Memorandum

To: ISO Board of Governors

From: Ryan Seghesio, Chief Financial Officer and Treasurer

Date: July 8, 2014

Re: **Decision on 2015 grid management charge**

This memorandum requires Board action.

EXECUTIVE SUMMARY

The grid management charge (GMC), is the vehicle through which the California Independent System Operator Corporation recovers its administrative costs. The GMC is based on a formula rate whereby the ISO's revenue requirement is allocated across three high-level cost categories and seven fees. The current rate structure expires December 31, 2014.

After completing an updated cost of service study and stakeholder process, the ISO is proposing the following changes to the GMC rate structure and revenue requirement:

- Updates to two cost category allocation percentages,
- Update the transmission ownership rights charge, and
- Increase the annual revenue requirement maximum by $3 million to $202 million with no set end date.

In addition, the ISO will add to its tariff a requirement to conduct a cost of service update every three years and make changes to the service category percentages and fees, if necessary. As part of the cost of service study, the ISO also updated the cost of service basis for the energy imbalance market administrative charge. There are no changes proposed for this charge.

Summary of Proposed Changes to Percentages and Charges for 2015

	Charge code	Current	Proposed	Change
Included in miscellaneous revenue				
Energy imbalance market administrative charge	4564	$ 0.19	$ 0.19	
Cost Category percentages				
Market services	4560	27%	27%	
System operations	4561	69%	70%	1%
Congestion revenue rights services	4562	4%	3%	(1%)
Fees and charges credited against service categories				
Bid segment fee	4515	$ 0.005	$ 0.005	
Inter-scheduling coordinator trade fee	4512	$ 1.00	$ 1.00	
Transmission ownership rights charge	4563	$ 0.27	$ 0.24	$ (0.03)
Congestion revenue rights auction bid fee	4516	$ 1.00	$ 1.00	
Scheduling coordinator-identification fee	4575	$ 1,000	$ 1,000	
Cost of service study update	Every three years and file for changes if necessary			

Summary of Proposed Changes to Revenue Requirement for 2015

Revenue requirement component	Current	Proposed
Maximum	$199 million	$202 million
Term	2015	No end date

Moved, that the ISO Board of Governors approves the proposed tariff changes regarding the 2015 GMC update, as described in the memorandum dated July 8, 2014; and

Moved, that the ISO Board of Governors authorizes Management to make all necessary and appropriate filings with the Federal Energy Regulatory Commission to implement the proposed tariff change.

BACKGROUND AND PROPOSED 2015 GMC UPDATE

The GMC is the vehicle through which the ISO recovers its annual revenue requirement from the entities that use ISO services. Funding the annual revenue requirement ensures that the ISO recovers its administrative, operating and capital costs. The current GMC rate design was vetted through a stakeholder process, approved by the ISO Board of Governors and the Federal Energy Regulatory Commission in 2011, and became effective January 1, 2012. As part of that order, the annual maximum revenue requirement was capped at $197 million for 2012 and $199 million for 2013 and 2014. The current revenue requirement expires at the end of 2014; accordingly the ISO is seeking a revised revenue requirement beginning in 2015. Since the proposed revenue requirement exceeds the maximum limit, FERC will have to approve an ISO filing seeking a revenue requirement increase under Section 205 of the Federal Power Act.

The GMC is made up of three service buckets and seven fees. The revenue requirement is allocated into the three service buckets: market services, system operations and congestion revenue rights services based on percentages developed in a 2012 cost of service study. The seven fees are fixed amounts and have a basis in the cost of service study.

In 2013 the ISO and PacifiCorp agreed to form the energy imbalance market, which relies on the real time portion of the market services activities and system operations activities. The energy administrative market administrative charge, derived from the 2010 GMC cost of service study, was developed in collaboration with stakeholders and is fixed for 2014.

As discussed further below, the ISO updated the 2012 cost of service study and has developed the following proposals for the 2015 GMC:

1) Adjust the percentage allocation for the three service categories using the 2015 cost of service study. The cost of service study is based on actual time incurred by ISO employees during 2013 applied to the 2013 budget.

2) Update the energy imbalance market administrative charge fee by:
   a. starting with the 2015 cost of service update;
   b. applying the percentage share of real time costs for market services to the 2013 market services rate to derive a rate for the real time market;
   c. applying the percentage share of real time costs for system operations to the 2013 rate for system operations to derive a rate for real time dispatch; and
   d. combining the two real time rates to determine the energy imbalance market administrative charge rate.

3) Update the transmission ownership rights charge using the 2015 cost of service update.

4) Propose a $3 million increase in the maximum revenue requirement and eliminate the tariff sunset provision.

The ISO will recalculate the cost categories percentages, the energy imbalance market administrative charge and the transmission ownership rights charge every three years and will provide the updated information to stakeholders. If those percentages change, a filing will be made with FERC to modify the rates or percentages.

COST OF SERVICE STUDY

To determine if changes to the GMC structure for 2015 and beyond were needed, the ISO updated its 2012 cost of service analysis. By way of background, the ISO implemented activity based costing in 2010. Activity based costing was utilized for the 2012 cost of service study to restructure the GMC rate design. The structure contains three cost categories: market services, system operations and congestion revenue rights services. Percentages are applied to the revenue requirement to determine the amount in each of the three cost categories upon which rates are set. The market services charge encompasses all activities related to the processing of bids to issuing schedules in both the day ahead market and real-time market. The system operations charge encompasses all activities related to the dispatch of energy in support of grid conditions and balancing area activities, such as transmission planning. The third component, congestion revenue rights services charge encompasses activities surrounding congestion revenue rights.

The updated 2015 cost of service analysis uses 2013 data to determine the percentages for the three cost categories, as reflected in the following table.

Summary of 2013 Cost of Service Study ($ in millions)

Revenue Requirement	2013 Budget	Market Services	System Operations	CRR Services	Indirect
Direct operating and maintenance costs	$ 68.4	$ 12.9	$ 42.5	$ 0.9	$ 12.1
Indirect operating and maintenance costs	64.7				64.7
Non-ABC support operating and maintenance costs	29.8	0.6	1.8		27.4
Total operating and maintenance costs	**162.9**	**13.5**	**44.3**	**0.9**	**104.2**
Debt service 2008 bonds	24.7	7.3	12.5	1.2	3.7
Debt service 2009 bonds	17.8				17.8
Cash funded capital	24.0				24.0
Other income	(7.9)	(0.7)	(4.9)		(2.3)
Operating reserve credit	(25.5)	(1.7)	(3.0)	(0.3)	(20.5)
Total before allocation of indirect costs	**196.0**	**18.4**	**48.9**	**1.8**	**126.9**
Total direct cost percent		**27%**	**70%**	**3%**	
Allocate indirect costs		34.3	88.8	3.8	(126.9)
Total revenue requirement	**$ 196.0**	**$ 52.7**	**$ 137.7**	**$ 5.6**	**$ -**
Cost category percentages	**100%**	**27%**	**70%**	**3%**	

ENERGY IMBALANCE MARKET ADMINISTRATIVE CHARGE

The energy imbalance market relies on the ISO's existing real time portion of the market services activities and system operations activities. Real time activities occur in market services for the real time market and in system operations for real time dispatch. Conceptually, energy imbalance market participants will pay the same rate as existing customers but only for the real time market and real time dispatch activities specifically related to the energy imbalance market.

To determine the updated energy imbalance market administrative charge, using the 2015 cost of service study, the ISO identified and aggregated the real time activity costs allocated to the two main cost categories. Indirect costs were then allocated to the categories based on the proportion to direct costs. The respective real time cost proportions were then applied to the respective rates for market services and system operations. For the final step, these two real time rates were added to derive the updated energy imbalance market administrative charge rate. The energy imbalance market administrative charge will remain fixed until the next cost of service study.

Summary of EIM Rate ($ in millions)

Category	Revenue requirement	Net fees	Net costs	Cost of real time activities	% share of costs	2013 rate	EIM rate per MWh
Market Services	$52.7	($5.1)	$47.6	$28.9	61%	$0.09	$0.06
System Operations	137.7	(1.0)	136.7	60.9	45%	$0.29	$0.13
CRR Services	5.6	(0.2)	5.4	-	-	$0.01	-
Total	**$196.0**	**(6.3)**	**$189.7**	**$89.8**	**47%**		**$0.19**

The costs include the energy imbalance market's share of all components of the ISO's revenue requirement such that energy imbalance market participants will pay the same rate as existing customers for the real time activities they are using.

TRANSMISSION OWNER RIGHTS CHARGE

Under the existing GMC, transmission owner rights are granted a discounted rate due to the limited ISO services they require and because they utilize ISO controlled grid facilities within the ISO balancing authority area. The 2015 cost of service study underlying the transmission owner rights charge was updated. Based on the 2015 cost of service study, the ISO proposes a new rate of $0.24/MWh of transmission owner rights flow.

REVENUE REQUIREMENT MAXIMUM AND TERM

The ISO is proposing a long term revenue requirement maximum of $202 million with no sunset date. The ISO's annual budget development stakeholder process has been an effective tool and will remain in place. As long as the ISO's annual budget for each year does not exceed the annual revenue requirement maximum, and there are no proposed GMC rate design or billing determinant modifications for the next year, the ISO will not seek changes to the revenue requirement maximum or the GMC rate structure through a Section 205 filing. The annual budget will continue to be presented to the Board for decision at its December meeting.

The table below shows the major components of the actual revenue requirement from 2005 through 2014 and projected amounts of the revenue requirement for 2015 to 2019.

Summary of Components of Revenue Requirement 2005-2018

($ amounts in millions)

Year	Operations and maintenance Budget	All other costs (a)	Total revenue requirement	Bundled rate cents per MWh
Actual revenue requirement				
2005	$147	$62	$209	85
2006	$134	$47	$181	72
2007	$144	$46	$190	76
2008	$153	$39	$192	76
2009	$157	$36	$193	78
2010	$163	$32	$195	79
2011	$163	$27	$190	79
2012	$163	$32	$195	80
2013	$163	$33	$196	80
2014	$164	$34	$198	80
Projected revenue requirement				
2015	$168	$32	$200	80
2016	$170	$30	$200	80
2017	$174	$28	$202	80
2018	$178	$23	$201	80
2019	$183	$19	$202	80

The category labeled “All other costs” includes all of the remaining revenue requirement categories except for the operations and maintenance budget which are debt service including the 25% debt service reserve, cash funded capital, operating reserve credit from prior year, and miscellaneous income.

The ISO plans to fund future capital projects from GMC funds and not through the issuance of debt. Funding of capital projects through the GMC avoids interest costs, the 25% debt service reserve and issuance costs. Annual capital and project budgets are forecast to run from $19 million to $24 million. Cash funded capital takes the place of the 2008 debt service which was used primarily to fund the software related to implementation of the new market.

The ISO’s current revenue requirement is $198 million which is 99.5 percent of the revenue requirement maximum of $199 million. The ISO believes that a long term commitment to a revenue cap is superior to a six year term and will work diligently to stay within the revenue requirement maximum in future years rather than seeking an extension.

Over the last five years the increase in the consumer price index has averaged 2.1% while the increase in the ISO revenue requirement has averaged only 0.5%. The increase in the proposed revenue requirement maximum from $199 million to $202 million is only 1.5% - which is in line with the consumer price index for 2013 of 1.5%. Under the assumption that MWh volumes will increase over time, a long term cap of $202 million will keep rates flat or decreasing.

In addition to the extensive annual budget process, the ISO will add tariff language requiring that the cost of service study be updated every three years. Stakeholders will have opportunities for input and comment throughout that process. The ISO believes that there are sufficient opportunities for stakeholders to engage in the process, review the efficiency of the rate design and provide input into the resulting rates. Further, the ISO believes that eliminating the revenue requirement sunset provision is just and reasonable.

POSITIONS OF THE PARTIES

The ISO presented a straw proposal, a draft final proposal and engaged with stakeholders to discuss GMC at the following meetings and or calls:

- April 2014 – meeting to discuss the proposed 2015 GMC update
- May 2014 – call to discuss the final 2015 GMC update proposal

There was one stakeholder comment on the final 2015 GMC update proposal:

- CDWR commented that they could not support increasing the revenue requirement maximum but supported no sunset date.

Management believes the revenue requirement maximum is appropriate for the reasons discussed above.

MANAGEMENT RECOMMENDATION

Management recommends the 2015 GMC update as set forth above. The current rate structure expires December 31, 2014 and the GMC is the vehicle through which the ISO recovers its administrative costs. This proposed 2015 GMC update is based on cost causation principles, has been vetted with stakeholders and displays Management's commitment to cost containment and long term stable rates.