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July 23, 2007

Honorable Kimberly D. Bose, Secretary
Federal Energy Regulatory Commission
888 First Street, NE
Washington, DC 20426

Re: Termination of SWPL Operations Agreement
California Independent System Operator Corporation Original Rate
Schedule FERC No. 60
Docket No. ER07-

Dear Secretary Bose:

The California Independent System Operator Corporation ("CAISO") tenders for filing the enclosed Notice of Termination of the SWPL Operations Agreement ("Operations Agreement"), Original Rate Schedule FERC No. 60. This filing is made pursuant to Sections 35.15 and 131.53 of the Commission's regulations (18 C.F.R. §§ 35.15, 131.53), and the termination will be effective at the end of the Trading Day,¹ September 30, 2007. As discussed below, the Operations Agreement effectuated a settlement between the CAISO and San Diego Gas & Electric Company ("SDG&E") that resolved protracted litigation related to the CAISO's assessment of rates and charges to certain transactions on the Southwest Powerlink ("SWPL") transmission line. As the result of a series of decisions by the U.S. Court of Appeals and the Commission, SDG&E is now authorized to recover through its Transmission Revenue Requirement the SWPL cost differentials that were addressed through the settlement. The Operations Agreement, accordingly, terminates under its own terms.²

¹ Capitalized terms not otherwise defined have the meaning given them in Appendix A of the ISO Tariff.

² *Southern Cal. Edison Co., et al. v. FERC*, 415 F.3d 17 (D.C. Cir. 2005), *rev'ing and vacating*, *Pacific Gas & Elec. Co.*, 100 FERC ¶61,156 (2002) (Opinion No. 458), *reh'g denied*, 101 FERC ¶ 61,151 (2002) (Opinion No. 458-A); *Pacific Gas & Elec. Co., et al.*, 113 FERC ¶ 61,296 (2005); *SDG&E*, Docket No. ER06-818-000, Letter Orders dated May 31, 2006, August 7,

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I. Background

SWPL is a 500 kV transmission line that runs from the Palo Verde/Hassayampa Substation in Arizona to the Miguel Substation in San Diego County, California. The entire SWPL line is located within the CAISO Control Area. SDG&E, Arizona Public Service Company ("APS") and Imperial Irrigation District ("IID") jointly own SWPL.

The rights of the joint owners of SWPL are specified in two contracts executed in the 1980s, one between SDG&E, APS, and IID and the other between SDG&E and IID ("SWPL Ownership Agreements"). Under the terms of the SWPL Ownership Agreements, SDG&E, as the majority owner, operates the line and serves as the scheduling agent for APS and IID transactions on SWPL, and is responsible for submitting Schedules for such transactions to the CAISO. Among other matters, the SWPL Ownership Agreements establish procedures for determining line losses on SWPL transactions and allocate cost responsibility for those losses among the joint owners.

SDG&E transferred Operational Control of its transmission facilities and Entitlements, including the SWPL line, to the CAISO by signing the Transmission Control Agreement ("TCA") in 1998. When it began operations, and thereafter, the CAISO treated the APS- and IID-owned portions of SWPL and attendant rights ("APS/IID SWPL Shares") as Encumbrances on the ISO Controlled Grid under the TCA and assessed the costs of transmission losses, uninstructed deviations, the Grid Management Charge ("GMC"), and other applicable charges to transactions on the APS/IID SWPL Shares ("APS/IID SWPL Transactions"). The CAISO assessed those charges to SDG&E as the Scheduling Coordinator for the APS/IID SWPL Transactions.

The transmission loss percentages calculated by the CAISO were higher than the losses provided for in the SWPL Ownership Agreements and resulted in CAISO charges to SDG&E as the Scheduling Coordinator for APS/IID SWPL Transactions that exceeded the cost responsibility of APS and IID under the terms of the SWPL Ownership Agreements. The CAISO also assessed other charges, such as Ancillary Services, based on the SWPL Transactions that SDG&E could not fully recover under the SWPL Ownership Agreements.

In 1997, SDG&E had filed its original Transmission Owner Tariff, consistent with the ISO Tariff, that would have allowed SDG&E to recover its "cost differentials", *i.e.*, the difference between the CAISO's charges for losses, Imbalance Energy and Ancillary Services and the compensation provided for such matters by its Existing Contracts (such as the SWPL Ownership

Agreements), through the Transmission Revenue Balancing Account ("TRBA"), which is a component of its Transmission Revenue Requirement. In Opinion No. 458, however, the Commission ruled that SDG&E and the other original Participating Transmission Owners could not use the TRBA to recover such differentials and rejected that approach.³ SDG&E and the other Participating Transmission Owners sought review of Opinion No. 458, and Opinion No. 458-A that denied rehearing of the original decision, in the Court of Appeals.

While the appeal was pending, SDG&E initiated several legal challenges to the CAISO's authority to assess the charges on the APS/IID SWPL Transactions.⁴ The CAISO in each matter defended its authority to assess such charges.

In order to settle what was becoming protracted litigation, the CAISO and SDG&E entered into companion agreements, the "SWPL Settlement Agreement" and the Operations Agreement (collectively, "SWPL Settlement"), under which the CAISO would treat the APS- and IID-owned portions of SWPL as outside the ISO Controlled Grid and would refund to SDG&E the historic charges for transmission losses and uninstructed deviations, GMC, and other applicable charges. SDG&E, as the line operator for SWPL, would instead pay a new annual Line Operator Charge to the CAISO to compensate the CAISO for its capital costs and administrative expenses related to administering the SWPL Ownership Agreements. The agreement additionally provides that Transmission Losses for the APS/IID SWPL Transactions will be assessed to SDG&E based on a fixed percentage of 0.5 percent for calendar years 2005 through 2008, and thereafter on a fixed loss percentage determined annually based on actual losses

³ *Pacific Gas and Elec. Co., et al.*, 100 FERC ¶ 61,156 (2002) (Opinion No. 458), *reh'g denied*, 101 FERC ¶ 61,151 (2002) (Opinion No. 458-A).

⁴ *Cal. Indep. Sys. Operator Corp.*, Docket No. EL04-24-000 (CAISO appeal of October 23, 2003 Award in an arbitration initiated by SDG&E under ISO Tariff Section 13.2.2, which held that the non-SDG&E owned portions of SWPL are not part of the ISO Controlled Grid and are not subject to CAISO charges); *San Diego Gas & Elec. Co. v. FERC*, Case No. 04-1092 (D.C. Cir.) (SDG&E appeal of Commission Decisions in 2001 GMC case, at 103 FERC ¶ 61,114 (2003) and 106 FERC ¶ 61,032 (2004)), which held that APS and IID Schedules transmit Energy on the ISO Controlled Grid and the CAISO has authority to charge SDG&E the CAISO's administrative costs for procuring Imbalance Energy to cover imbalances, including transmission losses on the APS and IID SWPL shares; and *Cal. Indep. Sys. Operator Corp.*, 111 FERC ¶ 61,125 (2005) (order setting for hearing reserved issue of the 2004 GMC), concerning Imbalance Energy charges related to SWPL transaction, which granted SDG&E's request for rehearing and instituted hearing procedures on the reserved issue concerning SDG&E's objection to the application of GMC charges to Energy Schedules for APS/IID SWPL Transactions. SDG&E also protested the CAISO's compliance report in the 2001 GMC proceeding, related to refunds for SDG&E's self-provision of Imbalance Energy.

for the prior year. SDG&E also agreed to operate SWPL in accordance with specified operating requirements.

The SWPL Settlement did not resolve, but did address, the consolidated appeal of the Participating Transmission Owners, including SDG&E, of Commission Opinion Nos. 458 and 458-A. Both of the agreements in the SWPL Settlement included a provision that expressly conditioned the settlement on the outcome of that appeal. These special provisions provided for termination of the agreements in event that SDG&E prevailed in that case and obtained cost recovery of the SWPL cost differentials. Specifically, those provisions are as follows:

- **Termination for D.C. Circuit Case.** This Operations Agreement shall terminate if SDG&E prevails in SDG&E, et al. v. FERC, Case Nos. 02-1374, et al. (D.C. Cir.) with respect to FERC Opinion Nos. 458 and 458-A and is permitted to include in its Transmission Revenue Requirement all ISO charges applicable to APS and IID SWPL transactions in excess of the compensation owed to SDG&E by APS and IID under the SWPL Agreements.

Operations Agreement, § 2.2.5.

- **TO Tariff appeal:** SDG&E shall maintain its petition for review of FERC Opinion Nos. 458 and 458-A (Nos. 02-1374, et al., D.C. Cir.). If SDG&E prevails and is permitted to include all ISO charges to SDGE SCID for APS/IID SWPL Transactions in its TO Tariff rates, this Settlement Agreement will terminate and each Party will return any and all refunds and payments made pursuant to this Settlement Agreement, within 30 days of the date of a final, non-appealable FERC order accepting SDG&E's implementing pass-through report.

SWPL Settlement Agreement, § 5.5

On May 24, 2005, as amended on August 2, 2005, the CAISO filed the Operations Agreement with the Commission in Docket No. ER05-1013. The Commission accepted the Operations Agreement for filing by letter order dated

August 22, 2005.⁵

On July 12, 2005, the D.C. Circuit issued an opinion that granted SDG&E's Petition for Review.⁶ The Court vacated Opinions Nos. 458 and 458-A and remanded the case to the Commission for further proceedings consistent with its decision.⁷ The Court ruled that the ISO Tariff, which the Commission had earlier found to be just and reasonable, explicitly permits the inclusion of the cost differentials in the TRBA of the TO Tariffs; therefore, the Commission could not find the TO Tariffs, which conform to the CAISO Tariff, unjust and unreasonable.⁸

On remand, the Commission concluded that the TRBA was a proper vehicle for the recovery of the cost differentials. Specifically, it ruled that the Participating Transmission Owners could recover the cost differentials, consistent with the CAISO Tariff, through either bilateral negotiations between the parties to Existing Contracts or through the TRBA in the TO Tariffs.⁹

On March 31, 2006 SDG&E submitted to the Commission, in Docket No. ER06-818-000, amendments to its TO Tariff to implement the Commission's remand order, under which SDG&E would include the cost differentials related to APS/IID SWPL Transactions in its TRBA. The Commission approved the amendments by letter orders dated May 31, 2006, August 7, 2006, and September 27, 2006.

On September 29, 2006, SDG&E advised the CAISO of these Court and Commission rulings, and requested that the parties engage in discussions about unwinding the SWPL Settlement Agreement and Operations Agreement. Several discussions followed, which led to SDG&E and CAISO agreement on reversing the refunds and payments that had been made under the SWPL Settlement for the historic period, as well as on the amount of the adjustments and the process for accomplishing the reversal. Both parties have undertaken and completed the reversal process. The CAISO's compliance filing for the reversal of the GMC-related portion of the refunds and payments was submitted to the Commission on July 2, 2007 in Docket Nos. ER04-115-007.

⁵ On June 8, 2005, the CAISO filed the Settlement Agreement to resolve outstanding issues in Docket No. ER04-115. The Commission approved the settlement on September 22, 2005. *Cal. Indep. Sys. Operator Corp.*, 112 FERC ¶ 61,329 (2005).

⁶ *Southern Cal. Edison Co. v. FERC*, 415 F.3d 17 (D.C. Cir. 2005).

⁷ *Id.* at 23.

⁸ *Id.* at 21.

⁹ *Pacific Gas & Elec. Co., et al.*, 113 FERC ¶ 61,296 at P 18 (2005), *reh'g granted*, 115 FERC ¶ 61,226 (2006).

On June 4, 2007, the CAISO notified SDG&E of its intention to terminate the Operations Agreement. The letter is attached as Attachment B.

II. TERMINATION

As noted above, Section 2.5.5 of the Operations Agreement provides that the agreement shall terminate if (1) SDG&E prevailed in its Petition for Review of Commission Opinion Nos. 458 and 458-A and (2) SDG&E received permission to recover the cost differentials through its Transmission Revenue Requirement. Both conditions for termination have occurred.

The Court of Appeals ruled in SDG&E's favor in the consolidated appeal by the Participating Transmission Owners in *Southern Cal. Edison Co., et al. v. FERC*, 415 F.3d 17 (D.C. Cir. 2005). Specifically, the Court found that:

The language of the ISO Tariff at issue in this case is clear. Section 2.4.4.4.5 of the ISO Tariff is permissive, allowing for the recovery of cost differentials through the TO Tariffs, as well as through bilateral negotiations to reform existing contracts. The provision for the collection of a Transmission Revenue Credit as part of the Access Charge in section 7.1, combined with the definition of Transmission Revenue Credit, creates an explicit accounting mechanism for the ISO to recover the cost differentials through the TO Tariff on the TOs' behalf. Thus, Utility Petitioners are correct that the ISO Tariff allows them to recover the cost differentials associated with the formation of the ISO through their individual TO Tariffs.

Id. at 29.

The Court vacated Commission Opinion Nos. 458 and 458-A, and remanded the case to FERC for further proceedings consistent with the ISO Tariff. On remand, the Commission permitted the Participating Transmission Owners to include the cost differentials in their respective TRBAs, as part of the Transmission Revenue Requirement upon which transmission rates are set. *Pacific Gas & Electric Co. et al.*, 113 FERC ¶ 61,296 (2005).

On March 31, 2006, SDG&E filed for an out-of-cycle increase in its TRBA in Docket No. ER06-818-000, to implement the Commission's order on remand. This filing was accepted by the Commission in Letter Orders dated May 31, 2006, August 7, 2006, September 27, 2006.

As a result of these Court and Commission decisions, SDG&E is authorized to recover the SWPL cost differentials through its TRBA. Accordingly, the conditions for terminating the SWPL Settlement have been met and the Operations Agreement terminates according to its terms.

When a contract terminates according to its own terms, the only prerequisite to Commission approval is a finding that the termination would be just and reasonable. *Sacramento Muni. Util. Dist.*, 474 F.3d 797, 800-01 (D.C. Cir. 2006). In this instance, the decision of the Court of Appeals and the decision on remand have eliminated the underlying purpose of the agreement. Perpetuation of the agreement would serve no legitimate goal. *Cf. Pacific Gas & Elec. Co.*, 111 FERC ¶ 61,175 at P 26 (fact that contract would not further purpose of original agreements favors termination). In this instance in particular, since SDG&E has already acted to implement the order on remand and received Commission approval to include the cost differentials in its TRBA, there is no logical basis to continue in effect an agreement by which SDG&E is exempted from paying the charges that give rise to the cost differentials.

Further, SDG&E and the CAISO have already reversed the refunds and payments made for the historic portion of the settlement, and did so based on the termination provisions in the SWPL Settlement that were triggered by the Court of Appeals' decision and the Commission's orders. It would be unreasonable to leave the Operations Agreement in effect on a going-forward basis when its companion SWPL Settlement Agreement terminated due to the occurrence of the same underlying events.

In addition, as a provider of open access, non-discriminatory transmission, the CAISO must treat all customers similarly except to the extent they are differently situated. With the reversal of Opinion Nos. 458 and 458-A, the basis for special treatment of the SWPL transactions no longer exists, and SDG&E, as the Scheduling Coordinator for those transactions, should be assessed the applicable rates and charges and be subject to the standard provisions of the CAISO Tariff. Moreover, ending this special contractual arrangement, which was designed to address issues arising under the current tariff construct, is reasonable and in the public interest as the CAISO proceeds toward the implementation of its Market Redesign and Technology Upgrade.

For these reasons, the CAISO respectfully requests that the Commission accept the termination of the Operations Agreement.

III. EXPENSES

No expense or cost associated with this filing has been alleged or judged in any judicial or administrative proceeding to be illegal, duplicative, unnecessary, or demonstratively the product of discriminatory employment practices.

IV. SERVICE

Copies of this filing have been served upon SDG&E and all parties on the official service list for Docket No. ER05-1013-000. In addition, the filing has been posted on the CAISO's website.

Enclosed for filing are six copies of each of the following:

- (1) this letter of transmittal;
- (2) Notice of Termination effective at the end of the Trading Day, September 30, 2007 (Attachment A); and
- (3) the termination notice letter (Attachment B).

Also enclosed are two additional copies of this filing to be date-stamped and returned to our messenger.

V. CORRESPONDENCE

The CAISO requests that all correspondence, pleadings and other communications concerning this filing be served upon the following:

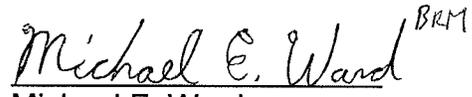
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203(b)(3), 18 C.F.R. § 203(b)(3).

Respectfully submitted,


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Counsel for the California Independent
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ATTACHMENT A

ATTACHMENT B



California ISO
Your Link to Power

California Independent System Operator Corporation

Jim Detmers
Vice President, Operations

June 4, 2007

Mr. Jim Avery
Senior Vice President
San Diego Gas & Electric
8330 Century Park Court
San Diego, CA 92123-1530

Dear Jim:

I'm writing to follow up on the discussion we had on Thursday, May 10. As you know, our respective teams worked extremely hard and collaborated together in an effort to identify a suitable replacement for the SWPL Line Operations Agreement (LOA). Regrettably, we were unable to formulate an acceptable alternative. I understand that your company is in a very difficult situation in relation to your pre-existing contracts with APS and IID. However, for the reasons outlined in our call, and after a comprehensive review of the issues and options available, the CAISO has no alternative other than to terminate the LOA. Consequently, David Timson will be contacting Scott Peterson in the near future to coordinate an orderly termination of the LOA.

As I'm sure you remember, SDG&E's primary motivation in negotiating the original LOA was due to a significant disparity in cost recovery related to the to the transmission losses associated with APS/IID schedules. Based on our LMP studies, it appears highly probable that the costs attributed to losses on the APS/IID schedules will be lower than what SDG&E is authorized to collect from IID under the existing contracts. We believe this change may go a long way in offsetting other transactional costs associated with the schedules.

Thank you for taking time to discuss your issues related to ISO transactional costs in relation to other Control Area schedules. I am concerned about the relative costs and we are committed to working with SDG&E in an effort to identify opportunities that will encourage increased use of the CAISO Grid providing lower costs for all participants.

This was a difficult decision for the CAISO to arrive at and I sincerely hope it does not diminish the positive working relationship our Companies have had over the past several years.

Sincerely,

A handwritten signature in black ink, appearing to read "Jim Detmers".

Cc: K. Edson
D. Fuller
B.A. Burns
D. Timson

CERTIFICATE OF SERVICE

I hereby certify that I have served the foregoing document upon the parties listed to receive service in the attached document, in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and Procedure (18 C.F.R. § 385.2010).

Dated at Folsom, California this 23rd day of July, 2006.

Susan Montana ^{BAM}
Susan Montana