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To: Scott Jercich, P.E.
Senior Market Design Engineer
California ISO

From: Alexander Cabrera
Federal Regulation & Contracts
Transmission & Distribution Business Unit
Southern California Edison
Tel: (626) 302-9629 Fax: (626) 302-1152
Alexander.Cabrera@sce.com

As promised during the August 26 CRR Stakeholder Conference Call, SCE includes below the alternative proposal that SCE has developed for allocating CRRs to Merchant Transmission. Feel free to distribute and post this proposal for CRR stakeholder review as needed.

SCE Proposal Summary

The CAISO's Draft CRR Proposal (dated 8/6/04) attempts to provide Merchant Transmission owners with CRRs associated with the incremental benefit provided by the Merchant Transmission project. While SCE does not disagree with this principle, we do not believe the Draft CRR Proposal provides an equitable or practical approach to implementing that principle. We believe that, if implemented, the proposal would unfairly disadvantage the vast majority of consumers that are dependent upon CRRs associated with transmission that is included in their transmission rates to provide hedges against transmission congestion charges. As an alternative, we recommend that Merchant Transmission owners receive CRRs for the full amount of capacity added to the system based on the physical addition to the transfer capability as determined by the CAISO or through the regional reliability council process of the Western Electricity Coordinating Council or its successor. This approach is based on the Section 3.2.7.3 of the current CAISO Tariff. In addition, the Merchant Transmission CRRs should be subject to the same reductions as non- Merchant Transmission CRRs should there be a rating decreases on the facilities associated with the Merchant Transmission upgrade. Additional details on our concerns and support for our recommended alternative are provided below.

ISO Response No. 1

It appears from your comments that SCE believes MT owners should be credited only with the amount of capacity added to the system based upon the physical addition that was made by the MT owner. For example, if an MT owner increases the capacity of line A-B by 100 MW due to an upgrade, than the MT owner should receive "credit" for the 100 MW of added capacity only between points A and B. You indicate this approach is consistent with the approach suggested in Section 3.2.7.3 of the ISO Tariff.

It is important to remember that many aspects of the current ISO Tariff, like Section 3.2.7.3, are based upon the current radial network model and three-zone approach to congestion management[1]. However, when the ISO implements the Market Redesign and Technology Upgrade (MRTU) project in early 2007, we will move away from the current radial model and utilize a full network model. The concept of a radial system (where we pretend that energy only flows along specific paths) will be replaced by an approach that recognizes that an energy injection at a single point (say point A in the example above) creates not only flow along line A-B but can also create flow through the network.

Imbedded in the current ISO proposal is the notion that a fair and balanced approach to giving MT owners "credit" for upgrading line A-B is to recognize that such an upgrade has the potential to "awaken" capacity in other parts of the network that, absent the upgrade, would not exist.

In addition, you indicate that the Merchant Transmission CRRs should be subject to the same reductions as non- Merchant Transmission CRRs should there be a rating decreases on the facilities associated with the Merchant Transmission upgrade. The ISO believes your comment has merit but wishes to point out that, during the term of an existing non-MT CRR, the CRR owner enjoys the full benefit (or possible liability in the event of a CRR obligation) during the term of the CRR, even when system reductions (i.e., short-term rating decreases) occur.

Concerns with CRR Duration Differences for Merchant Transmission and LSEs

The Draft CRR Merchant Transmission Proposal provides for Merchant Transmission to obtain lifetime CRRs. Under the current CRR allocation proposal, the maximum duration for CRRs for LSEs is one year. This non-comparable treatment creates two concerns.

First, the CAISO proposes to perform a one-shot calculation to determine the amount of CRRs the Merchant Transmission owner would receive for the operational life of the Merchant Transmission facility. This calculation, as described to date, is extremely complex and heavily dependent upon a simulation of latent (available but not allocated) CRRs (so-called "capacity CRRs"). These capacity CRRs are really future CRRs for LSEs.

ISO Response No. 2

You correctly state that the ISO proposal suggests a "one-shot calculation" to determine the quantity of CRRs for MT owners with terms lasting for the life of the MT upgrade. We don't follow your concern that this calculation is "complex." We will be happy to discuss this more with you in the future.

[1] This concept is exemplified in Section 9 of the ISO Tariff dealing with Firm Transmission Rights granted only between inter-zonal interfaces.

The concept of "capacity CRRs" is to establish a baseline for which to measure the additional capacity throughout the network created by an MT upgrade. The methodology does, in essence, reserve that capacity for others to use, including entities requesting CRRs in the future that utilize the capacity set aside by these capacity CRRs.

The use of a single snap shot analysis based on an extremely uncertain modeling problem, combined with the lifetime duration of the outcome, puts an unacceptable risk on the LSE.

Second, this one-shot calculation approach without periodic re-evaluation would result in LSEs bearing a disproportional share of a reduction in transfer capability should such reduction occur. This is more than just a hypothetical concern. For example, as a result of the investigation to the August 2003 eastern United States blackout, changes were made in criteria that led to a reduction in the rating of the path from Arizona to southern California. Under the Draft CRR Merchant Transmission Proposal, Merchant Transmission would not be required to share in such a reduction because the one-snap-shot determination of the amount of their CRRs would be locked in for life. Consequently, the LSEs would have to take a disproportionate share of the reduced capability because the amount of capacity that is used to determine their CRRs allocations is subject to revisions (annually, monthly).

ISO Response No. 3

The ISO sees merit in your concern and believes that the reduction in capacity caused by a long-term reduction in rating could pose a problem with revenue inadequacy.

Concerns with Unlimited Source/Sink Requests and Reliance on Complex Modeling

Section 4.3 of the Draft CRR Merchant Transmission Proposal states that there will be no limitations on the location of either the Sources or Sinks associated with Merchant Transmission CRR requests. This creates two key concerns, it provides a risk-free incentive for the Merchant Transmission owner to request an infinite number of option CRRs and it does not restrict the Merchant Transmission owner to requests that are only associated with the physical incremental transmission capacity resulting from the Merchant Transmission upgrade.

ISO Response No. 4

Section 4.3 states that "For MT upgrades not associated with Large Generator Interconnections, there will be no limitations on the location of either the Sources or the Sinks." [Underline emphasis added.]

We agree that the proposal does not restrict the MT owner to requests that are only associated with the physical incremental transmission capacity resulting from the Merchant Transmission upgrade. The reason we believe such a limitation is too restrictive is mentioned in ISO Response No. 1 above.

First, the proposal has no down side for a Merchant Transmission owner to request as many options CRRs (i.e. risk-free CRRs) as mathematically and/or physically possible. What results is a very difficult analysis problem for the CAISO that is only as good as the DC Full Network Model used in the CRR allocation and the application of "capacity CRRs". If the network model and the application of "capacity CRRs" are not accurate, which is highly unlikely with a snap-shot approach to modeling inherent in the DC model, then the unlimited requests made by Merchant Transmission combined with a flawed modeling approach will limit LSEs' future ability to obtain CRRs associated with the transmission capacity that they are paying for in rates. This occurs because the snap-shot modeling approach would inaccurately estimate the benefit associated with a Merchant transmission upgrade and allocate CRRs to the Merchant Transmission owner that are actually associated with existing transmission capacity.

ISO Response No. 5

As mentioned in ISO Response No. 2, we don't follow your concern as to the difficulty of the analysis in calculating Capacity CRRs. Also, we do not believe the proposed approach to modeling, including the use of capacity CRRs and a DC model is "flawed." With respect to use of the DC model, the ISO explained in the CRR educational classes why it is felt a DC model will work for purposes of the CRR allocation and auction.

Second, the limitless selection of risk-free Source/Sink pairs that the Merchant Transmission owner can request does not reflect the physical incremental transmission capacity associated with the Merchant Transmission upgrade. Rather, this limitless selection reflects the ability of the Merchant Transmission to request, without risk, CRRs that result from a one-shot analysis based on modeling assumptions.

ISO Response No. 6

Please see ISO Response No. 1

SCE Proposal

As an alternative to the Draft CRR Merchant Transmission Proposal, SCE recommends that Merchant Transmission CRRs be based on the same principle that guides the determination of Merchant Transmission FTRs in the current CAISO Tariff. This approach provides transmission rights (FTRs today, CRRs under MRTU) based on the incremental transmission capacity that results from the Merchant Transmission. The Merchant Transmission owners would be allocated CRRs for the incremental capacity added to the grid. These CRRs would be valid for the life of the transmission facility; however the quantity of CRRs would be subject to a reduction based on an annual review if the rating of the transmission capacity was reduced.

ISO Response No. 7

For reasons stated in ISO Response No. 1 above, the ISO does not support the approach of limiting MT owner CRRs only to the physical capacity in the element of the transmission system that was upgraded. This approach disregards that, under MRTU, we are moving away from a radial model and moving to a FNM. We do feel, however, that an annual review has merit.

As an example, suppose a Merchant Transmission project consisted of installing a facility that, after applicable CAISO and WECC review, resulted in an increase the line rating from A to B (and B to A) from 75 MW to 100 MW. In addition, the facility resulted in the rating from C to B (and B to C) increasing from 200 MW to 250 MW. The Merchant Transmission would be eligible to receive 25 MW of option CRRs from A to B, 25 MW of option CRRs from B to A, 50 MW of option CRRs from C to B, and 50 MW of option CRRs from B to C. The Merchant Transmission would not be eligible to receive CRRs from any other source/sink pairs. Finally, an annual review would occur to determine if the quantity of Merchant Transmission CRRs is subject to a reduction should there be a decrease in the rating of A to B or B to C, as determined by the CAISO and/or WECC, as applicable.

ISO Response No. 8

We don't fully understand your example above. We look forward to discussing this with you in the near future.

We believe this approach is preferable to the Draft CRR Merchant Transmission Proposal for the following reasons:

This approach results in more comparable treatment with LSE CRRs. The comparability comes from the fact that both entities (Merchant Transmission and LSEs) will be receiving CRRs associated with the transmission capacity based on the accepted transmission capacity rating process. The aspect of the current CRR proposal that allocates CRRs to LSEs on an annual/monthly basis while providing Merchant Transmission with lifetime CRRs is not as much of a concern since the methodology that determines the transmission capacity that results in CRR allocations are comparable over time.

This approach ensures the Merchant Transmission provider receives the CRRs associated with incremental transmission capacity added, eliminates the uncertainties associated with speculative CRR requests not associated with the physical capacity added by the Merchant Transmission, and avoids the complicated and uncertain modeling and optimization problem that creates risks for LSEs. While some may argue that the incremental physical capacity associated with an upgrade is also dependent upon modeling, the rating methodology process currently used is more rigorous and accurate than a CRR optimization problem that bets on the outcome that an unlimited number of infeasible Source/Sink requests can be

solved in a transparent and equitable manner. This approach is consistent with FERC policy and what FERC approved for the CAISO regarding merchant FTRs.

ISO Response No. 9

The ISO appreciates your comments and is very anxious to discuss your ideas more in future discussions.