MEMORANDUM

July 14, 2006

TO: David Withrow, California Independent System Operator

FR: Nancy Rader, California Wind Energy Association ("CalWEA")
Scott Hempling, Law Offices of Scott Hempling, Attorneys for CalWEA

RE: Comments on June 28, 2006, CAISO White Paper -- "Proposal for a Third Category or Alternative Treatment of New Transmission Facilities for Renewable Generators"

Introduction and Summary

CalWEA is extremely appreciative of the CAISO's consideration of and attention to the unique characteristics of renewable energy generators and associated resources. In particular, the CAISO's precedent-setting scheduling program for intermittent resources has been a linchpin in the development of wind generation in California; we support the CAISO's current efforts to improve that program. The CAISO's recent entry into state transmission planning, and its attention to accessing the state's major renewable resource areas in the most efficient way possible, is also of enormous importance to the development of the state's wind energy resources.

We also appreciate the fact that the CAISO has apparently concluded that the cost of network upgrades that provide access to renewable resource areas in the most economical way can be rolled into transmission rates through the normal approval process.[1] We agree with this conclusion, as explained in Section III of these comments.

Although we appreciate the CAISO's effort to further promote renewables by seeking to enable the cost of non-network transmission upgrades to be rolled into transmission rates, as proposed in the white paper, we believe such an effort – whether classified as a "third category" or not -- will fail at FERC because it is legally incorrect. Where transmission is non-network, the Federal Power Act forbids roll-in. A more productive effort would be for the CAISO, instead, to attempt to describe the facilities in a manner that places them persuasively in the "network" category. This might be done based on technical criteria, by using parallels to FERC's cost recovery practices with gas collection facilities, or some other argument.

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[1] CAISO's determination on this point was confirmed by you in response to our question at the July 7, 2006, CAISO workshop.

The CAISO should take the time necessary to determine the approach that is consistent with the statutes, thus avoiding the risk of FERC disapproval or FERC approval followed by judicial reversal. There is no reason to rush, as the California legislature has already provided the CPUC with tools to address the transmission financing barrier facing renewables -- i.e., the cost recovery mechanism in Public Utilities Code § 399.25.

Apart from any changes to FERC ratemaking policy, we believe that the best way for the CAISO to promote transmission access to renewable resource areas is to design network configurations wherever possible. Where network configurations are not possible, the CPUC must not hesitate to provide Participating Transmission Owners (PTOs) with cost recovery assurances under § 399.25 when the PTO agrees to finance non-network high-voltage upgrades that provide access to multiple renewable generators that are necessary to facilitate achievement of the state's RPS goals.[2]

We describe below the legal underpinnings that support these views. We also comment on the CAISO's proposed procedural process, and provide comments to some of the specific arguments made in the White Paper in support of a "third category."

I. The FPA precedent creates two categories and only two categories: network and non-network. No "third category" is allowed.

Network facilities benefit all transmission customers. Non-network facilities do not benefit all transmission customers. The costs of network facilities are rolled-in; the costs of non-network facilities are directly assigned to generators. This distinction stems from a foundational principle in the Federal Power Act (FPA): costs are assigned to customers only when benefits are received by customers. Either there are benefits or there are not.

Thus there are only two categories: facilities that benefit customers and facilities that do not. There is no third category.

Who are the customers? This is the crucial legal concept. In the context of transmission service, the customers are the transmission customers. The question regarding the facility is: does it benefit those customers in their capacity as customers? If network, yes; if non-network, no. The FPA recognizes no third category. That these individuals might enjoy renewable power, or might be California residents who benefit from the RPS statute, is 100% irrelevant under the FPA. The FPA addresses only their status as transmission customers.

[2] CalWEA (along with the IOUs and the CAISO) have also advocated that the CPUC provide advance cost recovery assurances for network upgrades, but the CPUC opted not to do so in its recent decision (D. 06-06-034, June 15, 2006).

Thus, the CAISO's white paper makes an error in conceptual reasoning when it states (e.g., at p. 11, emphasis added):

> "[The] approach being considered by the CAISO is consistent with the principles underlying rolled-in rate treatment, *i.e.*, the upgrades provide benefits to all participants in the CAISO markets <u>in the form of greater access to renewable generation and therefore a more diverse portfolio and economic means of meeting the State's RPS, currently 20% by 2010.</u> … In these circumstances, the CAISO suggests that it's appropriate that costs for transmission facilities that facilitate the efficient development of renewable energy resources to meet State and regional policies be initially spread to all transmission customers."

The white paper errs when it equates "efficient development of renewables" with "all transmission customers pay." That equation is incorrect. The alignment required by the FPA is not "efficient development of generation resources" and system-wide transmission charge; the alignment required by the FPA is *system benefit* and system charge. "System" means transmission *network* system, not the broader electricity system. If the upgrade is not a network upgrade, its origins in a statewide law are irrelevant. So the quoted passage is correct only if confined to network facilities; in which case their origin in the RPS statute is irrelevant because all network facilities go into the system-wide charge.

Conclusion on FERC precedent: The concept of a "third category" is legally defective because under the FPA there are only two categories: network and non-network. "Renewables" is not a valid FPA category. Were the construction of the upgrade certain to bring perpetual peace to the Middle East, it still could not receive roll-in treatment if it is not network. Renewable energy is no more relevant to the FPA than is Middle East peace. It is not a matter of FERC discretion.

II. The ISO's independent status is not relevant to whether a "third category" is allowed.

The ISO's independent status does not alter the foregoing analysis. The foundational FPA principle is that customers cannot pay for facilities that do not provide network benefits. It doesn't matter whether the monopoly charging for the facilities is for-profit or nonprofit, or independent of market participants or not.

Thus the suggestion in the Brownell dissent on the SCE petition, that if the ISO made the proposal instead of SCE the result might be different, is in error. The "costs must follow benefits" principle is unrelated to the "independence principle." Independence is about ensuring that the operator of transmission does not discriminate; independence protects against discrimination. The costs-benefits principle relates to the reasonableness of rates: are the customers receiving the benefits they're paying for?

III. The CAISO tariff allows cost recovery for facilities that are economical; no tariff change is required for economical network facilities that provide access to renewable resources.

This section explains that FPA precedent and the CAISO tariff have all the necessary ingredients for achieving cost recovery of transmission needed to access renewable resources, where that transmission is network transmission. Not only is a FERC petition not needed in this area; it would rest on an incorrect legal premise. Either it would be rejected or deemed irrelevant. For this reason, we are pleased that the white paper does not propose a “third category” when it comes to network facilities that provide access to renewable resources.

The concept of "economical" necessarily means "economical in light of constraints." The California utilities are transmission customers and transmission owners. They have legal obligations. If the California Legislature declared that "all utilities must have 18% reserve capacity," the CAISO would be obligated to plan its transmission to ensure access to the necessary reserve capacity on the most economical basis. The ISO would not have to file a petition for declaratory order seeking permission to roll in the costs; the responsibility to incur the costs would arise automatically from the CAISO's existing tariff obligation.

The RPS statute is no different. Under the RPS statute, the California utilities must buy a certain amount of renewable energy. The utilities have decided that the most economical way to buy this energy is to pay for transmission to access certain renewables-rich areas. The CAISO, under its tariff, is obligated to provide that access on the most economical basis. Just as the CAISO need not ask FERC for special permission to build the transmission necessary to satisfy the hypothetical 18% reserve margin, so the CAISO need not ask FERC for special permission to build the transmission necessary to access the mandatory renewable amount.

As the memo from Frank Wolak to the ISO Board of June 7, 2006 says well (at p. 4), summarizing the Market Surveillance Committee’s discussion:

> "[I]f the state's RPS was a hard constraint similar to a reliability constraint, then it may be unnecessary to create a third category of transmission facilities. The constraint of meeting the RPS could be included in the transmission planning and evaluation process so that the most economical upgrades needed to meet this standard would be constructed."

In the case of a network facility that provides access to renewable resources economically, not only would a third category be "unnecessary," it would be unlawful.

IV. A more promising course is to describe the facilities in a manner that places them persuasively in the "network" category.

An approach that is more likely to be fruitful, or one that at least would not hit a brick wall at FERC, would be to describe the facilities in a manner that places them within the definition of network facilities. Facilities that access multiple generators, whose power will strengthen the entire grid, could be viewed as network – although this approach is not free from legal doubt (as compared with the idea of a "third category," for which there is no legal doubt: the FPA forbids it). The CAISO could either describe the characteristics that such facilities must have to be deemed network, or classify such facilities as network using precedents established in the gas pipeline area. In either case, two things must be clear in the argument presented:

(a) the request must be to classify the facilities in question as network facilities – not to seek roll-in for facilities designated as non-network; and

(b) the request must not be specific to certain technologies or resources, but be technology/resource-neutral.

The white paper hinted toward the first approach when it said, "The CAISO proposes to clarify the facilities that would qualify for alternative treatment would be transmission lines with certain characteristics, such as Interconnection to a sufficiently large supply of renewable resources, <u>or possessing a degree of integration that could benefit the regional grid</u>" (p. 9, emphasis added). If the CAISO believes that "trunk line" types of facilities can, in certain circumstances, provide benefits to the network sufficient to justify roll-in, it should explore that approach.

Alternatively, the CAISO could seek to clarify the definition of network facilities to include those that provide economic supply benefits, particularly if there are similar precedents in the FERC's regulation of gas pipelines. If the argument can be made that a high-voltage trunk line provides the same type of economic benefits to users of gas pipelines that are recognized for gas production supply pipelines, the argument could be made to extend that rationale to the electric side. The suggestion made at the end of the white paper (p. 12) fits under this approach:

> "[Costs rolled into the TAC could] be paid by all CAISO customers except those customers who are not mandated by current state law to meet RPS requirements. This approach would limit the cost recovery mechanism to CPUC jurisdictional entities and presumes that entities not legally obligated by state law to meet RPS standards would not benefit by having greater access to renewable resource development regions."

We note, however, that CPUC jurisdictional entities are not the only ones that are subject to the California RPS – municipal utilities are as well, although under their own self-governed approach.

Under either approach, there must be alignment between system benefit and system charge; and, the benefit must be irrespective of resource or technology. If the alignment is present, calling for a "third category" is neither necessary nor will it lead to success, because it suggests that the foundational FPA principle -- that costs must be assigned to customers only when benefits are received by customers – is not being met. There is no need for an unlawful "third" way when the facilities satisfy the right way.

V. Responses to other arguments made in the white paper.

We address here two other arguments that are made in the white paper, but which do not remedy the flaws in the proposed "third category" approach.

A. Costs to transmission customers would be "temporary."

The white paper justifies the proposed "third category" in part by arguing (p. 11) that the inclusion of costs to be rolled-in to transmission rates "is temporary because, as new generation is developed that interconnects to the facility, costs will be shifted from transmission customers to generators."

There are two problems with this argument. First, it ignores the possibility that generators will never fully subscribe the line – thus the risk that transmission customers will permanently pay at least some of the costs of the non-network line. It is this very risk that is the impetus for the proposed policy in the first place: trunk lines are not being built because PTOs do not want to accept the risk of building gen-ties for generators that may not materialize. (It is due to the same risk that FERC allows the transmission owner to require generators to finance network upgrades initially, where an upgrade is triggered by the generator.)

The problem is not solved by the white paper's proposed eligibility criteria for "third category" treatment, which includes Load Serving Entities entering into signed forward contracts with associated renewable resources in the area (p. 9). Signed contracts do not guarantee project development. Moreover, shifting the risk of cost recovery away from CPUC jurisdictional ratepayers (under § 399.25) to transmission customers moves the risk out of the jurisdiction of the entity that has the most control over that risk – i.e., the CPUC, which can influence whether or not renewable resources are developed, whereas the CAISO and the FERC cannot.

Second, the proposal would assign costs to transmission customers until the generators come on line. Even "temporary" assumption of costs by transmission customers who do not benefit violates the basic test for roll-in: that customers must benefit from the costs that they bear. As the Court of Appeals once said, "not even a little unlawfulness is permitted."

B. Cost recovery under P.U. Code § 399.25 is not a "last resort."

The white paper states (p. 5):

> "The CPUC's approval for cost recovery of certain facilities under Section 399.25 is viewed by a number of stakeholders as a 'last resort' that, while helpful, establishes an inconsistent framework among federal and state regulators that could delay development of renewable generation. In addition, the CPUC cost recovery mechanism is limited to CPUC jurisdictional entities and may not equitably allocate the costs of these facilities to all that could potentially benefit by having greater access to renewable resource development regions."

We disagree with all three assertions made or referred to in this paragraph.

First, characterizations of § 399.25(b)(4) as a "last resort" lack specific support in the statutory language, and in fact conflict with the plain language by narrowing its effect. It is unfortunate that the CPUC has characterized it this way. Section 399.25 commands the Commission to "take all feasible actions …to ensure retail cost recovery, with respect to any facility which is necessary to facilitate achievement of RPS goals." The obligation to "take all feasible actions" includes, but is not limited to, "last resort" situations or situations where a "process … impedes … development."

Second, No rationale is provided regarding the "inconsistent framework", and we see none. P.U. Code § 399.25 was designed specifically to address the gap between state and federal policy that impedes the financing of transmission lines providing access to renewable resource areas.

Third, we disagree with the statement that costs under § 399.25 will not be borne by non-CPUC-jurisdictional entities. As proposed by SCE in its CPCN application for Antelope Segments 2 and 3, it will charge each interconnecting renewable generator for a share of the costs of the upgrade as it comes on line. Those generators who have contracts with non-jurisdictional utilities will necessarily pass those costs on to those utilities.

We thank the CAISO for soliciting parties' views on this issue and for considering these comments.