BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Integrate and Refine Procurement Policies and Consider Long-Term Procurement Plans.	Rulemaking 12-03-014 (Filed March 22, 2012)

REPLY COMMENTS OF SAN DIEGO GAS AND ELECTRIC COMPANY (U-902-E) IN TRACK III OF THE LONG-TERM PROCUREMENT PLAN PROCEEDING

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I. INTRODUCTION

Pursuant to the Rules of Practice and Procedure of the California Public Utilities Commission ("Commission"), the *Scoping Memo and Ruling of Assigned Commissioner and Administrative Law Judge* issued in the above-captioned proceeding on May 17, 2012 (the "Scoping Memo"), and the October 4, 2012 e-mail ruling of Administrative Law Judge ("ALJ") David M. Gamson modifying the procedural schedule, San Diego Gas and Electric Company ("SDG&E") provides these reply comments concerning changes to current procurement rules and adoption of new procurement rules in Track III of the long term procurement plan ("LTPP") proceeding.

SDG&E responds below to comments regarding procurement rule changes or new procurement rules offered by parties in their opening comments in Track III, filed November 2, 2012. Specifically, SDG&E agrees with the Green Power Institute ("GPI") and Southern California Edison Company ("SCE") that the investor-owned utilities ("IOUs") should not be required to pursue additional greenhouse gas ("GHG") emissions reduction measures outside of the Cap-and-Trade

program adopted pursuant to Assembly Bill ("AB") 32.[1/] It points out the flaws in the analysis of California Environmental Justice Alliance ("CEJA"), Sierra Club California ("SCC") and the Division of Ratepayer Advocates ("DRA") on this same issue, and agrees with Pacific Gas & Electric Company ("PG&E") that the Commission should modify current GHG procurement rules by removing the restriction that requires all allowance and offset credit transactions to be conducted through a competitive solicitation or an exchange.

In addition, SDG&E points out that the new procurement rules jointly proposed by the Alliance for Retail Energy Markets, Direct Access Customer Coalition and Marin Energy Authority ("AReM/DACC/MEA") are redundant or currently under consideration in a separate phase of this proceeding. Finally, SDG&E urges rejection of DRA's proposal to require Independent Evaluator ("IE") assignments to be made by the Energy Division ("ED"), as well as of certain changes to credit and collateral requirements proposed by Calpine Corp. ("Calpine").

II.
DISCUSSION

A. The Utilities Should not Be Required to Pursue Additional GHG Emissions Reduction Measures

Included in the issues identified in the Scoping Memo for consideration in Track III is the issue of whether to require the IOUs to "reduce their need to procure GHG compliance instruments by pursuing cost-effective GHG emissions reductions on a portfolio-wide basis."[2/] SDG&E agrees with the comments of GPI and SCE regarding this issue. As a threshold matter, SDG&E agrees with SCE that the LTPP proceeding is not the appropriate forum for proposals regarding new command-and-control GHG emission reduction programs.[3/] IOUs already are providing substantial GHG reductions through command-and-control measures adopted in the areas of

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1/ Assembly Bill 32, Part 1, Ch. 4, § 38510 (Stats. 2006, Ch. 488).
2/ Scoping Memo, p. 12 (issue no. 3).
3/ SCE Comments, pp. 17-20.

energy efficiency ("EE"), the Renewable Portfolio Standard ("RPS") program and through contracting with combined heat-and-power ("CHP") facilities under the CHP Settlement. Moreover, as GPI correctly points out, there is no apparent need for the additional measures contemplated in the Scoping Memo, and adoption of additional IOU-only GHG reduction requirements will likely not result in an overall reduction in net carbon emissions.[4/]

California's Cap and Trade program has been designed to put a price on carbon emissions; thus, economics will dictate where and by whom the most cost-effective carbon emission reductions are undertaken. If additional mandates outside the Cap and Trade program are placed on the IOUs that require them to achieve carbon emission reductions *beyond* what the economic signals indicate, the result will be a shifting of cost to utility ratepayers and a funding of non-reductions in other sectors. In other words, utility emissions may be reduced (at potentially significant cost to utility ratepayers), but this extra reduction in the utility sector will allow higher emissions in non-utility sectors since the cap set by the Cap and Trade Program applies to overall GHG emission levels in California. The outcome would be imposition of higher cost on utility ratepayers and no reduction beyond the overall cap set by the Cap and Trade Program. Currently, the IOUs estimate they will incur more than $16 Billion in excess costs to comply RPS mandates.[5/] To prevent even higher costs from being imposed on utility ratepayers, SDG&E supports the approach advocated by GPI and SCE of allowing the utilities to respond to the price signals resulting from the Cap and Trade Program when determining whether or not to engage in new projects that are not covered by other existing programs.[6/]

[4/] GPI Comments, p. 2.

[5/] *See Reply Comments of Pacific Gas & Electric Company, Southern California Edison Company, and San Diego Gas & Electric Company on the Appropriate Use of Allowance Auction Revenues*, filed in R.11-03-012 on February 14, 2012, p. 14-17.

[6/] Current EE projects already assume an avoided GHG cost in evaluating cost-effectiveness. In addition, the Commission has the option of using Cap-and-Trade auction revenues for incremental programs under Senate Bill ("SB") 1018.

The comments offered by CEJA reflect a philosophy that is at odds with the market-based approach to GHG mitigation embraced by California. CEJA argues that the most effective means of minimizing risk to ratepayers "is to invest in measures that actually reduce emissions rather than invest in a market that is considered speculative and potentially volatile."[7/] Contrary to CEJA's assertion, it is the market-based approach that best protect ratepayers. Minimizing risk to ratepayers involves evaluating the cost of potential GHG emission reduction measures against forecasted costs of allowances and making an economic decision accordingly. The notion that it will in *every* instance be more cost-effective to invest in emissions reduction is plainly incorrect.

CEJA's proposed approach would require ratepayers to fund emission reduction projects at a higher cost than is naturally incentivized by the marketplace. These projects would decrease emissions in the utility sector, which would allow greater levels of emissions in non-utility sectors since the cap set by the Cap and Trade Program applies to overall, state-wide GHG emission. Raising the level of permitted emissions in non-utility sectors would reduce the need for IOU allowances/offsets. This reduction in demand for IOU allowances/offsets would lower the market price for allowances, which would in turn reduce the return from sales of the allowances allocated to the IOUs. Thus, in the end, the California IOUs would realize lower returns while incurring higher costs, and utility ratepayers would be burdened with a disproportionate share of the costs for reducing GHG emissions under AB 32.

In addition, CEJA's assertion that "utilities should evaluate how to reduce emissions so they do not need compliance products in the first place," demonstrates a fundamental misunderstanding of the operation of Cap and Trade Program.[8/] It is not possible for an IOU to

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[7/] CEJA Comments, p. 5.
[8/] *Id.*

serve the energy needs of its ratepayer customers without having at least some emissions requiring GHG compliance products. The IOUs are required to make all allowances they are allocated available to the auction, so any emissions whatsoever will require the purchase of compliance products. In short, there exists no realistic scenario in which the IOUs can entirely avoid the need to procure GHG compliance products.

Similarly flawed is the assertion by SCC that "consideration of greenhouse reductions on a portfolio basis should consider the environmental factors as well as cost-effectiveness."[9/] As explained above, California's Cap and Trade program is designed to achieve GHG emission reduction targets on a system-wide basis at the lowest marginal cost to consumers. This mechanism does consider environmental factors by setting a 'cap' on emissions but does not 'pick winners' in the process. As a practical matter, requiring the IOUs to make decisions regarding GHG compliance on a range of inputs, rather than on the basis of cost-effectiveness that includes the emission 'price' signaled by the market, will result in the IOUs undertaking a disproportionate share of GHG reduction efforts and the cost of GHG emission reduction being shifted to IOU ratepayers. Allowing IOUs to use the GHG market price as a signal, rather than imposing new mandates, will properly incentivize market participants, including the IOUs, to invest and implement EE and clean technologies in their portfolio.

DRA's proposal to develop a Marginal Abatement Cost ("MAC") curve for the purpose of assessing which IOU GHG emission reduction projects or mechanisms make economic sense based on the cost of carbon is unnecessary; this analysis is implicit to the Cap and Trade program and there exists no need to mandate it.[10/] Assessing which GHG emission reduction projects or

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[9/] SCC Comments, p. 2.
[10/] *See* DRA Comments, p. 3.

mechanisms make economic sense based on the cost of carbon will be a natural result of the Cap and Trade system, thus the MAC tool proposed by DRA is redundant and unnecessary.

Finally, SDG&E agrees with PG&E that the Commission should modify current GHG procurement rules by removing the restriction that requires all allowance and offset credit transactions to be conducted through a competitive solicitation or an exchange.[11/] The IOUs should have the flexibility to procure compliance products bilaterally and through brokers. It does not make sense to prohibit IOUs from procuring in these methods if they are the more cost-effective method to procure compliance products at the time as measured against the most recent auction price or secondary market prices.

B. The New Procurement Rules Proposed by AReM/DACC/MEA Should be Rejected

In their jointly-filed opening comments, AReM/DACC/MEA propose four "threshold rules to be applied by the IOUs in planning and procuring energy and capacity to meet the load and projected load growth of their bundled utility customers over the LTPP planning period."[12/] Specifically, AReM/DACC/MEA propose the following:

(1) The IOUs shall develop forecasts of bundled customer load that exclude existing and forecasted direct access ("DA") and community choice aggregator ("CCA") load;

(2) In developing the forecasts of bundled customer load, the IOUs shall evaluate the characteristics of the load that are driving bundled load growth, including changes to load factor (*i.e.,* "peakiness"), and report to the Commission how these factors have been incorporated into their Bundled Procurement Plans for the long term;

(3) Each IOU shall calculate its unmet resource need by comparing its bundled customer load forecast and load characteristics with all of its resources, including utility-owned generation and power purchase contracts. The IOU shall include in its calculation of unmet resource need the megawatts and megawatt-hours associated with: (a) power contracts that currently serve bundled customer load, which are terminating during the planning period; and (b) power plants that currently serve bundled customer load and are projected to retire or otherwise be unavailable during part or all of the planning period; and

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[11/] PG&E Comments, p. 3.
[12/] AReM Comments, p. 2.

(4) Each IOU's Bundled Procurement Plan shall specify the resources that it will procure or build to meet 100% of the identified unmet resource need. The IOU's unmet resource need shall be met by both existing and new generation resources with a priority given to demand response and energy efficiency, as required by P.U. Code Section 454.5(b)(9)(C). Each IOU shall consider output in megawatts and megawatt-hours, type of resource, and operational characteristics such that the planned resources match the IOU's bundled load and the profile and characteristics of that load.[13/]

The Commission should reject the procurement rules proposed by AReM/DACC/MEA. With regard to proposed Rule 1, the proposal to require IOU procurement plans to be based on a bundled load forecast that excludes existing and forecasted DA and CCA load is redundant given that this is the approach currently followed to determine IOU bundled load. SDG&E notes further that AREM/DACC/MEA mischaracterizes in a manner that is improper and misleading the process undertaken to determine the amount of DA/CCA load to subtract from total system load in order to determine bundled load.

SDG&E has historically developed and proposed a forecast for DA and CCA load to be used to reduce the total system load in order to determine bundled load. In the last LTPP proceeding, the issue of the correct forecast for DA/CCA load was the subject of debate, reflecting the practical reality that load forecasting is more art than science. The Commission considered the evidence presented and provided direction to the IOUs regarding the DA load forecast assumptions to be used for purposes of determining bundled load.[14/] SDG&E included that assumption in its adopted long term procurement plan, which guides its procurement activity. Although the load forecast adopted by the Commission did not match that proposed by SDG&E, the Commission did not find that SDG&E had acted "improperly" in providing its original forecast of DA/CCA load or had otherwise proceeded in bad faith, as

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[13/] AReM Comments, pp. 4, 5, 7.
[14/] *See* D.12-01-033, mimeo, pp. 30-31, Ordering Paragraph 8.

AReM/DACC/MEA improperly suggest. AReM/DACC/MEA's comments are, accordingly, misleading and inappropriate, and should be rejected as such.

Proposed Rules 2-4 are essentially a repackaged discussion of proposals offered by AReM/DACC/MEA in Track I of the instant proceeding, which have been comprehensively addressed by the parties. The arguments presented in Track I, which demonstrate that the proposals made by AREM/DACC/MEA are intended to permit non-utility load-serving entities ("LSEs") to unfairly avoid allocation of cost for procurement benefits, need not be repeated here. SDG&E submits that these issues should be addressed in Track I, rather than being relitigated in this phase of the proceeding.

C. The IOUs Should Continue to Determine Independent Evaluator Assignments

In its comments, DRA proposes that the ED bear responsibility for determining the pool of IEs for each IOU, as well as for determining individual IE assignments. DRA's proposal is premised on the incorrect assumption that "[a]n inherent conflict of interest is created . . . when an IE must first satisfy the IOU in order to be selected as a member of the IE pool then continue to meet the IOU's expectations to receive assignments."[15/] While SDG&E does not object to the suggestion that ED select the final IE pool, as this would merely formalize what in essence already occurs, it does object to the underlying assumption that the current process is prone to conflicts of interest. This conclusion is plainly incorrect. Indeed, the IE solicitation, shortlisting, and selection process is robust and competitive, involving and incorporating input from an IOU's Procurement Review Group ("PRG") and ED. Likewise, the IE assignment process does not, contrary to DRA's assertion, undermine the independence of the IEs.

SDG&E's PRG and ED are directly involved in selection of SDG&E's IEs. Specifically, PRG and ED input is solicited regarding, *inter alia*, (i) design and review of the IE Solicitation

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[15/] DRA Comments, p. 7.

materials; (ii) evaluation methodology; and (iii) participation in the IE interview panel. SDG&E does not select the final IE pool at its sole discretion; it instead presents its results to and collaborates with its PRG and the ED to determine the final IE pool to be submitted to the ED Director for approval. ED also holds annual IE pool meetings and, while IOUs are not included, it is reasonable to assume that these meetings present an additional opportunity for ED oversight of the IEs. The current process makes clear to IEs that IOUs are not the sole decision makers in selecting the final pool; therefore any risk of a conflict of interest is greatly reduced.

DRA's assumption that the IE assignment process involves a conflict of interest – and therefore that ED rather than the IOUs should determine individual IE assignments – is likewise incorrect. Under the current process, once an IOU has received approval from the Commission for its pool of IEs, it can then assign projects to IEs in its pool. It is typically the case that certain IEs are experienced in certain areas; one IE may have deep experience in renewable procurement, while another may have expertise related to resource adequacy products. The IEs understand that project assignments are based on core competencies. The fact that project assignments are driven by an IE's relevant areas of expertise rather than by utility bias or other factors reduces the likelihood of a conflict of interest. It also highlights the importance of having a thorough understanding the individual qualifications of each IE and the nature of each project.

In most cases, the IOU is best able to determine which IE has the most relevant skills for evaluating a certain type of solicitation or transaction. Expecting ED to cultivate a comparable understanding of the respective qualifications of each of the IOUs' various IEs, and to be intimately familiar with the details of each IOU solicitation or transaction, in order to be able to make the most effective IE assignments is unreasonable. This would impose significant administrative burden and could inject unnecessary delay into the process, without presenting

any improvement over the current process. SDG&E maintains an open dialogue with ED staff, and will continue to respond to any requests from ED staff regarding its IE assignments. Accordingly, the current process should be maintained and the IOUs should retain the ability to determine IE project assignments.

D. The Commission Should Reject Calpine's Proposed Reforms to Credit and Collateral Requirements

In its comments, Calpine proposes four reforms to the IOU credit and collateral requirements. Specifically, it recommends that the IOUs be directed to (1) allow netting of collateral requirements; (2) eliminate cross-default provisions; (3) post collateral themselves; and (4) cap the collateral required for any specific contract at an amount that realistically reflects the amount that might not be recoverable from a supplier in the event of non-performance.[16/] SDG&E submits that these proposed changes would undermine its ability to negotiate effective credit terms with risky counterparties and, ultimately, could expose SDG&E to increased credit and default risks.

1. Netting of Collateral Requirements

The use of a netting agreement is beneficial when buyers and sellers have multiple positions with reversing roles as buyers and sellers – *i.e.*, Entity A buys from Entity B at the same time that Entity B buys from Entity A in a separate transaction. In such circumstances, the use of netting agreements limits exposure by cross-netting the buys and sells. In the case of IOU transactions, however, the majority of positions entered under Power Purchase Agreements ("PPA") and Resource Adequacy ("RA") deals are on the buying sides. Netting in this case would result in excessive one-sided exposures that do not benefit the IOU (or, by extension, its

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[16/] Calpine Comments, p. 4.

ratepayers) and may expose ratepayers to considerable replacement costs if the counterparty defaults.

The illustrative example presented by Calpine highlights several flaws in its analysis:

> "For example, the IOU's current calculation of collateral requirements ignores the fact that if an IOU has multiple contracts with a single supplier and the supplier fails to perform under one of these contracts, the IOU can recover liquidated damages by withholding the payments due under another of these contracts. "[17/]

First, Calpine incorrectly assumes that withholding payments, as a form of liquidated damages, would satisfy the exposure amounts and replacement costs on other contract, which is generally not the case. Calpine also assumes that counterparty performance on a second contract is independent from the first contract, which is not true in a bankruptcy situation. Calpine ignores the fact that withholding a payment under one contract may encourage the seller to default on another contract, leaving the IOUs with two (or more) contracts in default and exposure to additional replacement costs.

Finally, Calpine erroneously assumes liquid markets – *i.e.*, availability of replacement products – and effective implementation of collateral netting with timely Mark to Market ("MTM"). Some positions, such as RAs, are not liquid and they bear higher credit risk than their market values due to the absence of adequate and timely replacement, as well as exposure to Commission and California Independent System Operator ("CAISO") cumulative penalty charges. In addition, the implementation of daily MTM for settling the netting agreements on all entered positions is cumbersome for IOUs, as well as for sellers. Accordingly, Calpine's proposal regarding netting of collateral requirements is not in the public interest.

[17/] Calpine Comments, p. 12.

2. Elimination of Cross-Default Provisions

Calpine proposes elimination of provisions that allow an IOU to terminate a transaction with a seller in the event that the seller fails to perform under a separate transaction.[18/] The cross-default provision is intended to protect ratepayers by permitting the IOUs to act in an anticipatory manner to limit cost exposure to ratepayers in the event a seller stops performing on a separate contract. Absent the cross-default provision, the IOU cannot act to protect ratepayers in the event of an imminent bankruptcy, for example, until such time that the seller actually defaults on the contract in question. In addition, many power generators use a corporate structure that shields the parent company from exposure to individual generating units and subsidiaries using Limited Liability Companies ("LLCs"). Given the lack of recourse against such LLCs in the event of a default, the cross-default provision provides IOUs with an alternate and necessary means of responding to potential non-performance. Accordingly, cross-default provisions should not be eliminated.

3. Posting of Collateral by IOUs

This proposal would penalize the IOUs while providing no material benefit to sellers. Each IOU's capital structure is set by regulators and the IOUs present limited credit risk and performance risk. As a practical matter, the probability of default by an IOU is extremely low as compared with the seller's probability of default related to its performance. Accordingly, requiring IOUs to post collateral would serve little purpose. Such a requirement could, however, impose significant costs on ratepayers. Given the minimal benefit of an IOU collateral requirement and the potential negative impact on ratepayers, Calpine's proposal should be rejected.

[18/] Calpine Comments, p. 13.

4. Cap on Collateral Required

While SDG&E agrees with Calpine that collateral is costly, SDG&E has an obligation to protect its ratepayers by requiring that non-credit worthy counterparties post collateral to cover non-performance risks and potential replacement costs. Imposing a cap on collateral requirements would prevent the IOU from performing its duty of effectively managing risk related to credit and counterparty performance. The costs associated with reasonable and risk-adjusted collateral requirements may pass directly or indirectly to ratepayers through higher contract prices. These costs constitute a protection cost that benefits the ratepayers in case of default or non-performance, which is the equivalent to the economic value of insurance. The collateral requirements imposed by the IOUs are necessary to protect ratepayers. Accordingly, Calpine's proposal to cap collateral requirements should not be adopted.

III.
CONCLUSION

For the reasons set forth above, the Commission should adopt PG&E's recommendation and modify current GHG procurement rules to remove the restriction that requires all allowance and offset credit transactions to be conducted through a competitive solicitation or an exchange, and should reject all other proposals described above.

Dated this 30th day of November, 2012 in San Diego, California.

Respectfully submitted,

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