California Independent
System Operator Corporation

Memorandum

To: ISO Board of Governors

From: Nancy Saracino, Vice President, General Counsel & Chief Administrative Officer

Date: May 11, 2011

Re: **Decision on 2012 Grid Management Charge Rate Design**

This memorandum requires Board action.

EXECUTIVE SUMMARY

The grid management charge, as the vehicle through which the ISO recovers its administrative costs, is a formula rate whereby the ISO revenue requirement is allocated based on a matrix of percentages reflecting the activities of all ISO cost centers to a set of GMC components, and then ultimately to GMC charge codes. The current rate structure expires December 31, 2011.

After conducting a detailed cost of service study and an extensive stakeholder process, the ISO is proposing a simplified and more transparent rate design. This new rate design will assess GMC charges to customers based on their volumes of activities in three main areas: market services, system operations, and congestion revenue rights service charges. There are also four proposed transaction fees: market bid charge, congestion revenue rights charge, inter-scheduling coordinator trade charge, and a scheduling coordinator identification code charge.

Moved, that the ISO Board of Governors approves the proposal regarding the 2012 grid management charge rate design, as described in the memorandum dated May 11, 2011; and

Moved, that the ISO Board of Governors authorizes Management to make all necessary and appropriate filings with the Federal Energy Regulatory Commission to implement the proposed tariff change.

BACKGROUND AND PROPOSED NEW GMC RATE STRUCTURE

The GMC is a formula rate whereby the ISO revenue requirement is allocated based on a matrix of percentages reflecting the activities of all ISO cost centers to a set of GMC categories, and then ultimately to GMC charge codes. The current GMC formula rate structure includes seven cost categories consisting of seventeen separate charge codes, and is based largely on a settlement agreement with stakeholders approved by FERC on September 22, 2005 for the period January 1, 2004 through December 31, 2006. The ISO and stakeholders have extended that settlement agreement, with FERC's approval, since then, avoiding the necessity for a rate case at FERC for the past few years
The ISO revenue requirement is reflected in the annual budget developed with stakeholder input according to a process set forth in the tariff and approved by the Board. The tariff contains a revenue requirement cap under which the ISO may continue to recover the GMC without seeking FERC approval for changes to particular charges due to the formula rate implementation. Except for certain modifications needed to reflect the new market design and other market enhancements, the ISO and its stakeholders have agreed to successive extensions of the current GMC through December 31, 2011, subject to the ISO's completion of a cost of service study for GMC charges that would become effective in 2012.

Based on the 2012 GMC cost of service study results, Management proposes to substantially revise the GMC rate design while preserving the use of a formula rate structure and a revenue requirement cap mechanism. We propose to reduce the number of cost categories from seven to three: market services, system operations, and congestion revenue rights services. The ISO also proposes to substantially reduce the number of billing determinants used to develop the charge codes under the current GMC framework.

For market services, customers will be charged on the basis of their volume of awarded bids. For system operations, customers will be charged on the basis of their volume of metered flows. For congestion revenue rights services, customers will be charged based on the total MW holdings of congestion revenue rights applicable to each hour. The four specific transaction fees are 1) market bid charge of $0.005 per bid segment; 2) congestion revenue rights bid transaction charge of $1.00 per final accepted bid; 3) inter-scheduling coordinator trade charge of $1.00 per trade; and 4) a scheduling coordinator identification code charge of $1,000 per month. In addition, the ISO proposes to charge transmission ownership rights holders a reduced GMC charge of $0.27 per MWh of flow based on the minimum of their supply transmission ownership rights MWhs or demand transmission ownership rights MWhs.

COST OF SERVICE STUDY

Principles and guidelines

The ISO initiated its 2012 GMC stakeholder process with a kickoff meeting in April 2010, at which time stakeholder input into the cost of service study was solicited. Based on stakeholder comments and other considerations, the ISO conducted its 2012 GMC cost of

service study by following the steps traditionally taken in developing public utility rates and charges.[1] The ISO also established guiding principles for developing the fram**e**work for a new GMC structure:

1) Cost causation
2) Focus on use of ISO services, not market behavior
3) Transparency
4) Predictability
5) Forecastability
6) Flexibility
7) Simplicity

In addition, the ISO surveyed other ISO and RTO rate designs throughout the country that have nodal markets and concluded that the rates being charged by these ISOs and RTOs are based on fewer service categories and charges than the current ISO GMC charges.

Development of cost categories

As the first step in the cost of service study, the ISO broke down each of the 10 core level 1 *activity based costing* activities into major processes (level 2 activities) which were mapped to the level 1 activities. The level 1 activities were categorized into two types: 1) direct operating costs – those costs that can be directly mapped to a market, grid service, or customer; and 2) indirect costs – those costs that support a direct activity.

Several options to aggregate activities were considered. Initially, the ISO considered mapping activities to the existing GMC service categories. However, based on the guiding principles described above, the existing structure, with its numerous cost categories and service charges, was considered too complex and did not correlate to level 2 activities.

Thus, the ISO considered another option, which was to map activities to customer categories. A list of 31 customer categories was prepared. The categories included utility distribution companies, merchant generation, proxy demand response, self-scheduled exports, and many others. These categories were then mapped to the level 2 activities. It quickly became apparent that in a majority of cases these level 2 activities applied to all categories of customers:

Customers submit bids[2]	>>	**Market systems award schedules**	>>	**Energy flows**

[1] The steps are: 1) functionalization of activities into service categories; 2) allocation of costs into service categories; 3) classification of customer cost causation into billing determinants; 4) rate design, the development of rates for each service category; and 5) bill impacts analysis.

[2] Includes self-schedules.

Activities related to congestion revenue rights services also applied across a wide variety of customers. Thus, based on this activity mapping process, the following three cost categories were developed:

- market services
- system operations
- congestion revenue rights services

This three-cost category is very similar to what other ISOs and RTOs with nodal markets have implemented to recover their administrative charges. The ISO's proposed cost categories were described in a white paper issued on October 7, 2010. At a meeting held on October 14, 2010, stakeholders were asked to comment on the proposed cost categories as well as the development of billing determinants, the next step in the cost of service and rate design process.

Selection of billing determinants

The ISO considered the stakeholder comments and the guiding principles in selecting the values to be used as denominators for each category. In a straw proposal issued on November 11, 2010, the ISO proposed that the market services and system operations GMC categories would be based on gross MWs per hour (capacity and congestion revenue rights holdings) and MWhs (energy), respectively. These billing determinants reflect each scheduling coordinator's use of ISO services and are flexible, transparent, easy to forecast, and simple.

The market services category includes the awarded ancillary services MWs, schedules, and a schedule of generation, load, imports and exports for energy or residual unit commitment. The market services charge will be applied to the scheduling coordinator's gross absolute value of awarded MWhs of energy, MWhs of residual unit commitment, and MWs of ancillary services in the forward and real-time markets.

The system operations category includes all flow quantities for generation, load, imports, and exports. The fundamental purpose of system operations is to reliably balance supply and demand in real-time. The system operations charge will be applied to the scheduling coordinators' gross absolute value of actual MWhs of real time energy flows.

The congestion revenue rights services category includes the total awarded MWs per hour of congestion revenue rights.

Transaction fees

In the November 2010 straw proposal the ISO also proposed the following transaction fees:

- Bid segment fee

  This fee is a charge of $.005 per bid segment applied to all bid segments submitted. This is a nominal charge that does not represent a significant expense to market participants under typical scheduling practices, but is enough to deter the submission of excessive bid volumes. The amount to be charged is similar to the rate used at the New York ISO.

- Inter-scheduling coordinator trade fee

  A $1.00 inter-scheduling coordinator trade transaction fee is designed to recover costs directly related to the scheduling and settling of inter- scheduling coordinator trades.

- Congestions revenue rights bid fee

  A $1.00 congestion revenue rights bid transaction fee is designed to recover a portion of the congestion revenue rights costs on a transactional basis. The fee will apply to the congestion revenue rights nominations and the congestion revenue rights allocations processes. The congestion revenue rights services category is designed to collect roughly $7.5 million annually, or 4% of the revenue requirement. Of that, $500,000 is estimated to be collected using the $1.00 bid fee. This represents 6% of the $7.5 million and less than 1% of the overall ISO revenue requirement.

- Scheduling coordinator identification administrative fee

  This fee is a $1,000 per month administrative charge per scheduling coordinator identification.

BILL IMPACT ANANLYSIS AND FURTHER RATE DESIGN DEVELOPMENT

On December 2, 2010, the ISO released aggregate bill impact comparison data. During the same time period we provided individual forecasted bill impact information upon request by individual scheduling coordinators and congestion revenue rights holders. Again, based on stakeholder response and comments, the ISO proposed modifications to the GMC rate design in a January 13, 2011 straw proposal. These modifications included:

Discounted GMC rates for transmission ownership rights

Under the existing GMC, transmission ownership rights are granted a discounted rate due to the limited ISO services they require and because they are non-ISO controlled grid facilities within the ISO balancing authority area. Because this existing discounted GMC charge reflects cost causation principles, the ISO proposes to continue to provide a discounted GMC rate to transmission ownership rights by:

- Exempting 100% of transmission ownership rights MWh from the market services charge; and
- Applying a fixed $0.27 system operations charge rate to transmission ownership rights flow MWh, but applying that rate only to the minimum of a scheduling coordinator's transmission ownership rights supply MWh or transmission ownership rights demand MWh.

Application of the scheduling coordinator identification fee

The scheduling coordinator identification administrative fee is in the existing GMC rate design and is intended to limit the number of scheduling coordinator identifications to those needed for legitimate business purposes. The ISO proposes to keep the charge at the current $1,000 per month per scheduling coordinator identification and apply the charge to scheduling coordinators that have settlements activity in a trade month.

Elimination of station power fee

The ISO reviewed the station power fee, which is part of the existing GMC rate design, and concluded that it should not be a separate GMC charge. The amount is insignificant and the full costs will be included in the system operations charge.

Exclusion of metered sub system load following energy from market operations charge

The ISO determined that it is appropriate to exclude metered sub system load following instructed imbalance energy from the market services charge.

RATE IMPACT MITIGATION AND GRANDFATHERING

While the ISO believes that the GMC proposal is equitable and adheres to the stated guiding principles, the new rate design does result in significant bill impacts to certain generation supply customers. Such bill impacts are caused by the substantial differences in design of the current and proposed GMC rates. The current GMC primarily charges load and exports for the majority of the categories. In addition, the current GMC does not charge for through-put (i.e., energy flow MWhs), but assesses charges based on behavior, particularly real-time uninstructed imbalance energy or deviations for the market awards and schedules.

In contrast, under the new GMC rate structure, the billing determinant for system operations will be total energy flow MWhs, without regard to whether the flows were forward-scheduled, instructed, or uninstructed. As a result, under the current GMC, a supplier that puts the same volume through the ISO system as a load-serving entity pays 60% less even though the same ISO services are being used by both entities.

Mitigating rate impacts is an important rate design principle, and accordingly, the ISO, in the January 2011 modified straw proposal, originally proposed phasing in the system operations charge to suppliers over a three-year period. However, after discussing this approach with stakeholders, the ISO concluded that grandfathering certain base load units with contractual restrictions preventing the recovery of additional GMC charges by the supplier is a sufficient mitigation technique. This method will limit the cost impact of the mitigation to other market participants by reducing the number of MWhs that are excluded compared to the phase-in approach.

The proposed contract grandfathering was described in the February 15, 2011 draft final proposal. The proposal exempts generation units with verified long-term contracts from the system operations charge if the contracts meet certain specified criteria. The generation units will be exempt from the charge until the first opportunity to renegotiate the contract or until the contract expires. Generation owners must certify compliance with the contract grandfathering criteria. With the adoption of the grandfathering approach in the draft final proposal, the ISO eliminated the system operation charge phase-in proposal described in the January 13, 2011 modified straw proposal.

The impact of the grandfathering provision is minimal. Based on the contracts that meet the criteria listed above, there is an approximate $2 million dollar impact per year which decreases over the course of 10 years. This figure represents roughly 1% of the annual ISO revenue requirement.

REVENUE REQUIREMENT CAP EXTENSION

As outlined in the draft final proposal, the ISO will retain the revenue requirement cap as part of the new GMC rate design, and has proposed the following three-year cap:

- The revenue requirement cap for 2012 will remain at $197 million;
- The revenue requirement cap for 2013 will increase to $199 million;
- The revenue requirement cap for 2014 will remain at $199 million.

As long as the ISO budgeted revenue requirement does not exceed the cap and there are no proposed changes to the GMC rate design, the ISO will not be required to make a Section 205 filing with the Federal Energy Regulatory Commission for rates that will become effective prior to January 1, 2015.

POSITIONS OF THE PARTIES

There has been an extensive stakeholder process over the last year made up of the following meetings and conference calls in addition to the opportunity for comments discussed briefly above:

- April 2010 – kickoff meeting
- October 2010 – cost of service study
- November 2010 – billing determinants and straw proposal
- December 2010 – bill comparisons
- January 2011 – modifications to straw proposal with revised bill comparisons
- February 2011 – modification for grandfathering of generation proposal with revised bill comparisons
- February 2011 – draft final proposal

The evolution of the GMC proposal began with the structure detailed above with three main GMC charge categories and four administrative charges. The initial proposal had a significant impact on suppliers. The ISOs initial mitigation proposal was to phase in charging supply the system operations charge over three years. This proposal met resistance from both load and supply. The ISO then determined that the real issue to supply was certain base load contracts that had no ability to recover the additional GMC costs they would incur. The grandfathering proposal was developed to target these specific contracts. Supply is supportive of this approach while there is some opposition to grandfathering in general from certain load serving entities. The ISO believes that this proposal is the best available solution.

Congestion revenue rights holders have also expressed opposition to being charged for these services. The ISO reminds the Board that in the current GMC design, there are no charges for participating in congestion revenue rights other than the $1,000 per month per scheduling coordinator charge. The amount collected in that charge does not offset the $7.5 million it costs the ISO to run these markets and recommends supporting these charges based on cost causation.

A stakeholder matrix is attached.

MANAGEMENT RECOMMENDATION

Management recommends that the Board approve the new grid management charge rate design effective on January 1, 2012. The new design is a significant improvement over the current design and achieves the stated goals of cost causation, focusing on services, transparency, predictability, forecastability, flexibility, and simplicity.