California Independent
System Operator Corporation

Memorandum

To: ISO Board of Governors

From: Charles A. King, Vice President, Market Development and Program Management
Anjali Sheffrin, Chief Economist / Director, Market and Product Development
Lorenzo Kristov, Principal Market Architect

Date: April 26, 2007

Re: *Deferred Decision on Proposed Tariff Changes to Enhance Rules for the CRR Release Process*

This memorandum requires Board action.

SUMMARY

On April 19, 2007, the ISO Board of Governors deferred a decision on the Motion to approve "Proposed Tariff Changes to Enhance Rules for the CRR Release Process." The Board expressed a desire to allow additional time for certain parties to resolve specific issues associated with the impact of long-term state power contracts upon one LSE's ability to receive its most desired CRRs in the initial allocation.

For the reasons stated herein and in the attached April 12, 2007, memorandum and presentation to the ISO Board of Governors, Management reaffirms its request that the ISO Board of Governors approve its Motion on the "Proposed Tariff Changes to Enhance Rules for the CRR Release Process." Management believes these changes have been fully vetted with stakeholders and meet a "just and reasonable" standard. Management further recognizes that the concerns discussed at the April 19th Board meeting can be addressed through measures that do not require changes to the ISO's filed rules, using the flexibility and bilateral trading opportunities built into those rules.

BACKGROUND

Throughout the stakeholder process that began in February, Management has attempted to address the concerns raised by San Diego Gas & Electric through possible changes in the CRR allocation rules. SDG&E has sought to remedy its situation by modifying the FERC-approved principle of using an historical reference period during which contractual or owned resources define LSEs' eligibility for some CRRs in the first allocation period. Specifically, SDG&E proposed to expand the historical reference period criteria so that SDG&E could obtain CRRs in the first year based on supply resources it expects to utilize in future years. Careful consideration and open discussion were conducted for this and various other rule changes suggested by SDG&E and other stakeholders, and several proposals offered by the ISO. Unfortunately, each proposed solution included the adoption of certain rules with significant and broad potentially adverse impacts upon parties other than SDG&E, or would require reopening at this late date fundamental principles of CRR allocation that were resolved during the 2005 CRR stakeholder process, filed in February 2006 MRTU Tariff and approved by FERC.

It is notable that the results of the CRR Dry Run indicate that SDG&E was adequately protected, to a degree fully comparable to other participating LSEs, using the historical reference year as the basis for determining eligible CRR nominations. With strong stakeholder consensus, including the support of SDG&E, the ISO has already agreed to update this historical reference period to the calendar year 2006 to make it more current. Even with this update to the historical reference period, however, SDG&E argues that its supply procurement pattern in the recent past was distorted by the assignment to it, by the CPUC, of certain power contracts negotiated by the state during the 2000-1 power crisis. This distortion, SDG&E argues, would severely limit SDG&E's ability to obtain in the first year the specific CRRs it will need in future years to support new supply resources.

The stakeholder process two years ago debated and ratified one of the key purposes of the first year CRR allocation, which is to provide LSEs with starting portfolios of CRRs that will enable them to manage the congestion costs they expect to face when the MRTU markets begin operating. For future years, the filed CRR rules provide flexibility for each LSE, according to its own preferences, to renew a significant portion of its starting portfolio or to relinquish some of those CRRs and nominate new ones that better meet their needs. Thus, the filed CRR allocation rules were never intended to provide each LSE, at MRTU start-up, with the CRRs it would necessarily want to hold several years into the future. Rather, the rules were designed to provide an equitable initial allocation for MRTU start-up, from which LSEs could modify their holdings from year to year as needed. The use of the historical reference period is a fundamental element of this first year CRR allocation approach that was developed, with considerable stakeholder input and support, to accommodate the different business models of various LSEs (allowing various mix of short term and long term contracting) in a manner that is both equitable and supportive of the overall MRTU market design.

In response to SDG&E's concern the ISO and stakeholders explored several potential ways to address that concern through changes to the previously filed rules, but were ultimately unable to develop effective changes that would not adversely impact other parties or undermine other important aspects of the previously filed CRR allocation design. Moreover, because the distortion SDG&E refers to derives from an allocation of the state-negotiated energy contracts by the CPUC among its regulated electric utilities, Management believes that parties involved have the ability to find a solution to SDG&E's concerns using the flexibility already afforded to participants by the ISO's filed CRR rules rather than requiring changes to the CRR rules already conditionally approved by FERC.

Under FERC regulation, the rules that the ISO adopts must be just and reasonable. The rules already established within the MRTU Tariff and conditionally approved by FERC might not be the most favored rules by each and every party, but do provide all parties equal opportunity to obtain CRRs without discrimination among similarly situated entities. As explained more fully in the April 12, 2007, memorandum, after a considerable amount of time and effort through its stakeholder process, the ISO has determined that the proposed enhancements to its CRR rules provide a just and reasonable opportunity for all parties to obtain CRRs. The ISO's most recent experience in trying to address SDG&E's concern through an ISO rule change demonstrates that further time and effort spent on exploration of ISO rule changes would not likely yield an outcome that is both satisfactory to SDG&E and free of unintended consequences to other parties or to the MRTU market redesign effort.

Because the process for releasing CRRs to market participants is a multi-stage, multi-month process that must be concluded in advance of the February 2008 start-up of the MRTU markets, the ISO must begin this process in July 2007. The ISO must therefore file the CRR rule revisions discussed in this memorandum in early May in order to obtain a FERC ruling on these revisions in time to start the CRR release process in July. Obtaining Board approval of the overall changes proposed in the April 12, 2007, is crucial for the ISO to maintain this timeline. Any lengthier deliberation process would likely delay implementation of MRTU, which is conditional on the ISO implementing its CRR allocation and auction processes in a timely manner during the summer of 2007.

Management understands that the ISO Board of Governors delayed its action on the April 12, 2007, motion in an effort to allow parties an opportunity to continue to seek resolution of SDG&E's issue outside of the scope of potential rule changes. Because the ISO must file its rule changes as soon as possible to be able to obtain FERC approval in a timely manner, Management ask that the Board not delay its approval of the motion any further.

MANAGEMENT RECOMMENDATION

Management recommends that the Board approve this proposal and authorize Management to file the associated tariff changes with FERC, and to implement these changes as needed to achieve the scheduled startup of MRTU.

MOTION

Moved,

That the ISO Board of Governors approve the "Proposed Tariff Changes to Enhance Rules for the CRR Release Process," as outlined in the memorandum dated April 26, 2007, and related attachments; and

That the ISO Board of Governors authorize Management to make all the necessary and appropriate filings with the Federal Energy Regulatory Commission to implement this proposal.