Exh. No. ISO-21

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

California Independent System Operator Corporation	)	Docket Nos. ER01-313-000
	)	ER01-313-001
	)	
Pacific Gas and Electric Company	)	Docket Nos. ER01-424-000
	)	ER01-424-001

REBUTTAL TESTIMONY OF
PHILIP R. LEIBER
ON BEHALF OF THE
CALIFORNIA INDEPENDENT SYSTEM
OPERATOR CORPORATION

Q. PLEASE STATE YOUR NAME.

A. Philip R. Leiber.

Q. ARE YOU THE SAME PHILIP LEIBER WHO HAS SUBMITTED TESTIMONY IN THIS PROCEEDING PREVIOUSLY?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I will respond to testimony submitted by certain intervenors and Commission Staff regarding historic increases in the ISO's revenue requirement, the level of the revenue requirement for 2001, the allocation of that revenue requirement among the three categories of the Grid Management Charge ("GMC") and the ISO's selection of the basis on which to bill for one component of the GMC, namely the Control Area Services ("CAS") Charge. On the last topic, I will address testimony by Mr. Kirsch that suggested the ISO should bill the CAS on some basis other than Load, while another witness, Deane Lyon, will be addressing testimony suggesting that the ISO should use "net" Load rather than "gross" Load as the billing determinant. I will also explain certain realities of the ISO's financial operations as they are relevant to the positions taken by intervenors and Commission Staff.

Q. WHAT CONCLUSIONS WILL YOU BE PRESENTING?

A. With respect to the revenue requirement, I will establish that it is fully justified and that none of the reductions proposed by others should be required. With respect to allocations among the three GMC categories, I will conclude that proposed re-allocations should not be adopted in this proceeding due to other, over-riding considerations. I also urge that the Commission apply only prospectively any changes in allocations that it might order. Finally, I conclude that the Commission should reject Mr. Kirsch's recommendation that the ISO bill the CAS Charge on a basis other than Load, although I also note that the proposal could be vetted through a subsequent stakeholder process.

Q. ARE YOU SPONSORING ANY EXHIBITS?

A. Yes, I am sponsoring 7 exhibits.

- Exh. No. ISO-16 is the Testimony I submitted with the ISO's December 15, 200 filing. It is being re-submitted now for ease of reference;
- Exh. No. ISO-18 is the Cost Allocation Matrix ("CAM") included as Attachment D with the December 15, 200 filing in this proceeding. It is being re-submitted now for ease of reference;
- Exh. No. ISO-22 are charts entitled "Tasks and Accomplishments vs. Revenue Requirement" for 2001 and 2002;
- Exh. No. ISO-23 is the ISO Budget presentation of October 16, 2000;

- Exh. No. ISO-24 is a study prepared by RJ Rudden Associates, dated September 21, 2001 and entitled "Report to the California ISO Regarding Cost Allocation Process";
- Exh. No. ISO-25 is a document entitled "Enhanced Allocation Detail for 2002" demonstrating how the ISO has improved the GMC cost allocations for 2002;
- Exh. No. ISO-26 is a document detailing ISO Human Resources statistics regarding retention and replacement of ISO personnel.

Q. WILL YOU BE REFERRING TO OTHER TESTIMONY OR FILINGS ON BEHALF OF THE ISO IN THIS PROCEEDING?

A. Yes. In my Direct Testimony, Exh. No. ISO-7, I described how the ISO budgeting process operates and how the various costs that make up the ISO's revenue requirement are assigned to the unbundled GMC categories, and the exhibits supporting my testimony provided examples of stakeholder participation in crafting the unbundled GMC. In the Testimony that I provided in the ISO's December 15, 2000 Filing, Exh. No. ISO-16, I went into substantial detail on the budgeting process for 2001, and explained the increased revenue requirement. My December 15 Testimony is now Exh. No. ISO-16. The allocation methodologies are described in greater detail in the Cost Allocation Matrix, which was included in the December 15 Filing as Attachment D, and which is now Exh. No. ISO-18. In his Direct Testimony, Exh. No. ISO-1, Michael Epstein described how the three GMC service categories were developed through a stakeholder process, and how methods were developed to allocate the ISO's costs among those three categories. I will be referring to these previous filings and pieces of testimony from time to time.

Q. WILL YOU BE USING ANY SPECIALIZED TERMS?

A. Yes, I will use capitalized terms as defined in the Master Definitions Supplement, Appendix A of the ISO Tariff.

I. REVENUE REQUIREMENT

Q. WHAT IS THE PURPOSE OF THIS PORTION OF YOUR TESTIMONY?

A. I will address general criticisms of the ISO's cost-control efforts to date. I also will respond to recommendations of measures that, according to witnesses making them, would give the ISO "incentives" to keep costs down. Finally, I will address specific recommendations for reductions in the ISO's revenue requirement for 2001.

Q. WHAT CONCLUSIONS WILL YOU PRESENT?

A. While it is perhaps understandable that parties paying the costs of the ISO would believe that those costs could be better controlled, I do not believe that the criticisms of the ISO's cost-control efforts are justified. I believe that most of the "incentives" for cost control recommended by others should not be adopted, although the ISO would agree with one of those measures, as I understand it to be proposed by the witness for the California Public Utilities Commission. Finally, I do not believe that the Commission should accept any of the specific recommendations for reductions in the ISO's revenue requirement.

A) <u>HISTORICAL INCREASES IN REVENUE REQUIREMENT</u>

Q. WHAT CRITICISMS HAVE WITNESSES MADE OF THE ISO'S BUDGETARY AND COST-CONTROL EFFORTS?

A. I have not seen any specific criticism of the actual budgetary process followed by the ISO. Rather, the criticisms are all in the nature of displeasure with the results of that process. For example, Mr. Cohen complains that the ISO's revenue requirement has increased 43 percent between 1999 and 2001, Exh. No. TNC-1 at 5-6, Mr. Helsby expresses concern that the revenue requirement increased 26 percent from 2000 to 2001, Exh. No. SMD-3 at 4-5, and Mr. Jobson contends that the ISO's costs are excessive. Exh. No. SMD-1 at 2-3.

Q. DO YOU HAVE ANY RESPONSE TO THESE WITNESSES' EXPRESSIONS OF DISPLEASURE WITH INCREASES IN THE ISO'S REVENUE REQUIREMENT?

A. While I understand that no one likes to see significant increases in the amount of costs that they have to pay, I believe all of the increases in the ISO's revenue requirement have been justified, and I do not believe the ISO's costs are excessive relative to the responsibilities of the ISO. It is important to keep in mind, as I will emphasize in several contexts during this testimony, that the ISO is a non-profit corporation. The ISO has no rate base on which it earns a return, such as is the case with a traditional utility. Its non-profit nature and the absence of a rate base means that the ISO has no incentive to increase its revenue requirement or asset base. No intervenor has suggested any incentive that the ISO might have to increase its revenue requirement beyond the level absolutely necessary to accomplish its various obligations to the public that depends on the reliability of the transmission system, to the participants in its markets, and to regulatory bodies.

The increases in the ISO's costs to date have been caused by the significant increases in the obligations thrust upon the ISO by regulators, as well as by the unexpected but now well-known complications and difficulties experienced since the start-up of the competitive California markets. As I described in my December 15 Testimony:

> In short, an increase in responsibilities and tasks performed by the ISO, and continued changes to our market rules and structure, increased the ISO's cost of doing business. Since startup in March 1998, the ISO has added substantially to its responsibilities, and has had to perform vital functions to ensure the reliability of the grid that were not originally contemplated. For instance, the ISO has had to

> lead efforts to encourage demand responsiveness programs in light of the tight energy supplies available to meet demand. Additionally, continued modifications to our market rules have required substantial changes to ISO computer software used to operate the grid and ISO markets. These changes have required not only up-front capital investments, but ongoing support costs for software maintenance agreements, computer hardware leases, and additional staff. Examples of this type of impact to our O&M costs include the ancillary service redesign efforts in 1999 and 2000, and the ongoing Comprehensive Market Design efforts, which will be implemented beginning in 2001. These efforts have caused and will continue to require substantial changes to ISO computer systems and staff that result in an increase in the ISO's ongoing costs. The ISO has also had to invest in tools and staffing to help it manage the grid effectively (for example procedures to handle out-of-market energy calls) and to meet regulatory requirements (for example, North American Electric Reliability Council-mandated Electronic Tagging requirements).

Exh. No. ISO-16 at 7-8.

The ISO has been required to undertake many new activities since start-up. Exh. No. ISO-22 demonstrates that the ISO's activities and responsibilities have increased dramatically.

Many of the new activities taken on by the ISO are a direct result of Commission Orders and directives of the State of California. As I described in my December 15 Testimony, the ISO's capital spending has increased in recent years to allow the ISO to implement changes to our market rules, and to allow the ISO to perform its increasing number of tasks. Exh. No. ISO-16 at 9. The ISO's 2001 budget was presented in a format to distinguish the costs of performing the tasks that the ISO had performed previously, versus those new responsibilities the ISO assumed. This provided a clear explanation of the increase in costs. If there are services the ISO should not be performing, then costs could be reduced. ISO management, however, has conducted top to bottom reviews of all aspects of the company's operations during the annual budgeting process, and has not identified significant programs or costs that are not considered important to our responsibilities. Similarly, if other parties have constructive, specific ideas to improve the ISO's cost efficiency, ISO management would be pleased to hear of them.

Q. WHILE THE ISO MAY HAVE NO PROFIT-BASED INCENTIVE TO INCREASE ITS REVENUE REQUIREMENT, SOME WITNESSES MIGHT BE SAYING IMPLICITLY THAT INCREASES HAVE BEEN GREATER THAN NECESSARY BECAUSE THE ISO HAS NO INCENTIVE TO KEEP COSTS DOWN. WHAT WOULD YOU SAY TO A SUGGESTION THAT THE ISO NOW HAS NO INCENTIVE TO KEEP COSTS DOWN?

A. I would disagree. First, the ISO has a duty under California law to ensure that the transmission system is used efficiently (Cal. Pub. Util. Code § 345), and the ISO interprets that duty to include an obligation to run its own business efficiently. Second, the personnel at the ISO are public-spirited and take seriously their obligation to control costs to the extent possible. These existing incentives to control costs have resulted in the ISO's implementing extensive cost-control measures. For example, capital projects costing over $1 million, even after they are included in the budget for a given year, are subject to review and approval by the ISO Governing Board when their costs are to be incurred. I described this in my December 15 Testimony, Exh. No. ISO-16 at 9. There is a significant desire on the part of the ISO management to control costs. Some of the efforts taken to discipline costs are documented in the annual budget package, attached as Exh. No. ISO-23. This exhibit previously was provided to the parties to this proceeding as an attachment to the ISO's response to Staff-ISO-32. These efforts have included benchmarking ISO costs against peers, contract renegotiations (*e.g.*, MCI and IBM), converting contracted staffing resources to permanent ISO employees where cost savings are possible, documenting alternatives to major initiatives to be approved by the ISO Governing Board, and others.

Q. DO YOU HAVE ANY RESPONSE TO MR. JOBSON'S RECOMMENDATION THAT "AN EFFECTIVE BUDGET REVIEW MECHANISM" MUST BE INSTITUTED?

A. Yes. I disagree with Mr. Jobson because I believe effective mechanisms already exist. The ISO's current budgeting process, as described in my Direct Testimony, Exh. No. ISO-7 at 21-24 and in my December 15 Testimony, Exh. No. ISO-16, already has mechanisms that encourage cost control. For example, the budgeting process is an open process, with the opportunity for interested parties to comment and influence the course of the budget. A preliminary budget is posted on the ISO web site in September, for the benefit of the public. Stakeholders have the opportunity to ask questions about and propose changes to this budget. Stakeholder comments are provided to the ISO Governing Board for their consideration before the final budget is approved. Stakeholder input has in past years played a significant role in the determination of the components of the ISO's capital budget.

Moreover, although SMUD witness Mr. Helsby has expressed concern that the ISO is not accountable to consumers, Exh. No. SMD-3 at 5, it is important to recognize that several stakeholders participating in the process described above are in fact representatives of consumer groups (*e.g.*, Michael Florio on behalf of TURN, "The Utility Reform Network"), or those responsible for consumer protection (*e.g.*, the California Electricity Oversight Board).

B) <u>RECOMMENDATIONS FOR COST-CONTROL INCENTIVES</u>

Q. DO ANY WITNESSES RECOMMEND THE ADOPTION OF SPECIFIC MECHANISMS TO INCREASE THE ISO's INCENTIVES TO CONTROL THE COSTS OF ITS OPERATION?

A. Yes. Mr. Jobson, Mr. Helsby, Mr. Pointer and Mr. Ramirez (on behalf of the California Public Utilities Commission) address this topic.

Q. WHAT ARE THEIR RESPECTIVE POSITIONS?

A. Mr. Jobson in Direct Testimony suggested that the ISO's budget increases should be limited to a specific percentage or dollar amount "above which the ISO must seek pre-approval from FERC or some other entity charged with consumer protection." Exh. No. SMD-1 at 10. Mr. Helsby in Direct Testimony recommended that the ISO should incorporate a revenue requirement ceiling into the ISO Tariff of 5 percent above the previous Commission-approved revenue requirement, with any proposed increase above the ceiling becoming effective only after Commission approval, and increases up to the ceiling becoming effective prior to Commission approval but subject to refund. Exh. No. SMD-3 at 7-8. Mr. Pointer's proposal is as follows:

> As a result of this proceeding, the parties will know the just and reasonable 2001 revenue requirement for each component of the GMC. Under this option, each of these just and reasonable revenue requirements will act as a mechanism to "trigger" the Commission's filing requirement for future CAISO GMC component revenue requirements. The CAISO would determine its projected revenue requirement for each component and as long as the projected revenue requirement for the applicable component did not exceed the "trigger" revenue requirement, the CAISO would not need to make a filing with the Commission concerning the numerator of the GMC component rates. If the CAISO's projected revenue requirements increase to a level above the "trigger" revenue requirements, the CAISO would be required to submit a filing under section 205 to support its proposal and to increase the "trigger" revenue requirements.

Exh. No. S-6 at 18-19. In Cross-Answering Testimony, Mr. Helsby said that he considered Mr. Pointer's proposal to be similar to the one he had made in Direct Testimony, *i.e.*, that Mr. Helsby like Mr. Pointer had proposed "placing a ceiling on the ISO GMC revenue requirements which would not be exceeded without a Section 205 filing." Exh. No. SMD- 10 at 2-3. Mr. Helsby went on to say that he had decided to adopt Mr. Pointer's proposed level of the ceiling in lieu of the level that Mr. Helsby had recommended in his Direct Testimony. *Id.* at 4. I interpret Mr. Helsby to mean that instead of a ceiling of

5 percent above current Commission-approved revenue requirement, he had decided to agree with Mr. Pointer that the ceiling should be exactly at that approved revenue requirement, and that there should also be a ceiling on each of the three components of the GMC set at the current Commission-approved level. Finally, Mr. Ramirez agreed with Mr. Pointer that there should be a ceiling on the overall revenue requirement and on each component of the GMC and that the ISO should be required to file under Section 205 to exceed any of those ceilings. Very importantly, however, Mr. Ramirez did not agree that the ceilings should be at the current Commission-approved level. Rather, he stated that the ceiling on the total revenue requirement should be at a level 10 percent greater than the current Commission-approved revenue requirement, and the ceiling on the revenue requirement for each of the three components of the total revenue requirement should be $5 million or 10 percent above the current Commission-approved level for that component. Exh. No. PUC-1 at 4-5.

Q. HOW DO YOU RESPOND TO MR. JOBSON'S PROPOSAL?

A. Mr. Jobson's recommendation that the ISO be required to obtain pre-approval from the Commission or some other regulatory body before implementing increased expenditures above some pre-determined amount is discriminatory and unworkable. (While Mr. Helsby's direct testimony suggested he might favor a similar ceiling above which the ISO would be required to obtain pre-approval, I interpret his adoption of Mr. Pointer's position as meaning he no longer would recommend that the ISO be required to obtain pre-approval to implement any increase, as opposed to implementing an increase subject to refund. If Mr. Helsby intends still to urge a ceiling above which the ISO requires pre-approval, my comments on Mr. Jobson's proposal also go to that aspect of Mr. Helsby's testimony.) To my knowledge, no other independent system operator is required to obtain such pre-approval. Moreover, the proposal is simply unworkable. No pre-determined hard ceiling could take into account the continuous and unforeseeable changes in the California market and the additional tasks and responsibilities the ISO is constantly being required to undertake. It would be impossible to craft a ceiling that would both act as an effective cost control measure and take into account the need for change and evolution in the ISO's activities. Mr. Helsby's concept of a 5 percent increase permissible during the interim prior to the new rate being approved (Exh. No. SMD-3 at 7) does not provide sufficient buffer.

In addition, one must recognize that the ISO's budgeting process is quite lengthy, lasting from June through October, or perhaps longer, in order to provide for a GMC filing and rates to be effective by the first of the year. Requiring the ISO's rates to be "pre-approved" would mean that the budgeting process for a given year would have to be moved many months earlier in time prior to the operating year, in order to allow for an entire regulatory proceeding before the budgeted rates could go into effect. This would create a yawning gulf between the time the ISO would have to make predictions regarding a year's costs and the time the costs actually would be incurred. Since estimates can be based only on the information available to the ISO when they are made, such a significant delay in the effectiveness of the GMC while the Commission reviews the ISO's proposed rates – perhaps as much as two years or more from the time of the estimate, given the possibility of appeals -- would render the estimate upon which they were based hopelessly out of date. Even under the statutory system, in which rates are meant to be effective within a couple of months of being finalized, estimates can sometimes be found to have been incorrect. The longer the delay between the prediction and the effective date, the greater the disparities will be.

Moreover, under Mr. Jobson's recommendation, in the interim between the date the rates would be filed and the date on which they would be approved by the Commission, the ISO would continue to incur costs. The ISO would still have to maintain the reliability of the grid, meet the requirements of the Western System Coordinating Council ("WSCC"), and undertake such new tasks as the Commission required of it. Should the rates in effect prove insufficient to finance such activities, the ISO would have no other source of revenue to fill the gap.

Additionally, any potential lenders would be unwilling to provide funds to the ISO under these circumstances. The ISO historically has depended on issuing bonds to fund its capital expenditure program, and prospective bond purchasers require assurance that debt service payments are covered in the ISO's rates. The end result of any additional constraints in this area would be either the ISO's inability to fulfill its responsibilities or the fatal undermining of the ISO's financial health – either of which would have grave consequences for the reliability of the ISO Controlled Grid and the interconnected grids

Q. WHAT IS YOUR REACTION TO THE OTHER WITNESSES' PROPOSALS?

A. I understand both Mr. Pointer and Mr. Helsby (after adopting Mr. Pointer's position) to be recommending simply that the ISO be required to follow the normal procedure under the Federal Power Act of filing any increase above the currently approved revenue requirement, and, if permitted by FERC, implementing it subject to refund. I understand Mr. Ramirez to be recommending a slight modification to that normal procedure. Mr. Ramirez would set "triggers" slightly above the currently approved revenue requirement, both for the total GMC and for each of the three categories within it, with the ISO required to file for Commission approval only if one of its proposed increases is above the level of the relevant trigger. To give a simplified example: If the approved level for the total GMC was $90 million, the revenue requirement for Control Area Services was $60 million and the revenue requirements for both Market Operations and Inter-Zonal Scheduling were $15 million, the ISO would not have to file unless either the total GMC increased more than $9 million (10 percent of $90 million), the revenue requirement for Control Area Services increased more than $6 million (10 percent of $60 million), or the revenue requirement for either Market Operations or Inter-Zonal Scheduling increased more than $5 million (since that alternative trigger is an increase in the budgeted revenue requirement of greater than 10 percent of the currently approved revenue requirement for each of those categories).

The ISO strongly favors Mr. Ramirez's recommendation. As both Mr. Pointer and Mr. Ramirez note, (Exh. No. S-6 at 5, 13; Exh. No. PUC-1 at 3), the ISO very much desires to avoid the necessity for annual rate filings, especially while the situation in California's electricity markets (and, indeed, the entire electricity industry in California) remains in such flux. The ISO does not have a dedicated, full-time rates department, but meets its current filing obligations through a staff of approximately four professionals who have other significant responsibilities in addition to the rates and budgeting function. Rate filings and defending them simply require too much of these people's time, given the constant demands on them to deal with the unexpected twists and turns in the California electric industry and the resulting shifts and, virtually always, increases in the responsibilities of the ISO. The ISO already commits significant resources to the development and documentation of its proposed budget (staff from throughout the ISO are involved in the preparation of the budget, not only the four professionals noted above), and provides for public participation prior to any rate filing at FERC.

It is true that Mr. Pointer’s proposal of annual filings any time there is any increase in revenue requirement would give the ISO a stronger cost-control incentive than would Mr. Ramirez’s, which provides some “leeway” for costs to increase without a filing. But I strongly believe there is a positive benefit to Californians from providing this leeway: it enables the ISO personnel to focus on fulfilling their responsibilities to the maximum during these difficult times for the electricity system, rather than spending their time defending every increase in costs caused by their having to meet new obligations. Time and resources spent on filings and litigation regarding the ISO's rates means other value-added programs must be deferred or dropped. Mr. Ramirez apparently agrees, as he notes that his proposal “allows the CAISO the flexibility to manage its budget while also providing the CAISO proper incentives to keep costs down.” Exh. No. PUC-1 at 5. I believe it is important to note that Mr. Ramirez represents the California agency charged with protecting the interests of most of the consumers of electricity in the State of California (the consumers and businesses served by investor owned utilities), the very people and businesses that ultimately will pay the great majority of the costs of the ISO.

Finally, I should also note that it is my understanding, based on discussions with attorneys, that implementing Mr. Ramirez’s “trigger” proposal would be consistent with the Federal Power Act, which allows the Commission through an order to modify the normal requirement that a regulated entity file under

Section 205 of the Act before implementing any increase in rates. It is also my understanding, again based on discussions with attorneys, that, if the Commission adopted Mr. Ramirez's proposal and the ISO thereafter raised rates an amount that did not exceed any of the triggers, any party that pays the GMC could still file under Section 206 of the Act and that, if the party could establish that the resulting rates were unjust and unreasonable, the Commission could reduce the rates to a just and reasonable level prospectively. I disagree with Mr. Jobson's contention (Exh. No. SMD-1 at 3, 9) that a 206 filing would not be adequate in controlling the ISO's costs. I mention these matters not because I want to testify on legal matters – I understand that the law is whatever it is – but only to note that before supporting Mr. Ramirez's proposal I did inquire into its legality and became satisfied in my own mind that it would be permissible.

C) <u>SPECIFIC REDUCTIONS RECOMMENDED BY INTERVENORS AND STAFF</u>

Q. DO ANY WITNESSES SUGGEST WAYS THAT THE COMMISSION MIGHT REDUCE THE AMOUNT OF THE TOTAL REVENUE REQUIREMENT THE ISO HAS FILED?

A. Yes. Mr. Cohen and Mr. Jobson note such possibilities.

Q. WHAT DO THOSE WITNESSES SAY ON THIS TOPIC, SPECIFICALLY?

A. Mr. Cohen states that a freeze on employee headcount at the ISO would save $16.1 million from the budgeted amount. Exh. No. TNC-1 at 8. Mr. Cohen also suggests that the ISO should make the reductions that ISO management had noted in a memorandum in November 2000 addressed to the Finance Committee of the ISO Governing Board. *Id.* at 12. This memorandum is included with Mr. Cohen's Testimony as Exh. No. TNC-8. Mr. Cohen also contends that, since the ISO has not been able to issue bonds due to its own unstable financial situation and the difficulties in the California markets, the ISO could save the $10.62 million the ISO budgeted for debt service. Exh. No. ISO-TNC-1 at 12. Mr. Jobson suggests that a possible way to reduce the revenue requirement would be to eliminate employee bonuses. Exh. No. SMD-1 at 10.

Q. WOULD THE ISO AGREE WITH ANY OF THESE SUGGESTED REDUCTIONS?

A. No. Before addressing each of them, I would note that neither Mr. Cohen nor Mr. Jobson has recommended that the ISO discontinue any activity that it currently pursues. In other words, no witness suggests that the ISO is pursuing some activity that it is not required to pursue, or is doing too much of something in the course of meeting one of its responsibilities. Moreover, their suggestions for cost reductions are rather tentative and are not supported with factual arguments; they have the flavor of someone having studied the ISO budget and searched for areas where easily stated steps – "don't hire" or "invest less" - could have significant dollar impacts. As I will show, while the steps might be easily stated, they cannot be easily accomplished – or accomplished at all -- if the ISO is to continue to do its job.

Freeze on employee headcount. Mr. Cohen fails to recognize that freezing the number of ISO employees while attempting to manage an increasing workload is simply not possible. ISO employees are already overworked, having completed start-up and significant market reforms, and currently are trying to address the continuing challenges of the energy crisis. Without increasing ISO full-time staffing, to complete the work that must be done would require the hiring of additional, higher-cost contract employees. In fact, the budget was prepared with the assumption that more costly contracted resources would be converted to full-time ISO staff, to save money. Accordingly, arbitrarily freezing the number of ISO employees actually would result in higher costs for the ISO.

Moreover, the budgeted target of 544 employees for 2001 can now be viewed as conservative, because the ISO has had to undertake additional tasks that were unforeseen at the time the budget was being prepared. For example, the Pacific Gas & Electric Company ("PG&E") bankruptcy, efforts to interface with the California Department of Water Resources ("CDWR") in light of its new role in the market, implementation of the Commission's market monitoring and price mitigation program, continuing investigations of ISO markets by a multitude of governmental agencies, the need to support the Commission's refund proceeding due to go to hearing in November, and the various market defaults that have taken place, have all resulted in a much higher workload for the ISO than originally foreseen. A chart comparing the additional tasks the ISO has undertaken for 2002 is provided as part of Exh. No. ISO-22. Despite these demands arising during 2001 that were not foreseen when the budget was prepared, the ISO has been very aware of the importance of maintaining its personnel count at the lowest possible level commensurate with meeting its responsibilities; however, the ISO will increase staff if that is the most cost-effective way to meet those responsibilities. In February of 2001, given the uncertainty of the ISO's own financial outlook and the difficulties of several of the parties that pay the GMC, the ISO instituted additional measures to control the addition of new staff. One of these measures is that all new employee offer letters require approval of the CEO, even if such positions had been included in the 2001 budget. These measures remain in effect.

November 2000 memorandum. Among the areas mentioned in the ISO management's November 9, 2000 memorandum ("November 9 Memo") to the Finance Committee of the ISO Governing Board were coordination with other Control Areas in the West and "seams" management, fines imposed by the Western Systems Coordinating Council under its Reliability Management System, property taxes, and several more general areas. The first point to note is that the items included in the November 9 Memo were not reductions that the ISO management *recommended* be made, but rather a listing of costs that management felt were less than absolutely certain to be incurred. The Finance Committee recognized the uncertainty of the market in California this year, and the inherent difficulty of predicting what costs will be incurred in such an environment, and decided to forgo any reductions in the budget after reviewing this memorandum at their November 13, 2000 meeting. As I noted in my Testimony included in the December 15 Filing, Exh. No. ISO-16, with regard to an earlier stage of the budgeting process, "[t]he Finance Committee provided guidance and directed management to proceed with the budget proposal that included the resources necessary for the ISO to be fully responsive to the issues anticipated in 2001." Exh. No. ISO-16 at 6. The Finance Committee continued this financially responsible approach after reviewing the November 9 Memo, and did not support making these reductions in the proposed budget. Accordingly, the ISO Governing Board approved the budget at the level reflected in the ISO's December 15 Filing. One must also note that many of the costs referenced in the memo have, in fact, been incurred, and more importantly, other substantial costs which were not foreseen at all in the 2001 budget have been incurred. For example, the ISO certainly has incurred WSCC fines this year. In fact, the ISO has been assessed $730,246 in WSCC fines as of August 2001 (compared with $900,000 budgeted for the year), and there are several more months left in the year. The costs for western coordination and seams work were budgeted to accommodate the development of RTOs in the West; while such expenditures have not been incurred at the rate anticipated, the shortage of power in the West this year has required substantial additional coordination with neighboring regions and has raised the importance of the seams management issue, and substantial efforts have been expended on this matter. Some other costs mentioned in the memorandum, such as property taxes, have not been incurred at the level included in the budget, due to successful efforts by the ISO in 2001 to obtain a ruling that lets it avoid certain property taxes as a not-for-profit entity. Many other ISO costs, however, have risen above budgeted amounts, with the net result that potential over-collections as a result of under-expenditures in areas mentioned in the memorandum have been eliminated. For example, legal costs are anticipated to exceed the amount budgeted by $1 million or more. Additionally, interest costs have exceeded budget by $4 million and debt service principal costs were under-budgeted by $2 million. Moreover, lower transmission and market volumes in 2001 have left the ISO with an anticipated shortfall in revenues approaching $13 million. Any downward adjustments to the revenue requirement given the totality of these circumstances could bring the ISO to the brink of insolvency.

<u>Debt service</u>. Mr. Cohen's view that the ISO can save the amount budgeted for debt service is based on a misapprehension. What is at issue when one discusses debt service is actually the ISO's capital investment. As

described in my Direct Testimony, the ISO traditionally has borrowed the funds to pay for capital expenditures by issuing bonds to investors. Exh. No. ISO-7 at 11. Mr. Cohen appears to assume that since the ISO has not been able to issue bonds this year, it has saved $10.62 million.[1] In fact, since the ISO has not been able to secure normal financing this year, it has been required to pay for its capital costs on a "pay as you go" basis, rather than financing them over a period of time. Since the current financial crisis has prevented the ISO from accessing the capital markets, the ISO has used the $10.62 million in the budget for debt service to fund 2001 capital expenditures on a "pay as you go" basis, pursuant to ISO Tariff Section 8.2.4. As I noted in my Direct Testimony, Exh. No. ISO-7 at 11, the ISO's capital costs are mainly computer software costs, because the greater part of our hardware is leased and its costs are already recorded as operating expenses.

The ISO certainly has made even greater efforts to reduce its capital costs in light of its inability to finance capital investment. For example, ISO management intends to hold year 2001 capital spending to approximately $23 million compared to the budget of $37.7 million. As I noted in my Direct Testimony, Ex. No. ISO-7 at 22, however, the ISO managers and officers already, in the budgeting process, eliminate the projects that are beyond the

[1] Total debt service incorporated into the 2001 GMC for the intended bond issuance is $8,494,000, which would have provided principal and interest recovery for a $36.8 million bond issuance for bonds with a five-year life at 5 percent interest. Also included in the GMC was the required operating reserve collection of 25 percent of this debt service amount, pursuant to ISO Tariff Section 8.2.4. Accordingly, a total of $10,617,000 is included in the budget for collection through the GMC to service the debt of this intended bond offering. This is the $10.62 million figure cited by Mr. Cohen. Exh. No. TNC-1 at 12.

budget and staffing constraints, leaving only the most crucial ones in the final proposed project listing. The reduced spending level of $23 million is possible due mainly to deferral of Comprehensive Market Reform/Congestion Management Reform efforts. Additionally, as I have noted, capital projects of $1 million or more must be approved by the ISO Governing Board at the time their costs are to be incurred, even though their costs have been included in the Board-approved budget.

The fact is that the ISO will spend *more* on capital projects than is collected through rates in 2001 due to its inability to secure financing, rather than saving money as Mr. Cohen suggests might be possible. The ISO has only two sources from which to secure the necessary funds for capital projects in the absence of financing capability: GMC collections that otherwise would have serviced the 2001 debt issuance, and the ISO's operating reserve, which I described in my Direct Testimony, Exh. No. ISO-7 at 33-37. Of course, extensive use of the operating reserve to fund capital projects puts the ISO at risk of insufficient liquidity to meet its day-to-day operating needs should the GMC payment stream be impaired due to the ongoing defaults by various Market Participants, and from revenue shortfalls due to lower volumes in 2001. The ISO must rely on the operating reserve to cushion any GMC shortfall from the failure of Market Participants to pay their share of the GMC (if the ISO is unable to secure the full GMC from its priority claim on market funds) and to deal with the instability of recovery of the ISO's costs related to the unbundling itself.

To explain the last points: To the extent that the ISO is unable to collect the GMC due to market defaults or bankruptcy of Market Participants (such as PG&E and the California Power Exchange ("PX")), such deficiencies are first met through the ISO's priority claim to market funds, which in some months of 2001 have only barely covered the GMC, but then have to be absorbed by the operating reserve. (The ISO could adjust the rate prospectively through the quarterly adjustment provisions if the shortfall met the threshold in those provisions.) Moreover, the ISO had anticipated that it would have in place a bank line of credit that would allow it to manage fluctuating revenues due to the uncertainties of this first year of GMC unbundling. *See* Exh. No. ISO-7 at 35-36. Due to the financial crisis in the California markets, however, the ISO has been unable to secure such a line of credit, and therefore all such fluctuations have had to be absorbed by the operating reserve. Despite these important "calls" on the operating reserve, the ISO currently plans to fund up to $12 million of the reduced capital spending plan for 2001 through the operating reserve.

Employee Incentive Compensation. I strongly disagree with any suggestion that the ISO eliminate or even reduce employee incentive compensation. The incentive compensation system was constructed carefully to encourage employees to meet specific goals established by the ISO Governing Board – which include cost containment. Encouraging employees to meet these goals is in the interests of ratepayers. Incentive compensation is a key element of the total compensation package offered to ISO employees. Total compensation is benchmarked annually against peers and the industry. It would be extremely detrimental to employee morale, not to mention fundamentally unfair, to reduce incentive compensation as an arbitrary cost-saving measure. This program is in effect a contract with employees; it is detailed in the offer letters to employees and reinforced through the announcement of the annual goals program. No one has suggested that the performance of ISO employees through the continuing challenges in California does not merit the remuneration the system in place would yield. Given the uncertainty in California markets and concerning the ISO's future role, the ISO is having significant difficulty in retaining key staff and attracting new employees to replace individuals that have left. Any removal of incentives for employees to remain, or that might be helpful in attracting new employees, would be extremely detrimental to the ISO.

II. ALLOCATION OF COSTS TO THREE GMC CATEGORIES

Q. WHAT IS THE PURPOSE OF THIS PORTION OF YOUR TESTIMONY?

A. In this section, I will address the testimony of various intervenors and Commission Staff concerning the ISO's allocation of its costs into three categories.

Q. WHAT GENERAL POINTS WILL YOU BE MAKING?

A. I will highlight a few points made previously in the ISO's Direct Testimony regarding the cost allocation methodology utilized in assigning costs to the three GMC categories; explain how the methodology was developed, and what input from the stakeholder process was incorporated; describe what efforts at improving the cost allocations are being developed for subsequent years' GMC filings, starting with that of 2002; address specific proposals by different intervenors concerning possible changes to the allocations made by the ISO for 2001; explain that certain criticisms made by those testifying on the allocation issue in this proceeding are based upon a lack of understanding of what has been done this year; and urge that no re-allocations be made for 2001 or, if any are made, that they be prospective only.

Q. WHAT IS YOUR OVERALL ASSESSMENT OF THE COST ALLOCATION METHODOLOGY USED BY THE ISO IN ASSIGNING ITS COSTS TO THE THREE GMC CATEGORIES?

A. I believe it is a good system, and certainly a reasonable approach given the time frame and the conditions under which we had to operate. The ISO worked extremely hard to achieve an unbiased, fair allocation process. The ISO did not have an agenda to achieve specific allocation results, and the process relied on the professional judgment of ISO staff responsible for the various ISO functions. The allocation of costs was performed at a detailed level, by ISO cost center and for each ISO capital project. Staff Witness Pointer captures the ISO's goal exactly when he notes in his Direct Testimony that "[t]he CAISO has undergone a long, arduous process to unbundle the GMC with the intent that the charges paid by the customers will better reflect cost causation." Exh. No. S-6 at 5. We made every effort to be fair to all Market Participants, by relying on the principle of cost causation to allocate and assign costs to the service categories. We have used the experience gained this year to help us assign costs more precisely for 2002.

A) <u>BACKGROUND</u>

Q. HOW WERE THE THREE GMC CATEGORIES DEVELOPED?

A. As described in Michael Epstein's Direct Testimony, Exh. No. ISO-1, the service categories were the result of a lengthy stakeholder process. Many proposals were considered during this process, but it was determined that the three service categories that we now have were the most suitable in terms of tracking cost causation and not being overly burdensome to either the ISO or those who would be paying the GMC. *See* Exh. No. ISO-1 at pp. 10-11; 16-17. Stakeholders had expressed the concern that if the service categories were too numerous, their existing accounting systems would not be able to accommodate them. It is important to remember that the ISO's original GMC, filed with the Commission on October 17, 1997, was a bundled rate through which all Market Participants were to pay for all services, whether they were the entities which caused specific costs to be incurred or not. That original GMC proceeding was resolved through a settlement. In this proceeding we take a real step forward toward linking costs to the entities that cause them to be incurred.

Q. WHAT ITEMS ARE INCLUDED IN THE THREE SERVICE CATEGORIES?

A. As noted in the proposed GMC Tariff language for the ISO Master Definitions Supplement, *see* Exh. No. ISO-5, the Control Area Services Charge is the "component of the Grid Management Charge that provides for recovery of the ISO's costs of ensuring safe, reliable operation of the transmission grid and dispatch of bulk power supplies in accordance with regional and national reliability standards". The Inter-Zonal Scheduling Charge is the "component of the Grid Management Charge that provides for the recovery of the ISO's costs of operating the Congestion Management process." Finally, the Market Operations Charge is the "component of the Grid Management Charge that provides for the recovery of the ISO's costs of market and settlement related services".

Q. HOW WERE THE DESCRIPTIONS OF THE THREE CATEGORIES DECIDED UPON?

A. The definitions of the three service categories were arrived at through the work of the lengthy GMC stakeholder process. The definitions are relatively brief, and provide a general description of the service category. The descriptions are not all-inclusive, but provide the general guidance that allowed all ISO costs to be appropriately assigned or allocated to these three categories. Costs for each ISO department and the ISO's various fixed assets were assigned to the three categories using the guidance of the definitions of those service categories. This assignment/allocation process was documented in the CAM, Exh. No. ISO-18.

Q. HOW DOES THE ISO ALLOCATE COSTS TO THE THREE GMC CATEGORIES?

A. As I described in my Direct Testimony, Exh. No. ISO-7 at pp. 10-17, the costs recovered by the GMC are primarily general operating and maintenance costs and debt service costs. With regard to operating costs, a proposed budget was developed for each ISO cost center (*e.g.*, Grid Planning, cost center 1521), and the ISO then developed the cost allocation percentages that allocate or assign these proposed costs to the three service categories. The concept and format of this process was derived from the August 17, 1998 R. J. Rudden Associates study on GMC unbundling, "Report to the California Independent System Operator on the Grid Management Charge Unbundling

Study", which has been provided as an exhibit in this proceeding. *See* Exh. No. ISO-3. Additionally, Rudden has performed an additional study of the ISO's allocation process, entitled "Report to the California ISO Regarding Cost Allocation Process", included as Exh. No. ISO-24, which finds that that ISO's allocation methodology and results are reasonable.

Q. HOW WERE THE COST ALLOCATION FACTORS FOR OPERATING COSTS DEVELOPED?

A. When possible, ISO managers and directors directly assigned their department's (or "cost center") budgeted costs to the service categories based upon their informed judgment. For cost centers that perform services directly related to the three unbundled categories, this direct assignment of costs was possible. For other cost centers, for example those that supervise other cost centers, or which provide services that benefit the company as a whole (support services), or which do not relate directly to the three service categories, other approaches were used to allocate their costs. In some cases, these "overhead" costs were allocated to service categories proportionally based on the directly assigned costs. This is described in my Direct Testimony, Exh. No. ISO-7 at 13-14.

Q. WERE ANY OTHER METHODS USED TO ALLOCATE OPERATING COSTS?

A. Yes. For certain cost centers, headcount was used as an allocation method. That is to say, for costs that support all ISO employees, such as human resources department costs, the ISO used the total number of employees whose activities fit into a given service category as the basis for allocating costs to that category.

Q. HOW WERE CAPITAL COSTS ASSIGNED?

A. As the ISO's capital costs usually have been collected from rates in the form of debt service on bonds, the costs of this anticipated debt service were allocated based on the purpose for which the bond funds were spent in the December 15 Filing. During 2001, where the operating reserve has been used to fund capital projects due to the ISO's inability to issue bonds, capital project costs are appropriately assigned to the separately calculated operating reserve for each unbundled service category. The separate operating reserve calculations are used in determining the rates for each service category for the following year. So, in either event, the capital project costs are appropriately assigned to the unbundled rate category that such expenditures benefit.

B) POSITIONS OF INTERVENORS REGARDING ALLOCATION OF COSTS

Q. WHAT POSITIONS DO INTERVENORS TAKE WITH RESPECT TO THE ISO'S ALLOCATION OF COSTS TO THE THREE CATEGORIES OF THE GMC?

A. Mr. Jobson contends that the allocation methodology used for the 2001 budget lacks sufficient detail and was overly dependent on the decisions of department managers and that consequently some costs were mis-allocated. Exh. No. SMD-1 at 10-12. He indicates certain areas where he believes costs should be re-allocated. *Id.* at 13. As a general matter, he believes that a work order system is needed to assign costs more precisely. *Id.* at 11.

Mr. Cohen, similarly to Mr. Jobson, contends that department managers played too large a role in allocating costs, and believes the ISO should have included a "detailed labor cost analysis" in its filing. Exh. No. TNC-1 at 14. He argues for different allocations of two specific cost centers, 1424 and 1441. *Id.* at 17-18. He says that the ISO has not sufficiently explained the allocations to the three categories and suggests the ISO should prepare a more detailed allocation study. *Id.* at 15, 20-21. Finally, he criticizes the ISO's allocation of costs on the basis of headcount, specifically with respect to cost center 1424, *id.* at 17, and contends the ISO should implement time-keeping by its employees and that the information gleaned should be used in the allocation decisions. *Id.* at 21.

Mr. Werner objects to the illustrative listing of the types of items that are included in the three categories of the GMC, contending that every item should be listed. Exh. No. DWR-2 at 14-15.

Q. DO YOU AGREE WITH ANY OF THESE GENTLEMEN?

A. No, I do not. I believe the process used in 2001 was justified and appropriate, and produced reasonable results. I do agree, however, that the ISO's allocation process can be improved over time, and believe that the allocation process used in the 2002 budget should further minimize the concerns raised by the intervenors this year. Accordingly, while I do not believe changes should be made to the 2001 allocation results, the ISO notes the concerns of stakeholders and continues to refine and improve the process going forward. For example, the ISO notes that the reallocations of the type proposed by Mr. Cohen for cost centers 1424 are reasonable to adopt going forward, and have been implemented for 2002.

1. Level Of Detail And Involvement Of Managers

Q. PLEASE ELABORATE ON YOUR DISAGREEMENT WITH MR. JOBSON'S AND MR. COHEN'S STATEMENT THAT THE ISO'S COST ALLOCATION LACKS SUFFICIENT DETAIL.

A. The specific detail on how each cost center was allocated is found in the CAM, Exh. No. ISO-18 (Attachment D to the December 15 Filing). The CAM goes into considerable detail regarding how each cost center has been allocated to each service category. The CAM describes, for each of 57 separate cost centers, what activities are performed by the cost center and how the costs of that cost center were allocated to the three service categories. I disagree with Mr. Jobson’s and Mr. Cohen's arguments that insufficient detail has been provided regarding these allocations. Mr. Jobson, for his part, does not spell out what more could have been done, apart from the single suggestion that employee timecards be introduced (Exh. No. SMD-1 at 11), which the ISO opposes, as discussed more fully below. I believe that the level of information provided in the ISO's December 15 Filing is reasonable and appropriate. Taken to an extreme, the ISO could file with FERC the cost allocation factors associated with each and every individual cost budgeted; however, a reviewer of such information would quickly become lost in a forest of details, rather than gaining an understanding of the bigger picture of how the ISO's overall costs were allocated. Even though the ISO in the 2002 budget development process will assign and allocate individual costs to the three service categories, I do not anticipate providing all of this information in a filing.

Q. WHAT IS YOUR RESPONSE TO MR. COHEN’S CONTENTION THAT THE ISO SHOULD HAVE INCLUDED A DETAILED LABOR ANALYSIS, INCLUDING SALARIES AND BENEFITS, IN THE APPENDIX TO THE COST ALLOCATION MATRIX IN THE DECEMBER 15 FILING?

A. I disagree. The Appendix to the CAM contains exhaustive data, including specific dollar figures for each cost center, together with the percentages of that cost center attributable to each service category. Including a labor analysis would not have added any necessary information to the Appendix. The individual managers and directors responsible for assigning the costs of their departments are well suited to perform the assignments. They are the individuals who budgeted all costs in the cost centers, and understand better than anyone else how those costs benefit the three service categories. They provided a description of the functions of their departments, and this provides the linkage between the costs and the allocation percentages.

Q. WHAT IS YOUR RESPONSE TO MR. COHEN'S AND MR. JOBSON'S OBJECTION TO THE ROLE OF ISO MANAGERS IN DETERMINING THE ALLOCATION OF COSTS TO THE SERVICE CATEGORIES?

A. ISO managers uniquely are able to judge how the costs of their divisions are utilized, and thus how those costs ought to be allocated to the service categories. It is not an exact science, and it cannot be made into one. When Mr. Jobson and Mr. Cohen criticize the ISO's reliance on manager judgment, I am at a loss to understand how else the costs could be allocated. Even if performed and documented at a more granular level, their judgment is still involved. Mr. Jobson speaks of "criteria that are consistently applied by all affected ISO departments", Exh. No. SMD-1 at 10, but fails to recognize that some human beings, *i.e.*, management personnel, will have to apply these criteria. Moreover, apart from employee timecards (which, as I will discuss below, the ISO opposes), Mr. Jobson does not mention what such criteria might be, or how they are to be developed or applied without a great deal of input from the department managers.

Q. WHAT IS YOUR OPINION OF MR. WERNER'S ARGUMENT THAT THE DEFINITIONS OF THE CATEGORIES OF THE GMC IN THE ISO TARIFF SHOULD CONTAIN A COMPLETE LISTING OF THE ACTIVITIES IN EACH CATEGORY?

A. I disagree with Mr. Werner. The lists included in the proposed ISO Tariff definitions are meant to provide a broad, fairly high-level description of the activities the ISO performs with regard to each service category. I do not believe it necessary to provide a comprehensive list of all sub-activities that comprise the categories. This is better left to the Cost Allocation Matrix and departmental descriptions. Formalizing an all-inclusive list in the ISO Tariff would also be problematic. For example, in the future the ISO may be required to take on additional tasks, perhaps due to a change in WSCC requirements for Control Area operators. In fact, as I've mentioned, the ISO constantly is being required to take on new tasks. Therefore, the "including but not limited to" language is necessary to provide for such an eventuality. The intervenors know, through information provided in the Cost Allocation Matrix and through discussions held in the stakeholder process, which activities are included within each category. If the ISO were to take on a new activity that Mr. Werner's client considered inappropriate, or if the ISO were to allocate an activity to the wrong category, his client could challenge the ISO before the Commission. I should note that his client has not challenged in this proceeding any activity the ISO is performing nor the allocation of the costs of any activity.

2. <u>Timecards</u>

Q. WHAT IS THE ISO'S POSITION ON WHETHER ITS EMPLOYEES SHOULD RECORD THEIR TIME?

A. I oppose this for a variety of reasons. Although I am aware that Mr. Jobson has suggested that a work order system is needed to ensure that "each specific task and its sub-components could be assigned to the accurate billing categories," Exh. No. SMD-1 at 11, and that Mr. Cohen also supports timecards, Exh. No. TNC-1 at 21, I do not agree with them.

The increased level of accuracy that Mr. Jobson and Mr. Cohen see resulting from the institution of timecards is illusory. First, no matter how detailed the specific task included in a timecard may be, judgment would still be involved in determining how the tasks are assigned to each category. Judgment cannot be removed completely from the process. Second, any actual data collected would not be used to assign the costs of that particular year, but would be used to assign the costs of the subsequent year to the service categories. Departmental staffing, priorities, work tasks, and budgeted costs are all subject to change from year to year. Using time data in this manner would apply stale data to the newly budgeted costs of the department. Third, even if a time recording system were in place, the data collected could be of questionable accuracy. Employees may be inclined to assign their time to routine categories in similar proportions without regard to actual activities.

Moreover, designing a timecard system would be both expensive and time-consuming. It would need to be implemented carefully, and its development and testing would be the work of several months, at least, to address the issues raised above to the extent possible. As well, detailed time-keeping is a time-consuming process for the employees that are required to undertake it, and an activity that inherently detracts from employee efficiency.

Nonetheless, if I thought a timecard system would enhance substantially the accuracy of the allocation process, and that the benefit of this additional accuracy would outweigh the setup and ongoing costs involved, I would support it. The important point, though, is that any gains in accuracy would be minimal, and that the ISO already has implemented an alternative system for 2002 that is an improvement over 2001.

Q. WHY WOULDN'T TIMECARDS IMPROVE THE ALLOCATION OF COSTS?

A. For consideration of this issue, I would divide the ISO employees perhaps five types: (1) support or overhead employees whose work is not directly related to the three unbundled categories -- for example human resources, treasury, communications, etc.; (2) supervisory employees who oversee the work of other employees, whose time and costs should be allocated based on the allocation results of the supervised departments, for example, officers and directors who oversee other cost centers; (3) employees whose work changes little from day to day, and is entirely related to one GMC category, for example, the grid planning function; (4) employees whose work changes little from day to day, and is related to more than one GMC category, for example, employees in RMR Contract administration; and (5) employees who work on a variety of constantly changing matters and whose work spans all GMC categories, for example, the legal department. The great majority of the employees at the ISO fall into the first four categories, and I believe time records for those employees would add little or nothing to the accuracy of the unbundling. Requiring all employees to complete timecards would be a complete waste of resources.

In addition, and very importantly, the culture of the ISO is very "results oriented", and employees are accustomed to focusing on "getting the job done" rather than on completing administrative tasks such as time recording. The ISO culture is such that employees were recruited on the basis that they were highly valued and were joining an organization that was not overly bureaucratized. In light of this, ISO employees are resistant to timecards as a concept. Timecards might make employees more conscious of their “assigned duties”, and perhaps make them less likely to pitch-in in other areas, which would be very detrimental to the culture of the ISO.

We are already in a situation where it is difficult for us to retain our employees – there are many places where they can go to avoid the lengthy hours at the ISO without sacrificing income. Rather than placing new administrative and bureaucratic demands on them, we strive to make their jobs as attractive as possible. Once we have lost employees, it is not easy for us to replace them. Most of the jobs at the ISO require highly skilled persons with a familiarity with the unique environment and applicable requirements of the independent system operator function and the ISO Tariff, and it takes significant time and resources to find and train suitable replacements. The ISO currently has a 12 percent vacancy factor, with some important positions having gone unfilled for months due to lack of suitable candidates. Exh. No. ISO-26 indicates the level of this problem.

I would note that Mr. Ramirez, testifying for the California Public Utilities Commission, stated his belief that “using timesheets for cost allocation would place a heavy administrative burden on the CAISO employees in return for marginal benefits.” Exh. No. PUC-1 at 9. I would certainly agree. In fact, for the reasons I have stated, I believe there may be no benefits at all, but only detrimental consequences.

3. Headcount As An Allocation Mechanism

Q. DO YOU CONTINUE TO SUPPORT THE ISO'S USE OF HEADCOUNT AS AN ALLOCATOR, DESPITE MR. COHEN'S CRITICISMS?

A. Yes, headcount is an excellent allocator in some situations, and a reasonably appropriate mechanism when no more precise method is available in other situations. For example, to allocate the cost of the human resources department (1211), facilities departments (1231), Corporate Services department (1221), and CEO (1111), this measure works very well. For others, it is workably acceptable, for example, to allocate the costs of the Telecommunications Services department (1441).

Mr. Cohen's particular criticism of headcount as an allocator concerns the lack of examination of individual costs in cost center 1424, which is Information Technology Assets, Contracts and Change Management. The ISO re-visited the allocation of this cost center in response to a data request from Staff, and plans to modify the allocation methodology for 2002. In the December 15 Filing, the costs of cost center 1424 were assigned to Control Area Services, Inter-Zonal Scheduling, and Market Operation, using factors of 50 percent, 5 percent, and 45 percent respectively. The factors were based on an assessment of how the department manager believed the costs of the department supported the three unbundled categories. These numbers were likely assessments of how the staff in that department worked to support the categories; however, the department's costs consist primarily of lease expenses for various computer equipment. As I discuss below, the most appropriate method of allocation would be to look at the individual costs, including the leases, and identify which programs and, ultimately, which unbundled categories they support. That is the approach the ISO used when we revisited the allocations for this cost center earlier in 2001, and noted that revised allocation percentages could be appropriate. For 2002 and future years, this approach will be used.

It should be noted that the costs of 1424 were not allocated using overall headcount as were departments like 1211, 1221, and 1231. The ISO continues to believe that using headcount as an allocator for support departments is a valuable tool for allocation. Mr. Ramirez, testifying for the California Public Utilities Commission, stated his belief that "headcount can be a proper allocation methodology for costs so long as the methodology is consistently used." Exh. No. PUC-1 at 10. I agree. And, when the ISO uses headcount as an allocator, it does so consistently: the costs at issue are allocated among the three GMC categories based on the relative percentages of the relevant employees whose work furthers activities in each of the three categories. Headcount as an allocator yields essentially the same results as the accepted methodology of "labor ratios", which the ISO intends to use in the 2002 cost allocation process.

4. <u>Specific Allocations</u>

Q. SMUD WITNESS MR. JOBSON HAS CRITICIZED THE MANNER IN WHICH THE ISO HAS ALLOCATED FACILITY-RELATED COSTS AS A FUNCTION OF OPERATING COSTS. EXH. NO. SMD-1 AT 11. DO YOU CONTINUE TO SUPPORT THE ISO'S ALLOCATION IN THIS REGARD?

A. Yes. Mr. Jobson's criticism is perhaps based on a misunderstanding of the current allocation. Headcount is used as the basis for allocation. Accordingly, facility-related costs are based on the relative utilization of the facilities in question, just as Mr. Jobson believes is appropriate.

Q. IS MR. JOBSON MISTAKEN ABOUT ANY OTHER ALLOCATIONS?

A. Yes. For example, all of the costs of hardware and software needed to run the Congestion Management system are allocated to the Inter-Zonal Scheduling service category, as Mr. Jobson suggests they should be. Mr. Jobson argues that the definition of Inter-Zonal Scheduling Charge should make this allocation clear. Exh. No. SMD-1 at 13. The ISO would be happy to make such a change in the definition in the ISO Tariff as part of a compliance filing resolving this proceeding. As well, the greater costs of system components and services attributable to the market-driven system of

Ancillary Services and Energy supply are allocated to the Market Operations Charge, just as Mr. Jobson would have them be. *Id.* Finally, Mr. Jobson raises the issue of the applicability of the Inter-Zonal Scheduling Charge on non-ISO Controlled Grid transmission. Non-ISO Controlled Grid transmission volumes are treated the same as service in accordance with existing transmission contracts ("ETCs") (transmission service agreements that pre-dated the start of the ISO) and are not included in the inter-zonal scheduled flows upon which the charge is assessed. Mr. Jobson's concern that they be so exempted therefore should be satisfied.

Q. MR. COHEN CRITICISES THE ALLOCATION OF TWO COST CENTERS IN PARTICULAR – 1424 AND 1441. WHAT IS COST CENTER 1441?

A. Cost center 1441 is Telecommunications Services. Since this cost center represents a large portion ($33.4 million) of the ISO's revenue requirement, it naturally attracts scrutiny. The bulk of this cost center represents the costs of the ISO's contract with MCI. The ISO has made clear that it is dissatisfied with the level of costs associated with this contract. This contract was entered into by the ISO Restructuring Trust, in early 1997 (and later transferred to the ISO), at a time in when there was tremendous pressure to get the ISO up and running quickly, and also at a time when alternative communications technologies were not widely available, as they are today. The contract provided for a very specialized, statewide, reliable communications network with high capacity. The ISO has not been able to reduce substantially the costs of this contract, and we must see it through until its conclusion, which is in 2003. That being the case, we have made every effort to allocate these costs as fairly as possible. Several of the ISO's telecommunications experts have devoted attention to this matter, and have been unable to develop a better approach than that used in our filing. In spite of the scrutiny applied to this cost center, I do not believe any witness, including Mr. Cohen, has come up with a more precise or more equitable allocation than the one presented in the ISO's filing.

Q. HOW DID THE ISO ALLOCATE THE COSTS OF COST CENTER 1441?

A. The allocation was based on a modified headcount method. A portion of the telecommunications costs was assigned to the three GMC categories using total ISO headcount; a portion was allocated based on a headcount of only those departments that use the network significantly; and a portion was assigned directly to Market Operations, based on the nature of the costs involved. The cost allocation was described in great detail in the CAM, Exh. No. ISO-18 at 15-16. I believe the method utilized for cost center 1441 was appropriate, given the unusual nature of this cost center, *i.e*, that it is used by all segments of the ISO, but not precisely at the same level.

Q. WHAT REVISION TO THE ALLOCATION OF COST CENTER 1441 DOES MR. COHEN SUGGEST, AND WHAT IS YOUR RESPONSE?

A. Mr. Cohen proposes, in essence, that the great bulk of the costs be assigned to Market Operations, based on the argument that the driving purpose of the MCI contract was to build an infrastructure for market communications. Ex. No. TNC-11 at 2-4. I have three important reasons for disagreeing with Mr. Cohen's proposal.

First, the MCI contract is a fixed cost that under-girds all of the ISO's operations, and for that reason its cost should be distributed more evenly across the three GMC categories than Mr. Cohen would have it. A prime feature of the network, and significant contributor to its development and maintenance costs, is its extremely high reliability and availability. This is certainly at least as critical to the Control Area Services portion of the ISO's services as to the markets function. For example, it is necessary to control and receive data from certain Generating Units every four seconds (by means of Automatic Generation Control or "AGC"), and the telecommunications network was constructed to provide this type of constant data transfer. On the other hand, the data transferred for market purposes is less time sensitive and could likely have used other available systems.

Second, as I noted above, we did allocate a portion of the costs of the contract directly to Market Operations, where it was clear that the costs involved were primarily related to the functions included in the Market Operations Charge. Thus, there is already some recognition, and I believe an appropriate level of recognition, of the primacy of market infrastructure in the contract. As Mr. Ramirez, testifying for the California Public Utilities Commission, noted, the ISO bases operation of its entire system on the product of its own and others' markets. For that reason, the fact that infrastructure support for markets predominates in the MCI contract does not necessarily justify the degree of assignment of the costs to Market Operations that Mr. Cohen suggests, as the markets themselves, and thus the MCI contract that contributes to those markets, support *all* of the ISO's activities.

My third reason for disagreeing with Mr. Cohen is that, as the ISO previously has noted, we have tried but have been unsuccessful in obtaining from MCI information that might enable us to perform a detailed direct assignment of the costs of the contract to the three GMC categories. *See* CAM, Exh. No. ISO-18 at 15. In the absence of that information, we believe our modified headcount approach to allocation of this cost center is appropriate.

Q. MR. COHEN ALSO CRITICIZES THE ALLOCATION METHOD USED FOR COST CENTER 1424, WHICH IS "INFORMATION TECHNOLOGY ASSETS, CONTRACTS AND CHANGE MANAGEMENT." WHAT IS YOUR RESPONSE?

A. As I described above, The ISO recognized part way through the budget year that this cost center was not allocated as accurately as possible. In preparing its response to a data request from the Commission Staff, the ISO reviewed cost center 1424, and found that certain refinements to the allocation of those costs could be made, by examining individual costs and assigning them as appropriate to the unbundling categories. Staff has included the ISO's response to this data request, Staff-ISO-76, with its testimony as Exh. No. S-10. Mr. Pointer has suggested in his testimony that the new allocation approach be incorporated into the ISO's budget for 2002, Exh No. S-6 at 23, and the ISO agrees that is the appropriate course to take.

I should note that Mr. Ramirez, the witness for the California Public Utilities Commission, believes that there is insufficient information in the ISO's filing or in ISO responses to data requests issued by the Transmission Agency of Northern California ("TANC") (on whose behalf Mr. Cohen testified), to enable one to identify a better allocation of these costs than the one in the ISO's filing for 2001. Exh. No. PUC-1 at 11. Mr. Ramirez did not reference the ISO's response to Staff's data request dealing with allocation of this cost center; I believe, and hope, that Mr. Ramirez would accept the allocation the ISO has proposed there and intends to implement in 2002. In fact, as I will discuss later, the ISO adopted an approach for application across the ISO in 2002 that incorporates the concept of looking at individual costs and assigning them to the three GMC categories.

Q. IF THE ISO AGREES THAT THERE IS A BETTER METHOD OF ALLOCATING THE COST CENTER THAN THE ONE IN THE FILING, WHY

WOULD IT NOT BE APPROPRIATE TO CHANGE THE ALLOCATION RETROACTIVELY FOR 2001?

A. As a policy matter, the ISO does not believe there should be piecemeal re-allocations of cost centers in the course of a year at the behest of individual parties. As I have noted, the unbundling of the GMC is a work in progress, and the ISO is continually refining its cost-allocation methodologies with input from all stakeholders – and, of course, input during proceedings such as this one. The re-allocation of any specific cost center is unlikely to have a material effect on the rate that any party pays. For example, the revisions of the allocation factors applied to cost center 1424 as shown in Staff-ISO-76 (Exh. No. S-10) (based on the approach that the ISO would propose to implement for 2002) would have affected the 2001 rates only minimally. The rate for the Control Area Services Charge would change from $0.406/MWh to $0.400/MWh, a decrease of about 1.6 percent, and the rate for the Market Operations Charge would increase from $0.951/MWh to $0.967/Mwh, an increase of 1.6 percent, which is minimal. While I do not say that a party should be indifferent to such small changes in rates, I would note that it is quite possible that this year or some other year, the ISO would identify on its own, or through suggestions from another party, additional sensible re-allocations that could more than offset any benefits to Mr. Cohen's client from re-allocating cost center 1424; but that these re-allocations would be made in the following year, in the normal budgetary process. It does not seem equitable to re-allocate for a single complaining party during the course of a year, but hold other possible re-allocations until the following year.

In any event, if the Commission should decide that a re-allocation of a particular cost center, such as cost center 1424, is appropriate in response to an intervenor's recommendation, the Commission should clarify that the decrease in the allocation to one GMC category or to one paying party must result in a corresponding increase in the allocation to another category or to another paying party, and that the ISO would have to adjust all the settlement statements accordingly. The reason such clarification is necessary is that, while the ISO believes that the ISO Tariff permits it to charge other parties additional amounts if necessary to make up any amounts it might have to refund to some parties if a re-allocation were ordered retroactively, at least one party, the California Department of Water Resources, does not fully accept that position. *See* Exh. No. DWR-2 at 17. The ISO is a revenue-neutral, not-for-profit entity that must recover its costs, and the issue in the circumstance of a re-allocation is not that the ISO incurred certain costs imprudently, but rather which parties should pay relatively more of specific costs the ISO reasonably has incurred. I respectfully would recommend that the sensible thing is for the Commission simply to make any re-allocations effective prospectively only.

I would submit that an even better approach is for the Commission not to make any re-allocation retroactive to the date the filed rates went into effect. In other words, there should be no refunds to any party that might have paid more under the filed allocation than under the one the Commission might decide it prefers. Rather, the Commission should require the ISO to implement the new allocation approach prospectively only. This approach also recognizes that the unbundling of the GMC into separate categories and the allocation of costs to those categories is an ongoing process; that the ISO has undertaken the process in good faith; and that "corrections" and "improvements" to the cost allocations will be necessary from time to time.

I would point out that the allocation issue related to 1424 is not the only change that *could* appropriately be applied to 2001. For example, the ISO could change the revenue requirements associated with each unbundled category based on actual vs. budgeted costs, new responsibilities assumed during 2001, or having managers and directors review their allocations in light of actual priorities in 2001.

Q. MR. POINTER INDICATES THAT THE COST ALLOCATION METHODOLOGY FOR COST CENTER 1631 (LEGAL AND REGULATORY) WAS CHANGED BETWEEN THE NOVEMBER 1 FILING AND THE DECEMBER 15 FILING. EXH. NO. S-6 AT 11. IS THAT CORRECT?

A. The methodology did not change, but the means by which the allocation percentages used to allocate 1631 were arrived at were modified slightly. Between the two filings, the ISO had the opportunity to improve the clarity and soundness of the CAM. The changes generally were limited to basing the allocation of the overhead departments, such as legal, on the allocation results of as many departments that directly assigned their costs to the categories as possible. In the November 1 Filing, this cost center was allocated based on the total costs of the Operations, Information Technology, and Client Services Departments. For example, in the November 1 Filing, the allocation results of cost center 1641, Market Surveillance, were not used in the determination of the figures used to allocate cost center 1631, Legal & Regulatory. For the December 15, Filing, cost center 1631, Legal & Regulatory, was allocated based on the results of all directly assigned cost centers, including cost center 1641, Market Surveillance. The ISO believes that this change has improved the GMC by allocating these costs in better accord with cost causation principles.

5. <u>Dr. Kirsch's Proposal For Allocating Control Area Services Costs</u>

Q. DR. KIRSCH HAS PROPOSED AN ENTIRELY DIFFERENT COST ALLOCATION METHODOLOGY FOR THE COSTS OF CONTROL AREA SERVICES. DO YOU AGREE WITH IT?

A. Dr. Kirsch seems to believe the sole billing determinant for the Control Area Services Charge should be Energy imbalances, rather than Control Area Gross Load as is currently the case. I am not an engineer and thus cannot speak authoritatively to the merits of his proposal. I do note that Mr. Pointer, testifying for Commission Staff, did not support Dr. Kirsch's proposal. Exh. No. S-6 at 24, 35. I will confine my comments to procedural and practical matters.

First, the billing determinant selected by the ISO was the product of an extensive stakeholder process in which many parties engaged in give-and-take over various proposals. Evidence of the lengthy and involved nature of the stakeholder process is found in the multi-part Exh. No. ISO-2. Neither Dr. Kirsch nor his client raised for consideration in that process the billing determinant that Dr. Kirsch now proposes. I am troubled by this, since much time and energy was invested in the stakeholder process and it would have been preferable for Dr. Kirsch's client to raise this proposal there for full discussion.

Second, once the stakeholder process ended and the ISO selected Control Area Gross Load as the billing determinant, the ISO set up its software, including its billing and settlement software, consistently with that billing determinant, and it is my understanding the parties responsible for paying the GMC did the same. As a result, the ISO does not currently have a system in place to readily extract, evaluate and monitor the information necessary to implement Dr. Kirsch's proposal. While the ISO may have this data in its various computer systems, the issues and difficulties involved for the ISO and others in implementing such an alternative approach should be fully vetted through the stakeholder process.

Dr. Kirsh's statements in his Cross-Answering Testimony (Exh. No. MID-4 at 9-10) to the effect that the ISO has all the data needed for his proposed allocation methodology, are misleading, as substantial effort would be required by the ISO to extract the necessary data in the format needed to implement Dr. Kirsch's proposal. Moreover, it is not persuasive to argue that the ISO has "incomplete data" from which to determine its own proposed billing determinants. *Id.* at 10. While it is true that certain behind-the-meter Load refuses to provide the ISO with the data it would prefer to use to calculate the CAS Charge, the ISO has developed a satisfactory estimation method, as described in the Direct Testimony of James Price (Exh. No. ISO-12), to overcome this difficulty.

Third, as I have stated elsewhere, it is one of the ISO's primary concerns in this proceeding that it not be required to retroactively change allocations of GMC charges, but that it be allowed to make any changes required by the Commission on a going-forward basis only. Adoption of Dr. Kirsch's proposal would, of course, change the allocation of the Control Area Services Charge.

Thus, should the Commission decide to order adoption of that proposal, the ISO would urge that it do so prospectively only. Again, the unbundling of the GMC and the adoption of billing determinants is a work in process and can be improved over time. Trying to "unscramble eggs" and re-allocate what has already been billed would be a very difficult process, especially given the tremendous effort that has already been expended on statement reruns during 2001 for earlier periods. As a final note on this point, if the Commission should, despite my urging, order retroactive adoption of Dr. Kirsch's proposal, I would hope, for the reasons stated elsewhere, that the Commission would make clear that there should be *complete* re-allocation, *i.e.*, that some parties would effectively receive refunds for past payments (or cancellations of balances due) and others would be required to pay more for past periods. The issue is one of allocation; it is not an issue of the ISO having incurred costs imprudently.

Finally, I endorse Mr. Pointer's recommendation that Dr. Kirsch's proposal be rejected without prejudice, that the ISO undertake a new stakeholder process in 2003, and that Dr. Kirsch's client be encouraged to submit his proposal for consideration there.

6. Continuing Improvements To Cost Allocation

Q. HAS THE ISO MADE ANY EFFORTS TO IMPROVE THE COST ALLOCATION PROCESS SINCE THE DECEMBER 15 FILING?

A. Yes. The ISO continues its efforts to improve the cost allocation process. We have gained a great deal of experience in our first unbundling effort, and believe we have improved the process for 2002 as a result. For example, the ISO revamped its budgeting process during 2001 (for development of the 2002 budget) to accommodate an improved unbundling approach. Each individual ISO cost that is budgeted (each expense or staff cost) is assigned directly to the unbundling categories (or to a "General" category, which is subsequently assigned to the unbundling categories using various approaches.) This more granular approach should result in improved accuracy of the unbundling and allocation process, and address concerns raised by intervenors during 2001.

Additionally, during 2001, the ISO has begun development of detailed lists of tasks performed by each department. The ISO is investigating how these tasks relate to the unbundled categories, in order to consider assigning costs to these tasks rather than directly to the unbundled categories. This could facilitate further unbundling efforts, or could lead to the use of limited employee time information in the allocation of staff costs. This demonstrates our acknowledgment that the unbundling effort is an evolving one, and that improvements can and will be made. Each year of additional experience will bring new insights and improvements for subsequent years.

Q. MR. JOBSON ARGUES THAT THE ISO MUST RETAIN THE SAME PROCESS OF ALLOCATION FOR EACH YEAR'S GMC. EXH. NO. SMD-1 AT 12. DO YOU AGREE WITH THIS ARGUMENT?

A. We are in complete disagreement with Mr. Jobson on this point. In fact, the ISO hopes to improve not just the result but the process by which GMC costs are allocated, perhaps as often as every year. As I noted above, we believe that each year's experience will help us make improvements for the future. For that reason it would be unwise to lock in the allocation method that the ISO used for the 2001 GMC. That being said, the ISO intends to use the same *criterion* in making cost allocation decisions from year to year. The criterion we use now -- cost causation -- will be the same criterion that we use in the future.

Q. IS IT POSSIBLE TO DIVIDE UP THE SERVICE CATEGORIES FURTHER, SO THAT A PARTICULAR CUSTOMER WOULD PAY ONLY FOR PART OF A GIVEN SERVICE CATEGORY?

A. That is a possible goal for subsequent stakeholder discussions on unbundling – to make the categories more granular, possibly adding new service categories or dividing existing service categories into more than one category.

As noted above, our development of specific tasks associated with each ISO department will facilitate exploration of this issue.

Q. CAN THIS BE ACHIEVED IN THE 2001 GMC PROCEEDING?

A. No. We do not currently have data that would permit allocating 2001 costs to more service categories than we now have. Our billing and accounting system is not set up to administer more than the three current charges. As I described in my Direct Testimony, Exh. No. ISO-7 at 24-29, our rates are based on the predicted billing determinant volumes for the year, based on the three-category structure. Sub-dividing the categories at this time, even if it were possible despite accounting and software limitations, would require the GMC rates for 2001 to be completely overhauled, because it would lead to changes in the billing determinants and their respective determinant volumes. Major changes such as the addition of new service categories are best handled prospectively.

Moreover, during the stakeholder process, the Market Participants agreed that each service category should represent at least 5 percent of the ISO's costs. *See* Exh. No. ISO-1 at 16-17. Unless each of the resulting categories would continue to constitute 5 percent of the ISO's costs, breaking down the three service categories further now, would violate one of the criteria by which these categories were developed in the first place.

7. <u>Response To Mr. Werner's Testimony</u>

Q. ARE THERE ANY PARTS OF MR. WERNER'S TESTIMONY ON BEHALF OF THE CALIFORNIA DEPARTMENT OF WATER RESOURCES TO WHICH YOU WOULD LIKE TO RESPOND?

A. Yes. I have already referred to Mr. Werner's testimony where he agrees with positions I have taken in response to the testimony of other witnesses. However, Mr. Werner has taken certain other positions with which I do not agree, or on which I would like to comment for other reasons. Those positions are as follows:

- His position that the cost categories and allocations in the GMC filing for 2001 should be "frozen" until the ISO conducts a new stakeholder process in 2003 (as suggested by Mr. Pointer, in testimony for Staff). Exh. No. DWR-2 at 3–7.
- His concern at the possibility that the ISO's charges to CDWR for one or more of the GMC's three cost categories might be increased as a result of a Commission decision in this case. Exh. No. DWR-2 at 8-14.

Q. WHAT COMMENTS DO YOU HAVE ON MR. WERNER'S FIRST POSITION, CONCERNING FREEZING OF THE GMC CATEGORIES AND COST ALLOCATIONS?

A. Although I have some sympathy with Mr. Werner's concerns, I nevertheless disagree with his position. Mr. Werner notes that his client supported the

ISO's "unbundled GMC" filing for 2001 as a whole, and objects to individual parties' proposals of changes, particularly to the cost allocations, in the course of this proceeding without the input of all stakeholders; he does not want the ISO to make any of those changes. If I may paraphrase his position, it seems to be that the unbundling of the GMC is a work in process; that this first filing represents the ISO's best effort to incorporate the results of the long stakeholder process that preceded it; that the California markets and the ISO's collections of the GMC are both unstable and should stabilize before a review of the unbundling process is undertaken; that Mr. Pointer's recommendation of a complete review by another stakeholder process in 2003 appears to be timed appropriately; and that in the meantime no party should be allowed to suggest "rifle shot" changes to the current status of the unbundled GMC that benefit that party at the expense of others, nor should the ISO be making changes from year to year that shift costs among stakeholders.

I fully agree with Mr. Werner that the GMC unbundling is a work in progress, and that the current filing represents the ISO's best effort to synthesize the results of the stakeholder process. I also agree that the markets and the ISO's collections have been and remain unstable, and that for both reasons any comprehensive review of the categories or the cost allocations would best wait – until 2003 at the earliest. Finally, I also agree with Mr. Werner that it would be preferable if individual parties would refrain from seeking to change the cost allocations filed by the ISO in a given year and, instead, seek to work desired changes through a collaborative process that involves all affected parties (rather than a litigation process such as this one). But my agreement on these points does not lead me to his ultimate conclusion that *no changes whatsoever* should be made before a comprehensive review of the current cost categories and allocations can be conducted.

Clearly, some changes will have to be made before 2003 to the GMC cost center allocations as filed by the ISO for 2001. The very instability in our markets and the twists and turns in the California electric industry restructuring process have led to modifications in the nature of the ISO's tasks, and consequently, changes in the cost centers at the ISO. For example, the ISO revised its organizational reporting structure in early 2001, to permit management to better address the challenges of the crisis conditions in the California energy market. Among the modifications in that reorganization was that all market functions, including the settlements department, now report to the Vice President of Market Services. Similarly, a new cost center to focus on regional coordination activities was created. These changes, along with several others, necessitate a change in the cost allocation process used to allocate the ISO's costs to the three service categories. Specifically, the changes have to be made in the CAM for 2002. Additional cost centers are to be added, some are to be deleted, and others are to be moved around. It would not be possible, given these changes, to freeze, or lock down the cost allocation procedures, as they were reported in the ISO's December 15 Filing, because the ISO has changed. Several new cost centers have been created, while others have been eliminated. Moreover, the changes in the ISO's tasks have led to different allocations of effort among the three GMC categories, within existing cost centers. Both types of change – creation of new cost centers, and noticeably different allocations of effort within cost centers – should lead to changes in the allocation of the ISO's costs among the three GMC categories even before 2003. Otherwise, those costs will become allocated, over a relatively short period of time, in ways that would no longer be appropriate even under the basic allocation assumptions used in the 2001 filing. Recognizing this potential for "mis-allocations," the ISO has proposed to make changes in the allocations among the three categories in the GMC filing for 2002, in recognition of the new cost centers and different allocations of existing cost centers. In fact, the ISO has developed preliminary allocation factors for the 2002 budget (which has not been approved by the ISO Governing Board as of the writing of this testimony), which include changes in the allocations among categories.

In addition to these changes that the ISO itself will be proposing, the ISO also recognizes that individual parties – other than the CDWR – have through testimony in this proceeding identified areas in which they believe the ISO's good faith effort to allocate costs for 2001 should be overturned. While the

ISO *agrees* with CDWR that it would be preferable for individual parties not to do this, the fact as I understand it from my attorneys is that, procedurally, they are entitled to do so. The ISO accepts their right to do so, and asks only, as I have noted elsewhere, that any changes the Commission might order be applied starting in a new budget year or, at the very least, prospectively only. As I have said, I believe this is appropriate in recognition that the unbundling of the GMC is ongoing and that the ISO, with no motive of personal profit involved, did its good faith best in the allocations that it filed.

Q. WHAT COMMENTS DO YOU HAVE ON MR. WERNER'S CONCERN THAT THE COMMISSION'S DECISION IN THIS CASE COULD RESULT IN THE ISO CHARGING MORE TO CDWR FOR THE GMC?

A. Mr. Werner's point, paraphrased, is that his client would prefer not to be billed additional amounts if the Commission should rule in favor of any of the positions put forward by other parties. These positions of other parties could relate either to allocations of specific cost centers, or to the ISO's ability to bill Control Area Services on the basis of Control Area Gross Load or to bill certain parties. If the Commission were to rule in favor of a party on one of these arguments, and rule that the party should receive refunds for payments previously made, Mr. Werner would prefer that this not result in additional billings to CDWR in order for the ISO to make up for the resulting shortfall.

Mr. Werner's objection to his client's being billed more under these hypothetical circumstances is understandable – no one wants to pay more if one can avoid it – but the objection also is totally unjustified. The fundamental points that must be kept in mind are, first, that the ISO is a revenue neutral, not-for-profit entity that *must* recover its costs, and two, that the circumstances being hypothesized by Mr. Werner all involve straightforward issues of *equitable allocation of legitimately incurred costs*. In each case, the Commission's ruling would simply mean that it disagreed with the ISO's decision to allocate all costs among more rather than fewer parties, or to allocate the costs of a specific cost center in a certain way. The Commission's decision would *not* mean that the ISO should not recover the costs, but that *different parties should have been paying all along*. It would be totally unjustifiable for the ISO to be required to refund amounts paid by some parties (those that hypothetically have succeeded before the Commission) but not to be able to recover those amounts from the parties that, according to the Commission, should have been paying more all along. Neither Mr. Werner nor anyone else has shown or could show that the ISO's right to recover from the parties that should have been paying more all along under this hypothetical set of circumstances is unjust or unreasonable. In fact, it would be unjust and unreasonable *not* to permit the ISO to do so.

I should note that Mr. Werner does hypothesize a circumstance under which he believes the ISO's admitted right to bill his client might be unjust. He alludes to the Commission's recent finding that the California Power Exchange's application of the "charge-back" mechanism in its tariff in the event of massive defaults would be unjust and unreasonable because it likely would cause the parties to whom the defaults had been charged back to default themselves. *See* Exh. No. DWR-2 at 12–13. While I am no expert on the charge-back mechanism in the PX tariff, it seems clear to me that Mr. Werner's allusion is irrelevant. First, the mechanism in the ISO Tariff allowing the ISO to ensure recovery of its GMC through increasing the billing rate is not a "charge-back" mechanism. Second, there is no reason to believe that the ISO would have to increase the billing rate for any of the three GMC categories so much that it would be difficult or impossible for parties to pay. Any changes proposed would be, in all likelihood, changes of no more than a few percent in either direction.

Finally, I would note that Mr. Werner expresses some concern about his client's ability to know when the ISO may have increased the billing rate to it due to a need to recover amounts that it had to refund to other parties, or when the ISO may have made a quarterly adjustment to the billing rate for any other reason. *See* Exh. No. DWR-2 at 13- 14. As Mr. Werner notes, in response to information requests the ISO has stated that it will file quarterly adjustments for information at the Commission, and will notify market participants and post the filing on the ISO web site. The ISO believes this process will fully inform Mr. Werner's client if and when the billing rate to it increases, and why. In addition, any quarterly adjustment the ISO makes will effect rates on a prospective basis only.

III. CONCLUSION

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.