

SCE Comments on CAISO CRR Issues Paper Dated February 21, 2007

The following comments reflect the preliminary opinions of SCE in regard to the numerous issues raised in the CAISO's CRR Issues Paper. As a general matter, SCE notes that each of these topics deserves a robust stakeholder process and SCE looks forward to meeting and discussing with stakeholders the various options that could be employed to resolve the stated issues.

Trading Hubs

SCE believes that the issues associated with trading hubs identified in the dry run present a significant problem that must be addressed sufficiently prior to the allocation of any transmission rights. While the CAISO analysis has focused on the inability of load serving entities to obtain sufficient quantities of trading hub rights, SCE notes that the priority for hub rights over that of a point-to-point right that sources at a generating node in the hub results in LSEs also not being able to obtain sufficient quantities of point-to-point rights and prevents the subsequent conversion of such rights to long-term. Given the ranging impact of this issue, SCE believes it is critical that an effective solution is implemented prior to allocation.

In considering the options presented to resolve this issue, SCE concludes that the only option offered thus far that truly resolves both the priority issue and the infeasibility of hubs once a binding constraint is reached is to turn a hub request into a multi-point request. This process would effectively break up a hub request into the components of the hub in accordance to the hub weighting at the time of allocation. In doing so, if any hub request encounters a binding constraint, rather than denying the entire request, the CAISO can simply reduce the point within the hub that has created the binding constraint. Additionally, by doing this, a point-to-point right sourced at a generating node in the hub and a now multi-point hub request can be treated equally in the process of allocating rights that must be reduced due to a binding constraint.

SCE acknowledges that this process may leave holders of a hub right with an instrument that does not precisely match the hub definition. This may result in an instrument that does not precisely hedge the actual congestion exposure experienced. However, it is our opinion that stakeholders would be better served receiving a right that may not be a complete hedge rather than receiving no hedge at all.

Further, SCE does not believe that the other options that have been offered to this point are sufficient to address the problem. The CAISO proposals to reduce the amount of requests or the amount of grid capacity in the first tier can not assure sufficient results. This is because the sensitivity analysis performed depended on the allocation nominations received in the dry run. However, these nominations were made by market participants without the knowledge that a hub request has a lower likelihood of being reduced than point-to-point rights if a binding constraint is reached. If participants can demonstrate the need for additional trading hubs, all other things being equal, we would

now expect more requests for hubs in the first allocation tier. If this is the case, the limitations contemplated by the CAISO may not be sufficient to ensure an appropriate allocation. In fact, an appropriate allocation is unlikely as hubs displace otherwise legitimate point-to-point nominations. For these reasons, SCE does not believe that either of the CAISO straw-proposals are appropriate.

50% Set-Aside for Scheduling Points

Certainly this argument is bound to be one of various parties arguing for a higher set-aside and others arguing for a lower set-aside. SCE objected to any set-aside when this mechanism was suggested as part of the MRTU proposal and continues its objections. All CRRs should be allocated to load and no set aside should be made for the auction. As a result, SCE believes the set-aside percentage should be set to 0%, at least for the initial allocation.

The CAISO should not place great weight on the fact that certain scheduling points (e.g. Palo Verde) generated bids well in excess of the amount of capacity made available under the 50% set-aside. This is nothing more than a demonstration that such points hold value.

Given the data provided thus far, there is certainly no reasonable argument to increase the set-aside percentage. Although SCE believes there should be no set aside, we realize that the CAISO developed its original position as an attempt to balance a host of stakeholder concerns. As a result, any change in the 50% set aside would upset this balance and SCE strongly objects to any increase in the current 50% rule. Given the contentious nature of this issue, SCE believes the best course of action is to simply leave the current rules in place.

Source Verification

The CAISO presents a number of questions on the subject of source verification. SCE addresses each of these questions below.

Should the CAISO retain provisional Dry Run rules whereby contracts as short as 1 day can count, with MW prorated to reflect average MW over CRR Term?

No. SCE believes that Seasonal and LT-CRRs should be based upon a demonstrated need (i.e. a commitment to serve load from a resource). A contract duration of one day whether entered into multiple days in a row or not does not demonstrate a commitment to serve load from a resource. Rather, it demonstrates a structure to obtain the best short-term pricing available. SCE finds it absurd to issue a seasonal right that is then converted to a long-term right on the basis of a contract that was only valid for a single day.

Additionally, SCE believes that such a process would prove to be a large burden to the CAISO. Depending on the definition of “1 day”, SCE believes that this could result in

upwards of 25,000 contracts to be evaluated.¹ According to the CAISO only a few participants opted for this option in the dry run. SCE believes that is because of the large effort that would be needed for other entities to gather and submit the voluminous data that would be required. However, if such a rule was put in place, participants would have an incentive to undertake such an effort.

Additionally, the CRR allocation process contains a non-source verified tier (both in the seasonal and monthly) that can be utilized to request rights for such activity. In fact, SCE understands that this precise issue was one of the drivers behind non-source verified tiers. The current “30-day” rule should remain in place.

Should the CAISO utilize RA capacity showings or LT procurement plans, in addition to historical period energy contracts?

No. To the extent that a contract for energy was signed and delivered in 2006 for RA or to address LTPP needs, then the contract can already be utilized in the CRR source verification. To go beyond this runs the risk of potential sham contracting that the CAISO based its original requirement for historical source verification upon. This potential is unchanged just because the procurement is said to meet RA or LTPP there is no guarantee that such contracts must necessarily be kept in order to satisfy RA or LTPP.²

Additionally, it is not clear how such showings or plans would be utilized to define a specific source. RA requirements are established only one year in advance and define a MW threshold for procurement on a system and local basis only. It is not until the resource has been contracted for that the source is known. Similarly, LTPPs only define the resource requirements of the utilities. They do not define the specific resources necessary to fill such requirements. As such, it is difficult to determine what such plans and showings would entitle a load serving entity to.

Should the CAISO eliminate the requirement to nominate verified sources in Tier 1 of the Monthly process? This is suggested because there is no corresponding Monthly PNP in Year 2.

No. SCE supported the allocation of CRRs on the basis that they would be allocated in the first year on a demonstration of need. This demonstration was not dependent upon the use of a priority nomination in subsequent years to enable renewal of such rights.³ In other words, the lack of a PNP in the monthly process was known at the time of the CRR proposal development. If the use of source verification for the monthly process was dependent upon a PNP in subsequent years, the issue would have been raised at that

¹ The figure is dependent on how much of the day, the contract must deliver over to be considered (e.g. 1 hour, all peak hours, all off-peak hours, a sub-set of peak or off-peak hours, etc.)

² It is entirely possible that an entity could sign a sham contract claimed to meet the annual RA requirements or future LTPP requirements to obtain valuable rights, then cancel or sell the contract, retain the rights, and obtain other resources to meet RA or LTPP requirements.

³ SCE supports the priority nomination process to enable entities to renew rights but we do not see the source verification as being dependent upon the existence of a PNP in subsequent years.

point. SCE continues to advocate source verification in the monthly process as a means to allocate rights as hedges particularly in the first year of allocation where there is much uncertainty to the value of hedges and the risks of congestion under LMP.

Transmission Outages

The CAISO presents a number of questions on the subject of source verification. SCE addresses each of these questions below.

What constitutes a “significant” outage?

For CRR purposes, the question effectively revolves around the impact to revenue adequacy.

What is a reasonable criteria for what constitutes “significant” impact on CRR revenue adequacy.

This question is difficult to answer not having any experience with CRRs and LMP. Potentially, the mechanisms put in place to mitigate revenue inadequacy (e.g. inclusion of auction revenues in the balancing account) may make the impact of outages minimal or even non-existent. On the other hand, a large outage on a valuable path during a period of high congestion may cause a significant financial burden upon load to fund any under-collection. Further, the CAISO will need to estimate the impact of a future outage on future revenue adequacy. The actual impact will differ from this estimate based upon differences between the model utilized and actual grid conditions.

One possible metric would be to forecast the dollar impact of an outage as percentage of total monthly congestion costs. The forecast of the outage cost could even be compared to recent actual grid congestion costs. If an outage was forecasted to have a dollar impact of 2% - 5% or more of total grid wide congestion costs, the outage could be “significant”. This would of course need to be balanced with the ability for PTOs to adequately and efficiently perform necessary transmission maintenance. SCE notes however, that the CAISO should perform studies to determine the appropriate level of what constitutes a significant impact. Without such studies, stakeholders can only guess at the appropriate level.

What percentage reduction in network capacity for the monthly CRR process might represent a reasonable margin to reflect impact on unplanned transmission outages and derates?

SCE believes that similar to our suggestion above, this process should be tied to the value of such outages on revenue adequacy. As a starting point, SCE suggests that perhaps a reduction in network capacity of 2% - 5% is appropriate. The CAISO should study the expected revenue adequacy impact of historical outages to arrive at the appropriate amount.

How should planned outages with short lead times be considered in CRR process?

If by definition, an outage with short lead time is one that occurs after the monthly allocation and auction process has concluded, then such outages should be addressed in the amount of network capacity that is not allocated in the discussion above. If these outages are known prior to the monthly process, then the CAISO should evaluate the revenue adequacy of such outages to determine the appropriate amount of rights to make available in the monthly process.

How should unplanned outages be considered in monthly process?

Such outages should be captured in the overall derate as suggested above.

Common Forecast for RA and CRRs

SCE originally offered this idea as a means to place the competing incentive to under forecast for RA purposes against the incentive to over forecast for CRR purposes. SCE continues to support this concept. However, in order to optimize the result of this proposal, it is important that the CAISO choose the correct RA forecast to base this analysis upon. Since the CAISO is proposing to use a load forecast for the monthly CRR allocation process, it may seem natural to also use the monthly RA forecast. However, SCE believes this would be inappropriate. This is because under the RA program, only the system RA requirement has a monthly true-up process. The local RA requirement is entirely dependent upon the annual load forecast. Therefore, if the CAISO were to utilize the monthly load forecast for CRR purposes, LSEs may still have an incentive to under forecast in the annual RA process to avoid local requirements. Therefore, SCE recommends that the CAISO utilize the annual RA load forecast adjusted for load migration as the basis for the monthly CRR Allocation process.

Frequency of Monthly Allocation and Auction Process

SCE is indifferent to performing the monthly allocation and auction process monthly or every other month. However, since contracts do not generally contain terms that coincide with half seasons, SCE would prefer that the “half-season” (i.e. 8 times per year) proposal not be considered.

Load Migration

SCE believes the following objectives must be achieved in any load migration process:

1. The CAISO must be responsible for tracking load migration – If a tracking mechanism is not available on day one of MRTU, then the CAISO should not require load migration immediately. Instead, the financial aspects of the CRRs can be settled at a future point in time when load migration can be tracked. At

- such time, parties should then financially “true-up” based on the CAISO’s calculations of load migration.
2. A percent of load migration must result in an equal percent of CRR transfer – It would be untenable if an entity were forced to transfer a disproportionate amount of CRRs for the amount of load that migrates. While simple in concept, execution may be complicated.
 3. The financial transfer must be based on settlements after-the-fact or must be optional – Unless the financial transfer option is guaranteed to be the financial equivalent of transferring the actual CRR, then LSEs can not be forced to utilize the financial transfer option.

The CAISO must be responsible for tracking load migration

Currently, the CAISO tariff requires LSEs to track and transfer CRRs due to load migration. In the LT-CRR filing, the CAISO committed to amending this methodology. If the CAISO is not capable of implementing a tracking and transfer mechanism on day one of MRTU, then at a minimum, the current provisions of the tariff must be suspended as the current provision will lead to disputes with little probability of resolution.

Additionally, since CRRs are financial instruments, the impact of a lack of a migration methodology on day one can be accommodated through an after-the-fact settlement. SCE does not advocate this option as a legitimate reason to delay the development of a complete load migration method but rather offers the concept to avoid relying upon the current deficient tariff language.

A percent of load migration must result in an equal percent of CRR transfer

As a policy matter, it would be untenable for an LSE to lose 100% of their load and be required to transfer 120% of CRRs or to lose 100% of CRRs for an 80% loss of load with no further CRR transfers occurring for additional load transfer. While the above statements are self-evident, developing a process to accomplish such is not trivial.

SCE notes that the allocation of CRRs is based upon the amount of load that is exceeded on 0.5% of the hours in the year. This is further broken up by season and time of use. In defining this total MW value for each season and TOU, each customer contributes to the total MW value. If load migration is to be customer specific, then each customer must have 8 usage measurements (4 seasons X 2 TOU periods) identified and tracked each year. Additionally, since these transfers are applicable to LT-CRR as well, this data would need to be retained each year for a minimum of 10 years.

This process could be simplified by moving to a class average approach in which specific customer load would not be retained. Rather, the class average load for the 8 usage measurements for 10 years would be retained. Then, when a customer load migrates, it would carry the average load of the class eliminating the need for individual customer data.

However, in either case, the process would need to account for new load. If for example, a customer were to build a new home in 2011, and in 2011 migrate from one LSE to another, there should be no transfer of CRRs received in 2010 for 2001 or in prior years as a LT-CRR. This circumstance must be left to load growth and should only be subject to load migration after rights have been allocated based upon this load. Additionally, in the class average case, the class of each customer would need to be tracked over the relevant 10 year period to ensure that the appropriate amount of CRRs are transferred for the appropriate years.

These are but a few complications in developing a load migration process which can achieve the objective of a percent of CRRs for an equal percent of load migration. Further, it highlights the reason why SCE advocates starting an in-depth stakeholder process soon.

As a potential simplification, stakeholders and the CAISO should consider utilizing the RA load forecast rather than the recorded historical load in the annual allocation process. By doing so, the natural tension of under v. over forecasting will be achieved and it may be possible to then utilize the load migration process already developed in the RA process. Obviously, if this methodology is pursued, the process must meet the primary objective stated above of transferring a proportionate share of CRRs based upon the amount of load that migrates.

The financial transfer must be based on actual settlement values after-the-fact or must be optional

In the CRR Issues Paper, the CAISO contemplates utilizing either auction prices or historical LMP to calculate the financial value of rights to be used in the financial transfer option. SCE objects to any methodology that would estimate the value of CRRs. Such a methodology places unnecessary risk on the part of the load losing and gaining entities. Since CRRs are financial instruments, the value of the rights can be known with certainty in the settlement process. It should be this value that is required to be transferred from the load losing entity to the load gaining entity. Any other measure leaves risk on both sides of the transaction for an instrument that is designed to be a hedge that will significantly reduce if not eliminate such risk.

If an after-the-fact settlement is not utilized, then the financial transfer must be optional for the load losing entity. The reason for this is simple. The CAISO tariff should not create a circumstance under which a load losing entity is forced to take a risk that they otherwise would not have undertaken.

SCE believes an after-the-fact settlement would not be difficult to implement and would address the circumstance in which the load losing entity has sold the rights that would otherwise have been transferred. In this circumstance, the CAISO would calculate on a monthly basis the value of the rights and invoice both parties (as a credit to the load gaining entity and a debit to the load losing entity).

Additional Issues Raised in the CAISO Paper

The CAISO raised several other issues in regard to load migration in their paper. The following are SCE's preliminary thoughts on these issues.

Definition of CRRs to be transferred

In the LT-CRR NOPR proceeding, SCE suggested that three criteria should be met prior to requiring any transfer of long-term rights due to load migration. Those criteria are:

- (1) The original right was allocated (*i.e.* any rights purchased bilaterally or in an auction would not be transferred regardless of any load migration); and
- (2) The load-gaining entity has the ability to utilize the same source/sink pair that was used to allocate the long-term right to the load-losing entity; and
- (3) The load losing entity can no longer use the entire long-term transmission right for the output/load upon which the long-term right was initially awarded to the load-losing entity.

SCE continues to believe that such a methodology should be pursued and looks forward to working with the CAISO and other stakeholders to examine the options.

Transparent Formula

SCE agrees that CRR holders should have a transparent formula available so that the holder can validate the calculations performed by the CAISO.

Business Process

SCE agrees that transfers of CRRs due to load migration should be performed by the CAISO. The tariff should be modified to require the CRR holders to register bilateral transfers and the CAISO to register transfers due to load migration.

Eligibility for Nominating Transferred CRRs in the PNP

SCE would only find it appropriate to allow the priority nomination of rights transferred due to load migration, if the definition of load transfer is modified as discussed above. Currently, if a load losing entity wants to re-acquire rights to a resource that were transferred due to load migration, they can do so by competing equally in the subsequent allocation process. While this is not desirable (since these resources may be owned resources that the load losing entity will be using to serve load), to eliminate the possibility that the load losing entity will be able to re-acquire those rights is even less desirable. Therefore, any change in the PNP process can only be considered in light of potential changes to the requirements for the specific CRRs that must be transferred due to load migration.

Merchant Transmission

The material posted by the CAISO requires further explanation before SCE can make substantive comments on this issues at hand. Therefore, SCE recommends a stakeholder meeting as soon as possible to describe and discuss each of the issues postulated in the CRR Issues paper.

From a fundamental standpoint, SCE is concerned that the method of allocating CRRs to merchant transmission owners should not benefit those owners at the expense of ratepayers. For example, suppose the utilities have built transmission facilities with a capacity of 1,000 MWs but due to the configuration of the grid, those facilities must be limited to 800 MWs. Ratepayers have paid and continue to pay for the full 1,000 MWs through rates. If a Merchant were to make some investment in the grid that now made the full 1,000 MWs of the existing transmission facility available, it does not appear to be reasonable to allocate the value of the 200 MWs to the Merchant when the ratepayers have and continue to pay for that 200 MWs.

Additionally, the process used to allocate such CRRs is very important. In the previously posted Draft Proposal for the Allocation of Congestion Revenue Rights to Merchant Transmission, the CAISO contemplates an allocation that would take place between annual allocation processes. SCE notes that in the annual process, the CAISO only makes 75% of existing grid capacity available. The amounts not allocated in the annual process are then made available in the monthly process. Thus, at a minimum, 25% of the grid will be available in the monthly process. It would not be reasonable to allow a Merchant access to this 25+%. By doing so, the CRRs that entities otherwise would have obtained may be unavailable. Further, those rights will have nothing to do with the grid expansion provided by the Merchant.

SCE encourages the CAISO to convene a stakeholder meeting to address these concerns and further discuss the other pertinent issues in this matter.

Credit

SCE respectfully submits that the LECG white paper has missed the primary issues necessary for the credit discussion. The LECG white paper primarily discusses how to calculate credit and collateral requirements by basing their value on the prices derived from the auction. SCE notes that the primary method of distributing CRRs is through an allocation. Therefore, it is entirely possible that for some source/sink pairs, there will not be any CRRs available for auction and/or there may be no interest in procuring at auction rights between a source/sink pair for which an allocation did occur. Thus, the CAISO must have a methodology for determining credit and collateral requirements absent an auction process.

Further, SCE is concerned that the potential for very large collateral requirements due to the 10-year term of LT-CRRs may prevent entities from holding such rights if collateral for all years must be posted up front. Additionally, SCE is concerned that the length of

term for LT-CRRs creates the potential for the value of such rights to change over time. SCE believes that such changes in value should not be ignored. For these reasons, SCE asks the CAISO to work with stakeholders to develop a credit and collateral process that re-evaluates the value of CRRs and the corresponding credit and collateral requirements on an annual basis. In doing so, SCE recognizes that the CAISO must have sufficient leverage to ensure that CRR holders post the additional collateral required when it is determined that such collateral is necessary. SCE believes that mechanisms can be developed to provide such leverage (e.g. loss of positively valued rights for failure to post collateral, suspension of qualified CRR holder status for some period of time, exclusion from future allocations or PNP, etc.). SCE believes that this issue is as important as the methodology for determining the credit and collateral value in the first place.

Implementation Issues

In the CAISO CRR Issues Paper, the CAISO discussed several implementation issues. SCE addresses each of these briefly.

TRTC Instructions

SCE provided comments on TRTC instructions to the CAISO on March 6, 2007

Authority to begin gathering of data

SCE does not object to the CAISO request for authority to gather the data necessary to perform the allocation of CRRs prior to MRTU implementation. Parties which refuse to provide the “showing” information should not be given a CRR allocation in Tier 1 or 2.

Registration Requirements/Process

SCE has no objections to the proposed registration requirements and process proposed

CRR BPM

SCE provided comments on the current CRR BPM on March 2, 2007. SCE reserves the right to comment further should the policy changes discussed in the CRR Issues paper come to fruition.