BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Petition of the Alliance for Retail Energy Markets *et al.* to Adopt, Amend, or Repeal a Regulation Pursuant to Pub. Util. Code § 1708.5.	Petition 06-12-002 (Filed December 6, 2006)
Rulemaking Regarding Whether, or Subject to What Conditions, the Suspension of Direct Access May Be Lifted Consistent with Assembly Bill 1X and Decision 01-09-060.	FILED PUBLIC UTILITIES COMMISSION MAY 24, 2007 SAN FRANCISCO OFFICE RULEMAKING 07-05-025

ORDER GRANTING PETITION FOR RULEMAKING AND INSTITUTING RULEMAKING AS TO WHETHER, WHEN, OR HOW DIRECT ACCESS SHOULD BE RESTORED

Table of Contents

Title **Page**

ORDER GRANTING PETITION FOR RULEMAKING AND INSTITUTING RULEMAKING AS TO WHETHER, WHEN, OR HOW DIRECT ACCESS SHOULD BE RESTORED

1. Summary

By this order, we grant the Alliance for Retail Energy Markets *et al*. (AREM)[1] Petition, captioned above, subject to the preliminary scope and schedule outlined herein. AREM asks the Commission to open a proceeding to consider whether, or under what conditions, the current suspension on "direct access" should be lifted. "Direct access" (DA) is a retail service option whereby eligible customers purchase electricity from an independent supplier rather than from an investor-owned utility.

We hereby institute the formal rulemaking, captioned above, concerning whether or under what conditions, direct access may be reinstituted. In opening this rulemaking, we acknowledge the legal and regulatory context in which direct access was suspended. We also, however, affirm our ongoing commitment "to the fundamental principles that have guided electricity market restructuring in California and elsewhere: competition and customer choice." as previously stated in Decision (D.) 06-07-029.[2] We indicated therein that "[at] an

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[1] AREM filed the Petition on behalf of 38 Petitioners, as identified on the title page of its pleading, and also included a list of 147 "Supportive Entities" that "endorse the goals" of the Petition. On April 16, 2007, AREM filed a motion to amend the Petition to (1) inform the Commission that their coalition now operates under the name of the Alliance for Cooperative Energy Solutions (ACES); and (2) to add 21 entities to the list of supporters of the Petition. We grant the motion. We identify Petitioners as "AREM' in this order consistent with the name referenced in their pleadings. For subsequent identification, we shall recognize the new name, "ACES."

[2] *See* D.06-07-029 (*mimeo.* at 2) in Rulemaking (R.) 06-02-013 to integrate procurement policies and to consider long-term procurement plans.

appropriate juncture, in another proceeding, we intend to explore how we may increase customer choice, by reinstituting DA or via other suitable means."[3] The opening of this rulemaking constitutes an appropriate juncture to commence such an exploration.

According to AREM, lifting the direct access suspension would offer a range of potential benefits for California. For example, AREM suggests that the competitiveness of retail markets would be enhanced, increasing consumer choice in the price, range and flexibility of electric service offerings, and that the prospects for increased retail competition could also motivate the investor-owned utilities to be more responsive to customers' needs. Furthermore, according to AREM, the possibility that utility customers might depart to a competitor could serve as a check against rising retail rates and promote price efficiencies, and the availability of alternative sources of retail competition also could serve as a potential benchmark to measure the efficiency of utility-provided services.

We also acknowledge parties' disputes as to the Commission's legal authority to lift the direct access suspension at this time. A number of parties contend that statutory restrictions preclude lifting the direct access suspension at this time. Based on this premise, these parties argue that it would be premature and disruptive to the development of critical energy policies to open a rulemaking now. For the reasons discussed below, however, we believe that opening an inquiry now to begin exploring these questions will best serve the public interest.

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[3] *Id.*

In particular, given the changes that have occurred since 2001 in terms of regulatory and market reforms, we believe that the time has come to consider the possibility of lifting the suspension on direct access and whether that would bring the benefits of competition to Californians.

As a threshold issue, we intend to resolve whether, or under what conditions, the Commission may have legal discretion to lift the direct access suspension. In setting the scope of this proceeding, we seek to ensure that any program to reinstitute retail competition be guided by sound legal principles with careful safeguarding of the relevant public policy interests. We shall conduct this rulemaking in a sequential, careful, and balanced manner, taking into account any lessons to be learned from previous efforts to bring competition to electric retail markets.

2. Procedural Background

On December 6, 2006, AREM filed its Petition pursuant to Pub. Util. Code § 1708.5 to institute a rulemaking and investigation on the reopening of electricity markets to retail competition through direct access. Section 1708.5 authorizes "interested persons to petition the commission to adopt, amend, or repeal a regulation." Pursuant to § 1708.5, the Commission considers the petition and, within six months, either denies the petition or institutes a proceeding to adopt, repeal or amend the regulation.

Responses to the Petition were filed on January 5, 2007. Third-round replies were filed on January 22, 2007. Responses in support of the Petition (Petition) were filed by the "Indicated Commercial Parties,"[4] "Direct Access

[4] The "Indicated Commercial Parties" include Los Angeles County, Los Angeles Unified School District, Catholic Health Care West, and Del Taco, Inc.

Residential Energy" (DARE),[5] and AT&T. Pacific Gas and Electric Company (PG&E), and San Diego Gas & Electric Company (SDG&E) each filed comments identifying important issues they believe need to be resolved in the event that a rulemaking is considered. Southern California Edison Company (SCE) filed comments opposing the Petition. The Utility Reform Network (TURN) filed comments also opposing the Petition, on behalf of itself and Aglet Consumer Alliance, Utility Consumers' Action Network, Consumer Federation of California, Natural Resources Defense Council, and Coalition of California Utility Employees. Separate comments were filed by the Division of Ratepayer Advocates (DRA). Comments in opposition to the Petition were also filed by Californians for Renewable Energy (CARE).[6]

The California Department of Water Resources (DWR) also filed comments in the form of a memorandum.

We have reviewed parties' comments, taking them into account in preparing this order. We have considered the merits of arguments both in favor and against the Petition. In particular, we have incorporated parties' suggestions concerning the scope of issues as a basis for this rulemaking. We provide further procedural direction in the scoping and scheduling section of this order.

3. Historical Framework

As a framework to address the AREM Petition, it is useful to review key developments that have brought us to this point in time. We originally

[5] "DARE" is a California nonprofit public corporation organized to represent the interests of potential residential and small commercial direct access customers.

[6] CARE is a non-profit corporation that represents the interests of "low-income people of color retail ratepayer members."

implemented "direct access" on April 1, 1998, as an integral part of a comprehensive restructuring program to bring retail competition to California electric power markets.[7] Under this competitive restructuring program implemented pursuant to Assembly Bill (AB) 1890, retail customers had the choice either to subscribe to traditional bundled utility service or to purchase electricity on a competitive basis from an "electric service provider" (ESP). Customers who purchased bundled utility service paid the utility a charge for distribution and transmission as well as for the electricity commodity. A direct access customer also received distribution and transmission services from the utility, but purchased electricity directly through an independent ESP. Although the ESP supplied electricity to the direct access customer, the utility remained the electricity provider of last resort. For its first two years of operation in the late 1990s, California's restructured markets worked reasonably well. Wholesale prices appeared to be competitive, and direct access grew to approximately 16.0% of California retail load by May 2000. The restructuring program was cut short, however, by the events of 2000-2001 which caused wholesale power costs to increase exponentially.

The Governor's Proclamation on January 17, 2001, stated that an emergency existed in the electricity market threatening "the solvency of California's major public utilities..." On February 1, 2001, Assembly Bill (AB) 1 from the First Extraordinary Session (Ch. 4, First Extraordinary Session 2001) (AB 1X) was signed into law which, among other things, required the California

[7] *See* D.95-12-063, as modified by D.96-01-009 (1995) 64 Cal. PUC 2d 1, 24 (Preferred Policy Decision).) The Legislature codified the Preferred Policy Decision in AB 1890, Stats. 1996, ch. 854 (AB 1890).

Department of Water Resources (DWR) to procure electricity on behalf of the customers of the investor-owned utilities. DWR thereafter entered into a series of power contracts and also issued long-term bonds to support funding for the power procurement program.

In order to ensure that responsibility for the DWR procurement and other utility costs was assigned in a fair manner among retail electric customers, the Legislature instituted a range of measures, including suspending direct access. In this regard, AB 1X incorporated the following requirement in Section 80110 of the Water Code:

> "After the passage or such period of time after the effective date of this section as shall be determined by the commission, the right of retail end use customers pursuant to Article 6 (commencing with Section 360) of Chapter 2.3 of Part 1 of Division 1 of the Public Utilities Code to acquire service from other providers shall be suspended until the department [the Department of Water Resources] no longer supplies power hereunder."

By D.01-09-060, the Commission suspended the right, pursuant to AB 1X and Pub. Util. Code §§ 366 or 366.5, to enter into new contracts for direct access service after September 20, 2001. We opened R.02-01-011 in which we subsequently issued a series of decisions to implement the suspension. We adopted a "standstill approach" whereby, consistent with AB 1X, direct access was suspended with no new arrangements, but preexisting direct access contracts continued in effect. As a condition of remaining on direct access, however, such customers were assessed a "cost responsibility surcharge" (CRS) for their fair share of DWR and other procurement-related costs, as required by the statute.

Since February 2003, the number of customers and amount of load on direct access service has declined from 15.9% to 10.1% of statewide load. The total 10.1% of Direct access statewide retail load includes 27.1 % of large industrial load (greater than 500 kW), and 12.6% of large commercial load (20-500 kW).[8] Direct access under the current "standstill approach" provides service to manufacturers, agricultural producers, retail malls and stores, restaurants and fast-food chains, hotels, hospitals, educational institutions, as well as residential and small commercial customers.

4. Petition for Rulemaking

4.1. Parties' Positions

AREM requests that the Commission commence a rulemaking or investigation in order to establish rules regarding how and when direct access should be reopened in California. AREM argues that the electricity crisis of 2000-2001 is behind us, and the purposes for direct access suspension have been served, addressed through other means, or no longer apply. As a result, AREM contends that continued suspension of direct access is unnecessary, counterproductive, and overly restrictive on California consumers.

AREM argues that the Commission has authority to lift the current suspension and to reestablish direct access without new legislation. As a basis for such action, AREM asks the Commission to commence a rulemaking to determine the form which such a reconstituted direct access market should take.

The following preliminary issues are proposed by AREM to be considered in the rulemaking: (1) statutory authority to determine when to reopen the market; (2) type of retail market structure that would apply; (3) default service

[8] *See* CPUC webpage.

provisions for DA-eligible customers to be provided by IOUs or other third party; (4) rules for switching between direct access and default service; (5) measures to protect DWR bond cost recovery; and (6) measures to assure that all public purpose program charges continue to be recovered. AREM requests that the investigation or rulemaking be opened and concluded by July 2007, to allow for the reopening of the market by January 1, 2008.

Comments in support of the petition were filed by various parties, including those representing customer groups expressing an interest in direct access as a service option. Other parties (such as PG&E and SDG&E) express general support for competitive choice, but believe that the schedule proposed in the Petition is unrealistic given the scope, extent, and complexity of issues to be addressed. DRA references the 2004 Commission staff report entitled: "A Core/Noncore Structure for Electricity in California."[9] This report identified various issues to be addressed if the direct access suspension was to be lifted. DRA believes that most of the issues identified in that staff report would need to be considered if the Commission considers reopening direct access. DRA argues, however, that a new rulemaking would complicate the review of issues in other proceedings (such as renewable portfolio standards, greenhouse gas reductions, energy efficiency, and resource adequacy).

Other parties (in particular, SCE and TURN) filed comments in opposition to the Petition. Opponents of the Petition argue that the ultimate relief sought is

[9] *See* Staff Report, Division of Strategic Planning, dated March 15, 2004. The report identified various issues to be addressed in connection with the possible lifting of the direct access suspension, including resource adequacy, coordination with utility planning cycles, carrier of last resort obligations, cost responsibility surcharges, and eligibility standards for direct access.

barred by statute and beyond the power of this Commission to grant. Based on the view that DA suspension cannot be lifted until the last of the DWR power contracts expire in 2017, they argue that it would be a waste of resources to undertake a rulemaking at this time regarding reinstitution of DA. Based on their premise that direct access cannot be reinstituted for another eight years, opponents argue that the Commission should not open a rulemaking at this time given the other high priority energy policy matters being considered.

4.2. Discussion

For the reasons set forth below, we conclude that the Petition for Rulemaking should be granted subject to the scope and schedule constraints set forth herein. As referenced previously in our consideration of long-term procurement planning policies in D.06-07-029, although we suspended direct access in compliance with AB 1X, the suspension did not repudiate our fundamental commitment to principles of competition and consumer choice. Although direct access continues to be suspended, we have moved forward with measures to provide for more retail competition through the Community Choice Aggregation (CCA) program. Other customers have pursued alternatives through departing to municipally owned utilities or through increased reliance on distributed generation.

Moreover, the conditions that led to the suspension of direct access in 2001 have changed and are continuing to evolve. Since 2001, California electric power markets have become more stabilized. The IOUs have been restored to creditworthy status, and have resumed responsibility for procuring energy supplies for their customers. Ratemaking mechanisms have been put in place to assure that direct access load bears its fair share of cost responsibility and that DWR Bondholders recover their costs. Moreover, recent increases in the market

price for power have had the result that the DWR power contract prices are currently more competitive. Given the regulatory reforms and market forces for change currently in process in California, we believe the time has arrived to take a fresh look at the status of the direct access suspension. Given the potential benefits from increased retail choice from direct access competition, a formal inquiry opening a rulemaking to consider whether, or how, to lift the suspension is warranted.

The petition raises questions as to the Commission's legal discretion to lift the direct access suspension, as well as the public policy merits of doing so at this time. We recognize that the extent of the Commission's legal authority to lift the suspension on direct access is a threshold issue to be resolved. Disagreements as to the Commission's legal discretion to lift the suspension relate to the interpretation of the statute continuing the suspension "until DWR no longer supplies power." Arguments on both sides of this issue warrant careful consideration. We discuss this issue further in Section 5.1 below.

We are not persuaded, however, by arguments opposing the opening of a rulemaking before resolving the legal questions concerning whether, or under what conditions, the Commission has the discretion to lift the suspension. Whatever we ultimately conclude as to our legal discretion to lift the direct access suspension, we are not precluded from opening a proceeding concerning how direct access could be reinstituted once any legal barriers are cleared. We only need to determine that good cause exists to warrant a formal inquiry at this time.

In whatever manner that questions of legal authority are resolved, we conclude that good cause exists to begin exploring whether or how a reinstituted direct access market could operate. By instituting the rulemaking now, we can

address relevant direct access issues in a thoughtful, proactive, and integrated manner. We disagree with parties who argue that opening this rulemaking would be premature while other high priority policy proceedings are before the Commission. To the contrary, by considering the policy and timing implications of any reinstated direct access market as we develop policy in other proceedings, more coordinated and integrated policies and market structures may result. Related issues in other proceedings include long-term procurement planning, competitive market structure design, resource adequacy, renewable portfolio standards, and greenhouse gas restrictions.

Delaying consideration of whether, when, or how direct access may be reinstituted will prolong the uncertainty facing the electric power industry as to the regulatory and market environment. Market and regulatory uncertainty does not foster the proper incentive signals for merchant generators or Investor-Owned Utilities to invest in generating capacity needed for a reliable long-term power supply. With clearer definitions of the regulatory and market environment, the utilities and merchant generators can be better positioned to undertake commitments to meet new generating capacity demand. By taking a proactive stance to begin addressing retail competition issues now, we can progress forward in providing greater regulatory and market certainty.

We find no basis to deny the petition based on the claims of CARE which argues that the Petition is made "moot" by two federal appellate orders issued on December 20, 2006. CARE claims that these orders "effectively gutted FERC's decade-old approach to fostering bulk power markets…"[10] CARE claims that

[10] *See* CARE comments, p. 2. The circuit opinions to which CARE refers are: Public Utility District v. FERC (Docket No. 04-70712) and Public Utilities Commission v. FERC

Footnote continued on next page

AREM's Petition would violate requirements that wholesale contracts be presented in advance to FERC for review subject to "the just and reasonable standard set by Sec. 206(a) of the Federal Power Act…"[11] We disagree that the Petition is made "moot" as the result of any federal court action or that opening a rulemaking would conflict with federal regulations. Our inquiry in no way is intended to interfere or conflict with FERC jurisdiction or federal contract review standards.

We recognize the importance of proceeding with this rulemaking in a thoughtful and coordinated manner before any reinstitution of direct access could occur. We are persuaded that the proper sequence is to open a rulemaking proceeding first, and then to resolve the applicable legal issues relating to the statutory authority to lift the suspension in a first phase of the proceeding. In this manner, we can give the proper attention to the pertinent legal questions, and integrate our analysis, as appropriate, with the rulemaking record as a whole.

In opening this rulemaking, we do not prejudge how the disputes over legal interpretation should be resolved. We do recognize, however, that the questions, themselves, warrant careful consideration, given the potential benefits to California from opening retail power markets to greater consumer choice.

5. Preliminary Scoping Memo

This proceeding will be conducted in accordance with Article 7 of the Commission's Rules of Practice and Procedure. Pursuant to Rule 7.3, this order

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(Docket No. 03-74207), both issued by the U.S. Court of Appeals Ninth Circuit on December 20, 2006.

[11] *See* CARE comments, p. 5.

includes a preliminary scoping memo as set forth below. Pursuant to Rule 7.1(d), we preliminarily determine the category of Phase I of this proceeding to be quasi-legislative as the term is defined in Rule 1.3(d). We preliminarily determine the category of Phase II and Phase III of this proceeding to be ratesetting as the term is defined in Rule 1.3(e).

It is contemplated that this proceeding shall be conducted through a written record and that Commission orders will issue on the merits based on the pleadings timely filed in this docket. However, parties will have the opportunity to comment on the necessity of hearings, and we may re-evaluate both the categorization and need for hearings after review of the comments.

We shall scope the issues to be addressed in this OIR in three sequential phases, as identified below. The record developed in each phase shall inform us in proceeding with successive phases. We set forth a preliminary scope and schedule for all three phases in this OIR, recognizing the value of a comprehensive, integrated perspective of the issues to be addressed, at least on a preliminary basis, while maintaining the flexibility to adjust as we move forward. In the Appendix of this order, we provide a more abbreviated summary of the issues to be addressed in each of the phases. In commenting on the issues in each phase, parties are advised to organize their comments in the order of questions presented in the Appendix. We elaborate below as to the nature and extent of the issues and information that is needed to develop the record in this proceeding.

The three phases shall be designated, as follows:

Phase I – Commission Legal Authority to Lift the Direct Access Suspension in compliance with AB 1X.

Phase II – Public Policy Merits of Lifting the Direct Access Suspension and Applicable Wholesale Market Structure/Regulatory Prerequisites.

Phase III – Rules Governing a Reinstituted Direct Access Market: *e.g.,* Entry/Exit/Switching; Default Arrangements, and Cost Recovery Issues.

5.1. Phase I – Legal Authority to Lift the DA Suspension

5.1.1. Interpretation of Water Code § 80110

In the initial phase of this proceeding, we shall address threshold questions of whether, or under what conditions, the Commission has legal authority to lift the suspension on Direct Access. Parties' differences over the question of legal authority focus on the interpretation of AB 1X as codified in Water Code § 80110, which requires direct access suspension until DWR "no longer supplies power" under AB 1X. Certain parties argue that DWR is still "supplying" power by virtue of having an ownership interest in the power sold under the DWR power contracts.

Although DWR's authority to enter into new power contracts terminated as of January 1, 2003, its authority to sell electric power delivered pursuant to previously executed DWR contracts continues. DWR continues to submit annual revenue requirement determinations to the Commission, as required by the 2002 Rate Agreement, approved in D.02-02-051. The Rate Agreement requires the Commission to set Power Charges and Bond Charges sufficient to recover DWR's revenue requirement, allocated among electric utility customers. As noted in DWR's 2007 Revenue Requirement Determination, approximately 53,749 GWhs of energy is projected to be provided through the DWR long-term power contracts during 2007 on behalf of retail customers of the IOUs. Based on certain parties' interpretation, DA suspension must continue as long as DWR has

an ownership interest in *any* DWR power contract. They believe that the Commission has no legal authority to lift the direct access suspension until the last DWR contract expires, currently due to occur in 2017.

AREM and its supporters challenge opponents' interpretation, arguing that language in the statute is ambiguous. AREM disputes the meaning ascribed by several parties that the phrase "supplies power" requires direct access suspension until the last DWR contract expires. AREM argues that such an interpretation is unreasonably extreme and would preclude resumption of direct access even if just one contract remained for MW. AREM interprets the phrase "supplies power" to refer merely to DWR's role in *contracting* to supply power. DWR's procurement authority under AB 1X terminated after January 1, 2003, pursuant to Water Code Sec. 80260, when the utilities resumed responsibility for procuring power for their customers.[12] Although DWR continued to sell electricity under its existing DWR contracts in its role as a counterparty, the management and implementation of those contracts was delegated to the three utilities beginning in January 2003. From that time forward, the utilities were reinstated to the role of procuring power supplies.

Given these developments, AREM argues that the condition precedent for lifting the direct access suspension has occurred. AREM argues that the status quo that existed prior to crisis conditions of 2001 has been restored, and the direct access suspension is now merely an historical anachronism. Accordingly,

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[12] Water Code Sec. 80260 provides:

On and after January 1, 2003, [DWR] shall not contract under this division for the purchase of electrical power. The section does not affect the authority of [DWR] to administer contracts entered into prior to that date or [DWR's] authority to sell electricity.

AREM believes that there is no statutory impediment to the Commission's authority to reopen direct access.

AREM argues that direct access suspension was intended by the Legislature to be temporary, and that the Commission has discretion to interpret the statute in the light of changed circumstances since AB 1X was enacted. Moreover, AREM argues that the Commission need not decide the issue of the legal authority to lift the suspension as a basis merely to open a rulemaking. AREM asks that the Commission defer a final decision on issues of legal authority pending further briefing after the rulemaking is opened.

In Phase I of the rulemaking, we shall address questions relating to the Commission's legal authority to lift the direct access suspension, and consider the statutory interpretation of Water Code Sec. 80110 that the DA suspension must continue "until DWR no longer supplies power." In addressing the legal issues, we shall consider the parties' responses and replies to the Petition. Parties need not repeat arguments previously presented, but may incorporate them by reference. In the interests of a complete record, however, we shall permit parties to file an additional round of comments in Phase I on the issue of whether, or subject to what timing and conditions, the Commission has legal discretion to implement a lifting of the suspension on direct access.

Certain parties suggest that even if the statute is interpreted to refer to power supplied under existing DWR contracts, direct access could still be reinstituted on a partial basis prior to 2017. Specifically, parties suggest that additional capacity might be opened up to direct access corresponding to the capacity in each respective DWR contract as it expires. Under such interpretation, the statutory restriction that DWR no longer supply power could

apply on a contract-by-contract basis. We solicit parties' comments in Phase I on the legal and practical merits of such an interpretation.

5.1.2. DWR Contract Assignment Option

Resolution of questions regarding the Commission's legal authority relate to the timing of when direct access could be reinstituted. Even if the AB 1X were ultimately interpreted to mean that DWR continues to "supply power" as long as it has ownership interests in the power contracts, alternatives may be available whereby DWR could terminate its ownership interests earlier than the current contract expiration dates.

Theoretically, DWR could terminate early one or more of its contracts, but such early termination for reasons other than breach or default by the counterparty supplier could require the payment of the entire estimated value of the contract. Also, energy no longer provided under such DWR contracts may need to be replaced by the investor-owned utilities.

While it may be unrealistic for DWR to terminate its remaining contracts in view of the constraints involved, DWR may be able, under the appropriate circumstances, to assign its interests in the remaining power contracts to another creditworthy party.

Under a scenario where all contract interests were assigned, DWR would no longer be "supplying power" even under the interpretation of AB 1X that opposing parties advocate. In that event, it would not be necessary to wait until 2015 before the DA suspension could be lifted. That condition as prescribed in the statute would no longer be a bar to lifting the suspension on direct access.

Accordingly, in this proceeding, we shall also explore whether, in order to satisfy legal requirements, it may be necessary or appropriate for DWR to terminate its ownership interests by assignment of its existing contracts to one or

more of the IOUs, or other credit-worthy third parties through novation or other assignment.

As noted in its 2007 Revenue Requirement Determination,[13] DWR has renegotiated 19 of the original contracts from 2001 that currently remain in effect, and has terminated five additional contracts for cause. DWR has continued efforts to renegotiate additional contracts, and regularly monitors its contracts to determine if there are opportunities for bilateral negotiation which could lead to more favorable terms and costs.

A number of the renegotiated DWR contracts contain novation clauses which may be exercised at the discretion of DWR. Under a novation clause, upon a written request by DWR, the counterparty to a contract must enter into a replacement agreement with one or more qualified electric suppliers.[14] The execution of such a replacement agreement would thereby constitute a novation that would relieve DWR of any liability or obligation arising under the new agreement.

For DWR contracts that do not contain novation clauses, the contracting parties may still negotiate contract assignment. Without a novation clause, however, DWR may not unilaterally require the counterparty to enter into a replacement agreement. In the event that we conclude that DWR must be

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[13] *See* the DWR Revenue Requirement Determination for 2007, submitted to the Commission on August 2, 2006, pursuant to Sec. 80110 and 80134 of the Water Code.

[14] In order to be qualified to take over the rights and obligations of a DWR contract, the supplier's long-term unsecured senior debt must meet specified minimum credit rating standards.

relieved of all ownership obligations under the power contracts before the direct access suspension can be lifted, we will consider measures to facilitate relieving DWR of its obligations under the contracts through novation or other negotiated assignments to a third party. The terms of any renegotiated and/or reassigned contract would require Commission approval based upon review and determination under the "just and reasonable" standards of Pub. Util. Code § 451.

Assuming that DWR proceeds with the assignment of DWR Power Contracts, we envision that the following steps would be involved:

> (1) Subject to legal statutory conclusions governing the direct access suspension as determined in Phase 1, the Commission may request that DWR enter into discussions with qualified entities regarding a process to assign its DWR contract interests. Such qualified entities may include investor-owned utilities, as well as potentially other third-parties that are willing and able to assume the rights and obligations under such contracts.
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> (2) DWR enters into discussions with the applicable entities as identified in Step 1 above to discuss arrangements and processes whereby DWR may assign its rights and obligations under the respective power contracts containing novation clauses.
>
> (3) Upon reaching agreement with one or more qualified entities for the assignment of rights and obligations, DWR provides written request to counterparties to contracts with novation clauses to enter into a replacement agreement with one or more of the designated entities. Pursuant to the novation clause, before a supplier may be compelled to enter into a replacement agreement, the Commission must determine that its terms are "just and reasonable" pursuant to Pub. Util. Code § 451.
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> (4) Since DWR may not have unilateral discretion to require counterparties to enter into replacement contracts for

contracts without novation clauses, DWR would enter into negotiations with the counterparties for such contracts. The goal of the negotiations would be to adopt amendments to allow the substitution of another credit-worthy entity to assume the rights and obligations of DWR under such contracts. Upon reaching mutually agreeable terms, the parties would submit the renegotiated contract to the Commission for review and approval pursuant to Pub. Util. Code § 451.

(5) The assigned ALJ would establish a process to develop a record for the "just and reasonable" review pursuant to Pub. Util. Code § 451. The Commission conducts a review, develops a record, and issues a decision concerning whether the replacement contracts and other renegotiated contracts are "just and reasonable" pursuant to Pub. Util. Code § 451.

(6) Upon issuance of "just-and-reasonable" findings by the Commission, DWR executes the replacement contracts with the applicable entities where novation clauses apply. DWR executes renegotiated contracts where novation clauses do not apply.

We solicit comments from parties in Phase I as to the legal, procedural process, and timing issues that would be involved with DWR assigning its contract interests through novation or other assignment as a possible vehicle to satisfy the condition that DWR no longer "supplies power" under AB 1X. We solicit comments from DWR regarding its willingness to participate in such a process. In particular, we seek input regarding the expected timeframe that may be required to review, approve, and implement replacement contracts under novation clauses, and renegotiated contracts without novation clauses.

The DWR contracts do not expire simultaneously, but expire in gradual increments over a period of years. The vast majority of DWR contracts are

scheduled to expire by 2011.[15] Therefore, depending on the time table assumed for the lifting of direct access, the number of remaining power contracts (and associated capacity) that would require reassignment may be substantially less than what exists today. The task of DWR assigning its remaining contract interests could become more manageable as fewer unexpired contracts continued in effect.

In the event, or to the extent that we decide in Phase I that DWR contract assignment would be necessary or appropriate to satisfy legal requirements, the relevant impacts of DWR contract assignment on various interests will need to be assessed and weighed in relation to the overall question of the public policy merits of reopening direct access as part of Phase II of the proceeding. We address the preliminary scope of such an inquiry relating to DWR contract assignment in our discussion of Phase II of this order.

We shall issue an interim decision in Phase I of this proceeding to address whether, or subject to what conditions, the Commission has (or may acquire) legal discretion to lift the suspension on direct access. The Phase I decision shall also address whether, or to what extent DWR contract assignment or novation, as discussed above, would be necessary to satisfy the legal conditions under AB 1X to lift the direct access suspension.

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[15] *See* the DWR Revenue Requirement Determination for 2007, submitted to the Commission on August 2, 2006, pursuant to Sec. 80110 and 80134 of the Water Code, pp. 22-24, TABLE D-5 LONG-TERM POWER CONTRACT LISTING.

5.2. Phase II – Public Policy Merits of Lifting the DA Suspension

Based on our disposition of Phase I issues relating to the legal conditions under which the Commission may lift the direct access suspension, we will proceed with Phase II of the rulemaking. Our Phase I decision on the nature, extent, and timing of the Commission's legal authority to lift the direct access suspension will provide a foundation and framework for subsequent inquiry as to the public policy merits and conditions under which a reconstituted direct access market would be appropriate. We set forth herewith a preliminary Phase II scope, to consider whether, or subject to what market and regulatory preconditions, lifting the direct access suspension would be in the public interest.

In Phase II, we shall weigh potential benefits versus risks of problems due to a reconstituted direct access market. We acknowledge parties' claims regarding potential detrimental effects from reinstituting direct access. Concerns have been raised as to whether direct access could drive the wholesale power markets in the direction of shorter-term power commitments, even though longer term contracting is currently needed to secure new generation investments. Parties claim that pursuing renewed retail competition could also conflict with the goal of assuring resource adequacy and supporting the Commission's Public Purpose Programs.

5.2.1. Wholesale Market and Regulatory Prerequisites

We intend to issue a second interim decision in Phase II, addressing the public policy merits of reinstituting DA and determining the necessary wholesale market and regulatory prerequisites in which the reinstitution of direct access could be appropriate. As a foundation for assessing whether a

reinstitution of direct access would be warranted, we must first determine appropriate wholesale market and regulatory prerequisites.

As part of Phase II, we will consider what conditions are necessary for wholesale market and regulatory stability conducive to the proper functioning of a competitive retail market. We recognize that for successful retail competition, there must first be a properly functioning wholesale power market. The necessary conditions must assure energy reliability without increasing risks of price volatility or stranded utility costs. Wholesale energy markets must be stable so as to avoid adverse consequences both to bundled and DA customers such as those that occurred during 2000-2001 periods. Wholesale market conditions must also provide the necessary incentives for investment in long-term capacity and infrastructure development, with the ability to manage shifts in load between bundled service and direct access without cross-subsidies or cost shifting between customer groups. We must consider the interplay between IOUs and ESPs, (as well as other market participants) in terms of the appropriate wholesale market design, incentives, and planning for investment in long term capacity and efficient pricing.

5.2.2. Coordination With Other Statewide Energy Policies

We recognize that relevant policies, issues, and requirements being addressed in the other major Commission proceedings can inform the record here concerning wholesale power market and regulatory conditions needed as prerequisites to any reopening of the direct access retail market. In addressing Phase II issues, we shall coordinate with the major energy policy formulations currently underway in other proceedings that could affect (or be affected by) our inquiry here. Actions in this proceeding must be integrated with our broader

energy policy goals for California. In this regard, we will ensure that for any program to reinstitute direct access, the ESPs serving that load bear the appropriate share of responsibility to support the state's energy infrastructure. Where issues are identified in this proceeding which may relate to policies being formulated in other proceedings, we will prohibit duplication or relitigation, but also assure that issues are properly delineated and resolved in the appropriate proceeding.

In any plan to restore direct access, we shall require adherence to the principles set forth in the Energy Action Plan (EAP) that has been created by the Commission and its sister agencies. The EAP envisions a "loading order" of energy resources that are to guide decisions made by the agencies jointly and singly. This loading order envisions: (1) optimizing strategies for increasing conservation and energy efficiency, (2) meeting new generation first by renewable resources and distributed generation, (3) use of additional clean, fossil fuel central station generation, and (4) improving the bulk electric transmission grid and distribution infrastructure to support demand growth and interconnection of new generation. We will require adherence to these "loading order" principles as a prerequisite in evaluating and implementing any measures to restore direct access.

In formulating statewide energy policies and rules to date, the Commission has recognized the role of existing direct access customers and the ESPs that serve them. In considering whether, or how, to reinstitute direct access, we shall identify applicable requirements that already apply to ESPs in other rulemaking proceedings as a beginning point for considering any further requirements or conditions. The rules applied to date, however, are based on the standstill approach for direct access load, with no new contracts allowed. A

reinstituted direct access program must consider whether or how existing rules applied to ESPs and direct access customers may be affected or need modification to reflect the prospects of growth in direct access. We will consider the need for broad reach of applicable rules to include ESPs while taking into account relevant differences in the business models of the utilities and ESPs.

We highlight below the major energy policy proceedings to be coordinated with this proceeding:

5.2.2.1. Resource Adequacy and Long-Term Procurement

R.05-12-013 is addressing resource adequacy requirements to ensure adequate, cost-effective investment in electric generation capacity for California and to ensure that such capacity is made available to the CAISO for reliable transmission grid operations. These policies currently apply to California's large investor-owned utilities, as well as the ESPs and community choice aggregators that serve retail customers within the service territories of those IOUs. D.06-06-064 established requirements whereby LSEs must demonstrate annually that they have acquired adequate amounts of generation capacity within defined, transmission-constrained areas. Further consideration of wholesale capacity markets and multi-year resource adequacy requirements will be addressed in Phase II of R.05-12-013. We shall consider in this proceeding how resource adequacy requirements being developed in R.05-12-013, or any successor proceeding, may be impacted, or need to be augmented, in the event that direct access is reinstituted. In order to be viable, any program to restore direct access must ensure that all LSEs, including ESPs, bear their appropriate share of responsibility to meet the Commission's resource adequacy requirements.

R.06-02-013 is addressing measures to ensure a reliable and cost-effective electricity supply through review of long-term procurement plans. R.06-02-013

is the forum to integrate all procurement policies and related programs, with adoption of long-term procurement plans by the IOUs for the period 2007 to 2016. ESPs are respondents in that proceeding. In D.06-07-029, the Commission adopted a limited transitional cost allocation mechanism for new generation procurement, and stated that in Phase II of R.06-02-013, questions of longer-term market structure will be addressed.

5.2.2.2. Renewable Portfolio Standards Rulemaking

R.06-02-012 and R.06-05-027 are addressing renewable portfolio standards (RPS). Based on the principles enunciated in D.05-11-025, we determined that ESPs, as well as Community Choice Aggregators, and Small/Multi-jurisdictional Utilities must comply with the fundamental aspects of the RPS program, including procuring 20% of their retail sales from renewable energy sources by 2010. In D.06-10-019, we set ground rules for the participation of ESPs and Community Choice Aggregators in the Commission's RPS program. We are also setting additional standards for contracts for the procurement of eligible renewable resources by all LSEs obligated under the RPS program. We will continue in R.06-02-012 to develop RPS program design as it relates to ESPs and others. R.06-05-027 addresses implementation and administration of the RPS program for all LSEs, including ESPs. We intend to ensure that any program to restore direct access includes appropriate responsibility for ESPs to meet renewable portfolio standards associated with such load.

5.2.2.3. Greenhouse Gas Rulemaking

R.06-04-009 is addressing greenhouse gas policies for LSEs and regulated natural gas providers. In D.07-01-039, the Commission adopted a greenhouse gas emissions performance standard for all new long-term financial commitments to baseload electric generation undertaken by LSEs. Phase 2 of

R.06-04-009 is considering implementation of a load-based greenhouse gas emissions cap for the electricity sector, as adopted in D.06-02-032, and will also consider greenhouse gas emissions cap policies for natural gas. On September 27, 2006, the Governor signed into law AB 32, "The California Global Warming Solutions Act of 2006," which requires the California Air Resources Board to adopt a greenhouse gas emissions cap on all major sources, including the electricity and natural gas sectors. In collaboration with the California Energy Commission, Phase 2 will focus on the development of guidelines for greenhouse gas emissions limits for the electricity and natural gas sectors that the California Air Resources Board can consider as it implements AB 32 economywide. Phase 2 of R.06-04-009, rather than this rulemaking, will address the manner in which the greenhouse gas emissions cap will apply to ESPs.

5.2.2.4. CAISO Market Redesign and Technology Upgrade

As an integral part of the process of assuring that adequate conditions of energy market stability exist, we also recognize the need for active participation in this proceeding by the California Independent System Operator (CAISO). In this regard, we take note of the CAISO Market Redesign and Technology Upgrade (MRTU) that is currently underway. The CAISO plans to have the MRTU program in place by February 2008. We intend to take into account the results of the MRTU program in considering whether market conditions provide adequate stability as a prerequisite to support the implementation of a reconstituted DA market.

5.2.3. Potential Effects of DWR Contract Assignments

In the event that we determine in Phase I that DWR would need to assign its contractual interests to the IOUs and/or other credit-worthy third parties to satisfy legal requirements to lift the DA suspension, we shall examine in Phase II

how such DWR assignments could affect various interests. In addition to the contracting parties, other relevant interests include those of bundled and direct access customers, the IOUs, and the DWR bondholders. We shall provide parties an opportunity to address such impacts on the relevant affected interests in Phase II of this proceeding.

We shall consider whether or to what extent, power costs charged to retail electric customers, or service reliability, would be affected as a result of assignments of DWR contracts. We also shall consider whether, or to what extent, assuming additional financial obligations of the DWR Contracts could adversely affect debt equivalence, credit ratings, or costs of capital of one or more of the investor-owned utilities. The potential effects on utility procurement planning will also be considered.

We also recognize the necessity to protect the interests of DWR Bondholders. Water Code Section 80110 expressly entitles DWR to recover in electricity charges amounts sufficient to enable it to comply with Section 80134, which provides for the revenues to be pledged for support of the bonds that DWR was authorized to issue pursuant to Section 80130. Bond proceeds were used to repay the debt that DWR incurred to finance power purchases during the electricity crisis, including amounts owed to the State of California General Fund. D.02-02-051 prescribed the terms and conditions applicable to the DWR bonds, as set forth in the "Rate Agreement" adopted therein. The provisions of

the "Rate Agreement" do not terminate until the bonds and associated financial obligations have been paid or otherwise funded.[16]

As explained in D.02-02-051, the DWR bonds are supported by two streams of revenues. One revenue stream comes from Bond Charges imposed on electric customers, designed to pay for bond-related costs. The second revenue stream comes from DWR Power Charges imposed on electric customers, designed to pay the commodity costs of DWR power. Both streams of revenue were necessary to provide support for DWR to issue bonds with investment-grade ratings.

The DWR bonds were marketed and sold based in part on representations regarding the suspension of direct access and the reserves that DWR would maintain for operating expenses and debt service. DWR points out that if, or to the extent, that lifting the direct access suspension could create a material shift in the sources of DWR's revenue streams, it could require changes in the method of determining and the amount of DWR reserves. Such changes could be required to protect against the risk of significant load migration from bundled service to direct access, as well as any other relevant risks. In Phase II, we will consider any such affects of contract assignment on the DWR bonds and bondholders, including reserve requirements, bond ratings, interest charges, and any other relevant concerns.

[16] Sections 5.1(a) and 5.1(b) of the Rate Agreement have the force and effect of an irrevocable financing order issued by the Commission pursuant to Pub. Util. Code § 840 *et seq*., and these sections may not be amended after the bonds have been issued.

5.3. Phase III – Retail Rules Governing a Reconstituted DA Market

Based upon the applicable legal principles addressed in Phase I, and the necessary wholesale power market and regulatory prerequisites in Phase II, we shall then move to Phase III. With the conceptual framework from Phases I and II in place, we shall consider in Phase III what rules would be appropriate concerning the structural retail design of any reconstituted DA market. We shall give careful attention to appropriate limits and safeguards on any reconstituted DA market to make sure that broader public policy goals are not compromised, and that consumer interests are protected.

In considering new rules, we shall take into account the protocols already in place to serve existing direct access under the standstill arrangement currently in effect. Although direct access was suspended with respect to any new contracts effective after September 20, 2001, direct access customers with contracts that took effect on or before September 20, 2001 may continue to take service from ESPs.

The IOUs have protocols in place to provide the necessary interfaces with ESPs in order to serve such direct access customers. There are established rules as to how ESPs and DA customers are billed, and processes by which customers may switch from direct access to bundled service. Pursuant to Pub. Util. Code § 394, the Commission has the authority to set technical and operational standards for ESPs providing service to a direct access customer. We shall consider existing protocols as a starting point to assess any new rules.

5.3.1. Cost Recovery to Ensure Fair Share Cost Allocation

Under the standstill principle currently in place, existing DA customers are responsible for paying their fair share of DWR and related utility

procurement costs pursuant to AB 1X and Pub. Util. Code § 366.2(d). By considering the opening of direct access to new customers, we shall be careful to preserve existing ratemaking mechanisms applicable to existing direct access customers for their cost responsibilities. We shall also consider whether, or in what manner, any increased load that may subscribe to direct access should possibly be assessed surcharges to avoid cost shifting.

In D.06-07-029 (in R.06-02-013), we adopted an interim cost allocation mechanism through which the advantages and costs of new generation are shared by all benefiting customers within an Investor-Owned Utility's service territory. We shall consider whether the cost allocation system adopted in D.06-07-029 would be adequate, or if further refinements would be warranted to account for new DA load. We shall also consider whether, or to what extent, customers served through other forms of non-utility load (*e.g.*, Community Choice Aggregation or Municipal Departing Load) may have concerns regarding the fair sharing of any additional costs associated with a reinstituted direct access program. We shall consider such cost allocation issues in Phase III.

5.3.2. Eligibility to Participate in Direct Access

In assessing whether to lift the direct access suspension, we shall also consider any appropriate limitations on customers' eligibility to participate in direct access, as well as conditions for return from direct access to bundled service, and restrictions on switching between the two options. In considering direct access alternatives, our goal will be to achieve a fair and symmetrical assignment of procurement responsibility between bundled and direct access customers. We must also protect bundled customers from any service reliability risks originating with direct access load.

We intend to consider a range of alternatives for direct access eligibility, and not to limit our review merely to retail choice for the largest retail customers. One alternative to a complete market reopening could be to employ a "core/noncore" market structure that is analogous to the model that has been applied in California's natural gas market for over 15 years.[17] As applied in the gas industry, a core/noncore market structure allows large customers competitive choice while preserving the security of bundled service for small customers.

Another possible alternative would be to limit the reopening of DA only to those areas where the CRS undercollection has been fully recovered or to permit DA growth in proportion to the additional capacity associated with expiring DWR contracts and load growth in a given Investor-Owned Utility service territory. We shall evaluate the merits of each of these various alternatives.

5.3.3. Default Service for DA-Eligible Customers

We shall also consider what form of default service should be offered to DA-eligible customers who do not elect to be served under the direct access option. For example, we shall consider whether such default service be provided by the IOU or by a third-party supplier. We shall consider whether the default supplier should absorb any uncompensated risks/costs, and how should such default service be priced or structured to prevent cost shifting as a result of customers' switching between DA and default service.

[17] For example, the proposal for a core/noncore approach to Direct Access was presented in the 2004 Division of Strategic Planning Report referenced in DRA's comments, as noted above.

5.3.4. Effects on Public Purpose Programs

The Commission has implemented various "Public Purpose Programs" in response to various legislative mandates that are either funded through rates or implemented by the Commission and/or the utilities that it regulates. These programs relate to energy efficiency standards, low-income and baseline allowances for customers, and the promotion of renewable energy. As one prominent example, we instituted the California Solar Initiative in 2006 with the goal of installing 3,000 MW of new solar facilities in the service territories of the Investor-Owned Utilities over a 10-year period. We shall consider necessary safeguards to ensure that the funding and support for Public Purpose Programs are not compromised, but continue to be appropriately allocated, as the result of any reinstitution of direct access.

5.3.5. Effects of AB 1X Rate Protections

In its comments, SDG&E argues that before any action to reinstitute direct access, the Commission should first eliminate the rate protections presently in effect pursuant to AB 1X. Specifically, SDG&E references the requirement in AB 1X which froze the rates for 130% of electric customer baseline usage. SDG&E states that although this provision was enacted to protect small customers from the high costs of DWR contracts during the power crisis, the rate freeze has caused successive and excessive rate increases to residential usage above the 130% baseline level. SDG&E expresses concern that because of the price signals that result from the continued rate freeze, low-usage customers cannot be expected to make economically rational decisions when confronted with direct access options. SDG&E argues that retail service choices based on faulty and inaccurate price signals can only result in cost shifting and reduced efficiencies.

We acknowledge the concerns raised by SDG&E regarding the price signals under the AB 1X rate freeze on low-usage consumption. We agree that this issue needs to be considered before reinstituting direct access. This issue is being addressed in SDG&E's Rate Design Proceeding (A.07-01-047). PG&E and SCE have also intervened on this issue in A.07-01-047. Because this issue is being addressed in a separate proceeding, we will not address it here. We will, however, coordinate with our determinations in A.07-01-047, as appropriate, in considering the timing of any implementation to reinstitute direct access.

5.4. Schedule for the Proceeding

The schedule in this proceeding shall be set based on the three sequential phases identified. We shall issue interim decisions at the conclusion of Phases I and II, respectively, and a final decision at the conclusion of Phase III. The OIR schedule may change or be refined by ruling from the assigned Commissioner and/or Administrative Law Judge (ALJ) as we progress through the proceeding.

AREM asked that an investigation be completed by the summer of 2007 to allow for the reopening of direct access no later than January 1, 2008. It is unrealistic to adopt the schedule proposed by AREM. Given the extent and complexity of issues to be resolved, we conclude that the schedule set forth in this order provides a reasonable timeline in logical, sequential steps for addressing the pertinent issues.

We shall solicit initial comments to be due 30 calendar days after the effective date of this OIR, focusing on procedural and scoping issues for the entire proceeding. Reply comments shall be due 15 calendar days after the initial comments are filed. Any party filing procedural comments shall indicate any objections regarding (1) the determination that there is no need for hearings, and (2) the preliminary scope, phases, and timetable for this proceeding as described

in this order. Parties should indicate any proposed adjustments to the schedule, scope and/or content of issues assigned to each of the three phases. These procedural comments are not to address the substantive issues of the three phases. We may provide an additional opportunity for parties to comment on the scope of further issues to be addressed after we issue a Phase I decision. In particular, we may augment or clarify the issues to be addressed in Phase II based upon subsequent developments or decisions in our other major energy policy proceedings as referenced above.

Any party who believes that a hearing is required in this rulemaking should, in its comments, identify and describe (1) material issues of fact and (2) the evidence the party proposes to introduce at the requested hearing. Any right that a party may otherwise have to a hearing in Phase I will be waived if the party does not submit such information in its comments. We shall provide a subsequent opportunity for parties to request a Phase II and/or Phase III hearing by separate ruling.

We solicit a separate round of comments specifically addressing substantive issues for Phase I of this proceeding. The substantive comments on Phase I issues shall address the issues set forth above, and shall be due 60 calendar days after the effective date of this OIR. As previously indicated, parties may incorporate by reference any previous arguments presented in responses or replies to the Petition. After receipt of the substantive comments on Phase I issues, we shall consider if there is a need for any further development of the record. We plan to issue an interim decision on Phase I issues by the fall of 2007.

Following our Phase I Decision, we shall issue a ruling refining the scope and setting a schedule for substantive comments on Phase II issues. We estimate

that Commission Decision on Phase II issues will be released in the summer of 2008. Following the Phase II Decision, we shall issue a ruling refining the scope and setting a schedule for substantive comments on Phase III issues. We estimate that a Phase III Decision will be released in the winter of 2008/2009.

Given the multitude and complexity of issues to be addressed, we anticipate this proceeding will take longer than 18 months from the issuance of the scoping memo to resolve. Pursuant to Pub. Util. Code § 1701.5(b), this issue will be further addressed and refined in a subsequent scoping memo.

5.5. Service List for the Proceeding

This order shall be served on the service lists that received the original Petition 06-12-002. A new service list will thereafter be created for the proceeding pursuant to the following process. AREM (under its new name, ACES) and other parties that filed responses and/or replies to the Petition shall be added to the service list as parties.

Any additional person or entity not on the service list but who is interested in becoming a party should send a request to the ALJ in accordance with the procedure set forth in the Ordering Paragraphs below.

Individuals or entities seeking only to monitor the proceeding, but not to participate as active parties, should contact the Commission's Process Office, 505 Van Ness Avenue, San Francisco, California, 94102 either by letter or by e-mail to: process_office@cpuc.ca.gov, asking to be placed on the "Information Only" section of the service list. The official service list will be posted on the Commission's web site, www.cpuc.ca.gov, as soon as possible.

Persons on the service list should notify the Process Office of any subsequent address changes or if they wish to be removed from the list. Any other problems or questions about the service list after it is posted on the

Commission's web site should be brought to the attention of the assigned ALJ. The service list will be updated in accordance with the described procedures, consistent with Rule 2.3.

Any person interested in participating in this proceeding who is unfamiliar with the Commission's procedures should contact the Commission's Public Advisor's Office in Los Angeles at (213) 576-7055, (866) 849-8390 (toll free) or in San Francisco at (415) 703-2074, (866) 849-8390 (toll free), or (866) 836-7825 (TTY), or send an e-mail to public.advisor@cpuc.ca.gov

5.6. Requirements for the Filing and Service of Documents

There are different types of documents participants may prepare in this proceeding. Each type of document involves different obligations with respect to filing and service. Parties must file certain documents as required by the Rules or in response to rulings by the assigned Commissioner and/or the ALJ. All formally filed documents must be filed with the Commission's Docket Office and served on the service list for the proceeding. Article 1 of the Rules contains the Commission's filing requirements. Resolution ALJ-188 sets forth the interim rules for electronic filing, which replaces only the filing requirements, not the service requirements. Parties are encouraged to file electronically whenever possible as it speeds processing of the filings and allows them to be posted on the Commission's website. More information about electronic filing is available at http://www.cpuc.ca.gov/efile/static.htm.

Other documents, including prepared testimony, if any, are served on the service list but not filed with the Docket Office. We will follow the electronic service protocols adopted by the Commission in Rule 1.10 of the Commission's Rules of Practice and Procedure for all documents, whether formally filed or just

served. This Rule provides for electronic service of documents, in a searchable format, unless the appearance or state service list member did not provide an e-mail address. If no e-mail address was provided, service should be made by United States mail. In this proceeding, e-mail service shall be made concurrently on ALL persons on the service list for whom an e-mail address is available, including those listed under "Information Only." Parties are expected to provide paper copies of served documents upon request.

Any e-mail communications about this proceeding should include a brief description of the topic of the communication. Paper format copies, in addition to electronic copies, shall be served on the Assigned Commissioner and the ALJ.

6. Ex Parte Communications

Ex parte communications for Phase I are governed by Rule 8.2(a) and for Phase II and Phase III are governed by Rule 8.2(c).

7. Comments on Proposed Decision

Although not required, the proposed decision of the assigned Commissioner in this matter was mailed to the parties in accordance with § 311 of the Pub. Util. Code and Rule 14.2(a) of the Commission's Rules of Practice and Procedure. Comments were filed on May 14, 2007, and reply comments were filed on May 12, 2007. We have reviewed the comments and have taken them into account, as appropriate in finalizing this order.

8. Assignment of Proceeding

Michael R. Peevey is the assigned Commissioner and Thomas R. Pulsifer is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

1. On December 6, 2006, the Alliance for Retail Energy Markets *et al.* filed a petition pursuant to Pub. Util. Code § 1708.5 requesting that the Commission

institute a rulemaking to consider rules for lifting the suspension on direct access.

2. On April 16, 2007, AREM filed a motion to amend the Petition to (1) inform the Commission that their coalition now operates under the name of the ACES; and (2) to add 21 entities to the list of supporters of the Petition.

3. It is reasonable to institute a rulemaking regarding rules governing whether, or under what circumstances, the Commission may lift the suspension on direct access.

4. The market and regulatory conditions in effect at the time that direct access was suspended in 2001 have continued to evolve.

5. Although direct access was suspended pursuant to AB 1X, the suspension was mandated only until DWR "no longer supplies power" pursuant to the statute.

6. In D.06-07-029, the Commission stated its commitment to the fundamental principles of competition and consumer choice, and indicated the intention to explore how to increase consumer choice, and indicated the intention to explore how to increase consumer choice by reinstituting direct access or other means.

7. Opening the rulemaking in accordance with the scope set forth in this decision will provide an opportunity to develop a sound record both on legal issues concerning Commission authority to reinstitute direct access, as well as the potential public policy benefits and appropriate conditions of doing so.

8. Pursuing a rulemaking concerning the prospects for reopening direct access will provide for a more integrated and coordinated approach in addressing important issues in other major policy proceedings.

9. Subject to disposition of the legal question of Commission authority under AB 1X, it is appropriate to examine the potential for DWR to assign its interests in power contracts through novation or other assignment.

10. The potential assignment of DWR contract interests to another credit-worthy party or parties would require a Commission review as to whether the resulting contract was just and reasonable in view of the resulting impacts on utility customers, investors, and DWR bondholders.

11. The question of whether a reinstituted direct access program would be in the public interest depends in large measure on ensuring that conditions are in place for a stable wholesale power market that provides appropriate incentives for investment in sufficient long term capacity to serve all customer demand, priced in an efficient manner with no cost shifting.

12. In order to be in the public interest, any reinstituted direct access program must provide appropriate rules for eligibility for participation in the program, with appropriate ratemaking safeguards to prevent cost shifting, while continuing to support the Commission's Public Purpose Programs.

Conclusions of Law

1. Pursuant to Pub. Util. Code § 1708.5, the Commission has authority to consider a petition requesting the initiation of a rulemaking into whether, or subject to what conditions, the Commission may lift the suspension on direct access.

2. The petition which is the subject of this order should be granted to the extent set forth herein.

3. A rulemaking should be initiated to consider whether, or subject to what conditions, the Commission may lift the suspension on direct access.

4. It is not necessary to resolve questions as to the Commission's legal authority to lift the direct access suspension as a precondition of opening this rulemaking to conduct an inquiry into whether or subject to what conditions, it could be appropriate to lift the suspension.

5. Before the direct access suspension may be lifted, the Commission must first determine that such action is compliant with statutory authority in AB 1X mandating the suspension "until DWR no longer supplies power" pursuant to the statute.

6. As part of the inquiry into the Commission's legal authority to lift the suspension, it is reasonable to consider alternatives such as the reassignment of DWR contracts, or the partial lifting of the direct access suspension as DWR contracts begin to expire.

7. As a precondition of DWR implementing renegotiation or novation of any of its contracts, the Commission would be required to make findings that such revised contracts were just and reasonable pursuant to Pub. Util. Code § 451.

8. Any Commission action to reinstitute direct access must be based on sound legal authority for doing so, and must be conditioned on first implementing the necessary regulatory and market conditions to ensure reliable sources of long-term electric capacity at stable prices as well as fair and nondiscriminatory regulatory and ratemaking conditions to ensure that direct access customers pay their fair share of costs without the risk of free riding or cost shifting.

9. Consideration of appropriate conditions on the reinstitution of direct access should be carefully coordinated and integrated with policies being developed in other major rulemaking proceedings before the Commission

including those relating to resource adequacy, long-term resource planning, renewable portfolio standards, and environmental programs.

IT IS ORDERED that:

1. The Alliance for Retail Energy Markets *et al.* (AREM) petition for the Commission to institute a rulemaking to consider rules for lifting the suspension of direct access is granted to the extent set forth in this order.

2. A rulemaking on the Commission's own motion into considering rules for lifting of the suspension on direct access, as set forth in this order, is hereby initiated.

3. The issues to be considered in this proceeding are set forth in the Preliminary Scoping Memo and summarized in the Appendix of this OIR.

4. An initial service list for this proceeding shall be created by the Process Office and posted on the Commission's website (www.cpuc.ca.gov) as soon as it is practicable. We direct the Process Office to add all parties that responded or replied to the Petition as appearances.

5. After the initial service list is established, other additional persons or entities who wish to be placed on the new service list shall follow the directions below.

   (a) Appearance category. Those who wish to participate in this proceeding as a party must contact the assigned administrative law judge in writing, by email (trp@cpuc.ca.gov) or at CPUC, 505 Van Ness Avenue, San Francisco, CA 94102 and describe their interest in the proceeding, indicate how the person or entity intends to participate, and list all relevant contact information (name; person or entity represented; mailing address; telephone number; email address).

   (b) Information-only category or state-service category. Those who intend only to monitor this proceeding, must

> contact the Commission's Process Office in writing, by email at (Process_Office@cpuc.ca.gov) or at CPUC, Process Office, 505 Van Ness Avenue, San Francisco, CA, 94102), specify the service category desired and list the same contact information detailed in Ordering Paragraph 5(a).

6. The category of this rulemaking, for Phase I, is preliminarily determined to be "quasi-legislative" as defined in Rule 1(d) of the Commission's Rules of Practice and Procedure. The category for Phase II and Phase III is preliminarily determined to be "ratemaking" as defined in Rule 1(e). Pursuant to Rule 7.6, any party may file and serve an appeal of categorization no later than 10 days from the effective date of this OIR.

7. All parties shall abide by the Commission's electronic service rules contained in Rule 2.3.1 of the Commission's Rules of Practice and Procedure.

8. Comments are hereby solicited regarding procedural issues, including the schedule and scope of issues to be addressed as summarized in the Appendix hereto. Comments on procedural issues shall be due 30 calendar days after the issuance of this OIR. Reply comments shall be due 15 calendar days after initial comments are filed.

9. It is preliminarily determined that hearings are unnecessary. Any party who believes that an evidentiary hearing is required must identify and describe (a) the material issues of fact, (b) the evidence the party proposes to introduce at the requested hearing, and (c) the schedule proposed for the hearing. Any right that a party may otherwise have to an evidentiary hearing in Phase I will be waived if the party does not submit a timely request for an evidentiary hearing in the comments within 30 days. A subsequent order will schedule the time for requests for hearings in Phase II and Phase III.

10. Comments are hereby solicited regarding issues identified for Phase I of the proceeding as set forth in the Scoping Memo section of this order and summarized in the Appendix hereto. Comments on substantive Phase I issues shall be due 60 calendar days after the effective date of this OIR.

11. The due dates for any subsequent comments shall be set by assigned Commissioner and/or assigned Administrative Law Judge (ALJ) ruling at a later date.

12. The schedule for this proceeding is preliminarily approved and adopted, but may be changed, if necessary, by an assigned Commissioner Ruling or an ALJ Ruling.

13. The Motion to Amend the Petition filed on April 16, 2007 by AREM under its new name, the Alliance for Cooperative Energy Solutions is hereby granted. The new name shall be added to service list to replace the name, AREM.

14. This order shall be served on the service lists that were served with Petition 06-12-002 and shall also be served on all energy utilities under the jurisdiction of this Commission as shown on Appendix B.

15. Petition 06-12-002 is closed.

This order is effective today.

Dated May 24, 2007, at San Francisco, California.

MICHAEL R. PEEVEY
President
DIAN M. GRUENEICH
JOHN A. BOHN
RACHELLE B. CHONG
Commissioners

I dissent.

/s/ TIMOTHY ALAN SIMON

APPENDIX A
Preliminary Scope of Issues to be Addressed in this Rulemaking

Phase I: Legal Authority to Lift the DA Suspension:

1. Under what conditions, constraints and timetable, does the Commission have the legal discretion to lift the suspension on direct access without additional legislation?

2. What is the proper interpretation of Water Code Sec. 80110 in requiring direct access suspension "until DWR no longer supplies power?" Under this interpretation, is DWR currently "supplying" power that is sold pursuant to currently effective DWR contracts? Alternatively, is DWR no longer "supplying" power in that its authority to contract for new power supplies has terminated pursuant to Water Code Sec. 80260?

3. The following questions apply based on the assumption that the statutory constraint "until DWR no longer supplies power" were interpreted to apply until DWR no longer retains an ownership interest in its existing contracts:

   (a) Does this interpretation necessarily mean that the suspension must continue until the very last DWR power contract expires? Alternatively, is there a legal basis for the Commission to lift the direct access suspension on a partial basis as individual DWR contracts expire? In other words, could additional amounts of direct access load be legally authorized corresponding to MW capacity levels in DWR contracts as they expire? Based on the expiration dates and associated MW capacity in existing DWR contracts, what timetable would be appropriate for authorizing incremental new direct access MW capacity on a phased-in basis?

   (b) Through what processes and subject to what considerations, conditions, or constraints could (or should) DWR assign its ownership interest in existing

contracts to one or more third parties (through novation or other assignment) as a possible way of satisfying the requirement that "DWR no longer supplies power" pursuant to Water Code Sec. 80110? The scope of Phase I comments should be focused on the legal, procedural process and timing issues that would be involved in reviewing, approving and implementing any assignment of DWR contracts assuming such a process was deemed necessary or appropriate in order to satisfy legal requirements for lifting the DA suspension.

Phase II: Public Policy Merits and Prerequisites for Lifting the DA Suspension

1. What sorts of prerequisites are necessary to assure long-term supplies of power and generation/transmission capacity, consistent with the "loading order" principles in the Energy Action Plan, as a basis for a reinstituted direct access program to succeed? In this regard, what sorts of statewide energy policy coordination issues need to be resolved in the interplay between ESPs and IOUs as well as other market participants with respect to resource adequacy, capacity planning, and investment?

2. What effect may the CAISO Market Redesign and Technology Upgrade process have on the design of a reinstituted direct access program?

3. What incentives are needed to develop and retain sufficient generation capacity if direct access is reinstituted? Do the measures for wholesale capacity and power market design in R.05-12-013 and R.06-02-013 provide the necessary incentives?

4. What form of market design should be developed to enable DA load to migrate from one load serving entity (LSE) to another without creating stranded capacity costs, or excessive shortage-induced costs?

5. What other miscellaneous effects on and consistency with other LSEs may be implicated by reinstituting direct access?

6. Identify the relevant issues in the other formal proceedings that may be relevant or that would be implicated in deciding whether or how to lift the direct access suspension (*i.e.*, resource procurement (R.06-02-013), resource adequacy (R.05-12-013), renewable resource standards (R.06-02-012 and R.06-05-027), greenhouse gas policies (R.06-04-009), or other environmental considerations applicable to future electric generation mixes, etc. Assuming a reinstitution of direct access, what effects would there be (or what additional restrictions, conditions, or requirements should apply) with respect to the market and regulatory issues being developed in these proceedings?

7. In the event, or to the extent, that it is determined in Phase I that DWR contract assignment (through novation and/or negotiation) would be necessary to meet the legal conditions to lift the DA suspension, Phase II will examine the effects of impacts on the IOUs, customers, and DWR Bondholders that may result as a consequence. Parties should address the nature, magnitude, and likelihood of each relevant effect identified if DWR were to assign its contracts to the IOUs or other third parties. If the IOU were to be assigned the DWR contracts, what would be the effect regarding IOU debt equivalence, cost of capital, and other aspects of IOU financial and/or resource planning? If DWR contracts were to be renegotiated, what potential effects could result regarding the level of power costs charged to retail customers? How do such impacts relate to the overall balance of advantages and disadvantages of lifting the DA suspension, as referenced in the following question?

8. Identify the relevant benefits to Californians versus risks of adverse effects from lifting the DA suspension. Do the potential benefits outweigh possible

problems or disadvantages? What measures may be appropriate to mitigate or to avoid potential problems?

9. Assuming the Commission has legal discretion to lift the direct access suspension, would it be in the public interest to do so, considering both potential advantages and disadvantages?

Phase III - Rules Applicable to a Reinstituted Direct Access Program

1. What rules should apply regarding eligibility for entry into the direct access program? Should a core/noncore structure be adopted similar to that used in the natural gas industry? If so, what criteria should apply for delineating the core/noncore categories?

2. What standards should apply to ESPs regarding eligibility for providing retail service in the direct access market?

3. What relevant ratemaking concerns arise by the potential lifting of the DA suspension? What measures would be appropriate to mitigate or neutralize any potential for cost shifting? What affects or concerns may relate to Departing Load and Community Choice Aggregation in terms of assuring that customers bear their fair share of applicable power costs.

4. What concerns may be implicated in terms of potentially stranded costs associated with current utility procurement (which assume DA suspension) and Public Purpose Programs?

5. If direct access were to be reinstituted, what measures may be warranted to continue to protect DWR Bondholders' revenue stream consistent with Rate Agreement?

6. What protections may be needed for customers that do not elect retail choice in order to provide for equitable allocation and to avoid cost-shifting (*e.g.,* surcharges for cost responsibility)? What form of default service should be

offered to direct-access-eligible customers who do not elect to be served by direct access? For example, should default service be provided by the IOU or by a third-party supplier?

7. What rules or ratemaking treatment is needed regarding customers' rights, restrictions, and/or obligations to switch between bundled and DA options? How can cost shifting be avoided?

8. Issues relating to the proposed termination of the 130% residential baseline protection (required under AB 1X) will be addressed in the SDG&E Rate Design Proceeding, but timing of that proceeding will be coordinated with this rulemaking as warranted.

(END OF APPENDIX A)

APPENDIX B
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Attn: Ray Czahar, CFO

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(END OF APPENDIX B)