

CROSSBORDER ENERGY

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September 3, 2004

HAND DELIVERED

Legal Document Examiner
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102

Re: R 04-04-025

Legal Document Examiner:

Enclosed for filing in the above-referenced proceeding are the original and five (5) copies of the **Reply Comments of the California Cogeneration Council in Response to Redline Comments on the E3 Report**. Copies have been served on all parties of record in this proceeding.

Please return a filed-stamped copy to us using the enclosed self-addressed and stamped envelope. Thank you for your attention to this matter.

Sincerely,

/s/

R. Thomas Beach

On Behalf of the
California Cogeneration Council

Enclosures

cc: The Honorable Michael R. Peevey, President
The Honorable Loretta Lynch, Commissioner
The Honorable Susan P. Kennedy, Commissioner
The Honorable Carl W. Wood, Commissioner
The Honorable Geoffrey F. Brown, Commissioner
Presiding Administrative Law Judge Julie Halligan
All parties on Service List in R 04-04-025

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

Order Instituting Rulemaking to Promote)	
Consistency in Methodology and Input)	
Assumptions in Commission Applications of)	R. 04-04-025
Short-run and Long-run Avoided Costs,)	(Issued April 22, 2004)
Including Pricing for Qualifying Facilities)	
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**Reply Comments
of the California Cogeneration Council
in Response to Redline Comments
on the E3 Report**

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On behalf of
CALIFORNIA COGENERATION COUNCIL

September 3, 2004

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**Reply Comments of the California Cogeneration Council
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In accordance with the presiding ALJ’s electronic ruling of July 15, 2004, the California Cogeneration Council¹ (CCC) respectfully responds to the August 20, 2004 “redline” comments of other parties on the study prepared by Energy and Environmental Economics (the “E3 Report”).² The E3 Report proposes a comprehensive avoided cost methodology for the purpose of evaluating the cost-effectiveness of energy efficiency programs. As requested by the ALJ, parties have also commented on the potential application of the E3 avoided cost methodology to other applications, including the pricing of power from Qualifying Facilities (QFs).

The CCC’s reply comments will focus on the redline comments of the three IOUs. The CCC disagrees with certain aspects of the IOUs’ comments, particularly Edison’s erroneous

¹ The CCC is an *ad hoc* association of natural gas-fired cogenerators located throughout California, in the service territories of all three of California’s major investor-owned electric utilities (IOUs)—Pacific Gas & Electric Company (PG&E), Southern California Edison Company (Edison), and San Diego Gas & Electric Company (SDG&E). CCC members are qualifying facilities (QFs) under the FERC’s rules implementing PURPA. CCC members have sold their power to the IOUs for many years, pursuant to contract terms and avoided cost prices established by this Commission. In aggregate, CCC members’ QF projects in California sell 1,845 megawatts (MWs) of generation into the California grid.

² “A Forecast of Cost Effectiveness of Avoided Costs and Externality Adders,” released January 8, 2004 to parties in R. 01-08-028

assertion that the Commission has found that current short-run avoided cost (SRAC) prices exceed the IOUs' avoided costs, in violation of the Public Utilities Regulatory Policies Act of 1978 (PURPA).³ The CCC also opposes SDG&E's support for the concept of a "resource balance year" that the E3 Report employs. These reply comments also support the E3 Report's development of avoided cost components related to transmission and distribution costs, environmental mitigation costs, reliability costs, and the price elasticity of demand. The IOUs generally oppose these cost components, particularly for QF pricing.

However, the CCC also finds that it agrees with the IOUs in certain areas. The CCC will summarize these points of agreement, in order to assist the Commission to recognize those areas in which there may be some degree of consensus.

I. POINTS OF DISAGREEMENT

A. The Commission Has Not Found That Current SRAC Prices Violate PURPA.

Edison twice asserts that "the Commission has acknowledged [that] . . . the current SRAC methodology . . . yields prices that exceed avoided cost."⁴ In support of this assertion, Edison cites two orders in the Commission's procurement docket, D. 03-12-062 and D. 04-01-050, although Edison fails to provide a page cite for either order. Edison mischaracterizes both of these orders, and fails to mention D. 04-07-037, the recent order on rehearing that clarifies the Commission's statements on SRAC in these prior decisions. In fact, in D. 03-12-062 the Commission found that there was a need to review the current SRAC methodology because the

³ 16 U.S.C. § 824a-3. The Federal Energy Regulatory Commission (FERC) has promulgated rules for the implementation of PURPA; *see* 18 CFR § 292 *et seq.*

⁴ *See* Edison Redline Comments, at 4 and 23.

IOUs may pay too much for QF power “in certain time periods relative to market prices”⁵ (and thus not necessarily relative to avoided costs). The Commission did not conclude that SRAC prices exceeded avoided costs on average over all hours of the day. D. 04-01-050 is silent on this issue, although the order does note the Commission’s planned review of SRAC pricing.⁶ Edison sought rehearing of both orders, arguing that the Commission could not allow current QF contracts to be renewed at SRAC prices, because the Commission allegedly had found that current SRAC prices exceed avoided costs. In D. 04-07-037, the order on rehearing, the Commission decisively rejected Edison’s request for rehearing, and clearly found that, although current SRAC prices need to be reviewed, they do not exceed avoided costs:

In any event, SCE overstates the findings in the decisions concerning the SRAC formula. Although we were clear in D.03-12-062 on the need for SRAC prices to be reviewed, we did not state they are inadequate or in violation of PURPA. D.03-12-062 stated the utilities have “paid too much for QF power *in certain time periods relative to market prices*” (D.03-12-062, at p. 56 (emphasis added).) As CCC notes, spot market prices are not necessarily the same as avoided costs, and therefore this is not a statement that avoided cost has been exceeded. Furthermore, PURPA does not require that QF prices be less than avoided cost at all times. Rather, PURPA requires a reasonable approximation of avoided costs over time. (18 C.F.R. 292.304 (b)(5).)

SCE’s claim that the evidence in this proceeding demonstrates that the SRAC formula violates PURPA is similarly unconvincing. According to SCE, the evidence in this proceeding shows that “the SRAC formula has yielded and will continue to yield prices for QF energy that systematically and materially exceed avoided cost.” (SCE App. for Rehg. of D.03-12-062, at p. 4.) In fact, the evidence cited by SCE only demonstrates that during *some periods* SRAC formula costs exceeded spot market costs. This is not the same as systematically exceeding avoided costs in violation of PURPA, and the evidence in the proceeding does not show systematic and continuously excessive prices.

For instance, although SCE cites to evidence indicating that SRAC prices have exceeded avoided costs during specific time periods (see e.g., SCE/Bergman Exs. 16C/17, at 58:4-59:4; CCC/Beach Ex.102, 26:15-16), the evidence does not demonstrate that SRAC prices violate PURPA. There is also a good deal of

⁵ See D. 03-12-062, at 56 - 58.

⁶ See D. 04-01-050, at 140.

evidence in the record supporting the view that these snapshots of certain time periods are not necessarily representative of how the power market will function during other periods. (Ex. 104, Resp. to Q 1(a).) Therefore, over time the SRAC prices may reasonably represent avoided costs, as required by PURPA. (See TR, at 4702:14-4703:2 (CCC/Beach).)

CCC's suggestion that the Commission clarify that the evidence in this proceeding does not demonstrate that SRAC prices exceed the utilities' avoided costs is well taken. We agree that the evidence in this proceeding has not demonstrated that SRAC prices are in violation of the PURPA avoided cost standard. However, that evidence has raised issues concerning the accuracy of the SRAC formula, which the Commission will review in its recently opened rulemaking. *See* D. 04-07-037, at 6-7.

Thus, the Commission has clarified that current SRAC prices do not exceed avoided costs and do not violate PURPA. The Commission should give no credence whatsoever to Edison's repeated efforts to mischaracterize the Commission's most recent assessment of the current SRAC pricing methodology.

B. SDG&E's Comments on E3's Use of a "Resource Balance Year" Illustrate the Flaws in This Concept.

SDG&E's comments support E3's use of the concept of a "resource balance year."⁷ E3 proposes to base avoided generation costs on electric forward market prices prior to the "resource balance year" (2008) and on the all-in costs of a new combined-cycle gas turbine (CCGT) beginning in that year and for all subsequent years. E3 does not discuss at length how it chose 2008 as the resource balance year, but it appears to assume that California has surplus capacity prior to 2008 but that supply and demand will be in balance thereafter. As a result, E3's avoided generation costs are less than the full cost of a new CCGT prior to 2008. SDG&E is more explicit, stating that "resource balance should be defined in terms of the time period until the electric planning supply, including reserves, and planning demand are in balance."⁸ As the Commission is well aware, California IOUs will not achieve the approved 15% to 17% reserve

⁷ SDG&E Redline Comments, at 10.

⁸ *Ibid.*

margins until 2008; thus, the utilities are presently deficit in capacity. The most recent CEC forecasts show that the state as a whole is short on capacity in the near term, even assuming reasonable amounts of imports from the broader regional market.⁹ As a result, contrary to E3's assumptions, avoided generation costs should be at least as high as the full costs of a new CCGT resource, for the full planning horizon. SDG&E appears to agree that the state is deficit, as shown by its statement that a five-year period until the resource balance year is a reasonable time frame to bring new supply on-line to close the gap between planning supply and demand.¹⁰ However, it makes no sense for avoided generation costs to be less than the full costs of a new resource if the state needs capacity today. As the CCC has explained at length in its prior comments, if the state is deficit in capacity today, then the concept of using market prices prior to a resource balance year does not reflect reality, particularly if those prices are lower than the full costs of a new resource.¹¹ Under California's present capacity-deficit circumstances, avoided generation costs should be based on the full costs of a CCGT for the entire planning horizon.

C. Edison's Proposal to Base Long-run Avoided Generation Costs on Long-run Production Cost Modeling Is Overly Complex and Lacks Transparency.

Edison proposes a fundamental change in E3's methodology for calculating avoided generation costs. Instead of identifying a CCGT as the avoided resource, and using the all-in costs of such a unit as the avoided generation costs for both energy and capacity, Edison proposes to use the deferral value of a combustion turbine (CT) for the avoided cost of capacity and its "system incremental energy cost" (as determined using a production cost model) as its avoided cost for energy. This is the approach that the Commission has used historically for calculating

⁹ See the CEC's July 2004 revision to its *California's Summer 2004 Electricity Supply and Demand Outlook*, at 4-5, Table 3, and Figure 3. This forecast is available on the CEC's website at http://www.energy.ca.gov/reports/2004-07-08_700-04-005REV.PDF.

¹⁰ *Ibid.*

¹¹ The CCC has explained in prior comments that today's thin wholesale electric market in California does not capture the full value of capacity today, because most generators in the state recover capacity-related costs through other mechanisms, such as reliability must-run contracts, DWR contracts, or utility rate-base recovery.

short-run avoided cost (SRAC) prices for QFs, and the CCC believes that this methodology may continue to make sense in the SRAC context. However, as the Commission is well aware, production cost models are complex “black box” tools that require detailed assumptions about future loads and resources across the entire interconnected grid in the Western U.S., Canada, and Mexico. As the Commission has learned over the past two decades, adjudicating the input assumptions for production cost models can be a formidable task even when the model is just calculating SRAC prices for the next one or two years – a period in which it is relatively easy to forecast loads, resources, and gas prices. This task becomes very problematic when the goal is a long-term, 20-year forecast of avoided cost prices. The CCC agrees with E3's observations on page 56 concerning the difficulties of using production cost models to project LRAC prices. The E3 methodology for long-run avoided generation costs, based on the all-in costs of a CCGT, has the considerable virtues of being transparent, easy to update, and readily verifiable by a wide range of parties. E3's approach is also consistent with the Commission’s approach to determining the market price referents (MPRs) used in the Renewables Portfolio Standard (RPS) program.

D. Edison’s and PG&E’s Suggestions to Use a “Black’s Spark Spread Option Model” to Value Capacity or Dispatchability Are Untested, Use Parameters That Are Not Transparent, and Are Far Too Complicated.

Edison’s redline changes for pages 15-17 of the E3 Report propose to use a Black’s spark spread option model to calculate the price for capacity that is reflected in current forward market prices. Interestingly, Edison’s summary comments do not discuss this proposed change, perhaps because the Black’s spark spread option model is very complex, as can be seen from the equations on page 16 of Edison’s mark-up of the E3 Report. In addition, PG&E proposes to use this model to value dispatchability.¹² Although the Black’s model is a well-known tool for the analysis of the value of financial call options, its use in this context is highly questionable, particularly since the electric forward market for California is thin and not transparent, with price

¹² PG&E Redline Comments, at 4; PG&E’s redline changes on pages 229 - 231 of the E3 Report.

information difficult to obtain and verify. In addition to forward electric price data, the Black's model also would require daily volatility parameters for both natural gas and electricity and a correlation coefficient between gas and power prices. Edison and PG&E have not explained how to obtain this input data, or how reliable and transparent the data would be. Nor have the utilities provided an illustrative calculation of capacity or dispatchability values determined using this model. The IOUs' approach might make sense if California had a deep, liquid, transparent market for electricity, such as exists for the financial products with which the Black's model is typically used. However, that is certainly not the case today, and the Commission should not accept these unsupported, overly complex proposals. Edison's and PG&E's proposals also assume that the Commission will adopt E3's proposal to use prices from the thin, opaque electric forward market as avoided generation costs – a proposal with problems that the CCC has discussed at length in its prior comments in this docket.

E. SDG&E Is Wrong In Asserting That Gas-fired QFs Do Not Avoid Environmental Costs.

SDG&E's redline comments, at page 36, assert that environmental avoided costs "are appropriate only for renewable QFs," because gas- or biomass-fired QFs will have similar or higher emissions than the avoided CCGT. This is clearly wrong, because all QFs, regardless of resource type, will allow the utility to avoid the costs of the emissions of the CCGT that the utility will not have to build due to QF generation. It is these avoided emissions from the deferrable resource that E3 values in its LRAC methodology. The QF's own emissions are irrelevant to the determination of avoided costs – if a QF emits criteria pollutants, the costs of mitigating those emissions will be the responsibility of the QF owner.

F. Edison Mischaracterizes the FERC's Rules Implementing PURPA In Asserting That Those Rules Do Not Allow QF Avoided Costs to Reflect The Adders That E3 Calculates.

Edison argues, at pages 22-23 of its redline comments, that the FERC's rules implementing PURPA do not allow the inclusion of the environmental, transmission and

distribution (T&D), reliability, price elasticity, and natural gas components of the E3 LRAC calculation, because these components are not included in the factors that the FERC enumerates that must be considered in formulating avoided cost prices. The CCC strongly disagrees with this very constrained reading of the FERC's rules.¹³ For example, the cost of NOx and PM10 emission credits is a real cost to utilities and other generators in California, and the availability of energy from a QF allows the utility to avoid these real environmental costs [18 CFR §292.304(e)(3)]. The FERC rules require the consideration of "the deferral of capacity additions," which may include T&D capacity as well as generation capacity [18 CFR §292.304(e)(3)].¹⁴ The FERC rules also explicitly require consideration in avoided cost rates of

¹³ In fact, in listing the factors enumerated in the FERC's rules, Edison conveniently omits the numerous sub-parts under 18 CFR §292.304(e)(2) that add considerable detail to the second factor.

¹⁴ In footnote 39 on page 22 of its redline comments, Edison quotes out of context and misrepresents FERC's conclusion in a Niagra Mohawk decision concerning avoided transmission costs. The case at hand involved whether the avoided transmission cost component of QF avoided cost payments could be properly included in Niagra Mohawk's Open Access Transmission Tariff rates. As reported in the Initial Decision, the State of New York expressly requires that avoided transmission costs be included in QF avoided cost payments under PURPA. The FERC Administrative Law Judge concluded, in an Initial Decision, that the avoided transmission cost component of QF payments should not be included in Niagra Mohawk's transmission rates because avoided transmission costs should not be included in QF payments under PURPA in the first place. 82 FERC 63,018 (March 12, 1998). Contrary to Edison's statement, however, FERC, on rehearing, expressly rejected the Administrative Law Judge's conclusion that avoided transmission costs may not be included in avoided cost payments under PURPA. FERC did find that Niagra Mohawk may not include the avoided transmission cost component of QF payments in its transmission tariff rates, but not based upon any view as to whether avoided transmission costs may be included in QF payments under PURPA. FERC concluded that a QF payment, even one based on avoided transmission costs, is a purchased power cost for the purpose of retail rate design and not appropriately included in transmission rates. In fact, FERC stated that the issue of whether it is appropriate to include avoided transmission costs in QF payments under PURPA was not an issue in the case and should never have been considered by the Administrative Law Judge. 92 FERC 61,168 (August 17, 2000). To our knowledge, avoided transmission costs remain a component of QF payments in New York, as required by New York law and consistent with PURPA.

In California, in the BRPU process in the early 1990s, the Commission recognized that QFs will avoid or incur transmission costs compared to the avoidable resource that the utility

“the expected or demonstrated reliability of the qualifying facility” [18 CFR §292.304(e)(2)(ii)].¹⁵ The price elasticity of demand is specified in the FERC requirement that avoided cost prices must account for the “aggregate value of energy and capacity” from QFs.¹⁶ The CCC believes that the Commission is on a firm foundation under the FERC rules to include all of these components in the avoided cost prices paid to QFs.

G. The Utilities’ Attempt To Distinguish “Planning” Avoided Costs from “Payment” Avoided Costs Is Not Credible.

Both PG&E and Edison argue that the E3 methodology is appropriate only for “planning” purposes, such as evaluating the cost-effectiveness of energy efficiency programs or distributed generation incentives, but is not accurate enough to be used as the basis of avoided cost payments to QFs.¹⁷ The CCC believes that this is a distinction without much of a difference. The Commission’s authorized energy efficiency and distributed generation programs involve the payment of hundreds of millions of dollars in rebates and incentives to participating customers, and the utilities clearly size these payments such that these programs produce cost-effective reductions in energy use – that is, so that program payments are less than or equal to the avoided costs of the MWs of capacity and MWhs of energy that these programs conserve. As a result, it is somewhat disingenuous, to say the least, for the IOUs to assert that, for energy efficiency and self-generation programs, E3's avoided costs will be used only for “planning,” but will have no influence on “payments.”

otherwise would build. These avoided transmission costs – positive or negative – were included in the BRPU bid evaluation process. *See* D. 92-04-045, at 40; also, D. 92-09-078, at 4-8.

¹⁵ As the CCC has discussed in its prior comments, QFs today allow the utilities to avoid the costs of Reliability Must-Run (RMR) contracts. In the future, the utilities will be able to count contracted QF capacity toward their resource adequacy requirements, and thus avoid the costs to acquire additional reserves.

¹⁶ 18 CFR § 292.304(e)(2)(vi). The Commission has recognized this factor in the past through the “QF_{In}/QF_{Out}” approach to calculating the SRAC incremental energy rate (IER).

¹⁷ Edison Redline Comments, at 23; PG&E Redline Comments, at 1.

II. POINTS OF AGREEMENT

The CCC's comments above discuss the significant issues on which the CCC and the IOUs disagree in their comments on the E3 Report. However, the CCC also finds that it agrees with one or more of the IOUs on a number of important points concerning the E3 methodology. The CCC will not dwell at length on these points of agreement, but believes that it is important for the Commission to recognize that the CCC concurs with the position of one or more of the IOUs on a number of important issues, as follows:

- **Use of the E3 Methodology for LRAC Pricing for QFs.** The CCC strongly concurs with SDG&E's statement that the "E3 methods may be useful for developing a long-run avoided generation cost for new QF resources."¹⁸ The E3 long-run avoided cost (LRAC) methodology should be applicable to QFs that sign new contracts to provide long-term resources to the IOUs, pursuant to the policy on long-term QF contract renewals and extensions that the Commission will develop in R. 04-04-003.
- **Eliminate Reliance on Electric Market Prices.** If the Commission needs to forecast electric avoided costs for several years in the immediate future, the CCC agrees with SDG&E's preference to replace the use of electric forward prices with a revised SRAC methodology that converts the much more transparent natural gas forward prices to avoided electric prices.¹⁹
- Both the CCC and Edison agree that **the use of electric market prices for SRAC would be inconsistent with the constraints of P.U. Code Section 390.**²⁰
- The CCC generally agrees with the IOUs that the Commission needs to develop **distinct avoided cost values for energy and capacity.** A distinct value for avoided capacity costs is important, for example, to price as-available capacity payments under existing QF contracts. The existing as-available capacity prices have not been updated since the mid-1990s.

¹⁸ SDG&E Redline Comments, at 35.

¹⁹ *Ibid.*, at 11-12.

²⁰ Edison Redline Comments, at 23.

- Edison advocates the use of the deferral value of a **CT to calculate avoided capacity costs**.²¹ Given California's need today for capacity to increase the IOU's reserve margins, the CCC concurs that the full cost of a CT is the appropriate proxy for the value of capacity.
- **The RPS program provides a more detailed model of CCGT costs.** The CCC agrees with the comments of Edison and the Green Power Institute (GPI)²² that the baseload market price referent model developed in the RPS proceeding provides a superior representation of all-in CGT costs than the limited CEC data used by E3. The Commission has already reviewed and approved the MPR model of CCGT costs in D. 04-06-015.
- **A distinct proceeding to review SRAC prices.** The IOUs agree with the CCC that SRAC issues present unique legal and technical issues that should be addressed through a separate process. The CCC has recommended a separate phase of this case to consider SRAC issues.

²¹ *Ibid.*, at 5 and 16.

²² Edison Redline Comments, at 19 - 20; GPI Redline Comments, at 1-5.

III. CONCLUSION

The CCC appreciates the opportunity to reply to the redline comments of other parties on the E3 Report.

Respectfully submitted,

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On behalf of
CALIFORNIA COGENERATION COUNCIL

September 3, 2004

CERTIFICATE OF SERVICE

I hereby certify that I have this day caused to be served a copy of the foregoing document, **Reply Comments of the California Cogeneration Council in Response to Redline Comments on the E3 Report**, by Electronic Mail where possible and First-Class Mail where not, on all known parties to R 04-04-025, named on the service list attached to the original certificate of this document pursuant to the Commission's Rules of Practice and Procedure.

I declare under penalty of perjury that the foregoing is true and correct.

Executed at Berkeley, California, Friday, September 3, 2004.

/s/

Christa Goldblatt