

opportunity for written stakeholder comments concerning the issues posed in each white paper, and two face-to-face meetings with remote participation available via telephone conference. The CAISO made every effort to solicit stakeholder input on all of the issues identified in the November 17 Order. Written comments were submitted by sixteen stakeholders, and over 80 interested parties participated in the meetings in person or by phone. Based on the input received from these parties, as well as its own evaluation of the issues, the CAISO has concluded that recovery of the costs of the pumped storage facility portion of the TNHC combined proposed project through the CAISO's transmission Access Charge (TAC) should not be allowed, nor should the CAISO assume Operational Control of the pumped storage facility (other than performing the normal role that the CAISO plays with respect to the operation of Generating Units).² As will be discussed in detail below, there are strong policy reasons supporting the CAISO's conclusion, and, based on the CAISO's analysis of the pumped storage facility, there is nothing unique about the benefits of the facility that cannot be obtained from the competitive market.

II. BACKGROUND

As noted above, on December 1, 2005 (as amended on December 22, 2005) TNHC filed its "Rate Request" with the Commission in this proceeding. In its Rate Request, TNHC has proposed to pursue completing the development,

² Capitalized terms, unless otherwise defined herein, are used in accordance with the definitions set forth in the Master Definition Supplement, Appendix A to the ISO Tariff, or Appendix A to the MRTU Tariff. For the purposes of this Response, the term "ISO Tariff" refers to the CAISO's tariff currently in effect, and the term "MRTU Tariff" will refer to the tariff filed and conditionally accepted in Docket No. ER06-615-000, and further revised through compliance filings made on November 20, 2006 and December 20, 2006 in FERC Docket No. ER06-615 and on January 29, 2007 in compliance with the Commission's long-term financial rights Final Rule in Docket No. ER07-475.

financing, construction and operation of a project consisting of a proposed Talega-Escondido/Valley-Serrano 500 kV Interconnect (“TE/VS Interconnection” or “transmission facility”) and the Lake Elsinore Advance Pump Storage (LEAPS or “pumped storage facility”) (collectively “the combined Project”). The TE/VS Interconnection is the “wires” (transmission) piece of the Project and LEAPS is the “non-wires” piece. In its application TNHC requested that the combined Project be treated as “Commission jurisdictional transmission assets” to be included in the CAISO’s transmission Access Charge (TAC) and explained that Operational Control of both the wires portion and non-wires (pumped storage facility) portion of the combined Project would be turned over to the CAISO beginning in 2007 when the combined Project was put into service. TNHC is seeking the following rate treatment for the combined Project: (1) an initial post-tax rate of return on equity of 14.5 percent for LEAPS and 13.5 percent for the TE/VS Interconnection; (2) an assumed 50/50 capital structure for at least the first three years of service; (3) a three-year rate moratorium; and (4) full recovery of prudently incurred construction work in progress (CWIP). Additionally, in its December 18, 2006 Compliance Filing, TNHC requested that the Commission allow 100% of all prudently incurred development costs, should the combined Project be canceled for reasons beyond TNHC’s control.³

Various parties, including the CAISO, filed motions to intervene and comments regarding the amended application. On February 17, 2006 the Commission issued a data request to TNHC seeking additional information necessary to process the filing. A response to this data request was submitted

³ TNHC December 18, 2006 Compliance Filing, Transmittal Letter, 11.

by TNHC on March 20, 2006 and supplemented on March 29 and April 7, 2006. Then, on September 11, 2006, TNHC submitted a supplemental response providing options for the Commission to consider regarding, *inter alia*, how the CAISO could assume functional control of the pumped storage facility without becoming a *de facto* Market Participant in its own markets (an issue of substantial concern to the CAISO, among other issues raised by the application). In that supplemental response, TNHC set forth three scenarios under which the CAISO could allegedly incorporate LEAPS into its system without causing market interference: 1) the CAISO assumes Operational Control and bids and schedules into the market but creates a firewall between the LEAPS operators and transmission personnel; 2) the CAISO auctions its right to operate LEAPS to Market Participants; and 3) the CAISO contracts with a third party to operate the pumped storage facility.

In response to the September 11, 2006 supplemental filing, the CAISO raised several issues of concern that must be resolved before its Board of Governors can make a determination regarding the appropriate treatment of the combined Project pursuant to the ISO Tariff, particularly with respect to the approaches suggested by TNHC for assuming Operational Control of the non-wires piece of the combined Project. The CAISO also reiterated its fundamental concerns as to whether the costs of the LEAPS pumped storage facility should be included in the CAISO's TAC rates or whether the pumped storage facility should be treated like similar transmission resources in California that earn revenues through participation in the market, not through recovery in

transmission rates. The CAISO requested a technical conference to further explore these factual and policy issues before the Commission makes a determination as to proper rate treatment for the combined Project.

In the November 17 Order, the Commission succinctly summarized the three issues on which TNHC is seeking a determination: 1) whether LEAPS is an “advanced technology” as described in the Energy Policy Act of 2005 (EPAAct 2005); 2) whether the rate incentives being sought, including the treatment of LEAPS as transmission for rate recovery purposes, is just and reasonable; and 3) whether the CAISO should manage (or facilitate the management) of LEAPS.⁴ However, the Commission resolved only issue number 1), finding that the pumped storage facility does meet the statutory definition of an “advanced transmission technology” that should be “encouraged” as set forth in §1223 of EPAAct 2005. With respect to issues 2) and 3), the Commission found that it did not have sufficient information to render a decision, and both TNHC and the CAISO were ordered to provide additional data in response to the November 17 Order. Specifically, the Commission found that TNHC had not adequately supported its requested return on equity (ROE) by showing that the rates it will produce will be in the zone of reasonableness required by Order No. 679.⁵ TNHC was ordered to submit further testimony within 30 days, and TNHC has complied with that requirement.

As to the CAISO’s role in the determination process, the Commission first noted that without information as to how the facility would be managed and

⁴ November 17 Order, ¶26.

⁵ *Id.*, ¶32.

whether and to what extent the facility will reduce congestion and increase reliability, the Commission cannot decide whether the requested rate incentives are appropriate.⁶ While sympathizing with the “predicament” in which the CAISO has been placed by the TNHC application, the Commission nonetheless found that a technical conference was not necessary and that the CAISO “has the expertise to determine how to best integrate the LEAPS project into the grid and has processes in place that allow it to meet with all affected stakeholders to determine what role the CAISO should have with regard to this project.”⁷ Thus, the CAISO was tasked with engaging in a stakeholder process and reporting to the Commission the outcome of its stakeholder discussions with regard to the following specific issues:

- 1) Operation and management options and recommendations;
- 2) Cost recovery options in light of the CAISO’s determination of the extent to which LEAPS reduces congestion and enhances reliability;
- 3) Whether the CAISO can effectively operate the Project in the context of being an independent system operator;
- 4) Whether it is appropriate to include a cost-based, fixed revenue requirement in the TAC when the benefits associated with that revenue requirement will be determined by the daily operation of the market; and

⁶ *Id.*, ¶28.

⁷ *Id.*, ¶30.

- 5) Whether the CAISO recommends inclusion of the LEAPS costs in its TAC and, if so, why?

The CAISO was also asked to provide information as to all correspondence or discussions that the CAISO has had with the IRS regarding whether the operational control options proposed by TNHC would affect the CAISO's tax-exempt status, including whether the CAISO intends to seek a letter ruling from the IRS.⁸

The CAISO undertook a significant effort to comply with the Commission's directives, both by facilitating a stakeholder process, and by independently evaluating the pumped storage facility. The results of the CAISO's analysis are set forth below.

III. THE STAKEHOLDER PROCESS

A. The First White Paper and Comments

On January 11, 2007, the CAISO issued a market notice which advised interested parties of the timeframe for issuance of the first white paper (White Paper 1) and the first stakeholder meeting. White Paper 1 was posted on January 19, 2007, with a stakeholder meeting on February 6, 2007 and written comments due on February 14, 2007.

White Paper 1 (attached hereto as Exhibit A) described the November 17 Order and explained that the purpose of the stakeholder process was to "explore the issues, options and solutions available to TNHC and to the CAISO regarding the LEAPS portion of the combined project." White Paper 1 was then organized

⁸ *Id.*, ¶31

according to the issues identified in the November 17 Order. With respect to operational issues (Items 1-3), White Paper 1 listed six potential options for the control and operation of the pumped storage facility portion of the combined Project, the first four of which were proposed by TNHC:

- Option 1- The CAISO would schedule and bid the pumped storage facility into the CAISO markets, with a firewall separating the operating personnel;
- Option 2- The CAISO would auction the right to schedule and bid the pumped storage facility into the CAISO markets for a specific period of time;
- Option 3- The CAISO contracts with a third party to schedule and bid the pumped storage facility into the CAISO markets under the terms and condition set by the CAISO, and the plant revenues would be recovered through the TAC net of revenues associated with the plant;
- Option 4- The pumped storage facility would be incorporated into the CAISO grid in the same manner that any other transmission facility of any other Participating Transmission Owner (PTO);
- Option 5- This is a “hybrid” TAC and market cost recovery option wherein TNHC would schedule and bid the pumped storage facility into the market and receive a portion of its fixed revenue requirement from the TAC with the remainder coming from the CAISO markets, similar to a Condition 1 RMR Unit; and

- Option 6- In the event the project is not completed, there would be a sharing of the abandoned plant costs between TNHC and the TAC.

To address Issue 4 (the appropriateness of including a cost-based, fixed revenue requirement in the TAC where the benefits associated with that revenue requirement will be determined by the daily operation of the market), White Paper 1 posed several questions regarding, *inter alia*, the revenues generated from a pumped storage hydro facility included in the TAC, the treatment of incremental Congestion Revenue Rights (CRRs) and Resource Adequacy Capacity issues. In the final section of White Paper 1, the CAISO set forth other discussion questions, including the need for tariff or contract changes should the pumped storage facility be included in TAC, how maintenance issues for the pumped storage facility should be handled, and whether the “wires” portion of the combined Project should proceed on a separate, expedited track.

Eighty-three stakeholders and interested parties participated in person or by phone at the first stakeholder meeting, and thirteen parties submitted comments in response to White Paper 1.⁹ Of these, only one party (Coral Power LLC) supported TNHC’s proposal that the costs of the combined Project should be included in the TAC. Every other party flatly rejected the proposition that the costs of the pumped storage facility should be recovered through the TAC and

⁹ The parties submitting comments in response to White Paper 1 were: Coral Power, LLC, California Department of Water Resources (CDWR), Calpine, California Public Utilities Commission (CPUC), Gene Frick, Modesto Irrigation District (MID), Metropolitan Water District of Southern California (MWD), TNHC, Pacific Gas and Electric Company (PG&E), Douglas Pinnow, Southern California Edison Company (SCE), San Diego Gas & Electric Company (SDG&E) and Williams Power Company. The comments are posted on the CAISO website at <http://www.caiso.com/1b6b/1b6beb4e41ee0.html>

rejected the notion that the CAISO should have any involvement in operating a generating facility that would compromise its independence in the market (Frick, CPUC, Calpine, MID, MWD, PG&E, SDG&E, Williams, SCE and CDWR).¹⁰

Several parties also noted that additional study of the combined project, as well as each component of the project individually, should be conducted before any recommendation or decision is made about TAC recovery (or any cost recovery mechanism) (PG&E, SDG&E, SCE, MWD). One party, CDWR, suggested that other forms of encouragement for the pumped storage facility might be appropriate if made available equally to all pumped storage hydro facilities. All parties (except TNHC) agreed that, under any circumstances, any operating options that would require the CAISO to control a resource for anything beyond direct reliability needs should be rejected (see, e.g. SCE comments, 3).

B. The Second White Paper and Comments

After considering the White Paper 1 stakeholder comments, the CAISO published the second white paper (White Paper 2) on March 9, 2007 (Exhibit B). In White Paper 2, the CAISO first set out the two basic sources of revenue for TNHC to recover the costs of the pumped storage facility portion of the combined Project: market cost recovery and cost based recovery through the TAC. While TNHC proposed TAC recovery, the normal mode of cost recovery for a pumped storage unit that provides generation services in an independent system operator/regional transmission organization (ISO/RTO) market regime is through

¹⁰ Williams and SCE strongly objected to including the costs of the pumped storage facility in TAC but indicated that, as a fallback position, if the Commission were to order TAC recovery for the unit contrary to their wishes, Option 2 would be the most palatable of the three options identified by TNHC.

participation in the market. The two other suggested forms of cost recovery identified in White Paper 1—partial cost recovery through the TAC with the remainder coming from the market, similar to an RMR Unit, and recovery of abandoned plant costs through TAC—were also noted in White Paper 2 (page 7).

As discussed above, White Paper 2 reflected the stakeholders' almost unanimous conclusion that TAC recovery for the pumped storage facility would be inappropriate. White Paper 2 pointed out that there was little stakeholder support for the abandoned plant proposal, or other hybrid recovery methodologies (Options 5 and 6). As indicated above, two stakeholders identified Option 2 as a possible “fallback” approach only in the event the Commission was to reject their primary position that the costs of the pumped storage facility should be recovered in the market, not in TAC. Although the stakeholders made it clear that cost recovery through the TAC should not be supported--and the CAISO noted its concurrence with this position in White Paper 2 at page 8--the CAISO sought further details about the auction scenario (Option 2) given that a couple of stakeholders had identified it as a “fallback” position.¹¹ (White Paper 2, 10-13).

Another stakeholder meeting was held on March 20, and was attended by fifty-six stakeholders and interested parties, in person or on a conference call. At the meeting, the CAISO not only solicited stakeholder input on the points

¹¹ As Williams so aptly put it: “Williams believes this option is the best option if the costs of the generation component of LEAPS are included in the TAC. It allows the market to competitively value the services provided by this facility. This option, while the best of a bad lot, does nothing to address the fundamental question of why generation costs would be underwritten through the TAC in the first place”. (Williams Comments, 1).

addressed in White Paper 2, but also described the various project studies that could be undertaken by the CAISO depending on the outcome of the stakeholder process and the CAISO's recommendation to this Commission.¹² CAISO staff explained that the CAISO's tariffed Interconnection Study procedures set forth a Large Generator Interconnection Procedure (LGIP) by which the proponents of Large Generating Facilities (such as the pumped storage facility) seek approval for the interconnection of their projects to the CAISO Controlled Grid. For the "wires" portion of the project, the CAISO typically conducts an evaluation of the reliability impacts/benefits, and possibly the economic benefits of the project, once the transmission plan of service is presented for study.

The CAISO staff also outlined the study processes that would be followed under the various cost recovery scenarios described in White Paper 2 (market-based cost recovery for the generating project, TAC recovery for the combined Project, and "hybrid" market and TAC recovery). Market based cost recovery for the pumped storage facility would dictate that the LGIP process be followed, as has currently been done for the pumped storage facility. In the event that the Commission were to determine that TAC recovery for the combined Project should be considered, the CAISO staff recommended that the costs of the generating plant still not be included in TAC unless further study revealed that the services provided by the plant could not be obtained from other sources, that its benefits far exceeded its costs; that it would not be developed but for cost recovery in TAC, and that it would not compromise the CAISO's independence or

¹² It should also be noted that TNHC was provided an opportunity to make presentations at both stakeholder meetings.

tax status. Finally, given the lack of any stakeholder support for the “hybrid” cost recovery options, the CAISO staff was unable to propose a study process for these scenarios. Stakeholders and interested parties were asked to provide written comments by March 28.

Twelve stakeholders and interested parties submitted comments in response to White Paper 2.¹³ All of the stakeholders in this round of comments (except TNHC) agreed with the CAISO that market recovery of the costs of the pumped storage facility, pursuant to the LGIP process, is the only appropriate cost recovery scenario. Additionally, most stakeholders expressed concern with the CAISO even leaving the door open for TAC recovery through the Option 2 auction scenario, should further study of the pumped storage facility show a “compelling benefit” that could not be obtained through other sources and would not be developed without TAC recovery.¹⁴

With the benefit of the stakeholder comments, the CAISO independently reviewed all of the information available regarding the combined Project and made its policy recommendations to the Board of Governors on April 18, 2007.¹⁵

¹³ Comments were submitted by Jacqueline Ayer, Constellation Energy Commodities Group, Inc., Constellation New Energy, Inc. and Constellation Energy Group (Constellation), Santa Clara d/b/a Silicon Valley Power (SVP) and M-S-R Public Power Agency, Doug Pinnow, TNHC, Williams, SCE, SDG&E, CPUC, Mirant, PG&E and CDWR. These comments are also publicly available at <http://www.aiso.com/1b6b/1b6beb4e41ee0.html>

¹⁴ Mirant pointed out that “... the CAISO should recognize that if an evaluation of the merits of the project leads CAISO to conclude that the pumped storage part of the project brings certain benefits *that are not reflected or recoverable in the market*, then the irrefutable conclusion must be that there is something seriously wrong with the market design and the price signals coming from the market place”. (Mirant Comments, 2).

¹⁵ The CAISO Management’s Memorandum to the Board of Governors can be found on the website at <http://www.aiso.com/1bbf/1bbfb4f4ad62.pdf>

IV. THE CAISO'S EVALUATION

A. EAct 2005 Does Not Dictate Or Compel A Particular Cost Recovery Mechanism For "Advanced Transmission Technology".

Any evaluation of the TNHC application for TAC recovery of the costs of the combined project must be based on the fundamental legal premise that EAct 2005, Section 1223, *does not mandate* a particular means by which "advanced transmission technologies" should be "encouraged." On the contrary, it is only TNHC that has made the leap of faith that once the LEAPS pumped storage hydro technology was dubbed an "advanced transmission technology" by the Commission in the November 17 Order, the proposed plant automatically *became* a transmission facility that the CAISO must consider to be eligible for TAC cost recovery even though the services that it provides in the market are services that are generally provided by generating facilities not transmission facilities. Notably, in its December 18, 2006 Transmittal Letter accompanying the discounted cash flow analysis and affidavit of J. Stephen Gaske, TNHC stated "(t)he Commission has found that the LEAPS project is an 'advanced transmission technology.' Accordingly, the facility should be treated in the manner of any transmission asset, including CAISO's assumption of functional operational control and inclusion in TAC rates."¹⁶

Later in the Transmittal Letter, TNHC expanded on its legal analysis of EAct 2005:

¹⁶ TNHC Transmittal Letter, 2

TNHC understands that the CAISO stakeholders do not agree with treatment of the LEAPS project as a transmission facility in the CAISO and may object to the TNHC's proposal for operational control by CAISO and direct dispatch of the facility. The Congress has already resolved this disagreement in EPAct 2005. LEAPS is a transmission facility.¹⁷

TNHC's advocacy of TAC treatment for the pumped storage facility is understandable, but that should not cloud the real matter at issue here -- whether a facility that has the attributes of a generator and a load should be treated as a transmission facility for purposes of cost recovery from transmission customers in transmission rates. As discussed herein, the services that the LEAPS pumped storage facility will provide are services that are typically provided by generating facilities, not by transmission facilities. The primary purpose of the pumped storage facility is **not** to move Energy in bulk from generation to load, which is the purpose of a transmission facility. The primary purpose of the pumped storage facility is to convert stored water to electricity and to provide Ancillary Services, services that are typically provided by Generating Units. In any event, the fact of the matter is that LEAPS is a case of first impression, and the Commission's decision should turn on important policy considerations and market implications because there are no clear legal mandates, as TNHC would have us believe.

Indeed, the broad reach of Section 1223 invites the Commission to very carefully weigh the appropriate means of "encouraging" each type of "advanced

¹⁷ *Id.*, 9-10

transmission technology” identified in the statute. That section lists 18 types of technology that could be eligible for encouragement if considered to be “advanced transmission technology,” ranging from items that clearly are transmission, such as superconducting cables and underground cables (Items 1 and 2) to items that clearly *are not* transmission, such as controllable load (Item 12), distributed generation (Item 13) and energy storage devices (pumped storage hydro, *i.e.*, item 11) that provide Energy and Ancillary Services for sale in the market. Section 1223 simply cannot serve as the basis for a legitimate legal argument that the form of “encouragement” for this wide variety of electrical industry components must be the same for each specified “advanced transmission technology,” and that such “encouragement” must be full cost recovery through the CAISO’s TAC or similar transmission cost assessment charge. Lumping technologies such as distributed generation or controllable load into the “transmission” category for cost recovery purposes not only makes no sense but completely distorts the price signals that the markets have been carefully designed to reflect. Clearly for these reasons, Section 1223 did not dictate the kind of “encouragement” that each of the listed technologies should receive, but rather left this determination up to the Commission.

This is supported by the Commission’s findings in Order 679.¹⁸ Order No. 679 provides no additional basis for argument that the costs of an “advanced transmission” project must be recovered through transmission rates. At ¶¶ 280-311 of Order 679, the Commission specifically considered incentive rate

¹⁸ *Promoting Transmission Investment through Pricing Reform*, Order 679, 71 Fed. Reg. 43,294 (July 31, 2006), FERC Stats. & Regs. ¶31,222 (2006) (Order 679).

treatment for the “advanced transmission technologies” identified in Section 1223. After considering the comments, the Commission concluded that:

288. We agree with comments that new technologies will be adopted when they are cost effective. *Incentives will be considered for advanced technologies through the same evaluation process as other technologies, as discussed in this Final Rule.*

289. We will not provide a unique incentive designed for a specific technology. To the extent that applicants seek additional incentives for advanced technologies, the Commission will consider the propriety of such incentives on a case-by-case basis.

(emphasis added)

The other statutory sections cited by TNHC in its November 29, 2005 transmittal letter and subsequent pleadings do reflect a Congressional intent that investment incentives be provided for certain types of innovative technologies, but they provide no specific support for the quantum leap of faith suggested by the TNHC application that the costs of a pumped storage hydro project that has the attributes of a generator, not a transmission facility, be spread to all ratepayers *as if* they were the costs of a traditional transmission project.¹⁹ Thus, the statutory framework for the Commission’s analysis provides no legal mandates for encouraging investment in advanced technologies, but rather envisions a policy determination based on the record evidence in each case.

¹⁹ See, e.g. EPCA §§925, 1211, 1242 and 1701 *et seq.* (November 29, 2005 Transmittal Letter, 27-30).

Both policy and the facts support the CAISO's conclusion that TAC recovery for the costs of LEAPS is not an appropriate incentive for this pumped storage facility.

B. There Are Strong Policy Reasons To Not Provide Cost Recovery Through The TAC For Projects With The Attributes Of Generation Such As LEAPS Or To Have The CAISO Take Over Operational Control Of LEAPS (Other Than The Limited Operation Of Generation Contemplated In The CAISO Tariff).

1. The Commission Should Not Permit The Costs Of The Pumped Storage Facility To Be Recovered Through The TAC And Subsidized By Transmission Ratepayers.

- a. The CAISO and stakeholders believe that it would be inappropriate to discriminate between LEAPS and existing pumped storage hydro units in terms of cost recovery and operation.

Upon completion of the combined Project, LEAPS would not be the first pumped²⁰ storage hydro facility to be interconnected to the CAISO Controlled Grid. The CAISO is very familiar with this type of generation facility because there are several large pumped storage hydro units located in the CAISO Balancing Authority Area that are interconnected to the network and provide

²⁰ *H.Q. Energy Services (U.S.), Inc v. New York Independent System Operator, Inc*, 110 FERC ¶ 61, 243 (2005) (addressing issues pertaining to the bids submitted by the Blenheim-Gilboa pumped storage unit); *ISO New England, Inc.*, 88 FERC ¶ 61,145 (1999) (amending the market rules to address reserve pricing issues associated pumped storage **generators**); *ISO New England, Inc.*, 88 FERC ¶61,197 (1999) (amending market rules as they pertain to the energy bids of pumped storage **generators**)

generation services to California ratepayers.²¹ The costs to build and operate these facilities are not reflected in the TAC, and yet they produce the same type of benefits and services that are offered by LEAPS. Likewise, in other ISO/RTO markets, pumped storage hydro facilities operate like generating units selling Energy and Ancillary Services in the markets operated by the ISO or RTO. These pumped storage hydro facilities recover their costs through participation in the market not through transmission rates. Thus, the Energy and Ancillary Services that the LEAPS pumped storage facility would provide would displace other generation.

Not surprisingly, the stakeholders, including owners of pumped storage hydro facilities, expressed concern that TAC recovery for LEAPS would unreasonably discriminate against their units. For example, as succinctly stated by CDWR:

...it would be unduly discriminatory to require similarly situated Advanced Transmission Technologies to subsidize LEAPS. SWP's [State Water Project's] Controllable Loads and Pumped Hydro Units are also Advanced Transmission Technologies under the Energy Policy Act of 2005, but they *pay* transmission rates (and other CAISO load-based charges such as GMC, intra-zonal congestion, reliability costs, etc.) when in pumping mode. It appears that LEAPS would not only be excused from these charges, but would also be subsidized by TAC payments

²¹ One of these units is owned and operated by PG&E, one is owned and operated by SCE, and the others are owned and operated by the California Department of Water Resources State Water Project (CDWR).

associated with SWP's Advanced Transmission Technology Pumped Hydro and Controllable Loads. This would be discriminatory.

The CAISO agrees with these statements. As discussed in the next section, TNHC has presented no compelling evidence that LEAPS offers benefits to the grid that cannot be obtained from other similarly situated pumped storage hydro units (as well as other Generating Units). The CAISO believes that there is no basis upon which to single out this particular facility for TAC recovery while, at the same time, not providing a similar cost recovery option for other pumped storage facilities (or to other Generating Units that also provide Energy and Ancillary Services).

Operational Control of LEAPS by the CAISO raises the same undue discrimination issues. Because the pumped storage hydro facilities currently available to the CAISO Controlled Grid are not reflected in the TAC, the CAISO has no Operational Control of these units beyond its limited involvement with the operation of generation facilities discussed above. Having the CAISO control the operation of LEAPS would provide TNHC with a substantial benefit vis a vis the owners of other pumped storage hydro units (as well as other Generating Units that provide similar services in the market). These other units would be at risk for recovering their costs in the market; whereas, LEAPS would provide similar services but would be guaranteed cost recovery in TAC without any risk. The CAISO has found no basis for providing such a benefit to TNHC, and therefore cannot support treating LEAPS differently than existing, similar Generating Units.

It goes without saying that Section 205 of the Federal Power Act prohibits the CAISO from providing an “undue” preference to any wholesale customer.²² This section has been interpreted by the courts as prohibiting “unreasonable” discrimination but that:

...differences in rates are justified where they are predicated upon differences in facts -- costs of service, or otherwise -- and where there exists a difference in rates which is attacked as illegally discriminatory, judicial inquiry devolves on the question of whether the record exhibits factual differences to justify classifications²³

There is no record support to justify the differences in cost recovery and Operational Control treatment between LEAPS and existing pumped storage hydro facilities, and therefore the treatment requested by TNHC amounts to undue discrimination.

- b. The stakeholders believe that providing TAC cost recovery for LEAPS could disrupt the development of competitive markets.

The CAISO Operational Control options proposed by TNHC raise the market distortion issue discussed in the next section. However, the stakeholders also pointed out that, as a general matter, TAC recovery for the pumped storage

²² 16 U.S.C. §824d(b):

No public utility shall, with respect to any transmission or sale subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

²³ St. Michaels Utilities Commission v. F.P.C., 377 F.2d 912, 915 (4th Cir. 1967).

facility poses problems for the continuous development of the wholesale markets.

As Mirant succinctly stated:

Any strategically placed generation resource can provide transmission benefits, such as reducing congestion or eliminating the need for transmission expansion, and to encourage or permit such resources to ‘change their stripes’ from the generation category to transmission is simply inappropriate. Indeed, it will undermine the development of competitive markets, including the implementation of LMP, which is intended to signal the need for locational generation expansion. This generation project, as with other generation projects, should recover its costs through ancillary services, energy markets, and resource adequacy procurement. Socializing a generation project through transmission rates will undermine wholesale market structures that support efficient price signals for new generation investment.²⁴

Constellation echoed these concerns, noting that because California’s energy policy is focused on ensuring that generation resources that serve load are competitively procured, there is no overriding reason that LEAPS should circumvent this procurement procedure.²⁵ SDG&E also focused on the competitive procurement process, commenting that TAC recovery for LEAPS discriminates against those merchant generators who must comply with the

²⁴ Mirant White Paper 1 Comments.

²⁵ Constellation White Paper 2 Comments, 2.

Request For Offers (RFO) process or take the risk of cost recovery through market prices.²⁶

- c. Stakeholders expressed strong opposition to shifting the risk of a generation project from the developer to the ratepayers by providing cost recovery through the TAC.

The stakeholders overwhelmingly expressed opposition to an unprecedented cost recovery scheme that would shift the development risks of a generation project to the ratepayers. The CPUC emphasized repeatedly that the LEAPS facility should be treated as Resource Adequacy (RA) Capacity/Energy, which would compete with other generation resources in the procurement process or would enter into a bilateral contract with a Load Serving Entity (LSE). SDG&E also stressed that LEAPS should participate in its request for offer (RFO) process like other merchant generation.²⁷

The CAISO concurs with the sentiments expressed by Williams with respect to shifting the risk of development to the ratepayers:

Including the pumped storage unit in the TAC amounts to socializing a generation facility's development risk. The CAISO offers no other generation facility this risk mitigation opportunity. If the economics of this project were favorable, it's rational to assume that a developer would proceed with the project on its own and retain the benefits for itself and its investors. If the economics were favorable, but financing was an issue,

²⁶ SDG&E White Paper 2 Comments, 2.

²⁷ CPUC White Papers 1 and 2 Comments; see also SDG&E White Papers 1 and 2 Comments.

the project could be financed with a purchased power agreement from a load-serving entity. If the economics are not favorable, underwriting this facility through TAC only serves to create additional stranded costs.²⁸

The consensus among stakeholders was that the benefits of the LEAPS facility should be recouped through the competitive markets for the services offered by the unit. To the extent that markets do not exist for certain services, the “fix” remains with the CAISO and competitive market, and should not comprise a shifting of the costs of the project from the developers to the ratepayers.

It bears repeating that the recovery of the costs of the LEAPS facility through the TAC is unprecedented, not only from the standpoint of other pumped storage hydro facilities, but with respect to all merchant generation facilities. The types of services that LEAPS would provide, *e.g.*, Energy, Ancillary Services and capacity, are services that are offered into the CAISO’s markets or via a competitive RFO process. These services are provided by other Generating Units (or by demand response) in the marketplace, not by transmission facilities. Allowing TNHC to recover the costs of the facilities that provide these services via guaranteed cost recovery in the TAC while other providers of these services must face the risks of recovering their costs in the market is unduly discriminatory and inconsistent with fundamental market principles.

TNHC attempts to avoid the preference that it is seeking for its facility vis a vis other generation projects by simply labeling LEAPS as “transmission” and then claiming that other stakeholders involved in this process are being “anti-

²⁸ Williams White Paper 1 Comments, 1.

competitive” because of their opposition to the LEAPS “transmission” project being included in the TAC. Indeed, the CAISO finds it ironic that TNHC has managed to bootstrap its argument that LEAPS is “transmission” into a claim that the CAISO will be violating Order 888 if it does *not* assume Operational Control of the facility:

In particular, while the CAISO should obtain the views of stakeholders, its determinations should be independent, in the best interests of the grid. It would be improper for the CAISO to serve as a tool to implement the anti-competitive strategies of certain stakeholders. Simply put, certain stakeholders may prefer to close out the competition of an independent utility (non traditional integrated investor owned utility). To the extent that the CAISO carries forward this preference, it thwarts EPAct 2005 as well as Order 888.²⁹

From the CAISO’s point of view, it would be discriminatory and anti-competitive for the CAISO to favor LEAPS over other merchant (or IOU-owned) generation facilities. TNHC’s illogical reasoning makes sense only if one accepts the fundamental premise that LEAPS *is* transmission that *must* be recovered through the TAC. Neither the stakeholders nor the CAISO accept that premise, and recommend that the Commission likewise not accept such premise.

It should also be noted that the stakeholders raised no concerns with TAC recovery for the TE/VS transmission portion of the combined Project (if separately studied and approved by the CAISO), and several parties specifically commented that these costs should be recovered through the TAC (including

²⁹ THNC December 18, 2006 Compliance Filing, 10

SDG&E).³⁰ Clearly TNHC’s purported concerns that the CAISO’s stakeholder process might be a “cover for joint anti-competitive conduct by competitors” are based on the very thin ice of semantics: *is* LEAPS transmission, or *should* the costs of LEAPS be treated as *if* it is transmission?³¹ The CAISO’s stakeholder process was obviously focused on the latter proposition, while TNHC stubbornly clings to the former.

³⁰ See, e.g., Constellation White Paper 2, 1; SDG&E White Paper 2 Comments, 2; CPUC White Paper 2 Comments, 2.

³¹ TNHC December 18, 2006 Compliance Filing, 10.

2. The TNHC proposal that the CAISO assume Operational Control of LEAPS will compromise CAISO independence and cause market distortion.
 - a. The CAISO and the majority of stakeholders believe that direct or indirect Operational Control of LEAPS by the CAISO would jeopardize the independence of the CAISO and the stakeholders' perception of the CAISO's neutrality.

For the all of the policy reasons discussed above, it is the CAISO's conclusion that TNHC's request for approval of TAC recovery for LEAPS should be rejected in the first instance, and that an evaluation of the various operating options proposed by TNHC (and the CAISO in White Paper 1) is actually unnecessary because without TAC recovery, there would be no scenario under which the CAISO would assume Operational Control of the facility. However, the concerns expressed by the stakeholders regarding the CAISO's direct or indirect involvement with the market participation of the facility compel the conclusion that a real and/or perceived compromise of the CAISO's independence provides an additional basis to reject TAC recovery for LEAPS.

In Order 2000, the Commission made it very clear that "the principle of independence is the bedrock upon which the ISO must be built".³² The Commission stressed that "an ISO must be independent both in reality and perception" and that "an RTO will not be successful unless all market participants

³² Docket No. RM99-2-000, *Regional Transmission Organizations*, 89FERC ¶61,285, 153.

believe that the RTO will operate the grid and provide transmission service to all grid users on a non-discriminatory basis.”³³ Although the Commission was addressing the issue of ownership in an RTO, this discussion of the need for independence is equally applicable to the instant inquiry:

It is the Commission's view that an RTO must be independent of any entity whose economic or commercial interests could be significantly affected by the RTO's actions or decisions. Without such independence, it will be difficult for an RTO to act in a non-discriminatory manner.³⁴

Further, in Order No. 2000, the Commission found that an ISO's or RTO's “control” of generation should be through a market where generators offer their services and the ISO or RTO chooses the least cost option.³⁵ The Commission clarified that such authority did not extend to initial unit commitment and the dispatch decisions of generators.³⁶ The Commission also stressed that an RTO should attempt to rely on market mechanisms to the maximum extent practicable to manage congestion.³⁷

The stakeholders quite clearly expressed concern that all of the Operational Control scenarios suggested by TNHC would compromise the CAISO's independence in some way.³⁸ As stated by Williams with respect to Option No. 1 (CAISO schedules and bids LEAPS with a firewall mechanism in

³³ *Id.*, 205

³⁴ *Id.*, 195

³⁵ Docket No. RM99-2-000, *Regional Transmission Organizations*, 89FERC ¶61,285, 318.

³⁶ The Commission stated that for reliability purposes, RTOs should have authority to order the redispatch of any generator subject to existing environmental and operational restrictions that may limit a generator's ability to change its dispatch. *Id.*

³⁷ *Id.*, 384

³⁸ “When an Independent System Operator (ISO) takes operational control of a generation facility, it may result in the ISO no longer being truly independent.” PG&E White Paper 1 Comments, 3.

place): "...this option turns some part of the CAISO into an interested market participant—competing with other market participants in the CAISO markets—rather than having the CAISO function wholly as an independent and neutral market facilitator."³⁹ SCE stated that "even with a firewall, the CAISO becomes a direct market participant and its actions will have direct financial impacts to individuals and the market at large."⁴⁰ SCE also cautioned that operating the LEAPS facility for anything other than specific reliability issues would be inconsistent with the CAISO's stated mission to provide "cost effective and reliable service, well balanced energy market mechanisms, and high quality information for the benefit of customers."⁴¹ The CAISO believes that inconsistency is inevitable since efficient operation of the pumped storage facility necessitates making use of the excess capacity from the pumped storage facility after all reliability needs are met.

Thus, establishing a "bidding and scheduling arm" of the CAISO as proposed by TNHC raises significant concerns regarding the independence of the CAISO and is inconsistent with the role that the Commission has envisioned for ISOs and RTOs with respect to their limited "control" over generation. Such a bidding and scheduling arm could be viewed as contrary to one of the reasons why the Commission created ISOs and RTOs in the first place -- the benefits of

³⁹ Williams White Paper 1 Comments, 2.

⁴⁰ SCE White Paper 1 Comments, 3.

⁴¹ *Id.*, 6.

eliminating reliance on the Standards of Conduct and other “firewalls” to ensure the independent oversight and operation of a transmission system.⁴²

Two of the operational options suggested by TNHC, Options 2 and 3, introduced the notion that the daily operations of the pumped storage facility would be conducted by a third party rather than the CAISO, as contemplated by Option 1. However, although ostensibly removed from plant operations, both Options 2 and 3 would require that the CAISO exert indirect control over the manner in which the services provided by the facility were bid into the market, through the terms and conditions established for the auction (Option 2) or the terms and conditions of the third party contract (Option 3). The CAISO pointed out in White Paper 1 that Option 3 would require continuous supervision by the CAISO to ensure compliance with the objectives supporting the incentive provided to LEAPS in the first place. Furthermore, the third party operators contemplated with Option 3 could require the CAISO to establish and monitor performance standards to assure third-party compliance with the objectives of the contract. While Option 2 would provide the winner of the auction an opportunity to maximize profits through the market operation of the facility, the CAISO also would run the risk that no acceptable bids are received and the Operational Control of the facility would default to Options 1 or 3.⁴³ Further,

⁴² See Order No. 888 at 31,731 (“An ISO and its employees should have no financial interest in the economic performance of any power market participant. . . . In addition, an ISO should not undertake any contractual arrangement with generation or transmission owners or transmission users that is not at arm’s length.”); *Regional Transmission Organizations*, Order No. 2000, 65 Fed. Reg. 809 (Jan. 6, 2000), FERC Stats. & Regs., Regs. Preambles ¶ 31,089, at 31,063, 31,065 (1999) (“Order No. 2000”) (“We reaffirm the NOPR proposal that an RTO, its employees and any non-stakeholder directors must not have any financial interests in market participants. . . . An RTO must be independent in both reality and perception.”).

⁴³ White Paper 1, 4-5.

Option 2 would also entail the very complex and cumbersome process of actually structuring the auction, a task involving a high level of detail and CAISO participation. White Paper 2 set forth a very preliminary list of the matters to be addressed in structuring an Option 2 auction.⁴⁴ CAISO believes that this extensive auction development process will create the stakeholder perception of a conflict of interest.

Options 2 and 3 were opposed by all of the stakeholders (except Option 2 as a possible fallback by two market participants) because of the level of indirect control by the CAISO that would be necessitated by these scenarios, as discussed in both white papers. For example, PG&E expressed concern that both Options 2 and 3 placed the CAISO in a position of assuming “indirect control” over LEAPS, and that the CAISO must maintain its independence by not exerting either direct or indirect control of the facility.⁴⁵ The CPUC made the point that, with respect to Option 2:

...the implementation of this option will inevitably cause lengthy disputes among the CAISO’s participating transmission owners as to which of them should pay how much of any project costs embedded in the TAC that are not fully offset by project revenues.⁴⁶

Option 4, which would have made the capacity of LEAPS available for Ancillary Services and the Energy bid into the market at \$0 by the LEAPS owner, was flatly rejected by all of the stakeholders, even by Coral, the sole stakeholder who supported TAC recovery for LEAPS. Coral noted that Option 4 presented

⁴⁴ White Paper 2, 6-7.

⁴⁵ PG&E White Paper 1 Comments

⁴⁶ CPUC White Paper 2 Comments.

the same problems as Option 1, particularly with respect to a lack of separation between the CAISO bidding and transmission functions as well as a lack of motivation to optimize the revenue stream produced by the facility.⁴⁷ Williams expressed similar concerns with Option 4, pointing out that the CAISO again would be directly involved in determining the optimization function for the unit.⁴⁸ Finally, SCE stated that Option 4 is simply “unworkable and should not be implemented” for a variety of reasons, not the least of which would be the direct operational decisions that must be made by the CAISO such as decisions to purchase Energy while in the pumping mode.⁴⁹

Even the CAISO’s “hybrid” proposal (Option 5), wherein a portion of the LEAPS costs would be recovered through “RMR-like” contracts with the CAISO, were viewed by the stakeholders as a step in the wrong direction at a time when the CAISO is moving away from the use of RMR Contracts in favor of more competitive solutions.

The TNHC request for recovery of the costs of LEAPS through the TAC necessitates that the CAISO take part, in some way, in the Operational Control of a generation facility. The CAISO agrees with its stakeholders that this basic premise raises—directly or indirectly—the very conflict of interest concerns that the Commission took great pains to avoid during the formative stages of ISOs and RTOs in Order 2000. Additionally, the CAISO believes that any potential involvement with the Operational Control of LEAPS could be viewed as being at odds with Order 888. As pointed out by Calpine, assuming Operational Control

⁴⁷ Coral Power White Paper 1.

⁴⁸ Williams White Paper 1,3

⁴⁹ SCE White Paper 1, 4

of LEAPS places the CAISO in the “untenable position of being both the Market Participant and the market referee who holds operational control of the transmission system”.⁵⁰

Importantly, even if the CAISO could somehow structure a third party contract or auction procedure/contract that it believed would truly preserve its independence, it is likely that its Market Participants (as that term was defined in Order 2000 and the CAISO Tariff) would perceive that the CAISO’s independence had been compromised. This perception in and of itself is sufficient grounds for the CAISO to reject all Operational Control proposals that involve TAC recovery and the CAISO participating, in some way, in the use of the LEAPS facility as a network resource.

- b. Stakeholders have expressed significant concern about potential market distortion associated with the CAISO having Operational Control of LEAPS.

The stakeholders identified potential market distortions and conflicts of interest that would be caused by the CAISO’s participation in the market through the Operational Control of LEAPS. For example, the Modesto Irrigation District (MID) noted that the CAISO would be placed in a position of favoring the product of a particular market participant (*i.e.*, Ancillary Services), in preference to others, by resorting to the service offered by certain generator in lieu of optimal dispatch.⁵¹ This is especially true for the fourth option proposed by TNHC which would utilize LEAPS for Ancillary Services before taking any Ancillary Services

⁵⁰ Calpine White Paper 1 Comments, 2.

⁵¹ MID White Paper 1 Comments, 1.

from the market. Williams agreed with this observation, noting that scheduling and bidding the services of LEAPS into the market would violate prior Commission orders such as *California Independent System Operator Corp. et al.*, 98 FERC ¶61,335 at 62,426-62, 427 (2002), *order on reh'g*, 101 FERC ¶ 61,241 at 24 (2202).⁵² Mirant specifically stated that the CAISO's operation of the LEAPS facility could dramatically affect on- and off- peak pricing.⁵³

The market distortions identified by the stakeholders compel the conclusion that the assumption of Operational Control by the CAISO is a step away from—and not towards—the restructured, efficient, competitive market that the CAISO, in conjunction with this Commission, its Market Participants, and the state of California have worked hard to achieve. Placing the CAISO in the “untenable” position of being both a generation operator and the overseer of the transmission network would be reminiscent of a vertically integrated electric utility, and beyond what was envisioned in the CAISO's enabling legislation. The CAISO simply cannot risk the potential harm that could be caused to the competitive market during this time of transition to MRTU and the benefits that will flow from this market upgrade by agreeing to accept a role it was not intended to play.

C. The Reliability and Economic Studies Done to Date Related to the Combined Project Demonstrate That There Is Nothing Unique or Compelling About the Combined Project that Cannot be Provided by the Market.

⁵² Williams White Paper 1 Comments, 2.

⁵³ Mirant White Paper 1 Comments, 2.

EPAAct 2005 Section 1223 identifies “advanced transmission technology” as a technology that “increases the capacity, efficiency or reliability of an existing or new transmission facility.” Following this guidance, the November 17 Order noted that “the Commission is committed to providing appropriate incentives for critical transmission infrastructure that, as stated in Order No. 679, either improve the reliability of the grid or reduce congestion costs”.⁵⁴ To that end, the Commission has asked the CAISO, with input from its stakeholders, to address “cost recovery options given the CAISO’s determination of the extent to which the combined Project reduces congestion costs or enhances reliability.”⁵⁵

The reliability and economic benefits of the combined Project have been evaluated in several contexts, both on a preliminary basis prior to the initiation of this stakeholder process, and in the ongoing CPUC proceeding involving the licensing of the Sunrise Powerlink transmission project.⁵⁶ Nonetheless, in light of this Commission’s directive to explore with stakeholders the TNHC proposal to treat the LEAPS facility like a transmission project for cost recovery purposes, the CAISO contemplated a two-step stakeholder process that would first explore policy issues and then conduct additional economic/reliability studies of the combined Project. However, after analyzing the clear and almost unanimous

⁵⁴ November 17 Order, Par. 26 (footnote omitted).

⁵⁵ *Id.*, Pars. 28, 30.

⁵⁶ *In the Matter of the Application of San Diego Gas & Electric Company for a Certificate of Public Convenience and Necessity for the Sunrise Powerlink Transmission Project*, A. 06-08-010 (filed August 4, 2006). The Sunrise Powerlink project was approved by the CAISO Board of Governors on August 3, 2006. At the request of the CPUC, the CAISO has evaluated the LEAPS combined Project (plus a transmission line proposed by the Los Angeles Department of Water and Power (LADWP) known as GreenPath North) as an alternative to Sunrise. Additionally, as an active intervener in the Sunrise CPUC case, TNHC also requested that the CAISO study the combined Project without GreenPath North as an alternative to Sunrise.

policy recommendations provided by the stakeholders in response to White Paper 2, as well as conducting its own policy evaluation, the CAISO has concluded that further reliability/economic studies of the combined Project are unnecessary. The CAISO has reached the conclusion that, from a policy standpoint, the combined Project should not be treated like a transmission project. Although the “wires” portion of the project provides a transmission function, the pumped storage part of the project has attributes that are more akin to those of a Generating Unit, and the types of services the unit can provide are the same types of services that can be, and in fact are being, provided by Generators in the marketplace (without TAC recovery). As discussed below, the studies conducted to date reveal that the potential benefits provided by the combined Project are not unique, can be provided by the market, and clearly do not require compromising any of the important policy reasons supporting the CAISO’s recommendation.

The CAISO’s conclusions stem from its Commission-approved tariff. The CAISO Tariff provides for two distinct study processes: one for proposed transmission projects and one for proposed generation projects seeking interconnection to the CAISO Controlled Grid. In the case of a transmission project, the CAISO conducts an evaluation to determine whether the project solves a reliability problem. If no reliability problem is solved, the CAISO Tariff also provides that if a transmission project that does not provide reliability

benefits could be approved by the CAISO if it is found to provide positive economic benefits.⁵⁷

For a proposed generation project that seeks interconnect, the CAISO does not investigate whether the generation project *so/ves* a reliability problem. Instead, the CAISO conducts an evaluation known as the Large Generator Interconnection Procedure (LGIP) to determine whether the interconnection will *cause* network reliability problems. If the proposed Generating Facility is found to negatively impact System Reliability, the project proponent will be advised of the facility upgrades necessary to correct the reliability problems triggered by the generation project. The project proponent then decides whether to pay for the upgrade costs, so as to have the project interconnected. The CAISO does not make the generation project decision; therefore it does not consider the economic benefits of the Generating Facility are not considered as part of the LGIP process.⁵⁸

As described in the TNHC September 11, 2006 Supplemental Response in this proceeding, the CAISO, in collaboration with market participants and project proponents, conducted several preliminary economic/reliability analyses of the combined Project as part of a study of two large transmission projects proposed for southern California, known as the CAISO South Regional Transmission Plan for 2006 (CSRTP-2006).⁵⁹ The interim findings of the

⁵⁷ See CAISO Tariff §24.1.

⁵⁸ CAISO Tariff Section 25; Appendix U.

⁵⁹ As requested by TNHC, the studies conducted as part of CSRTP-2006 called for the combined transmission/generation proposal being evaluated in conjunction with two large transmission projects: 1) the Sunrise Powerlink project sponsored by SDG&E in combination with the Imperial Irrigation District (IID)/Citizen's Energy Green Path Southwest project; and 2) Tehachapi area

CS RTP-2006 group regarding the combined Project were presented to the CAISO Board of Governors in a Memorandum dated August 31, 2006 (the CAISO Memorandum).⁶⁰

With respect to the preliminary reliability analysis of the combined Project, the CAISO Memorandum indicated that the combined Project presented no reliability concerns, “mainly due to the mitigating effect of the Sun Path [Sunrise Powerlink] project.”⁶¹ However, with the Sunrise project in service, the combined Project is not needed to solve any reliability problem⁶² Thus, the earlier CAISO preliminary studies indicated that (a) the combined Project can be interconnected without causing reliability problems, and (b) the combined Project does not qualify as a new transmission project that solves a reliability problem.

As to the economic assessment of the combined Project, the CAISO Memorandum, at pages 5-6, listed the following categories of benefits that could be produced by the specific portions of the combined Project:

- Energy benefit (from both the TE/VS transmission line which connects to generation supplies and moves them to load and the pumped storage facility Generating Unit which produces power)

transmission upgrades sponsored by SCE in connection with a large potential wind resource in the area. (Exhibit No. TNHC-14, 3).

⁶⁰ The CAISO Memorandum was attached to the Supplemental Response, Exhibit No. TNHC-13 and was discussed extensively in the testimony of Jaleh Firooz, Exhibit No. TNHC-14.

⁶¹ CAISO Memorandum, 4.

⁶² The CAISO stated in its January 26, 2007, Initial Testimony, Part I in the Sunrise CPUC proceeding that:

...Sunrise is expected to remedy the foreseeable reliability problems in the San Diego area for a period of approximately ten years in addition to compensating for the retirement of the South Bay power plant.

This testimony is available on the CAISO website at:
<http://www.caiso.com/1b75/1b75e7b64de10.pdf>

- Locational Capacity Requirement/RMR Unit benefit (due to the TE/VS transmission line which can deliver power to certain local areas)
- Capacity benefit (due to the pumped storage facility Generating Unit)
- Ancillary Services (AS) benefits (due to the pumped storage facility Generating Unit)
- Black Start benefit (due to the pumped storage facility Generating Unit- not quantified)
- Reactive reserve benefit (due to the LEAPS pumped storage facility Generating Unit- not quantified)

The above categories show that the combined Project's locational capacity requirement/RMR Unit benefits are transmission related, made possible by the new transmission, not by the pumped storage facility. The Energy benefit derives both from the transmission line and the pumped storage facility. The other benefits are generation-related, made possible by LEAPS. This is expected, as these benefits are typically associated with any Generating Unit: capacity, Ancillary Services (Regulation up/down, Spinning Reserve, Non-Spinning Reserve), reactive support, Black Start and electricity production. Nothing in the CAISO Memorandum pointed to any unique attributes of LEAPS producing substantial benefits that are not available from a generation project.⁶³

⁶³ Footnote 19 of TNHC's December 18, 2006 Compliance Filing refers to an additional CAISO preliminary LEAPS analysis dated September 19, 2006, showing increased Ancillary Services benefits including wind integration and over-generation. This analysis has not been submitted on

In the Sunrise CPUC proceeding, the CAISO's focus is transmission-related benefits. Thus, the generation benefits (e.g., AS and capacity benefits, etc.) provided by the pumped storage facility portion of the combined Project were not individually analyzed. Nonetheless, the CAISO has actually found that such benefits are primarily those typically associated with a generation facility selling capacity and AS services to the market, and are not unique to the LEAPS. None of the studies conducted by the CAISO would compel a finding that this particular project must be afforded unprecedented "encouragement" through TAC recovery so that its benefits to the transmission network will not be lost, especially in light of the significant policy reasons for not according the pumped storage facility such treatment.

V. Responses to the Issues Identified By the Commission.

At ¶30 of the November 17 Order the Commission set forth five specific issues and questions to be addressed by the CAISO with its stakeholders. These topics can be generally separated into two categories: whether the CAISO can effectively operate the combined Project in the context of being an independent system operator, and whether the costs of LEAPS should be recovered through the TAC. In the next paragraph, the Commission asked the CAISO to provide information as to any correspondence or discussions with the Internal Revenue Service (IRS) regarding the impact that operational control of LEAPS would have on the CAISO's tax status. Based on the stakeholder input

the record, but suffice it to say that such additional benefits are still not unique to the LEAPS facility.

and the CAISO's policy evaluation, the responses to these ¶30 and 31 issues are set forth below.

A. Can the CAISO Effectively Operate the Combined Project in the Context of Being an Independent System Operator?

The CAISO cannot support any operational or management option that would require CAISO to be directly or indirectly involved in the daily market operation of the LEAPS pumped storage facility. "Indirect" involvement would include contracting with a third party to provide Operational Control, or establishing the terms and conditions of an auction held for purposes of allowing third parties to bid on the opportunity to schedule the services provided by the facility into the market. The CAISO believes that all of the operating options proposed by TNHC and evaluated by the stakeholders would result in a conflict of interest and/or the appearance of a conflict of interest that could compromise its independence, cause market distortion and run afoul of the ISO/RTO requirements of Order 2000. The CAISO therefore recommends that it would be inappropriate for the CAISO to assume direct or indirect control of the LEAPS pumped storage facility.

B. Should the Costs of LEAPS Be Recovered Through the TAC?

The CAISO has concluded that the costs of LEAPS should not be recovered through the TAC and spread to California transmission ratepayers. Such treatment amounts to undue discrimination with respect to similarly situated pumped storage hydro facilities already located within the CAISO footprint and to other Generating Units that provide similar services. The benefits provided by

LEAPS should be derived from the market in the same way that other merchant generation facilities are compensated. Market compensation provides the discipline to assure efficient operation and maintenance that would not be addressed through a simple pass-through of costs through the TAC. There is no compelling evidence that the attributes of LEAPS are so unique that they cannot be provided by the market, and that these benefits will not be available to the network absent the inclusion of the entirety of LEAPS' costs in the TAC.

C. What is the Status of the CAISO's Discussions or Correspondence with the IRS?

Following the issuance of the November 17 Order, the CAISO sought an opinion from its outside financial and tax counsel as to the steps that must be taken to obtain an IRS ruling with respect to its status as a 501(c)(3) charitable organization should the Commission direct the CAISO to assume Operational Control of LEAPS. Counsel advised the CAISO that it would be premature to initiate discussions or correspondence with the IRS until the specific circumstances under which the CAISO would assume Operational Control had been determined. In other words, it was the CAISO's understanding that a request for an IRS ruling, whether based on informal contact or a written submission, would require a detailed description of how exactly the CAISO would dispatch the unit and/or otherwise participate in the combined Project. Because several very distinct Operational Control options were being considered by the stakeholders, the CAISO could proceed no further with the IRS until these very fundamental issues were resolved.

In light of the CAISO's conclusions and recommendation to this Commission that the costs of LEAPS should not be recovered through the TAC, the CAISO has taken no further action with respect to the tax implications associated with the Operational Control of the unit. However, in the event that the Commission rejects stakeholders' and the CAISO's recommendations and decides that further study is required as to whether the CAISO should assume Operational Control of the pumped storage facility, the CAISO seeks an opportunity to pursue an IRS ruling based on any direction provided by the Commission prior to any final Commission decision. Needless to say, the CAISO would strongly disagree with any determination that leaves the door open for CAISO Operational Control of LEAPS, and would urge the Commission not to follow this course. However, even if the CAISO promptly contacted the IRS following the publication of the Commission decision in this case, the issuance of an IRS ruling regarding the CAISO tax status could take up to six months. The CAISO respectfully urges the Commission to take this time frame into account when considering the issues involved in this proceeding.

Respectfully submitted,

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Certificate of Service

I hereby certify that I have this day served a copy of this document upon all parties listed on the official service list compiled by the Secretary in the above-captioned proceeding, in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and Procedure (18 C.F.R. § 385.2010).

Dated this 1st Day of May, 2007 at Folsom in the State of California.

/s/ Susan Montana
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