



California Independent System
Operator Corporation

June 14, 2007

The Honorable Kimberly D. Bose
Secretary
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, D.C. 20426

**Re: California Independent System Operator Corporation, Docket Nos. ER07-869-00_,
Amendments to Facilitate the Initial Congestion Revenue Right Allocation and
Auction Process under the Market Redesign and Technology Upgrade program;
and**

**California Independent System Operator Corporation Docket No. ER06-615-0__,
Congestion Revenue Rights For Sponsors of Merchant Transmission Upgrades.**

Dear Secretary Bose:

Enclosed for filing in the above-referenced docket is the California Independent System Operator Corporation's Motion for Leave to File Answer and Answer to Motions to Intervene, Comments, and Protests.

Thank you for your assistance in this matter.

Respectfully submitted,

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**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

California Independent System)	Docket No. ER07-869-000
Operator Corporation)	

**MOTION FOR LEAVE TO FILE ANSWER AND ANSWER TO MOTIONS TO
INTERVENE, COMMENTS AND PROTESTS OF THE CALIFORNIA
INDEPENDENT SYSTEM OPERATOR CORPORATION**

Dated: June 14, 2007

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accurate record in this case.² To that end, the CAISO's answer only addresses issues that serve to correct misconceptions raised in comments and protests or otherwise help clarify the record.³

II. EXECUTIVE SUMMARY

The CAISO's CRR rules as filed with FERC and conditionally accepted are the product of lengthy and robust CAISO stakeholder and FERC processes that span over a period of four years. The CAISO and Market Participants have had considerable time and opportunity to carefully consider many alternative methodologies and rules for the release of financial transmission rights in conjunction with the CAISO's transition to Locational Marginal Pricing ("LMP"). The CAISO has put forth for Commission approval a set of rules that provide a just and reasonable and not unduly discriminatory program for release of CRRs that is based on the following comprehensive set of inputs: (1) significant stakeholder input; (2) a series of Commission guidance orders; (3) guidance from the CAISO's Market Surveillance Committee; (4) guidance from the California Public Utility Commission; (5) guidance and policy approvals by the CAISO's Board of Governors; (6) careful consideration and scrutiny by industry expert consultants; (7) regional and state considerations, and (8) adoption of the Energy Policy Act of 2005 ("EPAct") that occurred in the midst of the CAISO's development of a CRR program. As shown in the CAISO's numerous pleadings to date, the balanced CRR rules that the CAISO has developed through a lengthy and deliberate process provide Market Participants with an equitable opportunity to obtain the CRRs they require to assist them in managing their congestion exposure based on LMP.

² See, e.g., *Entergy Services, Inc.*, 101 FERC ¶ 61,289, at 62,163 (2002); *Duke Energy Corporation*, 100 FERC ¶ 61,251, at 61,886 (2002); *Delmarva Power & Light Co.*, 93 FERC ¶ 61,098, at 61,259 (2000).

³ The fact that the CAISO has not addressed every issue in the protests and comments should not be deemed to be agreement or acquiescence by the CAISO on the issues not addressed.

Further, as explained by Dr. Lorenzo Kristov in his Direct Testimony, the CAISO's CRR rules strike the proper balance on a fundamental tension that exists in the release of CRRs: Market Participants' desire for flexibility to change their CRR holdings over time in order to meet their changing needs versus the early certainty sought by many parties that they will be protected against congestion exposure associated with the supply resources and patterns of grid usage they regularly depend upon.⁴

The CAISO also reiterates that, in proposing the limited changes contained in the May 7 Filing, the CAISO carefully considered the impact on its MRTU implementation schedule as it strives vigorously towards meeting its MRTU go-live date of February 1, 2008. As indicated in the Direct Testimony of Ms. Deborah A. Le Vine, in evaluating any possible changes to the CAISO's proposal, the Commission should consider the potential effect on the MRTU implementation schedule.⁵ Moreover, after reviewing the comments and proposed changes filed by parties in response to the CAISO's May 7 Filing, the CAISO has concluded, for the following reasons, that parties have failed to show good cause for any further changes to the filed CRR rules beyond those proposed by CAISO in its May 7 Filing:

1. The CAISO sees no evidence to suggest that its filed and previously conditionally accepted methodology for determining the intertie capacity set-aside will result in insufficient capacity available at the CRR Auction for interties. Powerex has protested the CAISO's decision not to make any change to its conditionally accepted methodology and has provided hypothetical scenarios that it alleges could result in fewer CRRs clearing in the CRR Auction based on bidding behavior in the CRR Auction. Importantly, Powerex fails to show that the CAISO's proposed rules do not provide an opportunity to obtain intertie CRRs through the CRR Auction. The CAISO believes it is not appropriate to undo, at this late juncture, the important policy objective that the CAISO's proposal achieves, *i.e.*, providing a preference to load serving entities through the bifurcated allocation/auction approach in the release of intertie CRRs. In particular, it

⁴ May 7 Filing, Attachment D, Testimony of Dr. Kristov, Exhibit ISO-1 at 45-47.

⁵ May 7 Filing, Attachment E, Testimony of Deborah A. Le Vine, Exhibit ISO-2.

is not necessary to amend the CAISO rules in order to enhance the possibility of more CRRs clearing through the CRR Auction given that the CRR Dry Run results clearly showed that the CAISO's methodology provided just and reasonable opportunity for Powerex to obtain CRRs through the CRR Auction.

2. The CAISO believes that San Diego Gas & Electric's ("SDG&E") proposed changes to expand the scope of the CRR source verification period beyond the changes contained in the May 7 Filing pose significant implementation concerns at this late a stage. Also, the proposed changes would produce inefficient contracting incentives that the Market Surveillance Committee and the LECG consultants strongly warned against. In addition, in expressing its concern about the potential for receipt of a meager amount of valuable CRRs, SDG&E appears to have overlooked the methodology included in the filed CRR rules to allocate shares of the intertie residuals to LSEs for nomination in the source-verified tiers. This feature, which was not available to LSEs in the CRR Dry Run, should mitigate SDG&E's concern to some extent. When actually implemented in the first CRR Year One allocation process, this feature will enable SDG&E to utilize the source-verified tiers to nominate and obtain import CRRs sourced at all interties to the CAISO grid, without having to wait for the free choice tier to nominate CRRs that are outside its set of formally verified source locations. If the residual quantities based on the 2006 historical period are even half of what they were based on the CRR Dry Run historical period (2004-2005), this feature could result in SDG&E obtaining hundreds of megawatts in valuable CRRs which they could then trade bilaterally for other CRRs that match their needs better.
3. The alternatives to the Trading Hub disaggregation proposal put forth in the CAISO May 7 Filing, were either fully vetted and rejected through the stakeholder process or cannot be implemented at the start of the first annual CRR Allocation and Auction. However, the CAISO will consider any future enhancements necessary for later implementation after the start of the first annual CRR Allocation and Auction.
4. In implementing the Commission's directive to make available CRR for wheel-throughs through the CRR Allocation process, the CAISO also proposed certain limitations in its May 7 Filing which are necessary to ensure that perverse contracting incentives are not engendered. In addition, the CAISO agrees with further limitations on the ability to use the wheel through CRRs as proposed by certain commentators because of the need to ensure that access to such rights is not used for purposes other than the OCALSE's legitimate need to serve its load that relies on the CAISO Controlled Grid. In response to concerns raised by the Sacramento Municipal Utility District ("SMUD") that the CAISO was further imposing an additional showing requirement on the amount of actual congestion OCALSEs were actually subject to in the prior year, the CAISO clarifies, that it did not intend to suggest that OCALSEs must provide evidence that actual congestion charges had been imposed in prior years.
5. Consistent with the Commission's Order Granting Extension of time regarding the BPM for Credit Requirements, there is no need or basis to further delay implementation of MRTU because the CAISO has provided ample documentation regarding its Governing

Board-approved methodology for evaluating Market Participants' CRR credit exposure requirements.

6. The CAISO has appropriately limited the source verification to one-month contracts and parties have not shown good cause to allow shorter term contracts.
7. The CAISO's proposed modifications to accommodate expiring Long Term CRRs and expiring ETCs and Converted Rights ("CVRs") are necessary so that holders of such rights are provided the opportunity for continuity while transitioning to Long Term CRRs. However, no further changes are required because as explained by the CAISO below the adjustments as proposed in the May 7 Filing already address the concerns raised by commentators. As a related matter, the CAISO notes that a stakeholder proposal regarding eligibility for the Priority Nomination Process by LSEs that gain load through load migration is currently being discussed in a stakeholder process to address rules for transfer of CRRs to reflect load migration. The CAISO has recommended adopting this stakeholder proposal in its recently released straw proposal. The CAISO expects to make a filing that would contain this change on or about July 20, 2007.
8. No changes are required to the Merchant Transmission CRR release methodology because, as further clarified herein, the issues raised by commenters are already addressed in the design of the Merchant Transmission CRR release methodology.

The CAISO notes that many of the protests raised by parties are motivated by an underlying concern regarding the permanence of the release of CRRs from CRR Year One. The concern is that the balance point in the currently filed rules leans too far towards establishing enduring certainty of CRR holdings obtained in CRR Year One and does not allow sufficient flexibility to parties to modify their holdings as their needs change. This theme is particularly prevalent in the comments and protests filed by the CPUC, SDG&E, and Powerex, who are the parties that propose the most extensive changes to the CAISO's filed rules. The CAISO acknowledged this prevalent tension discussed above, but believes that it has struck the proper balance to address the concerns raised by these parties. The CAISO submits that parties have not provided sufficient justification to shift this balance in any particular direction. In particular, the parties have not justified changing a proposal that has gone through lengthy and deliberate stakeholder processes and which strikes a delicate balance of the two "polarizing" considerations

that are at play here. It is especially imprudent to change the rules at this late juncture when the proposed changes could have significant impact on market incentives, an issue which other Market Participants and the Commission have not had sufficient time to explore. Further, as indicated in the testimony of Deborah A. Le Vine, such changes could impact the CRR implementation schedule and, therefore, the MRTU implementation schedule. In the CAISO's opinion, the only types of rule changes that could shift the balance on this issue without adversely impacting the MRTU schedule and without creating significant adverse market incentives are as follows:

- Limiting the overall quantity of each LSE's and OCALSE's load that is eligible to receive Long Term CRRs in CRR Year One to 20 percent of the LSE's or OCALSE's Adjusted Load Metric, with a provision for exceeding this limit upon a demonstration by the entity of the existence of long-term power supply arrangements in excess of this limit; with annual 10 percent increments to this limit in years beyond CRR Year One to attain the currently proposed 50 percent limit in the 2010 Long-Term CRR allocation covering the years 2011-2020.
- Incorporating a sunset date on Priority Nomination Process ("PNP") for renewing CRRs associated with contracts submitted for CRR Year One source verification, based on the contract expiration date. For example, CRRs associated with contracts that were valid in 2006 but expire prior to 2009 would not be renewable in the PNP for 2009 and beyond (but could be nominated in the free choice tiers).

III. BACKGROUND

The proposed amendments in the May 7 Filing fall into two broad categories: (1) those CRR-related changes filed under FPA Section 205 that came out of either the stakeholder process following the CRR Dry Run or the process of reconciling the material in the Business Practice Manual ("BPM") for CRRs and the conditionally-approved MRTU Tariff; and (2) those CRR-related changes filed in compliance with either the Commission's September 21, 2006

Order⁶ or its April 20, 2007 Order on Rehearing.⁷

The rule changes being proposed under the first category involve: (1) the use of Trading Hubs as sources for Long Term CRRs; (2) the process of “renewing” an expiring Long Term CRR as well as allowing expiring Existing Transmission Contracts (“ETCs”) and CVRs to transition to Long Term CRRs; (3) a change to the proposed historical reference period for source verification for CRR Year One to calendar year 2006;⁸ and (4) tariff changes as a result of reconciling material in the BPM for CRRs and the conditionally-accepted MRTU Tariff. The proposed amendments in the second compliance category provide (1) additional detail on the allocation of CRRs to the sponsors of Merchant Transmission upgrades or projects in compliance with the Paragraphs 873 and 1357 of the *September 21 Order* and *Order No. 681* and *Order No. 681-A*;⁹ and (2) tariff language as directed by the Commission in the *April 20 Order on Rehearing* regarding the allocation of CRRs to Load external to the CAISO Control Area (referred to as an “Out-of-Control Area Load Serving Entity” or “OCALSE”).¹⁰

⁶ *California Independent System Operator Corporation*, 116 FERC ¶ 61,274 (September 21, 2006) (“September 21 Order”).

⁷ *California Independent System Operator Corporation*, 119 FERC ¶ 61,076 (April 20, 2007) (“April 20 Order”).

⁸ This change was described in the CAISO’s January 29, 2007 compliance filing in Docket No. ER07-475-000 in response to *Order Nos. 681 and 681-A* (the Commission’s Final Rule regarding Long-Term Firm Transmission Rights in Organized Electricity Markets). However, because the change to the historical reference period for source verification affects all CRRs (and not just Long Term CRRs), the CAISO did not submit tariff language changing the historical reference period to calendar year 2006 until the instant filing.

⁹ See Commission’s Final Rule regarding Long-Term Firm Transmission Rights in Organized Electricity Markets. See *Long-Term Firm Transmission Rights in Organized Electricity Markets*, Order No. 681, 71 FR 43564 (Aug. 1, 2006), FERC Stats. & Regs. ¶ 31,226 (2006) (“Order No. 681”); and Order No. 681-A, 117 FERC ¶ 61,201 (2006) (“Order No. 681-A”).

¹⁰ See *April 20 Order* at PP 368-380.

IV. ANSWER

A. Modification to Long Term CRR Proposal to Facilitate Increased Use of Renewable Resources

In its comments, the CPUC indicates that it is concerned that the lack of a plan to coordinate the CAISO's long-term transmission planning process with the Long Term CRR allocation and renewal methodology threatens to magnify transmission costs for LSEs that deliver energy from future energy resources, including renewable resources. CPUC at 5-6. According to the CPUC, the Long Term CRR proposal allows load serving entities ("LSEs") to receive a large share of CRRs based on first year nominations and then to convert those short-term CRRs to Long Term. The CPUC states that the magnification of transmission costs for new resources will likely give LSEs strong incentives to enter and maintain long term contracts with older, less environmentally friendly generation sources because LSEs will be assured access to Long Term CRRs in near perpetuity based on their use of the grid in 2006. *Id.* The CPUC also states that LSEs may be able to obtain Long Term CRRs that are unrelated to their use of the grid in years to come. CPUC says this programmatic bias runs counter to California's goal of emphasizing reliance upon renewable resources, as well as its jurisdiction to determine the composition of resources that will fulfill the state's energy needs. *Id.* In response to its concerns the CPUC proposes the following changes to the CAISO's provisions for Long Term CRR nominations.

First, the CPUC recommends that the CAISO should initially limit an LSE's (or OCALSE's) allocation of Long Term CRRs to a maximum of 20% of the LSE's adjusted load metric ("ALM") to the extent the LSE's nominations are not supported by evidence of either a contract of 10 years or greater length or ownership of the generation source. CPUC at 16. The CPUC notes that the CAISO's current proposal would permit an LSE to obtain up to 50% of its

ALM in Long Term CRRs without verification of a source ownership or a long-term contract. The CPUC would not oppose raising this limit after the CAISO develops a plan to incorporate long-term planning for new resources into its Long Term CRR program. Second, the CPUC recommends that nominations that are verified, either by a source-specific energy contract of 10 years or greater length or ownership of the generation source, should remain subject to the 50% maximum amount allowed for nomination as Long Term CRRs as proposed in the filed MRTU Tariff.

CAISO Response. Throughout the Commission’s Long Term FTR proceeding, starting with the first rounds of comments submitted on the FERC staff white paper and continuing through the CAISO’s compliance filing, the CAISO and many of its stakeholders have advocated a “go slow” approach to the release of Long Term rights. At the same time, the CRR rules as a whole reflect CAISO’s recognition of the requests of many of its stakeholders for greater long term certainty regarding their ability to manage congestion costs under the CAISO’s new LMP-based market design. The CAISO also recognized the Commission’s directives to provide sufficient opportunity for long-term certainty in its implementation of EPCAct’s requirements.¹¹ In the midst of its CRR Dry Run and its evaluation of the CRR rules, the CAISO developed a set of rules that pertain to the allocation of Long Term CRRs that fully complied with the mandate of the Commission’s Final Rule and based on its understanding of stakeholder’s expressed needs, provided a proposal that provided for a substantial access to long term rights.

The CAISO believes that because the availability of Long Term CRRs in the future will depend in large part on Market Participant behavior that cannot confidently be predicted at this time, it is also not possible to predict definitively whether the CAISO’s filed rules will unduly

¹¹ *Order No. 681* at P 170.

hamper the ability of LSEs and OCALSEs to obtain the mix of short-term and Long Term CRRs that best meets their needs. Nevertheless, it is a fact by design that limiting the overall percentage of LSEs' and OCALSEs' load that is eligible to obtain Long Term CRRs in CRR Year One would make an important contribution to the ability to obtain sufficient CRRs in subsequent years to manage the congestion costs associated with new resources, including new renewable resources that they will need to procure to comply with Renewable Portfolio Standards ("RPS") and emerging rules on Greenhouse Gas emissions.

The CAISO therefore comments that more of a "go slow" approach that limits the amount of Seasonal CRRs that can be nominated as Long Term CRRs would free up capacity in subsequent years that could be used by parties to fulfill the RPS goals. These would provide Market Participants in the State of California greater flexibility and an opportunity to align their congestion management portfolio with their RPS requirements, which would therefore further the State of California's efforts in its attempts to encourage greater use of renewable resources. This more moderate pace in the release of Long-Term CRRs could be achieved by the adoption of a limitation on the amount of load that an LSE or OCALSE would nominate for an allocation of Long Term CRRs to a maximum of 20% of the LSE's ALM. Because, however, of the concern expressed by its stakeholders that parties should be provided ample opportunity to obtain protection against uncertainty related to the potential exposure of long-term procurement arrangements from congestion, the CAISO believes such a limitation should be coupled with an exception that would allow an LSEs or OCALSEs that can demonstrate that more than 20% of their load is covered by long term procurement arrangements of 10 years or greater or ownership of resources will be eligible for an exemption from the 20% limit, *i.e.*, such an LSE or OCALSE would be allowed to nominate the full amount of such contracts or owned resources up to a

maximum of 50% of its ALM as Long Term CRRs. In addition, the CAISO believes that such a limitation would also have to be lessened in subsequent years to allow parties to obtain more coverage for their load over time. Therefore, the CAISO believes such an approach would require that in years beyond CRR Year One, capacity would be released by increments of ten percent each year until the currently permissible 50% of the ALM would be permissible for all load serving entities.

The CAISO does not affirmatively offer this as a change at this time because it believes that through the guidance provided by its stakeholders, the Commission, and its Governing Board, as previously explained by Dr. Kristov, it has struck the proper balance. But the CAISO believes it is not inappropriate for the Commission to recognize the importance of providing regional flexibility to allow transmission providers to fashion rules that better meet regional concerns.¹² Clearly the policy goals regarding the RPS is a prominent regional priority for California and is one that could be furthered by making some provisions for greater opportunity to obtain Long Term CRRs in subsequent years than currently proposed. While there is not absolute certainty that this more gradual approach would guarantee the outcome sought by the State of California, it is clear that any lesser flexibility to obtain Long Term CRRs in the future provides lesser opportunity for support of the State of California's long-term procurement from renewable resources. Therefore, there would be good cause to allow California to adopt a more gradual approach to the CRR release rules that would in turn address these regional policy concerns.

As explained by Ms. Le Vine in Exhibit No. ISO-2, certain rule changes at this late

¹² See *Order No. 681* at PP 2, 100-107; *Order No. 681-A* at P 2. See also *PJM Interconnection L.L.C.*, 117 FERC ¶ 61,220 at P 52, *on reh'g*, 119 FERC ¶ 61,144 (2007).

juncture could have a significant effect on the CRR implementation schedule.. The adoption of the restrictions described above would have limited impact on the immediate schedule because they would not impact the source verification and load metric determination rules the CAISO is currently implementing in preparation for the commencement of the first annual CRR Allocation process later this summer. In addition, while this limitation certainly tips the balance Dr. Kristov described in his testimony in Exhibit No. ISO-1, the CAISO does not believe this change introduces adverse market incentives as it leaves intact the actual allocation rules and only advocates a more gradual approach to the reservation of capacity by Long Term CRRs in CRR Year One.

B. Capacity Set-Aside at the Interties for CRR Auctions

Powerex raises a number of concerns regarding the CAISO's decision in its May 7 Filing not to make any changes to its filed rules on the methodology for the determination of the capacity set-aside at the interties for CRR Auctions. Powerex points to the Commission's conditional approval of the CAISO's capacity set aside proposal where the Commission indicated that the CAISO should evaluate the adequacy of the intertie set-aside in order to ascertain whether there were any problems that required amendment to the proposed rules. Powerex at 9. Powerex asserts that there are four aspects of the CAISO's proposal that are problematic.

First, Powerex states that the CRR Dry Run results reveal that the set aside mechanism fails to achieve the stated objective because under the CAISO's approach many auction bids for import CRRs are infeasible, mainly due to downstream constraints within the CAISO system. Powerex asserts that this failure leads to unduly discriminatory outcomes for the 50% of residual intertie capacity reserved for auction participants relative to the 50% of the residual intertie capacity reserved for nomination by LSEs in addition to their source-verified amounts. Powerex

at 17-19. Powerex offers testimony by Mr. Wellenius which argues that applying the CAISO's approach to the set-asides gives a preference to entities that receive CRRs through the CRR Allocation and that, to address the preference, the CAISO should ensure the feasibility of obtaining CRRs utilizing the capacity set aside for the CRR Auction. Powerex at 22-23. Powerex proposes to have the CAISO model the set-aside quantities as fixed flows with injections at the Intertie and withdrawals at the corresponding Trading Hub claiming that this will ensure that CRRs sourced at the Interties using the auction set-aside are deliverable. *Id.*

Second, Powerex contends that the CAISO failed to evaluate the detrimental impact of the CRR rules after Year One on external suppliers in violation of the *September 21 Order*. Powerex at 23-25. Powerex claims that the allocation and auction rules become increasingly unfair to external suppliers in Year Two and every year thereafter because by delaying the timing of the auction set-aside until after both the PNP (tier 1) and a free-choice tier (tier 2) the CAISO gives LSEs not only the opportunity to use tier 1 to keep the premium CRRs they received in previous years but also the opportunity to use tier 2 to cherry-pick from CRRs that were previously in the auction. Powerex at 23. Consequently, Powerex argues that over time LSEs will be able to acquire all of the most valuable CRRs, including those at the interties, leaving only scraps for the auction. *Id.* Powerex proposed resolution of the issue is to carry forward the level of intertie capacity set aside for the auction in CRR Year One to subsequent years, rather than allowing the set aside to be subject to the possible erosion claimed by Powerex. Powerex at 24-25.

Third, Powerex contends that the CAISO, in changing the historic reference period for source verification, failed to evaluate the impact on external suppliers. Powerex at 25-26. Powerex alleges that it is "likely" that LSEs' source verified transactions are higher under

calendar year 2006 reference period and therefore, proposes that the corresponding reduction in residual capacity at each intertie should first reduce the portion of the residual capacity that is to be allocated to LSEs, rather than reducing the portion that is to be auctioned. Powerex at 26.

Finally, Powerex contends that the combination of the Long Term CRRs and the Priority Nomination Process (“PNP”) for Seasonal CRRs could enable LSEs to increase from year to year the quantity of Seasonal CRRs they are awarded for a particular Source-Sink combination. Powerex at 27. Powerex alleges that the CAISO's amendments fail to resolve this aspect of the PNP and Long Term CRR allocation process. *Id.*

CAISO Response. The CAISO recognizes the Commission’s reiteration that it is “sympathetic to Powerex’s concern that it is not clear how much residual intertie capacity will be left after the source-verified allocation.” Indeed, the CAISO has since evaluated evidence provided by the CRR Dry Run to determine whether the filed rules would provide for reasonable quantities of import capacity to be available for CRR Auction participants at the Scheduling Points. The fact is that in evaluating the results of the CRR Dry Run, and even after considering the arguments raised by Powerex in its latest pleading, the CAISO does not see any evidence to suggest that its filed rules unduly limit the ability of CRR Auction participants to obtain import CRRs in the auctions nor that implies that the CAISO must change the proposed market rules, which by design afford LSEs priority in obtaining CRRs through their right to participate in the CRR Allocation prior to the CRR Auction.

In reviewing the results of the CRR Dry Run, as discussed by Dr. Kristov, there is simply no evidence that external entities will be left with the dregs at the ties. Quite the contrary, Dr. Kristov explained that the CRR Dry Run demonstrated that for many interties and many CRR terms (season/TOU and month/TOU): (1) more import capacity was available for auctions than

was initially set aside, due to the fact that LSEs often did not nominate as much as they were eligible for in the CRR allocations; (2) on some interties the auction participants did not bid for much of the available capacity; and (3) on other interties the available capacity attracted significant quantities of bids and significant quantities of CRRs were awarded.

Indeed, Powerex' primary concern appears to be that import CRRs turned out to be infeasible in the CRR Dry Run due to downstream constraints within the CAISO system, not due to binding constraints on the capacity available at the interties. For this reason they assert that intertie CRRs were not available in the CRR Dry Run and propose that the CAISO should model the CRR set-aside as delivered energy at specific sinks within the CAISO system, *in order to reserve capacity on these downstream internal constraints as well as on the interties themselves*. It should be apparent that Powerex's concern and its proposal extend well beyond the issue at point, which is the capacity set aside at the interties. Powerex would have the CAISO reserve transmission capacity within the CAISO system in order to guarantee the availability of import CRRs that sink at potentially congested CRR Sink locations. This proposal goes beyond the CAISO's original proposal for the set-aside as filed in February 2006, FERC's direction to the CAISO to evaluate how much residual intertie capacity will be available, and the scope of the discussion of this issue with other CAISO stakeholders.

Within the currently proposed rules for the set aside of residual intertie capacity for the CRR Auction, Powerex could adjust its bidding strategy to increase its chances of obtaining import CRRs on the interties when there are binding downstream constraints within the CAISO system. For example, Powerex could divide its bid for an "import" CRR into two bids for two separate CRRs that, together, would be the same as the more extensive source-to-sink import CRR it desires. The first bid would be from the intertie Scheduling Point to a nearby PNode that

is upstream from constraints binding with the CAISO system. The second bid would be from this PNode to the CRR Sink location desired by Powerex. By dividing the bids in this way, Powerex would increase its likelihood of obtaining a CRR from the Scheduling Point to a point within the CAISO system, even in situations in which it is not willing to bid high enough in the CRR Auction to purchase the second CRR, which is sourced at an internal PNode and terminates at its desired sink. The first CRR will provide Powerex with a hedge against congestion on the Scheduling Point. If Powerex wants to increase the probability of purchasing CRRs all the way from the Scheduling Point to its desired sink within the CAISO, the current CRR rules provide it ample opportunity to do so by simply bidding a higher price in the CRR Auction for the second CRR to obtain a hedge against transmission congestion on the supposed constraint *within* the CAISO system.

Powerex raises some interesting comments on how aspects of the CRR Auction processes provide lesser certainty for participants on the CRRs that cleared the auction than does the allocation. Powerex argues that this difference *requires* the CAISO to adopt modifications that better ensure that the CRR Auction provides more certainty on what parties obtain through the auction. This perspective is rooted in the erroneous presumption that the CRR release rules should provide allocation participants and auction participants with an equal opportunity to obtain CRRs for CAISO controlled grid. The CAISO understands that the nature and sequencing of the CRR Allocation and Auction processes enable LSEs to receive an allocation of CRRs from Scheduling Points to their load locations rather than having to bid to obtain these CRRs at a price in the CRR Auction, and that LSEs can obtain such CRRs before they are made available through the auction to parties not eligible for CRR allocation. These facts are direct consequences of the design of the CRR release processes and indeed are stated intentions of

CAISO policy. These provisions for LSE priority were confirmed and understood by the Commission in its MRTU orders including the *April 20 Order*.¹³

There is a fundamental flaw to Powerex's line of reasoning concerning the CRRs available for LSEs on the Scheduling Points versus other entities, because it relies upon an inappropriate assumption of comparability between the certainty and opportunities provided by the CRR Allocation process versus the CRR Auction process. By its very nature, the outcome of an auction process depends on the magnitude of the bid prices; if the bid prices are high enough, transmission capacity would become available under the CAISO's proposed market rules, and the auction results could be just as certain as those of the allocation process. When bids are high, Market Participants will be more willing to buy "counterflow CRRs," which make transmission capacity available on constraints in excess of that apparently available at the end of the CRR Allocation. While such a concept may seem hypothetical, such counterflow CRRs are routinely and extensively traded in PJM and NYISO auctions.¹⁴ Conversely, if the bid prices are very low, the outcomes of the CRR Auction will not be certain at all. Thus it is not logical or appropriate to compare the results of the CRR Allocation and the CRR Auction, since the transmission capacity available in the auction will vary with the bid prices submitted to the auction.

It is therefore not evident how Powerex's list of examples that demonstrate how LSEs are afforded a priority through their eligibility for the CRR Allocation is cause for alteration of the proposed market rules for setting aside capacity for import CRRs on the interties. It should not

¹³ April 20 Order at P 384.

¹⁴ See, e.g., 2006 PJM State of the Market Report, Section 8 - Financial Transmission and Auction Revenue Rights, Figure 8-1 Annual FTR auction-clearing price duration curve: Planning period 2006 to 2007, at p. 316 (indicating that approximately 10% of the FTR purchases in the FTR auction cleared at negative prices; of the remaining FTR purchases, most were cleared at a price very close to zero, and approximately 20% cleared at prices substantially greater than zero).

be surprising or alarming to Market Participants at this time that there is a lesser guarantee for obtaining desired CRRs through the auction than the allocation unless the auction bid prices are high enough.

Powerex fails to account for the fact that while the CAISO has committed to provide the opportunity for parties to obtain import CRRs in the CRR Auction, it is not entirely in the CAISO's control – nor should it be – how many CRRs or which source-sink combinations actually clear in the CRR Auction. In fact, Powerex's suggestions would have the CAISO intervene in the CRR Allocation in order to alter the results of the CRR Auction. They would have the CAISO reserve transmission capacity within the CAISO in the CRR Allocation in order to insure that CRRs are available with more certainty, *i.e.*, at a lower price, in the CRR Auction. This intervention would decrease the auction revenue flowing to the LSEs to the benefit of Powerex.

It is important to recognize that the auction fundamentally is different from the allocation in that in the allocation all CRRs sink at the location of the load (except for OCALSEs whose sinks can be at a Scheduling Point); whereas in the auction CRRs can sink at any PNode and this reason need not be related to the way energy flows on the grid. This is one of the reasons why auction results are so sensitive to the full set of submitted bids, and why the CRR Dry Run auction results – while they do not guarantee the outcome Powerex desires – also do not provide any evidence that the result will be adverse. Clearly, under alternate scenarios that relieve the constraints at the interties through the workings of the CRR Auction participants bidding strategy, it is possible that more capacity may be made available to Market Participants at the interties than was even observed in the CRR Dry Run. Because it is not a number that can be pinpointed with much certainty, the CAISO does not see the merit in tweaking the rules to enable

a higher certainty of CRRs be released in the auction.

While the CAISO understands Powerex's observations of the reduced opportunities to obtain CRRs over the interties cheaply in the CRR Auction as opposed to the CRR Allocation, the CAISO believes it is not appropriate at this time to change the proposed intertie capacity reservation proposal. The CAISO and its stakeholders, as conditionally accepted by the Commission, clearly intended to have the CRR rules reflect a bifurcated release strategy that afforded LSEs greater priority. To alter this fundamental aspect of the CAISO proposal at this juncture, especially in the absence of any new methodological issues or substantiated empirical concerns would circumvent the lengthy stakeholder and FERC processes the CAISO has undergone to ensure that its market rules are fully vetted and supported by Market Participants.

With respect to Powerex's fourth concern, the CAISO suggests that the proposed tariff language in Section 36.8.3.5.1 could be clarified by modifying the section as follows:

In all annual CRR Allocations after CRR Year One, an LSE or Qualified OCALSEs may make PNP nominations up to the lesser of: (1) two-thirds of its Seasonal CRR Eligible Quantity minus the quantity of previously allocated Long Term CRRs for each season, time of use period and CRR Sink for that year; or, (2) the total quantity of Seasonal CRRs allocated to that LSE in the previous annual CRR Allocation minus the quantity of previously allocated Long Term CRRs for each season, time of use period and CRR Sink, and minus any reduction for net loss of Load through retail Load migration as described in Section 36.8.5.1. In addition, an LSE's or Qualified OCALSE's nomination of any particular CRR Source-Sink combination in the PNP may not exceed the MW quantity of CRRs having that CRR Source and CRR Sink that the LSE or Qualified OCALSE was allocated in the previous annual CRR Allocation for the same season and time of use period, adjusted for net Load loss resulting from Load migration, and minus any Long Term CRRs allocated in the previous year's Tier LT having the same CRR Source-Sink combination.

C. Historical Reference Period Used for CRR Allocation

In its February 9, 2006 MRTU Tariff Filing ("MRTU Filing"), the CAISO proposed the

use of a historical reference period to verify source nominations for CRRs of September 1, 2004 to August 31, 2005.¹⁵ After careful consideration of numerous comments from stakeholders that this period was too far in the past relative to the MRTU start-up date, the CAISO announced its intent to change the reference period to calendar year 2006 in the CAISO's January 29, 2007 compliance filing in response to the Commission's Final Rule regarding long-term firm transmission rights.¹⁶ However, because the change to the historical reference period for source verification affects all CRRs (and not just Long Term CRRs), the CAISO did not submit tariff language to implement this change until the May 7 Filing. The revised historical reference period to verify source nominations for CRRs is calendar year 2006.¹⁷

While SDG&E had also expressed concern with the prior historical period, SDG&E now protests that in the absence of mitigation, the CAISO proposal regarding the historical reference period is unreasonable, unjust, and unduly discriminatory and must be revised before irreparable harm is inflicted. SDG&E at 3-4, 17. In support of its protest, SDG&E argues that: (1) SDG&E is uniquely situated geographically and is dependent upon the Southwest Powerlink ("SWPL") to access resources outside of its service area, SDG&E at 5-8; (2) SDG&E's normal procurement practices have been disrupted by the California electricity restructuring and its aftermath, SDG&E at 9-10; (3) SDG&E's existing procurement plans require use of import capacity similar to its pre-CAISO levels, SDG&E at 11-12;¹⁸ and (4) SDG&E will not receive CRRs consistent

¹⁵ See MRTU Tariff Filing, proposed § 36.8.3.4.

¹⁶ On January 29, 2007, in compliance with the Commission's Final Rule in Docket RM06-8-000, the CAISO filed its proposal to make available Long Term CRRs under the MRTU Tariff. See January 29, 2007 filing in Docket No. ER07-475 ("January Filing").

¹⁷ See May 7 Filing, Attachment C, proposed tariff § 36.8.3.4.

¹⁸ SDG&E claims that the combined capacity of executed contracts with renewable resource developers in the Imperial Valley and the owners of the 480 MW El Dorado plant (which SDG&E says it anticipates acquiring through the exercise of an option acquired as part of a CPUC-approved settlement in 2006) is approximately 1200

with its anticipated grid usage under the CAISO Proposal, SDG&E at 13-16.

SDG&E recommends that the Commission adopt one of two proposals. The first alternative would be to have the CAISO retain priority nominations for tiers 1 and 2 based on resource verification from 2006, but expand the definition of a resource to include a contract signed on or before December 31, 2006 for delivery of a set amount of energy by a date certain at an existing CAISO-controlled facility. SDG&E at 24. According to SDG&E, the ability of an LSE to rely on contracts that are not yet flowing energy would be limited to back-filling newly-opened holes in its 2006 resource portfolio. *Id.*

The second alternative suggested by SDG&E would be to make the resource-based priorities for tiers 1 and 2 in CRR Year One limited to the term of the underlying commercial arrangement. SDG&E at 27. As a result, SDG&E claims that the allocation system would be gradually purged of the initial priority allocations in favor of allocations based on percentage of load. SDG&E says that consistent with its preference the CAISO could use priorities based on 2006 source verifications in the initial allocation, but in some cases there would be a temporal limitation on the ability to renew the priority in future years via the Priority Nomination Tier. SDG&E also notes that under its proposal no CRR awarded on the basis of a resource-verified priority could be converted to a long-term CRR unless the underlying commercial arrangement is for a term of at least 10 years. *Id.*

As noted in the Transmittal Letter to the May 7 Filing and Dr. Kristov's testimony, SDG&E's position regarding the historical reference period for source verification was fully

MW and that this is more than twenty times the meager 55 MW of power sourced in the desert Southwest that SDG&E can use for CRR resource verification under the CAISO's current CRR proposal. SDG&E claims that 1200MWs is "fairly consistent" with its usage of SWPL prior to formation of the CAISO. SDG&E at 12.

vetted in the most recent stakeholder process preceding the May 7 Filing.¹⁹ The CAISO again cautions that the Commission not be swayed by individual Market Participants arguments to amend the overall CRR release rules in order to address individual party concerns. SDG&E's concerns grow out of historical and potential future circumstances as they pertain to their purchasing patterns as opposed to an actual problem with the actual CRR rules filed.²⁰ It is the confluence of the circumstances recited by SDG&E and the CRR rules that result in an outcome that SDG&E proposes it cannot accept. As custodian of the policy making process in support of its tariff filing, the CAISO is not able to overlook the stringent review process that led to the filed CRR rules in light of one participant's dissatisfaction with their potential allocation. Rather the CAISO, as should the Commission, must weigh carefully all of the factors that result in a potential allocation that is just and reasonable and not unduly discriminatory.

The CAISO does, however, recognize that despite its attempts to address SDG&E's concerns through the stakeholder process, SDG&E continues to raise concerns that are rooted in

¹⁹ See Transmittal Letter to the May 7 Filing at 20-21; and Attachment D to the May 7 Filing, Testimony of Dr. Lorenzo Kristov, Exhibit No. ISO-1 at p. 47-66.

²⁰ There is a feature of the filed CRR rules that SDG&E seems to have overlooked in expressing its concern about the "meager 55 MW" of useful CRRs it was able to nominate in the source-verified tiers of the CRR Dry Run, a feature which should mitigate its concern to some extent. The filed rules call for the CAISO to calculate "residual" MW quantities of import CRR capacity on each of the interties, where these residual quantities are the difference between the available transfer capacity on each intertie and the of the total source-verified quantities submitted by the LSEs for the same intertie. The CAISO then sets aside 50 percent of each residual for the CRR auctions and allocates the other 50 percent to each participating LSE in proportion to its Adjusted Load Metric as eligible source locations that may be nominated in the source verified tiers (i.e., tiers 1 and 2) of the CRR Year One process. In the CRR Dry Run, the total quantity of residual intertie MW to be allocated to the LSEs in this manner ranged from over 7000 MW to over 8300 MW, depending on the particular Season and Time-of-Use period, of which SDG&E's share would be about 10 percent. Thus in the CRR Year One allocation process SDG&E will be able to utilize the source-verified tiers to nominate and obtain import CRRs sourced at all interties to the CAISO grid, without having to wait for the free choice tier to nominate CRRs that are outside its set of formally verified source locations. Although such sets of CRRs from all the interties may not reflect an LSE's individual pattern of usage of the CAISO grid, the CAISO anticipates that there will be some valuable CRRs among these that an LSE could acquire and trade bilaterally for other CRRs that match its needs better. In bringing this feature of the filed CRR rules to the Commission's attention, the CAISO hastens to add that it is understandable that SDG&E overlooked this feature in expressing its concern, because in the CRR Dry Run these residual quantities were calculated but were not made available to the participating LSEs in tiers 1-2 as they will be in the actual production CRR allocation process.

its fundamental discomfort of the longevity of the effectiveness of the CRR allocation in CRR Year One. Therefore, the CAISO offers its opinion on potential changes that could be made that would address the underlying concern regarding the fixed nature of the CRR Year One allocation and the limited opportunities for parties to expand and or adjust their holdings of Long Term CRRs over time to account for changes in their buying patterns. The CAISO again reiterates that it did not in its May 7 Filing and does not again in the instant Answer affirmatively offer these potential changes as proposals, because as previously discussed (in Dr. Kristov's testimony, through its stakeholder process, FERC's guidance, Governing Board approvals, and the directives under EPCAct), the CAISO believes it has struck the proper balance in addressing the underlying tension of the competing interests.

Through the most recent stakeholder process preceding the May 7 Filing, the CAISO considered SDG&E's proposed alternative to have the CAISO retain priority nominations for tiers 1 and 2 based on resource verification from 2006, but expand the definition of a resource to include contracts signed on or before December 31, 2006. The CAISO found that changing the nature of the historical reference period to allow contracts for future delivery would either have to be limited to a time horizon too short to provide any benefit to the parties advocating this change, or if extended several years into the future would raise difficult complexities regarding how to allocate pro rata shares of generating units to multiple LSEs and how to model non-existent generation in the CRR network model without creating vastly unrealistic flow patterns in the Simultaneous Feasibility Tests ("SFT").²¹ Furthermore, based on the implementation schedule provided by Ms. Deborah A. Le Vine in her Direct Testimony, the CAISO has

²¹ See, e.g., Attachment D to the May 7 Filing, Testimony of Dr. Lorenzo Kristov, Exhibit No. ISO-1 at p. 59-61.

determined that any changes that affect the source verification process would result in a four week delay in the CRR implementation schedule because such a change would require that the CAISO again receive and verify new information from Market Participants.

However, regarding SDG&E's second alternative (*i.e.*, making the resource-based priorities for tiers 1 and 2 in MRTU Year One limited to the term of the underlying commercial arrangement), the CAISO notes that Dr. Kristov discussed a similar change and stated that it was "in the category of more feasible changes."²² Dr. Kristov noted that CRRs allocated based on verified sources associated with certain energy contracts could have a predetermined limit to the number of times they can be renewed through the PNT, akin to a "sunset" provision to reflect the termination dates of the contracts.²³ Dr. Kristov's opinion was that such a proposal would create a greater release of CRRs each year and greater opportunity for LSEs to obtain CRRs from source locations they did not previously hold.²⁴ Dr. Kristov cautioned however, that such a provision, if adopted, be applied only at the initial source verification for CRR Year One because any kind of ongoing source verification beyond the first year would carry with it the inefficient contracting incentives the CAISO's Market Surveillance Committee and the LECG consultants warned against, not to mention the additional administrative complexity of conducting annual source verification.²⁵

The CAISO continues to support its filed proposal regarding the historic reference period as reasonable for all of the reasons outlined in Dr. Kristov's testimony. Nonetheless, the CAISO offers that SDG&E's concerns could in part be addressed by incorporating a sunset date on PNP

²² Attachment D to the May 7 Filing, Testimony of Dr. Lorenzo Kristov, Exhibit No. ISO-1 at p. 63.

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

renewability of CRRs associated with contracts submitted for CRR Year One source verification. Because such a change would not impact the rules currently being implemented in preparation of the first annual CRR allocation, there would be minimal if any schedule impact as a result of such a change. The CAISO notes that this change could be implemented by limiting the renewability in the PNP of CRRs associated with contracts that were valid in 2006 but, for example expire prior to 2009. Such contracts would not be renewable in the PNP for 2009 and in subsequent years but could be nominated in the free choice tiers. This limitation on the PNP provides added flexibility that again would tip the balance struck by the CAISO in its filed CRR rules.

D. Trading Hubs as Sources for CRRs

In the May 7 Filing, the CAISO proposed to allow CRR nominations with Trading Hub sources by disaggregating the CRR nominations for CRR allocation purposes into the individual generator PNode CRRs that comprise each Trading Hub. May 7 Filing, Transmittal Letter at 8. CRR nominations sourced at Trading Hubs will be disaggregated into bundles of point-to-point CRRs sourced at all the individual generator PNodes making up the Trading Hub, based on the weighting factors used to establish the Trading Hub. *Id.* The proposal eliminates certain undesirable effects observed in the CRR Dry Run because under the CAISO's proposal Trading Hub CRRs, which are really a bundle of linked CRRs, would not be evaluated in the SFTs; rather, the SFT would assess the feasibility of individual Point-to-Point CRR nominations sourced at either generator PNodes or Scheduling Points (interties). *See* Transmittal Letter at 8-9.

1. DWR Recommends Creating CRR Source Restrictions that Match the CRR Sink Limitations used in the MRTU Tariff Language

DWR opposes the proposal to disaggregate or unbundle Trading Hub CRR nominations into individual Point-to-Point CRRs from all generator PNodes based on the Trading Hub

weighting factors. DWR at 2. DWR believes the MRTU Tariff should specify restrictions on the quantities of CRRs that can be nominated in each tier from any specific source that match whatever the sink limitation is for the applicable tier (the sink limitation being the portion of an entity's load metric that can be used in the tier). *Id.* at 2-4. DWR believes that the source and sink limits should be matched evenly across the tiers of the allocation process. DWR also says it has raised this issue repeatedly and has yet to hear a response from the CAISO. DWR at 2, n.1.

The CAISO respectfully suggests that it has, in the context of the stakeholder meetings leading up to the May 7 Filing, responded to DWR's comments and explained why it did not accept DWR's proposal. As explained in greater detail in the attached affidavit of Dr. Kristov, DWR's proposal is very similar to Option 1 for addressing the Trading Hub CRR issue, which the CAISO initially recommended but was not preferred by stakeholders and was eventually abandoned once the CAISO determined it was feasible to implement the disaggregation approach which most stakeholders and the Market Surveillance Committee strongly favored. *See Attachment A* to this pleading, Affidavit of Dr. Kristov.

2. AReM Suggests Facilitating the Trading of Disaggregated CRR Bundles Issued as a Result of Trading Hub Source Nominations by Having the CAISO Develop Software to Perform the Reconstitution of Trading Hub CRRs

AReM states that it appreciates the stakeholder process held by the CAISO to discuss and find solutions to the issues involving nomination of CRRs sourced at Trading Hubs in the CRR allocation process. AReM at 3 (unnumbered). AReM recommends an additional refinement to assist the LSEs in reconstituting and trading Trading Hub CRRs in the market. AReM says that in discussions with CAISO staff, the staff has said that the disaggregated Trading Hub CRRs can be traded in the market if the LSE reconstitutes Trading Hub CRRs from all the individual PNode CRRs. Rather than have LSEs reconstitute the Trading Hub CRRs on their own, AReM

would prefer that the CAISO facilitate such trades by developing software to accomplish this reconstitution. AReM at 3-4 (unnumbered). AReM requests that the Commission direct the CAISO to develop appropriate software to allow easy trading of Trading Hub CRRs that would be available within 12 months after MRTU implementation. *Id.*

In response to AReM's suggestion, the CAISO notes that there already exist a significant number of post-MRTU start-up enhancements that have been identified as candidates for possible implementation at a later date, including several enhancements to the CRR systems, and that the CAISO has previously committed to conducting a stakeholder process in which all such candidate enhancements can be reviewed and prioritized. The CAISO believes it would be premature at this time for the Commission to pre-empt the planned stakeholder process and single out one party's desired enhancement and order its implementation. The CAISO can commit, at this time, to include AReM's suggestion on the candidate list of post-Release 1 CRR enhancements to be prioritized through the stakeholder process at a later date.

3. The Rounding of MW Amounts in the Software that Tracks CRRs Will Not Reduce an LSE's Eligibility for CRRs

Golden State Water Company ("GSW") notes that the CAISO software that tracks CRRs was designed to accommodate only a certain level of MW granularity and that it rounds off to zero any results that are less than 0.05 MW. GSW at 5. GSW claims that because of the rounding convention built into the tracking software, it is almost certain that it would not receive sufficient CRRs under the CAISO's disaggregation proposal. *Id.* at 5-6.

The CAISO acknowledges the MW granularity limit and the rounding convention that GSW identifies, and has already committed to increasing the MW granularity of the tracking system in time for the running of the second year CRR release process. Although this change cannot be implemented for the first year CRR release process, the CAISO points out that GSW's

concern about receiving too few CRRs is based on a misunderstanding of the impact of the rounding convention. Although it is correct that the granularity limit can result in the LSE that nominates Trading Hub CRRs receiving fewer CRR MW than it nominated even in the absence of binding constraints, the LSE will have the opportunity to make up for this result in subsequent tiers of the allocation process. In other words, the granularity limit and rounding convention do not reduce the LSE's overall eligibility for CRRs, they just affect how many CRRs the LSE gets back from a Trading Hub nomination. Even if the LSE only has Trading Hubs as verified sources to nominate in tiers 1-2 of Year One, the LSE can still exercise free choice in tier 3 to nominate non-Trading Hub CRRs and obtain a quantity of CRRs up to its full seasonal eligible MW quantity.

E. Entities Serving Load Outside the CAISO Control Area (OCALSEs)

1. Allocation of Wheel-through CRRs

In complying with the Commission's *April 20 Order* to allow OCALSEs to be allocated wheel-through CRRs (*i.e.*, CRRs that source at a Scheduling Point and sink at another Scheduling Point), the CAISO explained that a paramount principle to be adhered to is that the OCALSE (as well as an LSE internal to the CAISO Control Area) is entitled to participate in the CRR allocation process only to the extent that the load they serve is exposed to congestion charges on the CAISO Controlled Grid. Therefore, the CAISO proposed tariff provisions to require that an OCALSE who wants to be allocated CRRs to demonstrate that it serves a quantity of load that is exposed to congestion charges on the CAISO Controlled Grid that is at least as great as the quantity of CRRs the OCALSE wants to be allocated.²⁶ In addition, the

²⁶ See, *e.g.*, Attachment C, proposed tariff § 36.9.3; see also Attachment D, Testimony of Dr. Lorenzo Kristov, Exhibit No. ISO-1 at p. 36-44.

Commission's decision required the specification of tariff provisions governing the legitimate need showing for the Scheduling Point CRR sources the OCALSE wants to nominate for wheel-through CRR allocation. *See* proposed § 36.9.1.

In its comments on these proposed new tariff provisions, SCE recognizes that for OCALSEs wanting to nominate sources internal to the CAISO Control Area that the CAISO had proposed a forward-looking demonstration of need. SCE at 12; *see also* proposed § 36.9.1. SCE further notes that for OCALSEs wanting to nominate sources external to the CAISO Control Area, under the new provisions the OCALSE would only need to verify the sources in the CRR Year One allocation process in accordance with the same historical reference year provisions that apply to internal LSEs. *Id.* SCE states that under the CAISO's proposal for allocating wheel-through CRRs, after CRR Year One OCALSEs can submit wheel-through CRR nominations based on their previous year performance (*i.e.*, the future requests are not tied to an initial showing, but are based on the previous year's behavior). SCE at 12-13, 15. SCE argues that the rules for OCALSEs nominating CRRs from internal resources (*i.e.*, the requirement that a legitimate need showing be made each year) should be applied to OCALSEs wanting to nominate external sources to be allocated wheel-through CRRs. SCE at 13.

In other words, SCE recommends that in Year One, the OCALSE must demonstrate it had a historical use of the import path based on rules consistent with CAISO Tariff section 36.8.3.4. *Id.* Per the CRR Year One showing rules, SCE would require that delivery must have taken place between January 1, 2006 and ending December 31, 2006. *Id.* This showing would set the baseline for any future requests from the OCALSE. *Id.* SCE goes on to recommend that an OCALSE's maximum request for import CRRs be tied to their initial showing in CRR Year One. *Id.* at 16. If this is not done, SCE asserts the poor contracting incentive problem will

occur, *e.g.*, the OCALSE's will enter into future transactions for the purpose of obtaining wheel-through CRRs.

The CAISO acknowledges SCE's observation that under the filed provisions the required annual legitimate need showing would apply only to OCALSE CRR nominations sourced at generator PNodes internal to the CAISO, whereas OCALSE nominations for wheel-through CRRs would not require such an annual showing. The CAISO further acknowledges the appeal of greater consistency in the rules applicable to these two types of CRR nominations, but notes that there are two ways to achieve such consistency and both ways raise concerns. One approach would be to require a forward-looking annual showing of legitimate need for each CRR source the OCALSE wishes to nominate for allocation, regardless of the source location internal or external to the CAISO Control Area, as SCE recommends. The other approach would be to abandon the annual showing for OCALSE CRR sources entirely and rely on the CRR Year One source verification rules based on the 2006 historical reference year for the CRR Year One allocation, and then allow OCALSEs to utilize the PNP renewal process in subsequent years without having to show continued need for the resource, as the CAISO proposed in the May 7 Filing but only for external CRR sources.

The first approach raises the concern that OCALSEs will respond to the perverse contracting incentives that the Market Surveillance Committee and LECG consultants warned against, and will enter paper contracts in order to qualify for allocation of valuable CRRs. The second approach raises the concern that OCALSEs will be able to be allocated virtually any CRRs they wish with no verification by the CAISO to ensure that such CRRs are actually needed by the entities for legitimate load-serving needs in future years.

To better appreciate the logic of the CAISO's filed proposals it is helpful to review some

of the background of these proposals especially as regards OCALSEs. The fundamental principle of CRR allocation, as noted above, is that eligibility for allocation is limited to LSEs or OCALSEs on behalf of load that is exposed to both CAISO congestion charges and access charges that cannot be avoided. Entities that want CRRs that are not needed to manage the congestion charges for serving such load – for example, entities who wish to utilize the CAISO grid to move power for wholesale marketing purposes or want CRRs for speculative purposes – must obtain them through either the CAISO auctions or bilateral transactions. In the case of internal LSEs it is a straightforward matter to verify how much of their load is indeed exposed to unavoidable congestion charges and access charges, but for OCALSEs this verification is more difficult. When the CAISO first developed the rules for OCALSEs to be allocated CRRs in the stakeholder process leading up to the February 2006 MRTU Tariff Filing, the forward-looking annual showing for nominated CRR sources was determined to be the preferable approach (compared to reliance on Year One-only use of the historical reference year) in the context of limiting eligible OCALSE CRR sources to supply resources located within the CAISO control area. Within this limited context, the disadvantages of a forward-looking showing of need appeared to be minimal because it seemed difficult for an entity to take advantage of the rules by entering paper contracts crafted for the sole purpose of obtaining valuable CRRs, because it would become obvious if the OCALSE was not scheduling the internal supply resource in a manner consistent with its allocated CRR portfolio. However, when the set of CRR sources available to OCALSEs was expanded by the Commission's *April 20 Order* to include supply sources outside the CAISO, the CAISO became concerned that the extension of the forward-looking verification approach to Scheduling Points would create strong incentives for OCALSEs to enter paper contracts to garner valuable CRRs in competition with internal LSEs who are

heavily reliant on imports to serve their load. That was the reasoning that led to the CAISO's May 7 proposal regarding allocation of wheel-through CRRs, which was discussed in Dr. Kristov's testimony at that time.

After considering the arguments put forward by SCE in their comments, the CAISO is now less convinced that relying on the CRR Year One historical reference year source verification to discriminate between legitimate load-serving uses of intertie Scheduling Points by OCALSEs versus other uses that should not be eligible for CRR allocation is superior to the forward-looking showing of legitimate need. In particular, the CRR Year One-only source verification would provide no opportunity at all for the CAISO to verify that the OCALSE has supply arrangements corresponding to the CRRs it wants to be allocated in future years. The CAISO therefore proposes, subject to Commission approval, to apply the forward-looking showing to all CRR nominations by OCALSEs, including wheel-through CRR nominations, in conjunction with the rules for demonstrating eligible quantities of load for CRR allocation in accordance with proposed tariff section 36.9.3.²⁷

In addition, the CAISO also finds it prudent to limit the year-to-year increase in any OCALSE's eligible CRR quantities to reflect a reasonable two percent rate of load growth, consistent with the typical rate of load growth for internal LSEs. Upon consideration of this provision, the CAISO realizes that it was an oversight not to include this limitation in the May 7 Filing because the CAISO fundamentally does not believe that the CRR allocation process should be either an incentive or a vehicle for OCALSEs to engage in substantial year-to-year

²⁷ As a point of information for the Commission, although this does not diminish our reason for agreeing to this change, this rule change may require that the CAISO obtain and verify additional information from OCALSEs, which, if necessary the CAISO could allow more time for without delaying the start of MRTU in February 2008, but possibly delaying the scheduled completion date of December 21, 2007.

swings in their use of the CAISO grid to serve their load. Such swings could have an adverse impact on the ability of internal LSEs to meet their needs for CRRs from year to year, needs which typically will translate into very modest annual growth in CRR load metrics and eligible quantities.

SMUD argues that the Commission should allow OCALSE's to obtain Long-Term CRRs that are wheel-through CRRs. SMUD at 10-11. The CAISO notes that this issue is pending in Docket No. ER07-475-000 and believes the issue should be resolved in that proceeding.

2. The Restriction on CRRs Sourced at Trading Hubs

SMUD and IID protest the CAISO's proposal to the extent it does not allow OCALSEs to nominate a Trading Hub as a source for CRRs. SMUD at 4-8; IID at 4-6. SMUD and IID are correct that the CAISO's proposal does not allow OCALSEs to nominate CRRs with Trading Hub sources. *See* Proposed § 36.9.4 (which delineates eligible sources and sinks for OCALSEs and does not include a Trading Hub as an eligible source). However, this aspect of the MRTU design has not changed since the MRTU Filing, which did not allow OCALSEs to nominate Seasonal or Monthly CRRs with Trading Hub sources, and was not an element of the May 7 Filing. Similarly, with regard to Long Term CRRs, the CAISO originally did not propose to allow any Long Term CRR nominations to use Trading Hubs as sources for the reasons explained in the January 29, 2007 filing in Docket ER06-475-000.²⁸ While the May 7 Filing did

²⁸ The CAISO's January 29, 2007 Filing ("January Filing") in Docket No. ER07-475-000 was in compliance with the Commission Final Rule regarding Long-Term Firm Transmission Rights in Organized Electricity Markets. *See Long-Term Firm Transmission Rights in Organized Electricity Markets*, Order No. 681, 71 FR 43564 (Aug. 1, 2006), FERC Stats. & Regs. ¶ 31,226 (2006) ("Order No. 681"); and Order No. 681-A, 117 FERC ¶ 61,201 (2006) ("Order No. 681-A"). The CAISO rationale for originally proposing to prohibit Long Term CRRs sourced at Trading Hubs is set forth on page 25 of the Transmittal Letter to the January Filing. The CAISO noted that it was assessing whether the restriction on Long Term CRRs sourced at Trading Hubs could be mitigated. Transmittal

propose to allow Trading Hubs as sources for Long Term CRRs, the proposal did not revisit or change the restriction on using Trading Hubs as sources by OCALSEs. If the Commission were now to decide in favor of SMUD's and IID's protest and grant OCALSEs the ability to nominate Trading Hub CRR sources in the CRR allocation process, the CAISO emphasizes the importance of doing so in a manner consistent with the rules for the annual showing of legitimate need discussed in the previous section. Irrespective of how the Commission rules on SCE's and the CAISO's proposal that OCALSEs nominating wheel-through CRRs be subject to the annual legitimate need showing consistent with the conditionally approved rules for OCALSEs nominating internal CRR sources, the Commission should, if it approves OCALSEs to nominate Trading Hub CRR sources, make such nominations subject to the annual legitimate need showing consistent with internal CRR sources.

3. Clarification of the Phrase “Exposed to Congestion Charges”

SMUD believes the phrase “exposed to Congestion Charges,” in § 36.9.3 (CRR Eligible Quantities for OCALSEs) is ambiguous and should be clarified. SMUD at 8-9. SMUD also states that “exposure” to congestion charges should be a forwarding looking concept. *Id.* at 9. In responding to SMUD's request, it is important to recognize that in proposed § 36.9.3, the CRR eligible quantities for OCALSEs are determined using two related but different sets of historical hourly data, namely, data at the CRR sink (i.e., the export Scheduling Point) and data regarding the end-use customer load that relies on the CAISO Grid. SMUD's request applies to the second set of data, the OCALSE's “prior year's hourly metered load for the end-use customers the OCALSE served outside the CAISO Control Area that *were exposed to congestion charges* for

use of the CAISO Controlled Grid.” *See* proposed § 36.9.3.

The CAISO agrees with SMUD that the phrase can be clarified. The CAISO proposes that the phrase read as “the LSE’s metered load that was not served from sources other than what was exported to them from the CAISO.” Second, SMUD is correct that the requirement is not that the OCALSE has to show actual congestion charges paid in the past. Rather, the showing is a demonstration of the OCALSE’s net load that was not served by supply sources that did not require use of the CAISO grid and therefore depended on exports from the CAISO. Thus, although the required data is historical data, the concept is a forward-looking concept in the sense that this historical data, to be used in conjunction with historical hourly exports from the CAISO grid for purposes of determining the OCALSE’s load metric and eligible CRR quantities for the annual CRR allocation, is assumed to provide the best estimate of the OCALSE load that will depend on power exported from the CAISO grid during the coming year.

4. Clarifying Tariff Changes Regarding the Trading Hub Proposal

SMUD comments on the tariff language implementing the Trading Hub proposal and the use of the terms “LSE” and OCALSE.” SMUD at 4-8. SMUD assumes the uses and omissions of one term without the other are unintentional and requests the Commission to direct the CAISO to correct these inadvertencies. Contrary to SMUD’s assumption, however, almost all of the uses of the terms LSE and OCLASE in section 36 are intentional. For example, SMUD notes that § 36.8.3.1.1 and § 36.8.3.2(b) refer to both “LSEs” and “OCALSEs” in one passage but only refer to “LSE” when referring to nominating CRRs sources at Trading Hubs in accordance with the LSE’s verified CRR sources. SMUD at 5-6. The use of “LSE” and “OCALSE” in the sections mentioned by SMUD are intentional and implement the restriction on OCALSEs nominating CRRs sourced at Trading Hubs.

Similarly, SMUD notes that § 36.8.3.4 (regarding source verification) refers only to “LSEs” when referring to “a contact to take ownership of power at the relevant source *such as a Trading Hub or a Scheduling Point.*” SMUD at 6. The full sentence noted by SMUD states that:

*An LSE must demonstrate that it could actually submit Bids, including Self-Schedules and Inter-SC Trades, for Energy from the locations to be nominated as CRR Sources to serve its Load either through ownership of, or contractual rights to receive Energy from, the relevant Generating Units, or a contract to take ownership of power at the relevant source such as a Trading Hub or a Scheduling Point.*²⁹

The sentence is correct. The CAISO notes that later in the same section there is a provision that refers to the sources verification requirements for OCALSEs which states: “The provisions on source verification requirements based on legitimate need in Section 36.9.1 apply for Qualified OCALSEs.”³⁰

However, in reviewing SMUD’s comments, the CAISO notes that there are some tariff provisions that could be clarified. First, there is one aspect of proposed § 36.8.3.4 that is ambiguous and requires modification. The following sentence is contained in proposed § 36.8.3.4:

The Verified CRR Source Quantity associated with each verified CRR Source for a particular LSE or Qualified OCALSE will be: (i) for an owned generation resource the PMax of the unit multiplied by the LSE’s or Qualified OCALSE’s ownership share; (ii) for a contract with a generation resource, the hourly MWh of Energy specified in the contract averaged over all hours of the relevant time of use period, but no greater than the PMax of the unit; or (iii) *for a contract that delivers Energy to a Trading Hub or Scheduling Point, the hourly MWh of energy specified in the contract for delivery from the supplier to the LSE or Qualified OCALSE at the Trading Hub or Scheduling Point, averaged over all hours of the relevant time of use period.* (emphasis added).

²⁹ Proposed § 36.8.3.4 (emphasis added).

³⁰ *Id.* Section 36.9.1 does not mention Trading Hub sources.

To the extent the emphasized phrase implies that OCALSEs may nominate CRRs sourced at Trading Hubs, the phrase is incorrect and should be amended to read as follows: “*or (iii) (applicable to LSEs only) for a contract that delivers Energy to a Trading Hub or Scheduling Point, the hourly MWh of energy specified in the contract for delivery from the supplier to the LSE at the Trading Hub or Scheduling Point, averaged over all hours of the relevant time of use period.*”

Second, § 36.8.3.4 provides “CRR nominations whose CRR source is a Scheduling Point must be source verified in accordance with Section 36.8.4.2.” Proposed § 36.8.3.4 (emphasis added). However, the “source verification” section is § 36.8.3.4 itself, § 36.8.4.2 deals with eligible sources for Import CRR. The CAISO therefore recommends changing the quoted sentence to read as follows: ““CRR nominations whose CRR source is a Scheduling Point must comply with ~~be source verified~~ ~~in accordance with~~ Section 36.8.4.2.”

Finally, the first sentence of § 36.8.4 refers to “LSEs” and “Qualified OCALSEs.” The first sentence reads as follows: “LSEs or Qualified OCALSEs may nominate up to one hundred percent (100%) of their Adjusted Verified CRR Source Quantities for their Seasonal or Monthly CRRs in all relevant tiers except as provided in this Section.” Proposed § 36.8.4.2 (first sentence, emphasis added). The second sentence of § 36.8.4 provides that: “In the CRR Allocation processes for Seasonal CRRs, Monthly CRRs, and Long Term CRRs, sources of CRR nominations can be either PNodes (including Scheduling Points) or Trading Hubs.” Proposed § 36.8.4.2 (second sentence, emphasis added). The two sentences together, imply that OCALSEs can source CRRs at Trading Hubs. The CAISO recommends adding the following new sentence as the third sentence of the section: “Qualified OCALSEs may not source CRRs at Trading Hubs.” In conclusion to this section, the CAISO notes that if the Commission decides that

OCALSEs should be allowed to nominate Trading Hub CRR Sources as discussed earlier, the CAISO will, of course, appropriately modify (or not) the tariff language passages discussed here to comply with the Commission's direction.

5. Pre Payment of Wheeling Access Charges

SVP and MID contend that OCALSE requirement in Section 36.9.2.1 to (a) prepay for full 10 year term and (b) to allow those OCALSEs that are deemed creditworthy to pre-pay on an annual basis contravenes the intent of the MRTU Rehearing Order. SVP at 11-12; MID at 9-11.

Proposed § 36.9.2.1 reads as follows:

An OCALSE will be required to prepay for the full ten year term of the CRR to be nominated as a LT CRR the relevant Wheeling Access Charges in order to participate in the CRR Allocation process to be allocated such LT CRRs. An OCALSE deemed creditworthy pursuant to the requirements of Section 12 may elect to prepay its determined WAC responsibility on an annual basis, provided that such OCALSE has demonstrated a commitment to pay for the entire term of the LT CRRs sought by submitting to the CAISO a written sworn statement by an executive that can bind the entity. An OCALSE choosing to pay such WAC obligation on an annual basis shall make its prepayment each year at the beginning of the annual CRR Allocation process for the following year.

SVP and MID are asking the Commission to: (i) delete the lump sum payment option for Long Term CRRs of 10 years and, (ii) allow creditworthy OCALSEs to pre-pay their annual charges on a monthly basis as required in the *April 20 Order* for one-year CRRs. The CAISO respectfully suggests that the Commission reject the comment of SVP and MID. From a procedural perspective, SVP and MID erroneously interpret the *April 20 Order* to apply to WAC prepayment for Long Term CRRs, which it did not. Turning to the substance of the issue, the proposed language requires a full prepayment of the WAC for ten years for OCALSEs that are not creditworthy. For creditworthy OCALSEs, the entity can elect to prepay its determined WAC responsibility on an annual basis, provided that such OCALSE has demonstrated a

commitment commensurate with the term of the Long Term CRRs via a sworn statement by an executive with authority to bind the entity. These provisions are reasonably tailored to the underlying credit circumstances of an OCALSE, and should be approved.

F. CRR Credit Requirements

NCPA is concerned with the implication that the CRR credit requirements need not be final, or even necessarily filed with FERC, until after the annual CRR allocation process has begun. NCPA at 4. NCPA objects to the notion that LSEs must nominate CRRs without knowledge of either their to-be-determined auction values or the terms on which those auction values will be used to determine their collateral requirements. *Id.* at 5. NCPA also argues that the lack of information about valuations and credit terms is particularly problematic in the case of Long Term CRRs, where the CAISO contemplates requiring holders to post collateral for potential negative values over a ten year term. *Id.*

The CAISO notes that a draft Business Practice Manual (“BPM”) on Credit Management and draft CRR Credit policy tariff language were published on June 6, 2007. These documents provide detailed information on how the CAISO proposes to value a market participant’s CRR portfolio. *See* June 6, 2007 draft BPM on Credit Management at § 6.2.2. The Governing Board authorized CAISO management to file the tariff amendment to implement the CRR credit policies on May 30, 2007. This tariff language will be filed in June well in advance of the time period that the first Tier 1 nominations are due in the Annual CRR Allocation for Year One. Therefore, contrary to NCPA’s claims, Market Participants will be aware of the CRR credit requirements before the Tier 1 Nominations are due. Moreover, in the MRTU Tariff docket, ER07-613, the Commission granted the CAISO’s motion to file (for informational purposes only) the BPM for Credit Management by June 22, 2007, rather than the June 7, 2007 date

specified in the May 8 Order, despite NCPA's opposition. *Order Granting Extension of Time*, 119 FERC ¶ 61,244 (2007). NCPA raised the same arguments in opposition to the CAISO's motion for extension as it raised in its protests and the Commission found that Market Participants would have sufficient information to fully participate in the initial CRR allocation.

With regard to NCPA's claims regarding the credit requirements for Long Term CRRs and the potential for negatively valued CRRs over a ten-year term, it is important to remember that with Long Term CRRs (as with other CRRs) if: (a) a party's nomination CRRs reflect actual supply arrangements, and if (b) the party's schedules on average reflect those supply arrangements, the financial risk should be minimized because the congestion payments and CRR revenues received will offset one another. If Market Participants try to obtain Long Term CRRs for speculative purposes, the financial risks of negatively valued CRRs certainly will be higher.

G. One Month Minimum Requirement for Contracts for Source Verification

As noted by Dr. Kristov, in the MRTU Filing, the CAISO always intended to provide for a minimum contract length of one month for CRR source verification. *See* May 7 Filing, Attachment D, Testimony of Dr. Lorenzo Kristov, Exhibit No. ISO-1. at 54-55.³¹ The tariff language to reflect the one-month minimum requirement was submitted in the May 7 Filing as a clean-up item rather than a policy change. The CAISO did not, however, in the May 7 Filing propose the adoption of the rule that would allow parties to use contracts of a shorter duration, including up to one month. SVP and MID comment that shorter term contracts should be permitted to be used for source verification purposes as they were in the CRR Dry Run. SVP at 7-11; MID at 6-9.

³¹ Dr. Kristov noted that the CAISO's intent was clearly set forth in the Testimony of Scott Harvey and Susan Pope submitted with the February 9, 2006 MRTU Filing. *See* Exhibit No. ISO-1 at 54-55 (citing to Harvey and Pope testimony filed in Docket No. ER06-615-000, Exh. ISO-2 at pp. 91-92).

The CAISO respectfully suggests that the Commission not accept SVP's and MID's recommendation at this time. This issue was thoroughly debated during the 2005 CRR stakeholder process. In its May 7 Filing the CAISO maintained the one-month requirement because the CAISO did not see a sufficient reason or stakeholder demand to reopen the issue.

SVP states that use of 2006 as the reference period for source verification included wet conditions in the Spring in California and may result in an allocation of fewer CRRs on paths where LSEs rely more on Pacific Northwest power under typical weather conditions. According to SVP, using contracts of less than one month would result in an allocation of CRRs that would be more consistent with the transmission usage in an average year. SVP at 9-10. The CAISO notes that almost every market participant could find something abnormal with the historical reference period. This is the reason why the CAISO chose to balance source verification with the free choice tiers -- in order to get a reasonable starting allocation, which parties can modify in subsequent years. For all of the above-referenced reasons, the Commission should accept the policy decision to use a minimum contract length of one month for CRR source verification purposes.

H. Renewal of Expiring Long Term CRRs and Allowing Expiring ETCs and CVRs to Convert to Long Term CRRs

DWR states that it appreciates the CAISO's efforts to rectify the significant disadvantages that ETC holders face when their ETCs expire in the midst of the initial 10-year period for priority CRR allocations. DWR at 4. DWR says that CAISO's proposed change does remedy the problem that allowed non-holders of the expiring rights a first opportunity to obtain CRRs utilizing the transmission capacity freed up by the expiring rights, essentially shutting the ETC holder out of access to the rights to which it had been contractually entitled. *Id.* However, DWR postulates a problem with ETCs (*e.g.*, that expire sometime between 2008 and 2017) and

the CRR allocations after the 2008-2017 long term allocation. DWR appears to be saying, *e.g.*, for an ETC that expires in 2014, that: (1) the CAISO should reserve or hold the capacity of the ETC that expires in 2014 for the entire 2008-2017 period; and (2) in 2018 DWR will not be able to provide a Seasonal CRR in the PNP reflecting its desire to continue to use the equivalent of its ETC rights by transitioning to Long Term CRRs. DWR at 4-5.

CAISO believes the methods it proposed to allow ETC and CVR holders to use to transition to Long Term CRRs when their existing rights expire provide sufficient answers to DWR's concern. *See* § 36.8.3.5.5. DWR can: (1) avail itself of the options in § 36.8.3.5.5 which would allow DWR to either (i) nominate in the Priority Nomination Tier in 2014 a quantity of its existing rights that expire on 2014 comparable to the eligible quantity rules applicable to other LSEs, or (ii) nominate the eligible quantity and be allocated Long Term CRRs in Tier LT in the year prior to expiration (2013 in the example); or (2) give up its ETC rights in time to receive Long Term CRRs for the 2008 -2017 term for its non-ETC covered load. The CAISO does not believe it is appropriate or fair to other LSEs to grant what appears to be DWR's request to extend its expiring ETC rights to 2017 based on the fact that non-ETC LSEs can get 10-year CRRs at MRTU start-up that will extend through 2017.

AReM opposes the additional feature regarding the renewal of expiring Long Term CRRs and "transition" of ETCs and CVRs to Long Term CRRs. AReM at 4 (unnumbered). AReM notes that the CAISO stated that its proposal allows these parties to compete on a "level basis" with other LSEs and that no party opposed this change. AReM respectfully disagrees with the CAISO's statement; AReM claims the treatment is preferential to non-incumbent LSEs and contrary to the spirit of *Orders Nos. 681* and *681-A*. *Id.* AReM also notes that a similar proposal was filed by the CAISO in ER07-475-001 and opposed by AReM as discriminatory. *Id.* at 5-6

(unnumbered). AReM opposed the proposal in that filing because it did not allow an LSE that gains load through load migration and that obtains the associated transferred CRRs to have access to the PNP to renew the transferred CRRs associated with load migration. The CAISO did, however, provide PNP access for expiring ETC holders. *Id.* According to AReM, the CAISO's current proposals on expiring ETCs and Long Term CRRs are more of the same – providing special treatment for the holders of such rights. Accordingly, AReM requests that the Commission reject the CAISO's proposal and, specifically, Section 36.8.3.5.5 of the CAISO's CRR amendments. *Id.*

In response to AReM's concern, the CAISO notes that it has previously acknowledged, in the context of the recent stakeholder process on CRRs, AReM's proposal to allow a load-gaining LSE to utilize the PNP to renew CRRs that are transferred to the LSE due to load migration. The CAISO did not either reject or adopt the AReM proposal at that time because it was preferable to defer its discussion to the upcoming stakeholder process dealing with the rules for CRR transfers to reflect load migration, so that all issues related to that topic could be considered at the same time. The CAISO further notes that its recently published straw proposal on the load migration topic and certain other CRR matters does propose to adopt the AReM proposal.³² Under the CAISO's straw proposal, the load-gaining LSE that receives transfers of CRRs associated with the load it gains will also receive the PNP renewal rights for those CRRs. The CAISO believes that adopting this AReM proposal will achieve appropriate and sufficient parity in the treatment of LSEs who participate in retail Direct Access vis-à-vis other LSEs who wish to renew their holdings of Long Term CRRs or convert their expiring ETC rights and CVRs

³² See "CAISO Straw Proposals on Congestion Revenue Rights, Covering Topics to be Filed in July 2007," dated June 7, 2007, available at <http://www.caiso.com/1bf7/1bf76e4e35b80.pdf>.

into Long Term CRRs, and therefore the Commission should reject AREM's argument to overturn this aspect of the CAISO's May 7 filing.

I. Allocation of CRRs to Merchant Transmission Facilities

Two parties, the CPUC and SCE, raise issues with respect to the allocation of CRRs to Merchant Transmission Facilities. The CPUC requests that the Commission order the CAISO to modify the proposed tariff to issue only Obligation CRRs to merchant transmission owners, stating that the introduction of Option CRRs: (1) presents unknown complications in an already complicated new market, (2) will needlessly risk the revenue sufficiency of the overall CRR program, and (3) will reduce the availability of CRRs to LSEs seeking a hedge for transmission costs. CPUC at 18-19. For example, according to the CPUC it is not clear whether or how the CAISO plans to balance the allocation of Long Term CRRs for new transmission incorporated into the grid to serve a new generation source remote from load, especially where a merchant transmission sponsor that seeks Long Term CRRs as compensation for the addition of a new resource is a different entity than that which has contracted to purchase and deliver energy from that new resource to load. *Id.* at 23. The CPUC does not oppose the eventual issuance of Option CRRs to merchant transmission sponsors after the CAISO has developed a plan, with input from stakeholders, to incorporate new generation resources into the grid on an equal footing with existing generation as to the availability of CRRs to hedge congestion. *Id.* at 19. Indeed, the CPUC recognizes that Option CRRs mitigate financial risk for merchant transmission sponsors. *Id.* at 19-20. Nevertheless, the CPUC is wary of creating and distributing such a potentially valuable right as Option CRRs to Market Participants before a thorough analysis of all implications of such actions are analyzed and addressed. *Id.* at 19-23.

SCE is supportive of the general method proposed by the CAISO, for allocating CRRs to

Merchant Transmission Facilities. SCE at 3. While SCE agrees with the principles that the CAISO states should guide the allocation of CRRs to Project Sponsors of Merchant Transmission Facilities, SCE is concerned that under some circumstances the proposal could allocate more CRRs than the Merchant deserves. *Id.*

According to SCE, the principle most difficult to implement is having the quantity and source-sink pattern of Merchant Transmission CRRs allocated to the entity be commensurate with the transfer capacity that the project adds to the CAISO Controlled Grid. *Id.* at 3-7. SCE notes that allowing the Merchant Transmission Project to request five sets of CRRs provides ample opportunity for the Merchant to derive the value of the upgrade and states further that the use of temporary test CRR Options to block the Merchant Transmission Project from realizing value not associated with its upgrade is a necessary step in the process.³³ SCE is concerned, however, that it is possible that a merchant could upgrade a facility in one area of the grid, and request a CRR with a source and sink combination so far apart that it reflects value associated mostly with other constraints rather than the upgraded constraint. *Id.* at 5-7. Thus, SCE argues that the CAISO should not restrict “temporary test CRR Options” to having the same source and sink as the CRRs requested by the Merchant Transmission Project but instead the CAISO should issue additional temporary test CRR Options with additional sources and sinks to the extent that this is possible. *Id.* In addition, SCE argues that when the CAISO assesses the feasibility of the multiple CRR requests submitted by the Merchant it should test the nominations *sequentially*, rather than simultaneously as the CAISO proposes. *Id.* at 5.

SCE’s argument about sequential rather than simultaneous assessment of the feasibility

³³ The temporary test CRRs seek to “fill up” the pre-upgraded grid with CRRs that were previously feasible, to ensure that the Merchant is not allocated these previously-feasible CRRs. SCE at 5.

of the Merchant nominations is based on a misunderstanding of how the CAISO's proposal will work. Specifically, SCE argues that the CAISO's proposed approach is flawed because, as soon as any of the test CRRs associated with the request bind, the CAISO will lock in the value of all other test CRRs and use these values in the evaluation of the upgraded network to determine available CRRs for the Merchant. This misunderstanding can best be clarified and corrected by referring to the example presented on pp. 8-9 of SCE's filing and the associated Figure 2. SCE states that the CAISO's proposed procedure would "look at the original network, and begin to 'fill up' the remaining capacity with 'test CRRs.'" SCE at 9. With this statement, SCE reveals that they are mistakenly assuming a "start small and build up until you hit a constraint" approach, in contrast to the "start large and reduce until you achieve feasibility" approach that the CAISO's proposal actually entails. In terms of the example of Figure 2, the CAISO's approach would actually apply very large MW quantities of CRR nominations on each of the source-sink pairs nominated by the Merchant – say 2000 MW from A to B and 2000 MW from B to C – quantities which will be certain in advance to be infeasible on each of the Merchant's nominated source-sink pairs. These quantities will then be reduced to achieve feasibility, with the result that 500 MW would clear on A to B and 1000 MW would clear on B to C on the pre-upgrade network. Therefore, when the Merchant upgrade is added to the network and the actual Merchant nominations are tested, all that will clear will be 500 MW from A to B, correctly reflecting the capacity added by the Merchant upgrade. Thus the CAISO's proposed methodology, when correctly understood, achieves the result SCE agrees is correct and does so through simultaneous assessment of the Merchant nominations, without requiring sequential assessment as SCE proposes.

In response to the CPUC's argument opposing allocation of CRR Options to Merchant

Transmission Sponsors, the CAISO notes that allowing these entities to elect to receive CRR Options has been part of the MRTU design going back to the earlier conceptual filings because CRR Options constitute an effective and appropriate means to enable the Project Sponsor to capture the congestion revenues associated with the capacity addition without being exposed to financial risk of reversals in the direction of congestion. When an entity bears the cost of investment in a project that adds capacity to the CAISO Controlled Grid, it would not be appropriate to limit that entity to CRR Obligations because in general CRR Obligations cannot be configured so as to provide the correct stream of congestion revenues regardless of the direction of congestion across the new facility. Moreover, when an entity bears the investment costs it would not be appropriate to allow other parties to receive CRRs in the allocation and the auction that “lean” on the Merchant Transmission CRRs, which would occur if the Merchant Transmission CRRs were CRR Obligations, because the allocation process does not allow the Merchant Transmission CRRs to lean on the CRRs released to other parties – the last step of the CAISO’s proposed merchant CRR allocation process ensures this. Although the CPUC correctly observes that CRR Options do affect the amount of capacity available for allocation to LSEs to a greater degree than CRR Obligations would, this is also an appropriate outcome because LSEs are not paying the investment costs associated with the project. More importantly, the only way the Merchant Transmission CRR Options affect the CRRs available to the LSEs is due to the fact that options, unlike obligations, provide no free counterflows that the LSE CRRs might utilize. The crucial point is that the Merchant Transmission CRR Options do not consume any capacity that should be available for allocation to the LSEs, because they are completely incremental.

In contrast, when transmission projects are paid for through the Transmission/Wheeling Access Charges, the associated capacity is appropriately incorporated in the CRR network model

to become available to all participants through the CRR allocation and auction processes. With regard to the other concerns expressed by the CPUC, allocating CRR Options to Merchant Transmission Sponsors will not increase the risk of CRR revenue adequacy because such CRR Options will be fully taken into account in the CRR network model used for releasing CRRs through the allocation and auction process. Moreover, the use of CRR Options for this limited purpose does not add unknown complications to the CRR processes because it is a relatively simple and straightforward procedure to model the Merchant Transmission CRR Options as Fixed CRRs in the network model as part of the preparatory steps for running the CRR Allocation and Auction processes. It is also informative to note that PJM has been modeling options for over a year in its auctions, so this area is not untested ground.

J. Comments Trying to Preserve Arguments Pending in Docket No. ER07-475-000.

MID notes its objection to the allocation of uplifts for fully funding Long Term CRRs to exports (via use of the term “Measured Demand”). MID at 12. First, MID’s comments are pending in Docket No. ER07-475-000 and have nothing to do with the May 7 Filing. Second, with regard to the substance of MID’s comments, it is important to note that “exporters” from the CAISO Controlled Grid can be CRR Holders and, therefore, exporters are able to benefit from the full-funding of CRRs. Therefore, the allocation of uplift costs to exports to support full funding is reasonable.

V. CONCLUSION

Wherefore, the CAISO respectfully requests that the Commission accept the CAISO’s May 7 Filing as proposed and as discussed herein without suspension or hearing, to go into effect on July 9, 2007 as requested.

Respectfully submitted,

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ATTACHMENT A

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

California Independent System) Docket No. ER07-869-000
Operator Corporation)

AFFIDAVIT OF DR. LORENZO KRISTOV

I, Lorenzo Kristov, declare as follows:

1. My name is Lorenzo Kristov. I am the Principal Market Architect within the Department of Market and Product Development at the California Independent System Operator Corporation (“CAISO”). In that capacity, I have had a leading role in the team engaged in the market redesign effort, which was initially called MD02, and now is referred to as the Market Redesign and Technology Upgrade (“MRTU”). I have contributed to the conceptual proposals approved by the Commission that served as the foundation for the new market design and to the detailed tariff language implementing the proposals. I have also been engaged in numerous interactions with stakeholders both at meetings and in reviewing comments that have helped to shape the final design.

2. I have 16 years of experience in the electric utility industry. Prior to joining the CAISO, from 1995 to 1999 I worked at the California Energy Commission (“CEC”) and was involved in retail electric restructuring proceedings and stakeholder working groups developing rules for Direct Access. In 1999 I joined the CAISO in the Department of Market Analysis and became part of the internal team formed to reform the CAISO’s congestion management process and ultimately to develop a comprehensive redesign of the CAISO’s markets. In the early 1990s I worked on demand forecasting for the CEC, and from 1993 to 1994 I worked in Indonesia as a

Fulbright scholar on the development of a commercial and regulatory framework to support private investment in the power sector. I received a master's degree in Statistics from North Carolina State University and a Ph.D. in Economics from the University of California at Davis.

3. I have previously submitted Direct Testimony in this proceeding that discussed several topics related to implementation of Congestion Revenue Rights ("CRRs") in conjunction with MRTU. These topics were: (1) treatment of CRR allocation nominations whose CRR Source is a Trading Hub; (2) renewal of expiring Long Term CRRs and transition of expiring Existing Transmission Contracts and Converted Rights to Long Term CRRs; (3) allocation of CRRs for Merchant Transmission Upgrades; (4) allocation of wheel-through CRRs to load serving entities that serve load outside the CAISO Control Area; (5) expansion of the eligible set of verified CRR Sources in conjunction with 2006 historical reference year for CRR Year One allocations; and (6) potential changes to filed rules for setting aside import capacity on the interties for the CRR Auctions. Capitalized terms used in this affidavit shall have the meaning set forth in Appendix A, Master Definitions Supplement, to the CAISO's MRTU Tariff.

4. My affidavit responds to certain issues contained in the comments filed in this docket by the California Department of Water Resources' State Water Project ("CDWR"). In the first instance, my affidavit is intended to correct the record of the erroneous statements made by CDWR that the CAISO has never responded to a proposal put forth by CDWR. In so doing, I also address the substance of CDWR's proposal and its concern over the CAISO's filed proposal to disaggregate Trading Hub CRR nominations in the CRR allocation process into Point-To-Point CRRs from all individual generator PNodes making up the Trading Hub based on weighting factors.

5. While the CAISO has not had an opportunity to provide a written response to CDWR's comments and proposed changes, it has discussed the merits of CDWR's proposal in the context of the stakeholder process to develop the proposal filed on May 7 that addresses issues associated with the allocation of CRRs sourced at Trading Hubs. In fact, CDWR's proposal is very similar to what was called "Alternative 2" among the alternatives for addressing the Trading Hubs issue that were presented in the CAISO's February 21 CRR Issues Paper, and later became "Option 1" in the March 19 Updated CRR Issues Paper. Open public discussion of these and other options occurred at CAISO stakeholder meetings on February 27 and April 3.

6. CDWR opposes the CAISO's filed proposal to disaggregate or unbundle Trading Hub CRR nominations in the CRR allocation process and proposes instead the CAISO should limit the quantity of CRR nominations a Load Serving Entity ("LSE") may submit from any particular CRR Source in any given tier of the allocation process to a percentage of the source-specific, verified source quantity that is equal to the percentage of the LSE's sink-side eligible quantity that may be submitted in each tier. After considering such an approach in the form of Option 1 during the stakeholder process in which CDWR representatives participated, the CAISO, market participants and the Market Surveillance Committee recognized that it would have undesirable side effects which I describe below, and rejected it for the superior disaggregation approach that was ultimately proposed by the CAISO in its May 7 Filing.

7. In advocating its proposal, CDWR erroneously characterizes the lack of its proposed correspondence between source and sink nomination limits in each tier as the "root" of the Trading Hub issue. The root of the problem, as was thoroughly discussed in stakeholder meetings on this issue in which representatives of CDWR participated, is more appropriately summarized as a combination of three factors: (a) the fact that Trading Hubs are defined based

on fixed distribution factors over a set of generation PNodes that includes all the internal generators within the Trading Hub geographic area from which LSEs will also nominate resource-specific CRRs, (b) the fact that Trading Hubs are only used as sources, not sinks, in the CRR allocation process, thus creating flows in the CRR optimization that are not consistent with actual flows in the CAISO energy markets, where Trading Hubs can only be used for Inter-SC Trades that do not create any energy flows on the grid, and (c) the fact that Trading Hub CRR nominations will have very small impact on binding constraints in the CRR optimization compared to nominations from specific generation PNodes associated with such binding constraints. Although the CDWR proposal, like Option 1 in the CAISO's discussion papers for the stakeholder process, would be one way to try to address the Trading Hub issue, the absence of the CDWR or Option 1 rule is clearly not the root of the Trading Hub problem that CAISO and its stakeholders sought to address.

8. CDWR's proposal and the similar Option 1, *i.e.*, to limit the amount of LSE nominations from any specific verified source in tier 1 of the allocation process, was thoroughly discussed in the stakeholder meetings and ultimately rejected for several reasons.

9. First, the overwhelming preference of the stakeholders (and the recommendation of the Market Surveillance Committee) was for the disaggregation approach, which actually goes more to the root of the problem than the CDWR proposal because the disaggregation approach deals directly with one of the root causes, namely the fixed distribution factors mentioned as factor (a) above. To explain further, when a constraint becomes binding and the constituent PNodes of the Trading Hub must be adjusted by the CRR optimization in locked proportions determined by the fixed distribution factors, by design the optimization will reduce the most effective individual PNode CRR nomination and not touch the Trading Hub nomination because

the former provides the greatest relief to the constraint for the smallest reduction in CRR MWs. When the fixed distribution factors are relaxed under the disaggregation approach, however, the relevant individual PNode CRR nomination and the Trading Hub component corresponding to the same PNode will both be reduced somewhat, while the other constituent PNodes of the Trading Hub are reduced very little if at all. Therefore, although the CAISO first advocated Option 1 under the belief that disaggregation could not be implemented for CRR Year One, after pursuing the matter with the CRR implementation team and the vendors the CAISO determined that disaggregation could be implemented and therefore endorsed it as the preferred approach.

10. The second reason why Option 1 or the CDWR proposal were not acceptable to most stakeholders and the CAISO, was that it would undermine the ability of LSEs to use the tiered structure of the allocation process to express their priorities for CRR allocation. During the 2005 stakeholder process where the tiered structure was developed, a primary design concept was to use tiers as a way to enable LSEs to obtain a high percentage of their highest priority CRRs in the first tier, when the total quantity of CRR nominations would be small enough relative to the grid capacity available to limit the likelihood of binding constraints. Many LSEs noted that they would want to use Tier 1 to obtain significant quantities of CRRs from those source locations that they typically rely on to serve substantial portions of their load and that could present significant congestion costs. Limiting nominations from any specific CRR Source in Tier 1 would undermine this design objective.

11. A third reason why Option 1 and the CDRW proposal were rejected was because the proposal would tilt the balance to favor the clearing of Trading Hub CRRs over specific PNode CRRs even beyond Tier 1. Under the originally filed rules, without any changes to address the Trading Hub issue, in Tier 1 Trading Hubs would be favored over individual PNode

CRRs for the “root cause” reasons described above. But then in Tier 2 very few Trading Hub CRRs would clear, if any, because constraints that became binding in tier 1 would still be binding in tiers 2 and 3. Under Option 1 or the CDWR proposal, the optimization would favor Trading Hubs CRRs over individual PNode CRRs through all the tiers of the CRR allocation process, not just in tier 1. In contrast, the disaggregation approach avoids favoring one type of nomination over the other, and was therefore the clear preference of most of the participants.

12. In summary, given the clear preference expressed by other stakeholders for the CAISO’s filed proposal, plus the thorough vetting of the range of options through the stakeholder process, the CAISO believes that due consideration was given to CDWR’s proposed approach to the issue, even though there had not been an opportunity for the CAISO to provide a written response to CDWR before the May 7, 2007 filing. CDWR may not be satisfied with the outcome of the stakeholder process, which considered but did not adopt their proposal, but it is neither accurate nor fair to say that the CAISO has not responded to CDWR’s concerns or given CDWR the opportunity to raise its issue with other stakeholders.

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

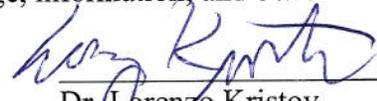
California Independent System
Operator Corporation

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Docket No. ER07-869-000

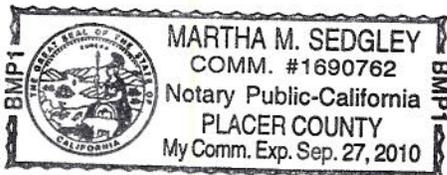
AFFIDAVIT OF DR. LORENZO KRISTOV

I, Lorenzo Kristov, being duly sworn, depose and say that the statements contained in the foregoing Declaration on behalf of the California Independent System Operator Corporation in this proceeding are true and correct to the best of my knowledge, information, and belief.


Dr. Lorenzo Kristov

State of California)
County of Sacramento)

Subscribed and sworn to (or affirmed) before me on this 12th day of June, 2007, by Lorenzo Kristov, personally known to me or proved to me on the basis of satisfactory evidence to be the person(s) who appeared before me.




Notary Public

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in the above-captioned docket.

Dated at Folsom, California on this 14th day of June, 2007.

/s/ Anna A. McKenna
