IS UNWARRANTED

In its Response to the ALJ Ruling filed on July 22, 2004 ("Response"), the CAISO argued that all LSEs should be required to acquire a reserve margin of no less than 10-12% in 2005 and fully satisfy the planning reserve margin by June 2006, subject to certain protections against market power for local capacity requirements. Three factors supported the CAISO's conclusion. First, aggregate supply conditions currently favor LSE procurement, which will allow acceleration of the phase-in schedule by dampening the threat of the exercise of market power by suppliers. Second, adequate prophylactic steps could be taken to protect against the exercise of market power by suppliers. Third, a full resource adequacy obligation should precede implementation of the CAISO's final phase of its market redesign. ORA, IEP and WPTF support an accelerated phase-in of the reserve requirement. ORA Comments, Attachment at 1; IEP Comments at 1; WPTF Comments at 2. SDG&E does not oppose an accelerated phase-in. SDG&E Comments at 2.

TURN, SCE and AREM oppose an accelerated phase-in of the full reserve requirement. TURN alleges that an accelerated phase-in will increase costs. TURN Comments at 5-6. TURN also argues that an accelerated phase-in is unnecessary because resources will be adequate for 2004-2008.² *Id.* at 7-8. TURN and SCE state that an accelerated phase-in will raise market

² In support of its position, TURN states that the CAISO experienced new peak levels last week and still had three times the amount of reserves needed to meet a 7% reserve operating reserve margin. Accordingly, TURN argues that the Commission should ignore the "sky-is falling" arguments. TURN Comments at 2-4.

power concerns.³ TURN Comments at 6; SCE Comments at 2. Likewise, SCE claims that an accelerated phase-in will not increase reliability because no new capacity will be added as a result of such acceleration. SCE Comments at 4. On the other hand, PG&E contends that an accelerated phase-in may increase short-term reliability, but will not result in new construction.⁴ PG&E Comments at 2. SCE and AREM argue that an accelerated phase-in is inappropriate because numerous resource adequacy issues are unresolved at this time. SCE Comments at 3-4; AREM Comments at 3.

The CAISO submits that waiting until 2008 to fully implement the planning reserve margin could subject California ratepayers to increased costs and, potentially, curtailments if the resource base deteriorates, there is a prolonged period of low hydro conditions, or there is a significant increase in peak demand (in California and/or the West). The parties seeking to defer implementation of the reserve requirement acknowledge that there is a surplus of cheap energy today. Thus, conditions are favorable for negotiating long-term capacity deals now. Conditions may not be so favorable in the future, forcing LSEs to meet their resource adequacy obligation in times where tighter supply increases prices.

Claims that competition between the utilities for capacity will drive up costs significantly are mere speculation and lack a logical basis given the acknowledged current supply conditions. Given that there presently is a supply surplus, and the utilities only need to procure a limited amount of additional capacity to meet the reserve requirement (because the CDWR contracts cover a significant percentage of the utilities' net short), it is not certain that any "bidding war"

³ TURN states that if the Commission accelerates the phase-in, it will need to adopt some mechanism to mitigate market power (e.g., set a "circuit breaker" for high prices). TURN Comments at 6.

⁴ PG&E states the utilities will need additional tools to comply with any accelerated phase-in including the authority to sign contracts beyond the third quarter of 2005 with delivery in years other than 2004. PG&E Comments at 2. PG&E also stresses that cost recovery issues will need to be addressed. *Id.*

will result. In any event, as the CAISO indicated in its Response, if there is evidence that suppliers are exercising market power, the utilities can always come back to the Commission and request that the effective date of the reserve requirement be pushed back. Alternatively, if there is a demonstration that suppliers are exercising market power, the CAISO could step in and execute RMR or RMR-like contracts, whichever is applicable under the circumstances, for a transitional period in order to meet locational capacity needs.

Further, parties fail to recognize that capacity is cheap compared to energy. As California learned during the energy crisis, high spot market prices are not cheap. When capacity is not locked-in in advance, LSEs must rely on volatile spot market prices to serve load, and that approach can be extremely expensive.

The claims that existing supply conditions obviate the need to “lock up” capacity now are shortsighted. Although there presently remains some excess capacity under optimal conditions (scenario of base demand and favorable resource availability), it should not be assumed that there will be excess capacity available to serve California load between 2006 and 2008. The CAISO believes the near-term potential for the “mothballing” and/or retirement of 3,000-4,000MW of generating units is very real and cannot be ignored.⁵ The CAISO’s Five-Year Assessment shows convergence in the supply-demand balance between 2004 and 2008, and does not reflect the likelihood that nearly 4,000 MW of capacity could retire over the next several years. The CAISO’s Five-Year Assessment also does not reflect our first evidence of this trend, the sudden mothballing just this year, of an additional 825 MW of capacity. Under these

⁵ The CAISO has received formal notification that some large older generators will retire prior to 2005 in the event they are not selected in the procurement process. Without a contract, owners of aging generators are not compelled to invest in needed maintenance based on hopes to run in the spot market. TURN argues that even if aging generators retire or mothball now they will likely return to service when needed. It can take from one-to-six months for a mothballed generator to re-commission. As such mothballed units cannot be considered as quasi-available to meet adverse conditions.

circumstances, the arguments that accelerated implementation of the full planning reserve margin will not result in any new capacity ignore the very real risk that existing resources will no longer be available to serve California load in future years. This could result in a capacity shortage in the near future if mechanisms are not in place to “lock-up” such capacity.

Parties also ignore the fact that, even if there is a capacity surplus today, that capacity may not be available to serve California load if it is not “locked-up” now. Low hydro conditions in upcoming years could turn a capacity surplus into a capacity deficit, and problems could arise if the remaining capacity is not “locked-up” to serve load in California. Further, load is growing at a rapid pace throughout the West, while the number of potential resource additions planned in California have declined. Many new generation projects that were in progress in 2003 are either on-hold or have been outright cancelled. Further, despite the currently favorable conditions, reserve margins in the West are the lowest in the nation, and the areas outside of California are experiencing significant load growth. *California Independent System Operator Corporation*, 100 FERC ¶ 61,062 at P 2, 32 (2002). Increasing load without a corresponding increase in new generation will put a strain on existing resources. Moreover, generation development in California has slowed considerably. Only 118 MW of new generation is expected by the end of 2004, compared to 4,830 MW built in 2003, 2,878 MW built in 2002 and 2,513 MW built in 2001. Load growth in other states will compete with California load for a finite set of supplies in upcoming years. Under these circumstances, there is no guarantee that existing supplies will be available when California needs them, especially if there is a region-wide heat wave and/or a low hydro year. California needs to act now to “lock-up” such supplies by accelerating the full phase in of the planning reserve margin by summer 2006.

The CAISO recognizes that accelerating the phase-in date for the full planning reserve margin will not result in incremental resources being constructed. However, that is not the objective of an accelerated phase-in. The objective of an accelerated phase-in is to increase reliability, reduce the risk of curtailments, and limit exposure to volatile spot market prices. These goals can be accomplished by ensuring that available resources are committed to serving California loads.

TURN “hones in” on the fact that the CAISO experienced record peaks last week, and still had significant additional resources in reserve. TURN Comments at 3. TURN states that any discussion of an accelerated phase-in of the full planning reserve margin must be considered with this in mind.

The CAISO submits that the existence of some excess capacity at this point in time is all the more reason for LSEs to begin “locking-up” that capacity now, especially given the specter of continued region-wide load growth and the potential for the mothballing and retirement of existing generation. With an excess of capacity, prices should be cheaper now, and it is less likely that suppliers will subject LSEs to the exercise of market power. The events of last week also demonstrate that loads in California are growing at a much faster rate than was previously anticipated. The July 21, 2004 peak was 3.9% higher than the peak demand for July 2003, with both peaks occurring under similar, average temperatures (temperatures slightly less than a 1-in-2 year pattern). That fact, and the fact that significant load growth is being experienced throughout the West, creates significant uncertainty for the future availability of resources to serve California. Stated differently, why is it prudent for LSEs to face unnecessary risk in the future when they can lock-up capacity at reasonable prices today.

The CAISO also notes TURN's reference to the significant additional resources that were in reserve during the week of July 19-23 is misleading. However, this assertion is misleading because the reserves shown cannot all be used to serve additional load. Included in those reserves were approximately 2,800 MW of Operating Reserves that the CAISO must carry to be compliant with WECC Minimum Operating Reliability Criteria. In addition, during the peak hours, the CAISO was importing from outside the Control Area on average in excess of 5,600 MW.⁶ California cannot count on that level of imports being available when temperatures are hot in neighboring states and/or hydro reserves are low.⁷

Certain parties also claim that an accelerated phase-in is not feasible given that the Commission has not finally decided all of the issues in the proceeding. This fact should not delay implementation of the full planning reserve margin. The Commission is scheduled to issue a final resource adequacy decision (including a decision on the Workshop issues) in September. That should provide sufficient time for LSEs to line up adequate supplies by the summer of 2006. As the CAISO indicated in its Response, LSEs should not be required to demonstrate compliance with the year-ahead showing requirement by April 2005 for May 2006. The first year-ahead showing should be scheduled for April 2006 for the 2007 summer season. This

⁶ In its 2004 Summer Assessment (p. 30), the CAISO's base case scenario for imports in July 2004 contemplated imports of 5,862 MW.

⁷ TURN's assumption that there were significant additional resources in reserve on July 21 was based on an assumption that the CAISO reached its summer peak on July 21 and that the *preliminary resource* data published on the CAISO webpage captures actual conditions. This assumption is erroneous for two reasons. First, recent trends demonstrate a slightly higher growth rate in peak demand than originally assumed in the 2004 Summer Assessment base forecast and approach the forecasted high peak demand. Second, the preliminary available resource capacity does not account for transmission constraints, and does not include other unreported outages for ambient de-rates (including capacity not available due to low hydro conditions). The actual resources available when considering data error, capacity limitation due to transmission constraints, and ambient de-rates approximately 600 MW higher than forecasted for the summer peak, mostly due to lower than average forced outages. Moreover, the Participating Thermal Outages on July 21 was 1,532 MW compared to the forecast of 2,500 MW. The maximum Participating Thermal Outages during peak hours for the 2004 summer season on June 1st was 4,296 MW. These types of unplanned outages can occur at anytime of any day.

timeline (in conjunction with the CAISO's proposal for a monthly forward contracting obligation for 100% of the reserve requirement) would give LSEs until April 1, 2006 to procure 100% of their capacity requirements for May 2006. That should provide LSEs with sufficient time to procure their capacity requirements.

The CAISO acknowledges PG&E's point that, if the Commission accelerates the phase-in date for the full planning reserve margin, LSEs will need a Commission decision revising prior Commission orders to allow them to enter into the necessary supply arrangements. The CAISO also concurs with PG&E that the Commission should allow LSEs the opportunity to recover all prudently incurred costs in complying with an accelerated phase-in.

III. A REQUIREMENT THAT LSEs PROCURE 100% OF THEIR SUMMER AND NON-SUMMER CAPACITY REQUIREMENTS BY THE MONTH AHEAD IS APPROPRIATE

In its Response, the CAISO strongly advocates a requirement that LSEs be required to procure the remaining 10% of their summer resource adequacy requirement, and their full non-summer reserve margin, one month ahead. Such a requirement precludes LSEs from placing reliable and reasonably priced service to load at risk by waiting until the last minute to procure an undue quantity of resources needed to serve load.

TURN agrees with the CAISO that LSEs should be required to procure 100% of their summer and non-summer reserves a month ahead. TURN Comments at 1. ORA states that LSEs should be required to demonstrate 100% resource adequacy for the summer months 30 days ahead of time. ORA Comments, Attachment at 3. However, ORA believes that the Commission should proceed with a summer-only requirement, and then determine whether specific requirements are needed for non-summer months. *Id.* ORA submits that any non-summer requirement should be less stringent than the summer requirement (*e.g.*, there could be a

monthly or quarterly demonstration for non-summer months made in the end-of year filing for the summer months). *Id.* at 3-4. San Diego agrees that the additional 10 percent summer requirement should be met in the month ahead, and the 15-17% showing for non-summer months should be made concurrently with the showing for the summer months for efficiency purposes. SDG&E Comments at 4. SCE and AREM argue that a requirement that LSEs forward contract 100% of their reserve requirements a month in advance will unnecessarily increase costs without providing any reliability benefits. SCE Comments at 7-9; AREM Comments at 7-11.⁸ SCE claims that anything beyond the 90% requirement is unnecessary because supplies will be available in the short-term markets anyway, and units are unlikely to be mothballed in the summer months. SCE Comments at 8. PG&E suggests that LSEs should meet 100% of their reserve needs one day before the operational month. PG&E Comments at 5-6.

The resistance to an obligation on the part of LSEs to line up sufficient capacity a month-ahead is unwarranted. Ultimately, LSEs must procure sufficient resources to meet the needs of their customers be it in forward markets or in the CAISO's markets. The alternative to month-ahead procurement is undue reliance on spot market purchases with the hope that sufficient supplies will be available. When purchases are made at the last minute, the range of options available to meet unforeseen circumstances is substantially more circumscribed than if purchases are made ahead of time.

⁸ AREM claims that the Commission's Interim Order, D.04-01-050, did not establish a 15-17% reserve requirement on a year-round basis. AREM Comments at 8. AREM states that, to the extent LSEs are required to make a month-ahead showing, such showing should be limited to the summer months. The CAISO does not believe that there is any basis for AREM's belief that the Commission did not establish a year-round reserve requirement. The order directed "LSE's to meet this 15-17% reserve requirement by no later than January 1, 2008." Interim Order, mimeo at 11. If the reserve requirement was a summer-only requirement there would be little sense in making the requirement effective in January. Also, the Commission established "a requirement that utilities forward contract 90% of their summer...peaking needs... a year in advance." *Id.* If the reserve requirement was a summer-only requirement, again there would have been no need to specify a separate summer forward contracting requirement.

PG&E, SCE and AREM have not provided a credible explanation as to why it is better to risk last minute purchases of needed capacity rather than to proceed with an orderly procurement of needed resources in advance of the day-ahead and real-time time frames. The requirement that LSEs procure their summer and non-summer capacity requirements a month in advance provides the utilities with a large degree of flexibility to firm up their capacity commitments when market conditions are optimal, while ensuring that surplus supplies, to the extent they exist, are committed to California and are not diverted elsewhere or available only at very high prices (due to adverse conditions such as a West-wide heat wave). In that regard, a month-ahead requirement would not unduly limit the ability of utilities to use short-term capacity purchases. Further, as the CAISO stressed in its Response, a month-ahead requirement does not in any way preclude LSEs from procuring energy that is available from other resources after the month ahead and is cheaper than the energy the utilities can purchase under their capacity contracts. In that regard, the month-ahead obligation is a capacity obligation only; LSEs are not being required to procure 100% of their expected energy needs a month in advance. As the CAISO has emphasized on numerous occasions, capacity is cheap (compared to energy) and the existence of a month-ahead obligation will place downward pressures on prices in the short-term markets.

On the other hand, a month-ahead requirement precludes the LSEs from placing reliable, cost-effective service to load at risk by waiting until the last minute to procure the resources needed to serve their customers' load. Moreover, the month-ahead requirement would ensure that, if there were problems looming, the Commission, the CAISO, and LSEs would have a month to attempt to line up additional supplies or encourage conservation rather than addressing a potential short fall at the last minute in a crisis mode.

SCE contends that a requirement that 100% of capacity requirements be procured by the month-ahead will unnecessarily increase costs without enhancing reliability in any material fashion. SCE Comments at 7-8. SCE's position is based on the following assumptions: (1) existing supplies are going to be available on a short term-basis anyway and are unlikely to be mothballed during the summer peak season; (2) new supplies take years to add; and (3) existing suppliers will not make commitments outside California and therefore will be available to meet California needs.

These arguments miss the point. Even assuming, *arguendo*, that supplies are available, that does not ensure that such supplies will be made available to California when California needs them. Only if LSEs procure necessary capacity in advance will any available capacity be guaranteed to serve California load and not potentially chase higher prices outside the State. If capacity is not locked-in in advance, LSEs will be forced to rely on volatile spot market prices to serve load, and that approach can be extremely risky and expensive.

SCE's argument regarding the mothballing of generating units also is without merit. Generating units are not casually mothballed during non-summer months and then brought back into service every summer. Units are mothballed because the unit is not under a bilateral contract and the unit owner does not perceive an opportunity to recover fixed costs by participating in the market. Indeed, there is general consensus among suppliers and generation developers that fixed cost recovery is unlikely to be realized through reliance on the California spot markets.

The arguments that a monthly obligation is unnecessary for non-summer months seem to stem from the mistaken assumption that resource adequacy is not as critical during the non-summer months. The CAISO believes that the forward contracting obligation should apply to the non-summer months as well as the summer months. While certain parties may assume that

adequate resources will be available for the non-peak months of the year, there is no assurance of this outcome because resources would not be locked up by California LSEs. Ignoring non-peak months could unnecessarily expose consumers to high spot market prices and potential curtailments. Blackouts can occur, and have occurred, during the off-peak winter months. Further, price spikes regularly can occur – and have occurred --during the shoulder months, especially when there are “heat waves,” low hydro levels, and/or significant quantities of capacity offline for scheduled outages. Further, there has been no showing that extending the forward contracting obligation to the non-summer months will unduly burden LSEs, especially given that LSEs are already making demonstrations of resource adequacy for the five summer months.

IV. RESOURCE ADEQUACY CONTRACTS SHOULD INCLUDE A REQUIREMENT THAT RESOURCES BE MADE AVAILABLE TO LSES AND THE CAISO IN THE DAY-AHEAD TIME FRAME

The CAISO stressed in its Response that a well-designed resource adequacy requirement must include an obligation that LSE-procured capacity resources be available to the CAISO through its day-ahead and real-time markets and scheduling processes when such resources are not otherwise scheduled in the day-ahead market. Therefore, the Commission should require that contracts between LSEs and suppliers include a provision making resources available to LSEs in a day-ahead timeframe and to the CAISO in the event such resources are not scheduled by LSEs in the day-ahead. Thus, to the extent resources are not scheduled by LSEs to meet their loads, but become necessary in the day-ahead or real-time periods to balance resources with load, the CAISO could use the resources for such purpose. CAISO Response at 19. Unless the Commission explicitly addresses the issue of coordination and an efficient hand-off of resources

to the CAISO, the value of the Commission's resource adequacy obligation will not be fully realized.

TURN, SDG&E and PG&E all agree with the CAISO that resources should be made available to LSEs in the day-ahead time frame and to the CAISO if they are not scheduled by LSEs. TURN Comments at 13; SDG&E Comments at 5; PG&E Comments at 6. WPTF states that a day-ahead offer obligation would be reasonable with adequate compensation via a capacity payment, as well as the ability to include opportunity costs in energy offers. WPTF Comments at 14. WPTF supports a unit commitment process and believes that capacity procured to meet resource adequacy requirements should seamlessly integrate with the transmission operator's markets. *Id.* at 13. ORA and SCE recommend that the Commission not decide the issue at this time. ORA states that a decision is unnecessary at this time because the ultimate form of the CAISO's market design is currently unclear and, as such, ensuring integration remains uncertain. ORA Comments, Attachment at 4. SCE states that the onus should be on the CAISO to determine whether the resource adequacy requirements placed on LSEs are sufficient to meet the CAISO's operational needs. SCE Comments at 10-11. SCE argues that the CAISO should provide this analysis after the Commission issues its final rules on resource adequacy. AREM contends that a day-ahead must offer obligation should be voluntary. AREM Comments at 12. As indicated in the CAISO's Response, a day-ahead must offer-type obligation is necessary for the following reasons: (1) it will ensure that LSE resources are made available in a manner that is consistent with the CAISO's scheduling and commitment requirements; (2) it will enhance the CAISO's ability to operate the grid reliably by moving unit commitment and dispatch out of real-time and into the day-ahead timeframe; (3) it will ensure that resources procured by LSEs are utilized by the CAISO to meet energy needs and that overall costs are not increased because

the CAISO was forced to commit resources that are less efficient than those procured by the LSEs; and (4) it is necessary to ensure that units are properly mitigated for system and local market power in the market runs that the CAISO conducts.

Contrary to SCE's and ORA's suggestion, there is no reason for the Commission to delay ruling on this issue. In the first instance, any resources procured by LSE's must be scheduled or made available to the CAISO regardless of the market design. Otherwise, the very purpose of resource adequacy, *i.e.*, to procure sufficient capacity, would not translate into reliable service to load. Moreover, ORA's claim that the CAISO's market design is uncertain lacks merit. FERC has already approved the CAISO's proposed market redesign on a conceptual basis. *California Independent System Operator Corporation*, 105 FERC ¶ 61,140 (2003) ("October 28 Order"). In a June 17, 2004 Order, FERC provided additional guidance regarding the details of seven specific elements of the market redesign, including the CAISO's residual unit commitment ("RUC") proposal. *California Independent System Operator Corporation*, 107 FERC ¶ 61,274 (2004) ("June 17 Order"). In its June 17, 2004 Order, FERC also ordered the CAISO to file tariff language on the seven market design elements by the end of 2004 and established procedures that will lead to resolution of a couple of distinct market design issues

Thus, the CAISO's market redesign is sufficiently "baked" for the Commission to rule on the merits of a day-ahead must offer obligation. The details of the RUC proposal have been approved by FERC. Given that a day-ahead must offer obligation is necessary in order for RUC to function effectively and efficiently,⁹ it is imperative that the Commission impose a day-ahead

⁹ Absent a requirement to make resources available to the CAISO for possible commitment through the RUC mechanism, the RUC procedure may not have a sufficient pool of resources, and the CAISO may not be able to commit sufficient resources to serve the next-day's forecasted load. Today, the CAISO satisfies this availability requirement through the FERC-established must-offer obligation, in combination with the must-offer waiver process (today's equivalent of the RUC process). Under a Commission-approved requirement that contracts between LSEs and suppliers include a provision for making capacity procured under the contract available to the

must offer requirement for resource adequacy contracts. The CAISO has previously identified the need for a day-ahead must offer obligation in several filings at FERC regarding the proposed market redesign.¹⁰ There is no need for the CAISO to go back and re-evaluate this issue as certain parties suggest. The CAISO has fully evaluated its needs in connection with the new market design and has concluded that it needs a day-ahead must offer obligation in order for the market design to function effectively and efficiently and for the CAISO to operate the grid reliably. That is why the CAISO included a day-ahead must offer obligation in its July 22, 2003 market redesign filing at FERC and has continued to stress the need for such a mechanism as part of the new market design.

Although FERC rejected the CAISO's day-ahead must offer proposal, it did so on the grounds that the CAISO was not proposing to provide a capacity payment to suppliers and no resource adequacy requirement existed as a substitute. However, FERC recognized that a Commission-approved, day-ahead resource adequacy product with a capacity payment would satisfy FERC's and the CAISO's objectives. June 17 Order at P 26. Previously, FERC has recognized that "absent a resource adequacy requirement, generators should not be required to bid into the day-ahead market." October 28 Order at P 227; *see also Midwest Independent System Operator Inc.*, 102 FERC ¶ 61,280 at P 96 (2002). Thus, FERC has recognized that a day-ahead must-offer obligation is best achieved via a resource adequacy requirement.

CAISO, capacity that is not included in a forward schedule by the LSE would be required to bid into the CAISO day-ahead integrated forward market ("IFM") and would be available for commitment or dispatch by the CAISO as part of the RUC procedure. However, absent a requirement that the CAISO be permitted to utilize the capacity procured by LSEs, there will not be any way to ensure that sufficient resources will participate in RUC, thereby potentially rendering the RUC procedure ineffective and exposing consumers to potential real-time supply shortages or high prices.

¹⁰ *See* Comments of the California Independent System Operator Corporation, Docket No. ER02-1656 (May 11, 2004); Amended Comprehensive Market Design Proposal, Docket No. ER02-1656 (July 22, 2003).

A contractual day-ahead must offer obligation is consistent with the general objectives and the design of the CAISO's market redesign and will provide important operational and market efficiency benefits. The CAISO's inability to consider a full complement of LSE-procured capacity resources in the day-ahead market and in the RUC process could introduce unavoidable market flaws, which could lead to (1) inefficient/inaccurate optimization of unit commitment and scheduling to manage congestion, and (2) insufficient protection from locational and system market power. A day-ahead must offer obligation will provide the CAISO with the means to both *reliably* and *efficiently* commit the resources necessary to serve the next day's load and meet local reliability needs when they are not scheduled by LSEs. Given FERC's actions, such resources can be made available to the CAISO on a day-ahead basis only pursuant to the rules and obligations established under a resource adequacy requirement.

ORA appears to express some support for a flexible offer obligation, whereby a supplier would be obligated to make its capacity available in either the day-ahead or the real-time markets. ORA's support for a flexible offer obligation seems to stem from its belief that the Commission supported such a mechanism (rather than a day-ahead must offer obligation). To the contrary, the Commission supported the CAISO's proposal for a day-ahead must offer obligation. The CAISO views the flexible offer obligation as a less-than-perfect "back-up" in the event FERC failed to approve a day-ahead must offer obligation.

In filings at FERC, the CAISO identified several problems with a flexible offer obligation. See *Comments of the California Independent System Operator Corporation Regarding Technical Conference*, Docket No. ER02-1656, pages 16-32 (May 11, 2004). Unlike a day-ahead must offer obligation, a flexible offer obligation could lead to (1) inefficient unit commitment, (2) deficient and/or inaccurate market power mitigation, and (3) the potential for

over-generation and excess on-line capacity in real-time. In particular, a flexible offer option would not adequately address the issues identified on pages 19-21 of the CAISO's Response. That is why the CAISO proposed a day-ahead must offer obligation to FERC and not a flexible offer obligation. Further, in order for the market design to work as planned, and for all of the benefits associated with a day-ahead must offer obligation to be achieved, it is necessary that the obligation be mandatory not voluntary. The problems identified in the CAISO's Response and herein can arise if the obligation is not mandatory.

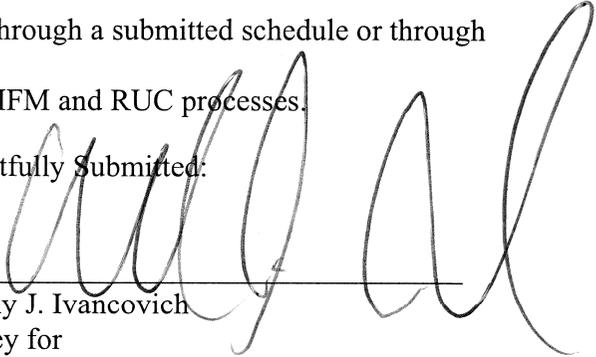
V. CONCLUSION

For the reasons set forth herein and in the CAISO's Response, the CAISO respectfully requests that the Commission include in its final order on resource adequacy issues, the following:

1. Full phase-in of the planning reserve margin by June 1, 2006, although the initial yearly reporting requirement may be deferred until April 1, 2006 for the 2007 summer peak season.
2. A requirement that LSEs must to procure and demonstrate the remaining 10% of their summer resource adequacy requirement and their full non-summer reserve margin one month ahead.

3. A requirement specifying that contracts will be deemed qualifying capacity for resource adequacy purposes only if such contracts include an express obligation that the capacity be made available to the CAISO in the day-ahead time frame either through a submitted schedule or through participation in the CAISO's IFM and RUC processes.

Respectfully Submitted:

By: 
Anthony J. Ivancovich
Attorney for
California Independent System Operator

Charles F. Robinson, General Counsel
Anthony J. Ivancovich, Senior Regulatory Counsel
Grant A. Rosenblum, Regulatory Counsel
California Independent System Operator
151 Blue Ravine Road
Folsom, CA 95630
Telephone: 916-351-4400
Facsimile: 916-351-2350

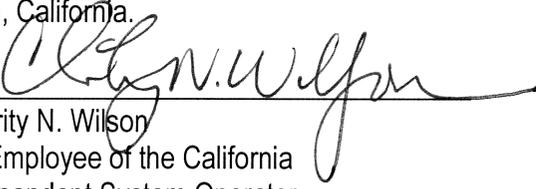
Attorneys for
California Independent System Operator

July 29, 2004

CERTIFICATE OF SERVICE

I hereby certify that I have served, by electronic and United States mail, a copy of the foregoing Reply Comments of The California Independent System Operator Corporation on Administrative Law Judge's Ruling Requesting Additional Comments on Resource Adequacy Issues to each party in Docket No. R.04-04-003.

Executed on July 29, 2004, at Folsom, California.


Charity N. Wilson
An Employee of the California
Independent System Operator

KEITH MCCREA
SUTHERLAND, ASBILL & BRENNAN
1275 PENNSYLVANIA AVENUE, NW
WASHINGTON, DC 20004-2415

ROGER A. BERLINER
MANATT, PHELPS & PHILLIPS, LLP
1501 M STREET, N.W., SUITE 700
WASHINGTON, DC 20005-1702

GARSON KNAPP
FPL ENERGY, LLC
770 UNIVERSE BLVD.
JUNO BEACH, FL 33408

JAMES ROSS
RCS CONSULTING, INC.
500 CHESTERFIELD CENTER, SUITE 320
CHESTERFIELD, MO 63017

LISA URICK
SAN DIEGO GAS & ELECTRIC COMPANY
555 W. FIFTH STREET, SUITE 1400
LOS ANGELES, CA 90013-1011

JAMES OZENNE
SAN DIEGO GAS & ELECTRIC COMPANY
555 W. FIFTH ST., STE. 1400
LOS ANGELES, CA 90013-1034

HOWARD CHOY
COUNTY OF LOS ANGELES
1100 NORTH EASTERN AVENUE
INTERNAL SERVICES DEPARTMENT
LOS ANGELES, CA 90063

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

RANDALL W. KEEN
MANATT PHELPS & PHILLIPS, LLP
11355 WEST OLYMPIC BLVD.
LOS ANGELES, CA 90064

GREGORY S.G. KLATT
LAW OFFICES OF DANIEL W. DOUGLASS
411 E. HUNTINGTON DRIVE, SUITE 107-356
ARCADIA, CA 91006

KEVIN DUGGAN
CAPSTONE TURBINE CORPORATION
21211 NORDHOFF STREET
CHATSWORTH, CA 91311

DANIEL W. DOUGLASS
LAW OFFICES OF DANIEL W. DOUGLASS
6303 OWENSMOUTH AVE., TENTH FLOOR
WOODLAND HILLS, CA 91367-2262

BETH A. FOX
SOUTHERN CALIFORNIA EDISON COMPANY
2244 WALNUT GROVE AVENUE
ROSEMEAD, CA 91770

ELIZABETH HULL
CITY OF CHULA VISTA
276 FOURTH AVENUE
CHULA VISTA, CA 91910

FREDERICK M. ORTLIEB
CITY OF SAN DIEGO - OFFICE OF CITY ATTOR
1200 THIRD AVENUE, 11TH FLOOR
SAN DIEGO, CA 92101

ALVIN S. PAK
SEMPRA ENERGY GLOBAL ENTERPRISES
101 ASH STREET, HQ15
SAN DIEGO, CA 92101-3017

JOSEPH R. KLOBERDANZ
SAN DIEGO GAS & ELECTRIC
8330 CENTURY PARK COURT
SAN DIEGO, CA 92123-1530

JOHN W. LESLIE
LUCE, FORWARD, HAMILTON & SCRIPPS, LLP
11988 EL CAMINO REAL, SUITE 200
SAN DIEGO, CA 92130

KEITH E. FULLER
ITRON, INC.
11236 EL CAMINO REAL
SAN DEIGO, CA 92130-2650

DAVID OLSEN
3804 PACIFIC COAST HIGHWAY
VENTURA, CA 93001

CHRIS KING
CALIF. CONSUMER EMPOWERMENT
ALLIANCE
ONE TWIN DOLPHIN DRIVE
REDWOOD CITY, CA 94065

MARC D. JOSEPH
ADAMS BROADWELL JOSEPH & CARDOZO
651 GATEWAY BOULEVARD, SUITE 900
SOUTH SAN FRANCISCO, CA 94080

JOSEPH P. COMO
CITY AND COUNTY OF SAN FRANCISCO
1 DR. CARLTON B. GOODLETT PLACE, RM.
234
CITY HALL, ROOM 234
SAN FRANCISCO, CA 94102

MICHEL PETER FLORIO
THE UTILITY REFORM NETWORK (TURN)
711 VAN NESS AVENUE, SUITE 350
SAN FRANCISCO, CA 94102

OSA ARMI
SHUTE MIHALY & WEINBERGER LLP
396 HAYES STREET
SAN FRANCISCO, CA 94102

DIAN M. GRUENEICH
GRUENEICH RESOURCE ADVOCATES
582 MARKET STREET, SUITE 1020
SAN FRANCISCO, CA 94104

JACK MC GOWAN
GRUENEICH RESOURCE ADVOCATES
582 MARKET STREET, SUITE 1020
SAN FRANCISCO, CA 94104

JODY S. LONDON
GRUENEICH RESOURCE ADVOCATES
582 MARKET STREET, SUITE 1020
SAN FRANCISCO, CA 94104

KAREN TERRANOVA
ALCANTAR & KAHL, LLP
120 MONTGOMERY STREET, STE 2200
SAN FRANCISCO, CA 94104

NORA SHERIFF
ALCANTAR & KAHL LLP
120 MONTGOMERY STREET, SUITE 2200
SAN FRANCISCO, CA 94104

ROD AOKI
ALCANTAR & KAHL, LLP
120 MONTGOMERY STREET, SUITE 2200
SAN FRANCISCO, CA 94104

SHERYL CARTER
NATURAL RESOURCES DEFENSE COUNCIL
111 SUTTER STREET, 20/F
SAN FRANCISCO, CA 94104

EDWARD V. KURZ
PACIFIC GAS AND ELECTRIC COMPANY
77 BEALE STREET
SAN FRANCISCO, CA 94105

JENNIFER K. POST
PACIFIC GAS AND ELECTRIC COMPANY
77 BEALE STREET, ROOM 2496
SAN FRANCISCO, CA 94105

CHRISTOPHER HILEN
DAVIS, WRIGHT TREMAINE, LLP
ONE EMBARCADERO CENTER, 6TH FLOOR
SAN FRANCISCO, CA 94111

JEANNE B. ARMSTRONG
RITCHIE & DAY, LLP
505 SANSOME STREET, SUITE 900
SAN FRANCISCO, CA 94111

JOSEPH M. KARP
WHITE & CASE LLP
3 EMBARCADERO CENTER, STE 2100
SAN FRANCISCO, CA 94111

STEVEN F. GREENWALD
DAVIS WRIGHT TREMAINE, LLP
ONE EMBARCADERO CENTER, 6TH FLOOR
SAN FRANCISCO, CA 94111

EDWARD W. O'NEILL
DAVIS WRIGHT TREMAINE LLP
ONE EMBARCADERO CENTER, SUITE 600
SAN FRANCISCO, CA 94111-3834

JEFFREY GRAY
DAVIS WRIGHT TREMAINE
ONE EMBARCADERO CENTER, 6TH FLOOR
SAN FRANCISCO, CA 94111-3834

LISA A. COTTLE
WHITE & CASE LLP
3 EMBARCADERO CENTER, SUITE 2210
SAN FRANCISCO, CA 94111-4050

JOHN W. BOGY
PACIFIC GAS & ELECTRIC
PO BOX 7442
SAN FRANCISCO, CA 94120

SARA STECK MYERS
122 - 28TH AVENUE
SAN FRANCISCO, CA 94121

AVIS CLARK
CALPINE CORPORATION
4160 DUBLIN BLVD.
DUBLIN, CA 94568

LINDA Y. SHERIF
CALPINE CORP.
4160 DUBLIN BOULEVARD
DUBLIN, CA 94568

MARJORIE OXSEN
CALPINE CORPORATION
4160 DUBLIN BOULEVARD
DUBLIN, CA 94568

STEVEN S. SCHLEIMER
CALPINE CORPORATION
4160 DUBLIN BLVD.
DUBLIN, CA 94568-6600

JOE DESMOND
INFOTILITY, INC.
4847 HOPYARD RD. STE. 4311
PLEASANTON, CA 94588

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

RAMONA GONZALEZ
EAST BAY MUNICIPAL UTILITY DISTRICT
375 ELEVENTH STREET, M/S NO. 205
OAKLAND, CA 94607

REED V. SCHMIDT
BARTLE WELLS ASSOCIATES
1889 ALCATRAZ AVENUE
BERKELEY, CA 94703-2714

R. THOMAS BEACH
CROSSBORDER ENERGY
2560 NINTH STREET, SUITE 316
BERKELEY, CA 94710

BARBARA R. BARKOVICH
BARKOVICH AND YAP, INC.
31 EUCALYPTUS LANE
SAN RAFAEL, CA 94901

JOHN R. REDDING
31 EUCALYPTUS LANE
SAN RAFAEL, CA 94901

JOHN REDDING
SILICON VALLEY MANUFACTURING GROUP
31 EUCALYPTUS LANE
SAN RAFAEL, CA 94901

JENNIFER HOLMES
ITRON INC.
153 WOODCREST PLACE
SANTA CRUZ, CA 95065

JUSTIN D. BRADLEY
SILICON VALLEY MANUFACTURING GROUP
224 AIRPORT PARKWAY, SUITE 620
SAN JOSE, CA 95110

BARRY F. MCCARTHY
MCCARTHY & BERLIN, LLP
2005 HAMILTON AVENUE, SUITE 140
SAN JOSE, CA 95125

C. SUSIE BERLIN
MC CARTHY & BERLIN, LLP
2005 HAMILTON AVENUE, SUITE 140
SAN JOSE, CA 95125

CHRISTOPHER J. MAYER
MODESTO IRRIGATION DISTRICT
PO BOX 4060
MODESTO, CA 95352-4060

SCOTT T. STEFFEN
MODESTO IRRIGATION DISTRICT
1231 ELEVENTH STREET
MODESTO, CA 95354

DAVID KATES
DAVID MARK AND COMPANY
3510 UNOCAL PLACE, SUITE 200
SANTA ROSA, CA 95403-5571

GRANT A. ROSENBLUM
CALIFORNIA INDEPENDENT SYSTEM
151 BLUE RAVINE RD.
FOLSOM, CA 95630

MATTHEW V. BRADY
MATTHEW V. BRADY & ASSOCIATES
2339 GOLD MEADOW WAY
GOLD RIVER, CA 95670

ANDREW B. BROWN
ELLISON, SCHNEIDER & HARRIS, LLP
2015 H STREET
SACRAMENTO, CA 95814

DOUGLAS K. KERNER
ELLISON, SCHNEIDER & HARRIS LLP
2015 H STREET
SACRAMENTO, CA 95814

W. KENT PALMERTON
CONSTELLATION POWER SOURCE
1215 K STREET, SUITE 1700
SACRAMENTO, CA 95814

LYNN M. HAUG
ELLISON, SCHNEIDER & HARRIS, LLP
2015 H STREET
SACRAMENTO, CA 95814-3109

DIANA MAHMUD
STATE WATER CONTRACTORS
455 CAPITOL MALL, SUITE 20
SACRAMENTO, CA 95814-4409

RONALD LIEBERT
CALIFORNIA FARM BUREAU FEDERATION
2300 RIVER PLAZA DRIVE
SACRAMENTO, CA 95833

MICHAEL ALCANTAR
ALCANTAR & KAHL LLP
1300 SW FIFTH AVENUE, SUITE 1750
PORTLAND, OR 97201

DONALD W. SCHOENBECK
RCS, INC.
900 WASHINGTON STREET, SUITE 780
VANCOUVER, WA 98660

CARLO ZORZOLI
ENEL NORTH AMERICA, INC.
1 TECH DRIVE, SUITE 220
ANDOVER, MA 1810

GARY HINNERS
RELIANT ENERGY, INC.
PO BOX 148
HOUSTON, TX 77001-0148

JOHN HILKE
FEDERAL TRADE COMMISSION
125 SOUTH STATE STREET
ROMM 2105
SALT LAKE CITY, UT 84138

DAVID SAUL
SOLEL, INC.
439 PELICAN BAY COURT
HENDERSON, NV 89012

CYNTHIA K. MITCHELL
ECONOMIC CONSULTING INC.
530 COLGATE COURT
RENO, NV 89503

KEVIN R. MCSPADDEN
MILBANK, TWEED, HADLEY & MCCLOY LLP
601 SOUTH FIGUEROA STREET, 30TH FLOOR
LOS ANGELES, CA 90017

CURTIS KEBLER
GOLDMAN, SACHS & CO.
2121 AVENUE OF THE STARS
LOS ANGELES, CA 90067

NORMAN A. PEDERSEN
HANNA AND MORTON LLP
444 SOUTH FLOWER STREET, SUITE 1500
LOS ANGELES, CA 90071

COLIN M. LONG
PACIFIC ECONOMICS GROUP
201 SOUTH LAKE AVENUE, SUITE 400
PASADENA, CA 91101

ROGER PELOTE
THE WILLIAMS COMPANIES, INC.
12736 CALIFA STREET
VALLEY VILLAGE, CA 91607

CASE ADMINISTRATION
SOUTHERN CALIFORNIA EDISON COMPANY
2244 WALNUT GROVE AVENUE, ROOM 370
ROSEMEAD, CA 91770

BERJ K. PARSEGHIAN
SOUTHERN CALIFORNIA EDISON COMPANY
2244 WALNUT GROVE AVENUE
ROSEMEAD, CA 91770

FRANK J. COOLEY
SOUTHERN CALIFORNIA EDISON COMPANY
2244 WALNUT GROVE AVENUE RM 345
ROSEMEAD, CA 91770

LAURA A. LARKS
SOUTHERN CALIFORNIA EDISON COMPANY
2244 WALNUT GROVE AVENUE, ROOM 345
ROSEMEAD, CA 91770

LAURA GENAO
SOUTHERN CALIFORNIA EDISON COMPANY
2244 WALNUT GROVE AVENUE
ROSEMEAD, CA 91770

DANIEL A. KING
SEMPRA ENERGY
101 ASH STREET, HQ13
SAN DIEGO, CA 92101

DOUGLAS MITCHELL
SEMPRA ENERGY GLOBAL ENTERPRISES
101 ASH STREET, HQ-15G
SAN DIEGO, CA 92101

DONALD C. LIDDELL, P.C.
LAW OFFICE OF DANIEL W. DOUGLASS,
A.P.C.
2928 2ND AVENUE
SAN DIEGO, CA 92103

IRENE M. STILLINGS
SAN DIEGO REGIONAL ENERGY OFFICE
8520 TECH WAY, SUITE 110
SAN DIEGO, CA 92123

SCOTT J. ANDERS
SAN DIEGO REGIONAL ENERGY OFFICE
8520 TECH WAY - SUITE 110
SAN DIEGO, CA 92123

CENTRAL FILES
SAN DIEGO GAS & ELECTRIC
8330 CENTURY PARK COURT
SAN DIEGO, CA 92123-1530

JOSE C. CERVANTES
CITY OF SAN DIEGO
9601 RIDGEHAVEN CT., SUITE 120
SAN DIEGO, CA 92123-1636

KURT J. KAMMERER
SAN DIEGO REGIONAL ENERGY OFFICE
PO BOX 60738
SAN DIEGO, CA 92166-8738

MARK SHIRILAU
ALOHA SYSTEMS, INC.
14801 COMET STREET
IRVINE, CA 92604-2464

CHARLES R. TOCA
UTILITY SAVINGS & REFUND, LLC
1100 QUAIL, SUITE 217
NEWPORT BEACH, CA 92660

MARK J. SKOWRONSKI
SOLARGENIX AT INLAND ENERGY GROUP
3501 JAMBOREE ROAD, SUITE 606
NEWPORT BEACH, CA 92660

DIANE I. FELLMAN
LAW OFFICES OF DIANE I. FELLMAN
234 VAN NESS AVENUE
SAN FRANCISCO, CA 94102

MATTHEW FREEDMAN
THE UTILITY REFORM NETWORK
711 VAN NESS AVENUE, SUITE 350
SAN FRANCISCO, CA 94102

Regina DeAngelis
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
LEGAL DIVISION ROOM 4107
SAN FRANCISCO, CA 94102-3214

SEAN CASEY
SAN FRANCISCO PUBLIC UTILITIES
COMMISSIO
1155 MARKET STREET, 4TH FLOOR
SAN FRANCISCO, CA 94103

SEAN CASEY
SAN FRANCISCO PUBLIC UTILITIES
COMMISSIO
1155 MARKET STREET, 4TH FLOOR
SAN FRANCISCO, CA 94103

DEVRA BACHRACH
NATURAL RESOURCES DEFENSE COUNCIL
111 SUTTER STREET, 20TH FLOOR
SAN FRANCISCO, CA 94104

VALERIE J. WINN
PACIFIC GAS & ELECTRIC COMPANY
77 BEALE STREET, B9A
SAN FRANCISCO, CA 94105

PETER BRAY
PETER BRAY AND ASSOCIATES
3566 17TH STREET, SUITE 2
SAN FRANCISCO, CA 94110-1093

CALIFORNIA ENERGY MARKETS
517-B POTRERO AVE.
SAN FRANCISCO, CA 94110-1431

BRIAN CRAGG
GOODIN, MAC BRIDE, SQUERI, RITCHIE &
DAY
505 SANSOME STREET, SUITE 900
SAN FRANCISCO, CA 94111

JAMES A. BOOTHE
HOLLAND & KNIGHT LLP
50 CALIFORNIA STREET, 28TH FLOOR
SAN FRANCISCO, CA 94111

LINDSEY HOW-DOWNING
DAVIS WRIGHT TREMAINE LLP
ONE EMBARCADERO CENTER, SUITE 600
SAN FRANCISCO, CA 94111-3834

DANIEL W. FESSLER
HOLLAND & KNIGHT LLP
50 CALIFORNIA STREET, SUITE 2800
SAN FRANCISCO, CA 94111-4726

LISA WEINZIMER
CALIFORNIA ENERGY CIRCUIT
695 NINTH AVENUE, NO. 2
SAN FRANCISCO, CA 94118

ED LUCHA
PACIFIC GAS AND ELECTRIC COMPANY
PO BOX 770000
MAIL CODE: B9A
SAN FRANCISCO, CA 94177

SEBASTIEN CSAPO
PACIFIC GAS AND ELECTRIC COMPANY
PO BOX 770000
MAIL CODE B9A
SAN FRANCISCO, CA 94177

BARRY R. FLYNN
FLYNN RESOURCE CONSULTANTS, INC.
5440 EDGEVIEW DRIVE
DISCOVERY BAY, CA 94514-9267

MICHAEL ROCHMAN
SCHOOL PROJECT UTILITY RATE
REDUCTION
1430 WILLOW PASS ROAD, SUITE 240
CONCORD, CA 94520

KEITH WHITE
931 CONTRA COSTA DRIVE
EL CERRITO, CA 94530

JAY BHALLA
INTERGY CORPORATION
4713 FIRST STREET, SUITE 235
PLEASANTON, CA 94566

GREGORY T. BLUE
DYNEGY INC.
5976 WEST LAS POSITAS BLVD., NO. 200
PLEASANTON, CA 94588

WILLIAM H. CHEN
CONSTELLATION NEW ENERGY, INC.
2175 N. CALIFORNIA BLVD., SUITE 300
WALNUT CREEK, CA 94596

PHILIPPE AUCLAIR
MIRANT CORPORATION
1350 TREAT BLVD., SUITE 500
WALNUT CREEK, CA 94597

STANLEY I. ANDERSON
POWER VALUE INCORPORATED
964 MOJAVE CT
WALNUT CREEK, CA 94598

TED POPE
COHEN VENTURES, INC./ENERGY
SOLUTIONS
1738 EXCELSIOR AVENUE
OAKLAND, CA 94602

CATHERINE E. YAP
BARKOVICH & YAP, INC.
PO BOX 11031
OAKLAND, CA 94611

MRW & ASSOCIATES, INC.
1999 HARRISON STREET, SUITE 1440
OAKLAND, CA 94612

DAVID MARCUS
PO BOX 1287
BERKELEY, CA 94701

GREGG MORRIS
GREEN POWER INSTITUTE
2039 SHATTUCK AVE., SUITE 402
BERKELEY, CA 94704

JOHN GALLOWAY
UNION OF CONCERNED SCIENTISTS
2397 SHATTUCK AVENUE, SUITE 203
BERKELEY, CA 94704

CRAIG TYLER
TYLER & ASSOCIATES
2760 SHASTA ROAD
BERKELEY, CA 94708

EDWARD VINE
LAWRENCE BERKELEY NATIONAL LAB
BUILDING 90-4000
BERKELEY, CA 94720

RYAN WISER
BERKELEY LAB
ONE CYCLOTRON ROAD
MS-90-4000
BERKELEY, CA 94720

KAREN NOTSUND
UC ENERGY INSTITUTE
2547 CHANNING WAY
BERKELEY, CA 94720-5180

PHILLIP J. MULLER
SCD ENERGY SOLUTIONS
436 NOVA ALBION WAY
SAN RAFAEL, CA 94903

WILLIAM B. MARCUS
JBS ENERGY, INC.
311 D STREET, SUITE A
WEST SACRAMENTO, CA 95605

STEVEN KELLY
INDEPENDENT ENERGY PRODUCERS ASSN
1215 K STREET, SUITE 900
SACRAMENTO, CA 95616

CAROLYN M. KEHREIN
ENERGY MANAGEMENT SERVICES
1505 DUNLAP COURT
DIXON, CA 95620-4208

SCOTT BLAISING
BRAUN & BLAISING, P.C.
8980 MOONEY ROAD
ELK GROVE, CA 95624

LEGAL & REGULATORY DEPARTMENT
CALIFORNIA ISO
151 BLUE RAVINE ROAD
FOLSOM, CA 95630

GARY DESHAZO
CALIFORNIA ISO
151 BLUE RAVINE ROAD
FOLSOM, CA 95630

PHILIP D. PETTINGILL
CAISO
151 BLUE RAVINE ROAD
FOLSOM, CA 95630

ROBERT SPARKS
CALIFORNIA INDEPENDANT SYSTEM
OPERATOR
151 BLUE RAVINE ROAD
FOLSOM, CA 95630

JAMES WEIL
AGLET CONSUMER ALLIANCE
PO BOX 1599
FORESTHILL, CA 95631

VICTORIA P. FLEMING
NAVIGANT CONSULTING, INC.
3100 ZINFANDEL DRIVE, SUITE 600
RANCHO CORDOVA, CA 95670-6026

ED CHANG
FLYNN RESOURCE CONSULTANTS, INC.
2165 MOONSTONE CIRCLE
EL DORADO HILLS, CA 95762

BRUCE MCLAUGHLIN
BRAUN & BLAISING P.C.
915 L STREET, SUITE 1460
SACRAMENTO, CA 95814

KEVIN WOODRUFF
WOODRUFF EXPERT SERVICES
1100 K STREET, SUITE 204
SACRAMENTO, CA 95814

LOREN KAYE
POLIS GROUP
1115 11TH STREET, SUITE 100
SACRAMENTO, CA 95814

MELANIE GILLETTE
DUKE ENERGY NORTH AMERICA
980 NINTH STREET, SUITE 1420
SACRAMENTO, CA 95814

TERRY A. GERMAN
LIVINGSTON & MATTESICH LAW
CORPORATION
1201 K STREET, SUITE 1100
SACRAMENTO, CA 95814-3938

GREG BROWNELL
SACRAMENTO MUNICIPAL UTILITY DISTRICT
6201 S STREET, M.S. B306
SACRAMENTO, CA 95817-1899

CAROLYN A. BAKER
7456 DELTAWIND DRIVE
SACRAMENTO, CA 95831

KAREN NORENE MILLS
CALIFORNIA FARM BUREAU FEDERATION
2300 RIVER PLAZA DRIVE
SACRAMENTO, CA 95843

KAREN LINDH
LINDH & ASSOCIATES
7909 WALERGA ROAD, NO. 112, PMB 119
ANTELOPE, CA 95843

NATHAN TOYAMA
SACRAMENTO MUNICIPAL UTILITY DISTRICT
6201 S STREET
RATES DEPARTMENT, MS 44
SACRAMENTO, CA 95852-1830

GAIL HAMMER
GAS TRANSMISSION NORTHWEST
1400 SW 5TH AVE., SUITE 900
PORTLAND, OR 97201

KEVIN CHRISTIE
GAS TRANSMISSION NORTHWEST
CORPORATION
1400 SW 5TH AVENUE, STE. 900
PORTLAND, OR 97201

LESLIE FERRON-JONES
GAS TRANSMISSION NORTHWEST
1400 SW 5TH AVE., SUITE 900
PORTLAND, OR 97201

G. ALAN COMNES
DYNEGY POWER CORP.
3934 SE ASH STREET
PORTLAND, OR 97214

LAURA J. SCOTT
LANDS ENERGY CONSULTING INC.
2366 EASTLAKE AVENUE EAST
SUITE 311
SEATTLE, WA 98102-3399

Maria E. Stevens
CALIF PUBLIC UTILITIES COMMISSION
320 WEST 4TH STREET SUITE 500
EXECUTIVE DIVISION
LOS ANGELES, CA 90013

Amy Chan
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
ELECTRIC INDUSTRY & FINANCE AREA 4-A
SAN FRANCISCO, CA 94102-3214

Bradford Wetstone
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
ELECTRIC INDUSTRY & FINANCE AREA 4-A
SAN FRANCISCO, CA 94102-3214

Brian D. Schumacher
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
ENGINEERING, ENVIRONMENTAL STUDIES,
CUSTOMER SERVICE AREA 4-A
SAN FRANCISCO, CA 94102-3214

Bruce Kaneshiro
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
NATURAL GAS, ENERGY EFFICIENCY AND
RESOURCE ADVISORY AREA 4-A
SAN FRANCISCO, CA 94102-3214

Burton Mattson
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
DIVISION OF ADMINISTRATIVE LAW JUDGES
ROOM 5104
SAN FRANCISCO, CA 94102-3214

Clayton K. Tang
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
ELECTRIC INDUSTRY & FINANCE AREA 4-A
SAN FRANCISCO, CA 94102-3214

Donald R Smith
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
ELECTRICITY RESOURCES AND PRICING
BRANCH ROOM 4209
SAN FRANCISCO, CA 94102-3214

Donna J Hines
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
ELECTRICITY RESOURCES AND PRICING
BRANCH ROOM 4102
SAN FRANCISCO, CA 94102-3214

Eli W Kollman
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
NATURAL GAS, ENERGY EFFICIENCY AND
RESOURCE ADVISORY AREA 4-A
SAN FRANCISCO, CA 94102-3214

Jack Fulcher
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
ELECTRIC INDUSTRY & FINANCE AREA 4-A
SAN FRANCISCO, CA 94102-3214

Jan Reid
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
ELECTRICITY RESOURCES AND PRICING
BRANCH ROOM 4209
SAN FRANCISCO, CA 94102-3214

Jay Luboff
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
NATURAL GAS, ENERGY EFFICIENCY AND
RESOURCE ADVISORY AREA 4-A
SAN FRANCISCO, CA 94102-3214

Jeanette Lo
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
NATURAL GAS, ENERGY EFFICIENCY AND
RESOURCE ADVISORY ROOM 4006
SAN FRANCISCO, CA 94102-3214

Julie A Fitch
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
EXECUTIVE DIVISION ROOM 5203
SAN FRANCISCO, CA 94102-3214

Karen M Shea
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
ELECTRIC INDUSTRY & FINANCE AREA 4-A
SAN FRANCISCO, CA 94102-3214

Kenneth Lewis
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
ENGINEERING, ENVIRONMENTAL STUDIES,
CUSTOMER SERVICE ROOM 4002
SAN FRANCISCO, CA 94102-3214

Louis M Irwin
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
ELECTRICITY RESOURCES AND PRICING
BRANCH ROOM 4209
SAN FRANCISCO, CA 94102-3214

Mark S. Wetzell
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
DIVISION OF ADMINISTRATIVE LAW JUDGES
ROOM 5009
SAN FRANCISCO, CA 94102-3214

Marshal B. Enderby
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
ENERGY COST OF SERVICE BRANCH ROOM
4205
SAN FRANCISCO, CA 94102-3214

Maryam Ebke
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
DIVISION OF STRATEGIC PLANNING ROOM
5119
SAN FRANCISCO, CA 94102-3214

Meg Gottstein
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
DIVISION OF ADMINISTRATIVE LAW JUDGES
ROOM 5044
SAN FRANCISCO, CA 94102-3214

Moises Chavez
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
NATURAL GAS, ENERGY EFFICIENCY AND
RESOURCE ADVISORY AREA 4-A
SAN FRANCISCO, CA 94102-3214

Nilgun Atamturk
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
NATURAL GAS, ENERGY EFFICIENCY AND
RESOURCE ADVISORY AREA 4-A
SAN FRANCISCO, CA 94102-3214

Noel Obiora
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
LEGAL DIVISION ROOM 4107
SAN FRANCISCO, CA 94102-3214

Paul Douglas
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
ELECTRIC INDUSTRY & FINANCE AREA 4-A
SAN FRANCISCO, CA 94102-3214

Scott Logan
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
ELECTRICITY RESOURCES AND PRICING
BRANCH ROOM 4209
SAN FRANCISCO, CA 94102-3214

Shannon Eddy
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
EXECUTIVE DIVISION ROOM 4102
SAN FRANCISCO, CA 94102-3214

Stephen St. Marie
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
ELECTRIC INDUSTRY & FINANCE AREA
SAN FRANCISCO, CA 94102-3214

Trina Horner
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
EXECUTIVE DIVISION ROOM 5217
SAN FRANCISCO, CA 94102-3214

Valerie Beck
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
NATURAL GAS, ENERGY EFFICIENCY AND
RESOURCE ADVISORY AREA 4-A
SAN FRANCISCO, CA 94102-3214

Zenaida G. Tapawan-Conway
CALIF PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
NATURAL GAS, ENERGY EFFICIENCY AND
RESOURCE ADVISORY AREA 4-A
SAN FRANCISCO, CA 94102-3214

ANDREW ULMER
SIMPSON PARTNERS LLP
900 FRONT STREET, SUITE 300
SAN FRANCISCO, CA 94111

CPA COUNSEL OFFICE
CALIFORNIA POWER AUTHORITY
901 P STREET, SUITE 142A
SACRAMENTO, CA 95814

CALIFORNIA POWER AUTHORITY
901 P STREET, SUITE 142A
CAP COUNSEL OFFICE
SACRAMENTO, CA 95814

CLARE LAUFENBERG
CALIFORNIA ENERGY COMMISSION
1516 9TH ST., MS 46
SACRAMENTO, CA 95814

CONNIE LENI
CALIFORNIA ENERGY COMMISSION
1516 9TH STREET
SACRAMENTO, CA 95814

EMILIO E. VARANINI, III
CALIFORNIA POWER AUTHORITY
901 P STREET, SUITE 142A
SACRAMENTO, CA 95814

ERIN R. KOCH-GOODMAN
CALIFORNIA ELECTRICITY OVERSIGHT
BOARD
770 L STREET, SUITE 1250
SACRAMENTO, CA 95814

JENNIFER TACHERA
CALIFORNIA ENERGY COMMISSION
1516 - 9TH STREET
SACRAMENTO, CA 95814

KAREN GRIFFIN
CALIFORNIA ENERGY COMMISSION
1516 9TH STREET, MS 39
SACRAMENTO, CA 95814

MICHAEL JASKE
CALIFORNIA ENERGY COMMISSION
1516 9TH STREET, MS-500
SACRAMENTO, CA 95814

MICHAEL MESSENGER
CALIFORNIA ENERGY COMMISSION
1516 9TH STREET
SACRAMENTO, CA 95814

TOM GLAVIANO
CALIFORNIA ENERGY COMMISSION
1516 NINTH STREET, MS-14
SACRAMENTO, CA 95814

Wade McCartney
CALIF PUBLIC UTILITIES COMMISSION
770 L STREET, SUITE 1050
NATURAL GAS, ENERGY EFFICIENCY AND
RESOURCE ADVISORY
SACRAMENTO, CA 95814

PEGGY BERNARDY
CALIFORNIA DEPARTMENT OF WATER
RESOURCES
1416 9TH ST.
OFFICE OF THE CHIEF COUNSEL, ROOM 1118
SACRAMENTO, CA 95814-4409

TOM FLYNN
ELECTRICITY OVERSIGHT BOARD
1516 NINTH STREET
C/O CALIFORNIA ENERGY COMMISSION
SACRAMENTO, CA 95814-5504

FERNANDO DE LEON
CALIFORNIA ENERGY COMMISSION
1516 9TH STREET, MS-14
SACRAMENTO, CA 95814-5512

HELEN SABET
CALIFORNIA ENERGY COMMISSION
1516 9TH STREET
SACRAMENTO, CA 95814-5512

ARLEN ORCHARD
SACRAMENTO MUNICIPAL UTILITY DISTRICT
6201 S STREET, M.S. B406
SACRAMENTO, CA 95817-1899

RON WETHERALL
CALIFORNIA ENERGY COMMISSION
1516 9TH STREET MS 20
SACRAMENTO, CA 96814-5512

ROSS A. MILLER
CALIFORNIA ENERGY COMMISSION
1516 9TH STREET MS 20
SACRAMENTO, CA 96814-5512