

**SDG&E PROPOSALS TO MODIFY THE RESOURCE VERIFICATION
MECHANISM FOR ESTABLISHING PRIORITY ACCESS TO THE TIER 1 AND
TIER 2 ALLOCATIONS OF CONGESTION REVENUE RIGHTS
(April 6, 2007)**

I. BACKGROUND

At stakeholder meetings and in formal comments filed at FERC, SDG&E has argued that the CRR dry-run results suggest that SDG&E is likely to be allocated relatively few of the congestion cost hedges that SDG&E needs to integrate the imported resources it has already committed to procure. SDG&E believes that the CAISO's resource verification process for establishing the right to make Tier 1 and Tier 2 CRR nominations based on a one-year historical snapshot¹ lies at the heart of its problem. Once the initial priority is established, it can essentially be preserved forever through the priority nomination process. The load-serving entity can retain the CRR, either as a short-term or long-term price hedge, even when the underlying commercial arrangement that gave rise to the priority has long since expired. Unless modified, this procedure will produce an outcome in stark contrast with SDG&E's 30-year effort to be closely integrated with the wholesale electricity markets beyond its borders. SDG&E urges the CAISO to examine all possible solutions to minimizing or eliminating what would be an unacceptable outcome for SDG&E.

SDG&E is seeking only an equitable outcome here, not a perfect solution. Our preferred approach would have been for the CAISO to auction all CRRs, with the resulting revenues being allocated to the consumers that are paying the fixed costs of the grid. Our second preference would be for the CAISO to allocate CRRs to LSEs in proportion to the LSE's share of the load, with LSEs conducting further trading in the

¹ The original historical period selected by the CAISO was September 2004 through August 2005, but more recently the CAISO has proposed using calendar year 2006.

secondary markets to assemble a desirable portfolio of transmission rights. SDG&E is also willing to support in MRTU Release 1 possible variants of both approaches, as long as the combination of allocating/auctioning produces a result that is within the just and reasonable zone for SDG&E.

The CAISO's proposal to allow Tier 1 and Tier 2 nominations only from verified resources actually flowing energy in the 2006 historical snapshot does not produce just and reasonable results for SDG&E. The 2006 picture is distorted and does not reflect accurately SDG&E's past usage of the grid or its expected future usage to deliver energy from contracts already signed.² Not only is the proposed resource verification procedure based on a brief and distorted historical record, any inequity in the initial allocation process will be preserved indefinitely by the long-term CRR conversion and companion annual roll-over mechanisms. In short, a 2006 snapshot of SDG&E's use of the grid totally fails to reflect its past reliance on imported power, what is already known about its future procurement portfolio, and the magnitude of the fixed transmission costs being allocated to its bundled customers.

In furtherance of legislative and regulatory mandates, SDG&E has already contracted for significant amounts of imported resources, mainly new renewable resources, and will therefore need CRRs to hedge the potential differences in prices between the points of injection and withdrawal. If the CAISO decides that some form of one-time priority mechanism based on a 2006 snapshot must be deployed to smooth the

² SDG&E's previous comments and pleadings on this subject have described how and why the 2006 historical period fails to capture SDG&E's past reliance on the grid to import power to serve its load. *See, MOTION TO INTERVENE AND COMMENTS OF SAN DIEGO GAS & ELECTRIC COMPANY REGARDING THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION'S PROPOSAL TO PROVIDE LONG-TERM FIRM TRANSMISSION RIGHTS IN ITS ORGANIZED ELECTRICITY MARKETS*, Docket Nos. 07-475-000 and RM06-08-000 at 6-9 (Feb. 20, 2007.)

transition to short and long-term CRRs, then the CAISO must take the steps necessary to ensure that the initial allocation of CRRs does not place one or more LSEs at a material disadvantage going forward.

II. SDG&E'S PREFERRED PROPOSAL

SDG&E has explored in the stakeholder meetings and subsequent comments different options for modifying the CAISO's CRR allocation mechanism to produce a just and reasonable outcome for SDG&E. The CAISO has made it quite clear that it wants to solve this problem in a fashion that does not require a major and time-consuming overhaul of the complicated mechanism that has been devised to integrate and award short and long-term CRRs. SDG&E respects this position and has confined its search for solutions accordingly.

SDG&E's preferred solution retains the front-loaded priority mechanism based on resource verifications from the 2006 historical period, but expands the definition of a resource to include a contract signed on or before December 31, 2006 for delivery of a set amount of energy by a date certain at an existing CAISO-controlled facility. Moreover, the ability of a LSE to rely upon contracts that are not yet flowing energy would be limited to back-filling newly-opened holes in its 2006 resource portfolio. For example, in order to perfect a right to substitute an equally-sized or less 2006 contract not yet flowing energy for a contract that was flowing energy in 2006, the LSE would have to demonstrate that the energy-flowing-in-2006 contract had expired or otherwise been removed from its portfolio by a date certain, say March 1, 2007. This substitution requirement would focus the remedial solution on those LSEs that have already lost resources from the historical period that give rise to the resource-based priorities to

nominate in Tiers 1 and 2. Further, substituted resources would be both known (thereby not distorting future procurement decisions) and aligned with the LSE's underlying commercial arrangements.

Under SDG&E's proposed substitution remedy, it is possible that two different LSEs could be relying upon the same physical resource to verify priority access to the Tier 1 and Tier 2 CRR nominations. This resource could be flowing energy in 2006 for one LSE and later flowing energy under a 2006 or earlier contract for another LSE.³ If this fact pattern emerges, then the first LSE should have the option of either: (1) using the verified resource to nominate in Tier 1, with any resulting CRRs being transferred to the second LSE when its verified contract commences; or (2) allowing the second LSE to use the verified resource to nominate in Tier 1, with any resulting CRRs being transferred to the first LSE until the second LSE's contract has commenced. In short, both LSEs should share the resulting CRRs in accordance with the terms of the underlying commercial arrangement that gave rise to the priority nominations.

This proposed substitution remedy would be available to all LSE's that are able to demonstrate the requisite foundational facts. In SDG&E's case, one of the CDWR contracts flowing energy to SDG&E throughout all of 2006 was re-allocated over SDG&E's objection to another LSE on January 1, 2007, thereby leaving a large hole in SDG&E's procurement portfolio. Having Tier 1 and Tier 2 priority access to the CRRs for the now re-allocated contract does nothing to help SDG&E hedge its going forward congestion risks. But if SDG&E were able to substitute a comparable amount of contracts already signed for a contract already departed, then rough justice would be restored.

³ Most of the resources that SDG&E would seek to substitute are new renewable resources that are not already being used to verify priority access to the Tier 1 and Tier 2 nominations.

SDG&E, in proportion to its load share, would have the same amount of resources to verify Tier 1 and Tier 2 nominations as those LSEs that lost nothing from their portfolios in place during the 2006 historical period. Being able to nominate in Tiers 1 and 2 roughly the same proportional number of MWs actually linked to a viable resource as everyone else, does not guarantee, of course, that the nominated CRRs would actually be allocated in full, but it would put SDG&E on an equal footing with the other LSEs that have not lost resources from the 2006 historical period. SDG&E's allocation under these circumstances is likely to be comparable to that received by other LSEs, and thus within the just and reasonable zone.

III. SDG&E'S ALTERNATIVE PROPOSAL

SDG&E has been able to identify another approach to addressing its concern that the calendar year 2006 historical period does not accurately reflect SDG&E's past or future usage of the grid. If the resource-based priorities permitting access to Tiers 1 and 2 were to be limited to the term of the underlying commercial arrangement, then the allocation system would be gradually purged of the priority allocations in favor of allocations based on load share ratio, the general allocation rule selected by the CAISO. The CAISO could continue its desired approach of dealing with resource-verified priorities only in the initial allocation, but it would have to place a temporal limitation on the ability to renew the priority in future years via the Priority Nomination Tier.

Two additional rules would have to be enforced to implement this option. First, the number of renewals permitted for any resource-verified priority CRR allocation would be governed by the term of the underlying commercial arrangement that gave rise to the priority. Second, no CRR awarded on the basis of a resource-verified priority

would be allowed to be converted to a long-term CRR unless the underlying commercial arrangement is for a term of at least 10 years. With these rules in place, initial “have-not” LSEs like SDG&E would have better prospects for being allocated useful CRRs in the future based on load share ratio. The initial resource-verified priority nominations would wane as the 2006 historical period contracts, especially the CPUC-allocated CDWR contracts, expire, thereby gradually allowing a more equitable equilibrium to prevail.

III. CONCLUSION

SDG&E urges the CAISO to incorporate one of the two approaches discussed above in its upcoming CRR filing at FERC so that a just and reasonable allocation methodology for short and long-term CRRs can be finalized for incorporation into the Release 1 MRTU tariff. The use of an historical period for CRR allocation purposes is designed to capture the past in order to reflect the expected future. SDG&E described in a previous comment the historical events that have distorted the calendar year 2006 snapshot of its procurement practices. The result is a sample that does not accurately reflect SDG&E’s significant 30-year effort to be integrated closely with areas beyond its service territory. Consequently, the basic premise underlying the use of a 2006 historical period is inapposite to SDG&E going forward.

Under the current CAISO allocation proposal, if SDG&E is unable to secure in the initial allocation a *pro rata* share of useful CRRs to hedge its known procurement portfolio, then SDG&E’s customers are almost certain to be financially damaged indefinitely. SDG&E has proposed above two different ways to promote better alignment between its known procurement portfolio and its allocation of CRRs to hedge that portfolio. The first option is to allow known, future resources to be substituted for 2006

resources that expired or were otherwise removed by March 1, 2007. The second option is to place limits on renewals and long-term CRR conversions to ensure that CRRs obtained on the basis of resource-verified priority access to Tiers 1 and 2 cannot be locked up beyond the term of the commercial arrangement that gave rise to the allocation priority in the first place.

Respectfully submitted,

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