MWD
THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

Date: March 1, 2004

To: CAISO CRR Development Staff

From: The Metropolitan Water District of Southern California

Subject: Initial Comments on CRR Study 2

Thank you for the opportunity to submit initial comments on the February 5, 2004 draft CRR Study 2. The CRR classes offered by the CAISO added significantly to our ability to understand the CAISO's CRR proposal and to submit comments on the draft CRR Study 2.

CRR Option/Obligation

Metropolitan's first and most important comment is not in direct response to the Study as it is to the CAISO's decision to allocate CRR obligations, rather than CRR options. Metropolitan is concerned that CRR obligations as proposed by the CAISO will provide an insufficient hedge from congestion costs for Load Serving Entities. This is due to several factors: (1) the CAISO proposes that CRRs may only be used in the day-ahead market, leaving LSEs exposed to congestion costs arising from schedule changes due to circumstances outside of their control in the hour-ahead market and in real-time; and (2) with CRR obligations, LSEs will be responsible for congestion costs if the LMP is greater at the source than at the sink, hence they will reduce their requested allocation of CRRs to minimize risk. In general, the CAISO's MD02 proposal will expose LSEs to significantly more risk of congestion cost, and provide inferior tools for controlling or hedging that cost, than today.

While the CAISO has explained that it modified its CRR proposal to feature CRR obligations rather than options due to concerns over CRR revenue adequacy, a CRR revenue shortfall should not occur, whether the CRRs are issued as options or obligations. First, in addition to the recovery of congestion costs in the day-ahead market, the CAISO will recoup congestion costs from the hour-ahead market and from real-time, with no distribution of congestion revenues in either market. Instead, such revenues will be available for distribution to CRR holders from the CRR balancing account. Second, the CAISO also proposes that its over-collection of marginal losses, estimated by at least one market participant as potentially amounting to $300 million per year, be tracked in its CRR balancing account. Thus, it appears virtually impossible for there to exist a shortfall in funds available from the CRR balancing account for distribution to CRR holders.

Finally, the CAISO faces vigorous opposition, a certainty of protracted litigation, and long odds for success should it proceed with its proposal to allocate CRR Obligations to

Existing Transmission Contract rightsholders. Instead of solely offering CRR obligations to holders of Converted Rights as proposed in section 2.7.2 of Study 2, the CAISO should extend similar treatment to ETC rightsholders, at a minimum, and to all LSEs if possible.[1] Accordingly, Metropolitan recommends that the CAISO expand CRR Study 2 to determine the difference in the number of CRRs that may be available if they are options rather than obligations. All LSEs should benefit from distribution of CRR options as opposed to obligations since the financial risk associated with CRR obligations won't exist, LSEs will be able to request additional CRRs to improve their ability to hedge against congestion costs. The CAISO won't have sufficient information regarding the feasibility of a distribution of CRR options unless CRR Study 2 is expanded to address this concern.

In addition, Metropolitan strongly objects to the CAISO's proposal to have the Participating TO decide on the number of CRRs to request for ETCs. It is the ETC rightsholder that holds the legal entitlement to the firm capacity associated with such rights for the term of the contract, and it is therefore the only entity that should be contacted for CRR request/allocation.[2]

CRR Modeling Assumptions

The CAISO proposes to determine the amount of CRRs that can be allocated using a DC network model, based upon the amount of CRRs requested by source and sink, including the use of trading hubs and load aggregation zones. Metropolitan agrees this is an appropriate starting point for a conservative determination of the amount of CRRs available for allocation. However, Metropolitan is concerned that it will produce misleading results in some instances, to the extent that counterflow in the opposite direction of the sink from source historically exists. In such cases, it is unlikely that CRRs would be requested in the counterflow direction because the CRR holder would face a net congestion liability, rather than receive congestion revenue. Yet, under typical CAISO operation, the counterflow will exist, it just won't appear in the proposed DC network model. In order to obtain a more accurate assessment of the number of CRRs available for distribution, Metropolitan recommends that the CAISO conduct a sensitivity run to model historic flow over those interfaces that are known for consistently experiencing such flow where CRRs are not requested, due to the probability that such counterflow would render a CRR a liability.

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1 Metropolitan notes the CAISO's offer made on February 23 to model ETC CRRs as options in a "sensitivity run," but believes stakeholders will have the ability to provide more informed comments on the MD02 design if Study 2 was expanded to model the allocation of CRRs options.

2 Metropolitan acknowledges the CAISO's desire to avoid involvement in ETC interpretation. If there is some question that the ETC rightsholder is requesting more CRRs than the ETC entitles them to, the CAISO could refer the CRR request to the PTO for review and comment.

Metropolitan supports the CAISO's proposal to conduct Study 2 based upon a 2005 model, because it will reflect the additional capacity that can reasonably be expected to exist due to termination of certain contracts and completion of construction of Path 15. However, Metropolitan is concerned about the CAISO's apparent intention to place sole reliance on a prospective analysis for assessment of the CAISO's CRR proposal. We note that, in the CRR Preliminary Study Report, Dr. Oren appeared to recommend that the CAISO conduct a retrospective study as a "check point, based on actual assets and utilization that can determine what would have been the financial implications of the prospective allocation methodology." Without a retrospective analysis, it's difficult to understand how the CAISO can achieve the second main objective of Study 2, to "Estimate the quantities of CRRs that each LSE serving CAISO control area load will need to maximize the hedge against congestion costs over the course of a year." Therefore, Metropolitan recommends that the CAISO undertake retrospective analysis of CRR availability and adequacy in addition to a prospective analysis.

Metropolitan supports the CAISO's proposal to exclude the sinks associated with non-conforming loads, such as pump-load, in calculating load distribution factors. Metropolitan encourages the CAISO to further develop as quickly as possible the details of the unique treatment that will be necessary for non-conforming loads in areas such as CRR allocation. Metropolitan also supports the CAISO's effort to include Network Service Rights in Study 2, if feasible. With the additional flexibility afforded through NSRs, an LSE's ability to hedge against congestion costs should be enhanced. Finally, Metropolitan agrees with the CAISO's proposed treatment of non-ISO grid transmission.

Metropolitan does not believe it has sufficient information upon which to submit an informed comment on the CAISO's proposal to utilize a simultaneous feasibility test for allocation of CRRs using the proposed priorities identified in section 2.9 of Study 2. Metropolitan observes that the assigned priority must be sufficiently large such that it ensures that CRRs associated with ETCs are always issued, in order to provide adequate protection for the property rights associated with the ETCs.