

July 30, 2012

Energy Division Tariff Unit
California Public Utilities Commission
Energy Division
505 Van Ness Avenue
San Francisco, CA 94102

RE: Reply to the Protest of Shell Energy North America, Marin Energy Authority and Alliance for Retail Energy Markets to Pacific Gas and Electric Company's Advice 4074-E (Agreement with Calpine Energy Services, L.P. for Combined Heat and Power Resource Adequacy Capacity Product from the Los Medanos Energy Center)

Dear Energy Division Tariff Unit:

Pacific Gas and Electric Company ("PG&E") hereby replies to the July 23, 2012 protest of Shell Energy North America (US), L.P., Marin Energy Authority, and Alliance for Retail Energy Markets ("DA/CCA Parties") to PG&E's Advice 4074-E ("Protest"). The advice letter requests approval of PG&E's Confirmation for Resource Adequacy ("RA") Capacity Product from the Los Medanos Energy Center ("LMEC Agreement").

DA/CCA Parties ask the Commission to reject the LMEC Agreement because according to DA/CCA Parties, the Settlement Agreement "does not contemplate or permit 'capacity-only contracts' with CHP facilities" and PG&E's proposed allocation of RA-capacity costs to Direct Access ("DA") and Community Choice Aggregation ("CCA") customers through the Cost Allocation Mechanism ("CAM") was not approved by Decision ("D.") 10-12-035, the decision approving the Qualifying Facilities/Combined Heat and Power ("QF/CHP") Program Settlement Agreement ("Settlement Decision"). DA/CCA Parties claim that "there is no method to calculate the 'net capacity costs' of a capacity-only contract." These claims lack merit.

The Settlement Agreement provides PG&E a variety of vehicles by which to meet its CHP megawatt ("MW") target, and PG&E included a capacity-only product in the scope of its CHP Request for Offers ("RFO") after appropriate regulatory review. The LMEC RA Capacity Agreement is a resource that can be procured through PG&E's CHP RFO to meet its CHP MW target; accordingly, the Settlement Agreement requires PG&E to allocate its RA benefits and costs to DA and CCA customers through a CAM-like ratemaking mechanism. The fact that the net capacity cost of a capacity-only contract

is identical to the contract price is no rational basis for avoiding the allocation of contract costs to DA and CCA customers. The position of the DA/CCA Parties is inconsistent with the terms of the Settlement Decision and, accordingly, the Protest must be rejected.

I. Background

In the Settlement Decision, the Commission authorized the investor-owned utilities (“IOUs”) to procure CHP products on behalf of DA and CCA customers and to recover from these customers net capacity costs associated with meeting the Settlement targets.¹ The DA/CCA Parties’ comments on the proposed Settlement Agreement asserted that CHP procurement costs should not be subject to cost allocation because there is no “nexus” between QF/CHP facilities and system reliability.² Those comments were squarely addressed in the Settlement Decision; the Commission found that CHP resources provide system and local reliability benefits³ and thereupon provided DA and CCA entities with a pro-rata portion of the RA value procured under the Settlement, which counts toward the DA and CCA entities’ respective RA requirements. The Commission found that “the cost allocation provisions of the Proposed Settlement, including provisions to allocate the costs of the QF/CHP Program among all Load Serving Entities (LSEs), are fair, reasonable, and consistent with California law.”⁴

Despite this clear direction, the DA/CCA Parties have recently protested PG&E advice letters for approval of Settlement implementation contracts and requests for authorization to collect procurement costs through non-bypassable charges.⁵ The Protest makes arguments that the Commission has already considered and rejected in the Settlement Decision. The protest of the LMEC Agreement should be rejected as well.

¹ D.10-12-035, as modified by D. 11-03-051 and D.11-07-010.

² *Joint Response of the Marin Energy Authority, Alliance for Retail Energy Markets and the Direct Access Customer Coalition to the Joint Motion for Approval of Qualifying Facility and Combined Heat and Power Settlement Agreement* (R.08-11-001, October 25, 2010).

³ D.10-12-035, Conclusion of Law 12.

⁴ *Ibid*, Conclusion of Law 14.

⁵ The DA/CCA Parties protested PG&E’s Advice 4010-E for approval of the O.L.S. Energy-Agnews, Inc. Replacement Power Purchase Agreement (“PPA”). The DA/CCA Parties also protested PG&E Advice 4034-E for approval of the Resource Adequacy Agreement between Calpine Energy Services, L.P. (Sutter Energy Center). The DA/CCA Parties have served direct testimony in the 2012 Long Term Procurement Plan proceeding, R.12-03-014 asserting that the CAM unfairly allocates IOU procurement costs to retail customers, and that non-utility customers should be able to opt out of any CAM-authorized projects. See, “*Testimony on Behalf of Alliance for Retail Energy Markets, Direct Access Customer Coalition, and Marin Energy Authority*” filed on June 25, 2012; and “*Reply Testimony on Behalf of Alliance for Retail Energy Markets, Direct Access Customer Coalition, and Marin Energy Authority*” filed on July 23, 2012.

II. Response to Protest

A. The LMEC Agreement for RA Capacity Counts toward the Settlement MW Target.

DA/CCA's claim that capacity-only contracts are not permitted under the Settlement is totally unsupported. The Settlement Agreement allows a variety of products and procurement avenues to meet the Settlement's CHP MW targets. LMEC is an eligible CHP facility. Its RA product counts toward PG&E's obligation to provide RA resources for system reliability and therefore provides the CHP capacity that PG&E must procure under the Settlement.

There is nothing improper about PG&E's decision to amend its CHP RFO Solicitation Protocol to include capacity-only offers. This change was made in response to an inquiry from an interested party regarding the eligibility of a capacity-only offer to participate in the RFO. In consultation with its Independent Evaluator ("IE") and Commission staff, PG&E determined that there was no reason to exclude such a capacity-only offer and revised its protocol accordingly. Public notice of this change was provided on PG&E's website -- specifically, from the webpage that PG&E posted the RFO timeline, RFO-related documents, and general information for generators interested in participating in PG&E's first CHP RFO -- and by email notification that PG&E's CHP RFO protocol had been revised and the provision of the revised protocol document.⁶ In addition, Southern California Edison Company ("SCE") has also signed a CHP RA-only contract.⁷

The DA/CCA Parties' claim that PG&E entered into this contract "for the sole purpose" of purchasing RA capacity is wrong. The LMEC offer was one of the most competitive offers that PG&E received in response to its CHP RFO. PG&E executed the LMEC Agreement because it provided a way to meet PG&E's MW targets that is favorable for all consumers within PG&E's service territory.⁸ In addition, payments under the LMEC Agreement will support the continued operation of a CHP facility more efficient than the Settlement Agreement's Double Benchmark.⁹ This RA contract contributes to the objectives listed in Settlement Term Sheet, including (1) retaining "existing CHP GHG

⁶ See, PG&E's "Combined Heat and Power RFO" webpage located at <http://www.pge.com/b2b/energysupply/wholesaleelectricssuppliersolicitation/CHP/CHP.shtml>.

⁷ SCE has executed four contracts with various CHP generators in Track 1 of its first CHP RFO, including Los Medanos Energy Center for 280.5 MW of capacity (see SCE's "Renewable & Alternative Power -- Combined Heat and Power (CHP)" webpage located at <http://www.sce.com/CHPRFO>).

⁸ The CHP RFO fully conforms to the specification of the Settlement, and was conducted under the supervision of the IE, the Procurement Review Group ("PRG"), and the Cost Allocation Mechanism ("CAM") group.

⁹ The Double Benchmark consists of a heat rate of 8,300 British thermal units per kilowatt hour ("BTU/kWh") and a thermal efficiency of 80 percent. (CHP Program Settlement Agreement Term Sheet ("Term Sheet") Section 7.2.)

emission reduction benefits” and (2) “grid reliability and/or local area reliability, including self-service of power supply for facilities’ loads in resource-constrained areas.”¹⁰

B. “Net Capacity Costs” are the only Costs in a Capacity-only Contract.

The DA/CCA Parties argue that net capacity costs for the LMEC Agreement cannot be calculated because the contract does not include energy-related products. This argument is groundless. The net capacity costs of the CHP Program are defined as the total costs paid by the IOU under a contract less the value of energy and ancillary services supplied to the IOU under the contract.¹¹ Under the LMEC Agreement, PG&E receives no energy or ancillary services; therefore the value of energy and ancillary services supplied is zero. As a result, the net capacity costs of this agreement are equal to the total costs of the contract. The LMEC Agreement is eligible for net capacity cost allocation because it was procured properly through the CHP RFO process and meets all other CHP eligibility requirements.

C. The Fact that the LMEC Agreement Provides No Contribution to the CHP Program GHG Reduction Target is Immaterial

The DA/CCA Parties criticize LMEC’s lack of GHG reductions that count toward the Settlement GHG target. In fact, the Settlement Term Sheet accepts “existing CHP facilities with no change in operations” which do not contribute to GHG targets.¹² This recognizes that existing CHP provide ongoing GHG benefits and need not create additional GHG reductions in order to confer the benefits of CHP procurement. The LMEC Agreement resulted from PG&E’s CHP RFO, the purpose of which was to procure firm and as available capacity from eligible CHP facilities to meet its Settlement MW targets.¹³ The LMEC Agreement provides RA capacity and cannot be faulted for not providing additional GHG reduction benefits.

D. CAM Cost Recovery is not Predicated on Whether the Contract Provides Products Besides Capacity.

The DA/CCA Parties assert that PG&E may not use the CAM for allocating the cost of the LMEC Agreement “because there is no way to determine if the capacity costs to be imposed under this contract reflect a reasonable netting of energy and ancillary services” (emphasis in original.) According to the DA/CCA Parties, there is “simply no way to ascertain that the price being paid for the capacity represents a net capacity cost.” As explained above, “net capacity cost” can be determined even if there are no

¹⁰ Term Sheet, Sections 1.2.2.2 and 1.2.4.3, p. 6 and 7

¹¹ Term Sheet, Section 13.1.2.2

¹² Term Sheet, Section 7.3.3.1. See also Section 6.2.1, “Maintaining GHG Emission Reductions from Existing CHP.”

¹³ “PG&E is seeking Offers for firm and as-available capacity from existing, new, repowered, and expanded CHP Facilities and CHP Facilities converting to dispatchable capacity under a Utility Tolling PPA.” *Combined Heat and Power Request for Offers Protocol for First Solicitation (PG&E)*, p. 10.

other products to be subtracted from the power purchase price. The lack of other components does not indicate that LMEC's net capacity cost is unreasonable.

E. The LMEC Agreement will Result in Lower Customer Costs Relative to Other Offers Received in PG&E's First CHP RFO

The DA/CCA Parties contend that the price being paid in the LMEC Agreement is not a reasonable net capacity price. PG&E disagrees. The initial RFO is indicative of the current market for CHP products¹⁴ and the LMEC Agreement offer is competitive when compared to other offers in the RFO.¹⁵ Commission approval of this agreement will translate into lower customer costs relative to other CHP offers to achieve the CHP Program's goals and will provide RA benefits to PG&E and DA/CCA customers.

DA and CCA customer interests are represented in PG&E's CHP RFO selection process by non-market participant DA and CCA representatives in PG&E's CAM Group. These individuals provided no comment when the CAM Group was presented with the evaluation and ranking of this transaction as compared to other offers in the CHP RFO. The DA/CCA Parties should be supportive of the value represented in the LMEC Agreement for all customers, including DA and CCA customers, as compared to other possible CHP contracts.

III. Conclusion

The LMEC Agreement is eligible for net capacity cost allocation because its RA capacity is a product within the scope of PG&E's CHP RFO, LMEC's offer was one of the most favorable offers received, and the final LMEC Agreement is reasonable. The protest of DA/CCA Parties is totally without merit and should be rejected.

Sincerely,

Handwritten signature of Brian Cherry in cursive, followed by the initials "IG".

Vice President, Regulatory Relations

cc: Ed Randolph, Director, Energy Division
Andrew Schwartz, Energy Division, CPUC
Jason Houck, Energy Division, CPUC
Cem Turhal, Energy Division, CPUC
Joseph Abhulimen, DRA, CPUC
John W. Leslie, Counsel for Shell Energy North America, L.P.
Service List R.12-03-014 (superseding R.10-05-006, which was closed on April 24, 2012)

¹⁴ The IE found that "the outstanding response of the market to PG&E's CHP RFO is evidence that the outreach activities of PG&E were effective and Sellers felt they had an adequate opportunity to receive a contract from the process". *Independent Evaluator Bid Evaluation and Selection Process Final Report*, Merrimack Energy Group, Inc., p. 32

¹⁵ The IE found that "the Los Medanos contract represents one of the highest ranked offers . . . and therefore merits approval". *Ibid*, p. 60.