California Independent
System Operator Corporation

# Memorandum

**To:** ISO Board of Governors

**From:** Charles A. King, Vice President, Market Development and Program Management
Anjali Sheffrin, Chief Economist / Director, Market and Product Development
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**Date:** January 18, 2007

**Re:** ***Decision on Long-Term Congestion Revenue Rights Compliance Filing***

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***This memorandum requires Board action.***

## EXECUTIVE SUMMARY

On July 20, 2006, the Federal Energy Regulatory Commission issued Order No. 681 on "Long-Term Firm Transmission Rights in Organized Electricity Markets" ("LT-FTR Final Rule") requiring the ISO to submit a compliance filing by January 29, 2007 with a proposal and associated tariff language for implementing long-term transmission rights. Since then the ISO has conducted an intensive stakeholder process exploring alternatives for meeting the unique business needs of the ISO's market participants while complying with the seven guidelines of the LT-FTR Final Rule. Management believes the result of this effort, a design for Long-Term Congestion Revenue Rights ("LT-CRRs"), has balanced the diverse needs of our stakeholders in hedging congestion costs on a long term basis, and best meets the seven FERC guidelines for the design of this instrument, in a manner that is fully compatible with the MRTU market redesign.

The features of this proposal, explained in the attached White Paper, create a LT-CRR instrument that provides for a ten-year term and builds upon the FERC approved process for one-year Congestion Revenue Rights ("CRRs") that are already a key component of MRTU. Moreover, the allocation process for LT-CRRs would be integrated in the release process for one-year CRRs so that 1) LT-CRRs will be available upon MRTU startup; 2) the transmission capacity for LT-CRRs and one-year CRRs will be allocated in a balanced way; and 3) load serving entities will be able to obtain the mix of LT-CRRs and short-term CRRs that is most suitable for their customers.

Management recommends that the Board of Governors approve this LT-CRR policy proposal as an important feature of the market redesign in California. This additional component within MRTU allows load serving entities to hedge the congestion costs associated with their energy market positions on a long term basis, and thus promotes investment and enhances market efficiency. Management recommends the following motion:

> ***That the ISO Board of Governors approve the Long Term Congestion Revenue Rights proposal, as outlined in the memorandum dated January 18, 2007, and related attachments; and***
>
> ***That the ISO Board of Governors authorize Management to make all the necessary and appropriate filings with the Federal Energy Regulatory Commission to implement this proposal.***

## BACKGROUND

Today's CAISO markets offer 1-year "Firm Transmission Rights" ("FTRs") which were designed to be compatible with the current CAISO market design, particularly the zonal congestion management approach and the absence of an energy market ahead of real time. The new CRRs to be available in conjunction with MRTU will replace today's FTRs with a design that is appropriate for the Locational Marginal Pricing ("LMP") approach that is the core of the MRTU market design.

As specified in the FERC-approved MRTU tariff, a CRR between a source and sink will hedge the hourly congestion charges for a specific month, season and time-of-use period up to one year in advance. Under the approved tariff, load serving entities will be allocated such CRRs in advance of making them available to other parties, and will be able to renew a portion of their allocated CRRs every year, for an indefinite number of years, to provide some degree of long-term certainty. Load-serving entities seeking greater long-term certainty than the approved renewal process provides have sought to obtain multi-year rights to hedge the congestion costs associated with their long term power supply arrangements, which ultimately led to Energy Policy Act 2005 provisions followed by the LT-FTR Final Rule.

As noted below, the ISO's LT-CRR proposal more than satisfies the seven guidelines specified by FERC in the LT-FTR Rule:

*(1) "The LT-FTR should specify a source, sink and MW quantity."*

This guideline is fully embodied in the approved CRR design already. To meet the needs of market participants, the LT-CRR proposal builds off of the existing CRR design, so that each LT-CRR would include a season and time-of-use (peak or off-peak) in addition to a specific source, sink and MW quantity.

*(2) "The LT-FTR must provide a hedge against day-ahead LMP congestion charges for the period covered and quantity specified. Once allocated, the financial coverage provided by a financial long-term right should not be modified during its term except in the case of extraordinary circumstances or through voluntary agreement of both the holder of the right and the transmission organization."*

The proposal guarantees the feasibility of LT-CRRs over their ten-year term. Moreover, the proposal extends a guarantee of "full funding" (i.e., no risk of revenue insufficiency to pay CRRs their full value) throughout the terms of all CRRs, not just the LT-CRRs as required by the LT-FTR Final Rule.

*(3) "LT-FTRs made feasible by transmission upgrades or expansion must be available upon request to any party that pays for such upgrades or expansion."*

As already provided in the filed MRTU tariff, the LT-CRR proposal continues to make LT-CRRs available by allocation to sponsors of transmission upgrades.

*(4) "LT-FTRs must be made available with term lengths that are sufficient to meet the needs of LSEs to hedge long-term power supply arrangements."*

LSEs may be allocated ten-year LT-CRRs for approximately 50% of their peak load.

*(5) "LSEs must have priority over non-LSEs in the allocation of LT-FTRs that are supported by existing capacity."*

The proposal is consistent with the FERC-approved one-year CRR structure that provides LSEs' priority by allocating LT-CRRs only to LSEs. Non-LSEs may acquire LT-CRRs through the secondary market.

*(6) "A LT-FTR held by a LSE should be re-assignable to follow load."*

Building upon the CRR rules that are conditionally approved by FERC, LT-CRRs or a financial equivalent would be transferred as load migrates between LSEs.

*(7) "The initial allocation of LT-FTRs shall not require recipients to participate in an auction."*
LSEs would be able to obtain LT-CRRs through a direct allocation process without having to participate in an auction.

## ADDITIONAL PRINCIPLES FOR LONG-TERM CRRs

In addition to the guidelines specified under the LT-FTR Final Rule, the ISO's proposal meets a number of important objectives in the following way:

- Utilizes the flexibility offered by the LT-FTR Final Rule to develop a proposal that is most suited to the California context and the MRTU markets.
- Promotes the efficient use of existing transmission and generation assets.
- Promotes the efficient investment in transmission and generation.
- Ensures the rapid implementation at the start of MRTU.
- Promotes the equitable allocation of LT-FTRs to entities that pay for the transmission network.
- Ensures that ownership of LT-FTRs does not degrade energy and ancillary services market efficiency and system reliability.
- Supports secondary market activity for both short-term and long-term CRRs.

## STAKEHOLDER PROCESS AND POSITIONS OF THE PARTIES

Many stakeholders have committed significant resources of time and expertise in this process to develop LT-CRRs. Since August the ISO has managed:

- A Market Issues Forum and panel discussion with Board participation (October 18)
- Three conference calls with stakeholders (August 10, December 19 and January 16)
- Four working days of stakeholder meetings (October 3, November 9, November 29 and January 9)
- Five White Papers posted for stakeholder review (August 18, November 7, November 28, December 15, January 5)
- Six rounds of written stakeholder comments (August 18, October 16, November 20, December 8, January 5, January 11)
- Fifteen hour-long meetings/calls with individual entities (August through January)
- Three MSC public discussions (September 18, November 13, January 18)

The involvement of many stakeholders has significantly shaped this LT-CRR proposal in positive ways, including the identification of issues most important to each entity and their acceptance of certain features as reasonable accommodations. While the ISO believes this LT-CRR proposal has the general support of most stakeholders, some issues of disagreement remain. For example, some parties advocate reserving capacity for an additional process to auction LT-CRRs. While the ISO is not able to add this step for the first year of MRTU because of the extension of time necessary to complete and obtain FERC approval for a design of the LT-CRR auction, this functionality can be examined for future releases. The ISO has incorporated many of the stakeholder suggestions into this recommended proposal.

The California Department of Water Resources (CDWR), the California Municipal Utilities Association (CMUA), the Northern California Power Agency (NCPA), the Sacramento Municipal Utility District (SMUD) and other municipalities have urged that 1) a significant percentage of transmission capacity be available for LT-CRRs; 2) expiring ETCs be allowed to be nominated as priority CRRs; and 3) that LSEs outside of the ISO control area be permitted to acquire LT-CRRs through an annual pre-payment of Wheeling Access Charges rather than a ten-year lump sum payment. The ISO has specified policy statements to accommodate all three of these suggestions.

San Diego Gas & Electric (SDG&E) and other parties have strongly advocated for updating the historical period by which sources are verified in the first year of the CRR allocation. The ISO has recently agreed to update this reference period to the calendar year 2006, which is much closer to the actual running of the production processes to release CRRs. Calendar 2006 also reflects the first year there has been a clear State of California requirement (imposed by AB 380) on all load serving entities to procure adequate power to meet their needs and support system reliability, and the experience of the recent summer demonstrated the ability of the existing grid to transport the power to load.

Southern California Edison (SCE) has consistently promoted the continued use of a requirement for verifying sources of CRRs. By utilizing the CRR process for allocating LT-CRRs, this proposal effectively requires a demonstration of verified sources in the first year of the LT-CRR allocation.

Pacific Gas & Electric (PG&E) has strongly urged a high percentage of grid capacity be allocated for LT-CRRs, and the ISO has moved significantly in that direction in this process. A key part of this final proposal permits LSEs to nominate nearly 50% of their peak hourly load as LT-CRRs which should generally incorporate the baseload generation for most LSEs. PG&E and other investor-owned utilities also raised concerns about allocating shortfalls in CRR funding to Participating Transmission Owners. The ISO recently revised its proposal so that potential shortfalls are allocated to measured demand instead of the PTOs.

The California Public Utilities Commission, the Alliance for Retail Energy Markets (AreM) and the Metropolitan Water District (MWD) also have expressed general support toward this LT-CRR proposal while urging development of more detailed processes for tracking CRR transfers between LSEs due to load migration and the methodology for allocating CRRs to merchant transmission developers. The ISO anticipates developing these processes in the Business Process Manual for CRRs in the near future.

A more complete summary of stakeholder written comments is contained in the attached matrix.

## MARKET SURVEILLANCE COMMITTEE OPINION

The MSC has discussed this proposal at three public meetings and participated in two stakeholder meetings as well as the Market Issues Forum. Their input and advice has contributed significantly to the understanding of interested parties on the uses and outcomes of proposed features.

The MSC is providing the Board with its written opinion on this LT-CRR proposal separately.

## SUMMARY

The merits of this recommendation include:

1) Leveraging the existing MRTU CRR rule set and process already approved by FERC in the September 21, 2006 MRTU order;
2) Avoiding unnecessary complexity by fully integrating the ten-year CRR product with the one-year CRR design;
3) Offering the ten-year CRR product on a compatible and comparable basis with the one-year CRR product, which enhances the flexibility and liquidity of both products.
4) Minimizing the software development and testing required to introduce the ten-year CRR product such that the new product can be implemented in MRTU Release 1 consistent with the recently approved MRTU budget and scheduled deployment of trade day 2/1/2008.

## MANAGEMENT RECOMMENDATION

Management recommends that the Board approve this proposal. Management also recommends that the Board approve of the efforts required to file tariff language that incorporates this proposal on January 29, 2007, as required by FERC's LT-FTR Final Rule and to implement this LT-CRR product and release process with the startup of MRTU.

**MOTION**

***Moved,***

***That the ISO Board of Governors approve the Long Term Congestion Revenue Rights proposal, as outlined in the memorandum dated January 18, 2007, and related attachments; and***

***That the ISO Board of Governors authorize Management to make all the necessary and appropriate filings with the Federal Energy Regulatory Commission to implement this proposal.***