

January 4, 2008

Mr. Charles King  
Vice-President of Market Development  
California Independent System Operator  
151 Blue Ravine Road  
Folsom, CA 95630

## **RESPONSE TO CAISO DECEMBER 6<sup>TH</sup> LETTER**

Dear Mr. King:

This letter responds to your December 6, 2007, letter (December 6th Letter), as well as the meeting held among the California Independent System Operator (CAISO), the Sacramento Municipal Utility District (SMUD), Turlock Irrigation District (TID), and Western Area Power Administration (Western)<sup>1</sup> (collectively, the "Parties") on December 11, 2007. More specifically, this letter refers to Attachment A of the December 6<sup>th</sup> Letter, in which the CAISO attempts to address and rebut the concerns raised in our letter dated November 14, 2007 (November 14<sup>th</sup> Letter).<sup>2</sup>

Regrettably, we have no other alternative but to conclude that the CAISO and the Parties have fundamentally different perspectives on how prices, schedules, and settlements should be modeled when the CAISO implements its Market Redesign Technology Upgrade (MRTU) initiative. We are especially concerned that the approach outlined by the CAISO proposes a piecemeal approach and would implement a new paradigm which potentially could have an unfair and disparate impact upon our business activities. Specifically, throughout our discussions, the CAISO has proposed to implement a new approach without providing the appropriate underlying assumptions, data, and studies which we could use to independently verify its claims that we would not be harmed. Additionally, we believe that the CAISO has been somewhat disingenuous in that not only has it only recently finalized its proposal, but expects the Parties to agree to its implementation without providing a fair and meaningful opportunity for comment and review.

We have summarized our principal points of disagreement:

- (1) The CAISO's proposal is untimely, incomplete, and lacks supporting analyses.

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<sup>1</sup> The City of Roseville, the Modesto Irrigation District, the Department of Energy (DOE), and the City of Redding are located within the Western balancing authority area.

<sup>2</sup> The November 14<sup>th</sup> Letter was co-signed by SMUD, the Western Area Power Administration (Western), the Turlock Irrigation District (TID), City of Roseville, the Modesto Irrigation District (MID), the Department of Energy (DOE) and the City of Redding Electric.

The Federal Energy Regulatory Commission (FERC) directed the CAISO at the control area seams technical conference (Seams Conference), to “pursue discussions with embedded and adjacent control [balancing authority] areas.” We understood the purpose of these discussions was to identify and resolve MRTU implementation-related seams issues in a timely and collaborative manner. Although the seams conference occurred in December 2006, the CAISO did not meet with SMUD or Western on the subject until June 2007. At the June 2007 meeting, the CAISO staff presented an initial concept. Although the Parties held several informal meetings to discuss the overall concepts and requested a formal proposal (both through several e-mail exchanges and oral requests), CAISO staff indicated that the proposal was still being vetted with senior management. A formal proposal was not received by the Parties until October 5, 2007.

Throughout the period between June and October, the proposal changed various times. During our discussions we were unable to discuss or review the underlying studies and their associated data and assumptions, as well as the CAISO’s underlying need and rationale for choosing to start with us first, rather than waiting to implement a more comprehensive solution to ensure that specific market participants like ourselves would not be inadvertently disadvantaged. Given the lack of specific details, it is accordingly difficult for us to independently determine its relative impacts upon our business operations. For example, during our discussions, the CAISO has not provided us with any specific supporting analysis which would show that their proposal would not negatively impact or disadvantage us as a result of implementing its proposed “hub” approach. Similarly, the CAISO has not provided any supporting analysis demonstrating that we would not be disadvantaged by implementing this “hub” proposal for us, while other neighboring balancing authority areas are still under the “radial” method.

The CAISO initially proposed using scheduling points for SMUD and Western (at this time no other parties, including TID, were part of the discussion); however, it proposed that distribution factors be used to allow the CAISO to estimate flows behind the ties. There was no mention then of aggregated hubs for SMUD or Western. It was not until an August 21, 2007, meeting at Western with the Parties that the CAISO orally described a new concept of using a “hub”, citing its concerns that allowing SMUD, Western, or TID to have multiple scheduling points could lead to opportunities to game the market. When pressed on the specifics, including the potential impact on congestion revenue rights (CRR) nominations, the CAISO promised a write-up in a week or two to outline the concept.<sup>3</sup> It was not until October 5, 2007, however, that the CAISO forwarded a proposal to the Parties. Moreover, as noted in the Parties’ November 14<sup>th</sup> Letter, that proposal was, at best, ambiguous as to its impacts on the Parties and represented as only as a work in progress. By its very title “DRAFT – For Discussion Purposes – DISCUSSION PAPER” the document was only a draft developed for discussion, not a definitive document from which the parties could make binding market or financial decisions.

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<sup>3</sup> The CAISO opened its market for CRR Tier 1 Annual (2008) Allocation requests on August 3, 2007, and closed the market on September 14, 2007. See <http://www.caiso.com/1bcc/1bccf1dccb30.pdf>, at 8.

We remain concerned that the proposal only provides a general overview, and is still lacking in specific details, which is needed to enable our staffs to conduct their own independent technical and financial review, much less get in place our own requisite business processes and testing parameters as part of the ongoing CAISO's Integrated Market Simulation testing activities. The last phase of this testing was initially scheduled to start January 2, 2008. We are concerned that attempting to implement this new approach, without having the appropriate entrance and exit criteria for market simulation testing will result in significant business risk and uncertainty for all of us. Because the CAISO is proposing to implement these changes to us on an incremental and piecemeal basis, we continue to remain concerned that we will be unavoidably disadvantaged as the CAISO's proposal is not part and parcel of an overall comprehensive solution.

(2) The proposal devalues the existing investment made by independent control area members.

The Parties have made significant investments in transmission infrastructure over the past decade which have increased the overall transfer capability of California's electric transmission system. Consequently, entities, such as the CAISO, which relies on the continued reliable maintenance and operation of neighboring balancing authority area entities, benefit from such investment in transmission infrastructure. Unilateral implementation of the "hub" concept by the CAISO "strands" such investments and creates an economic seam and impact which must be mitigated to assure fair and equitable treatment of all parties. In addition, without more information, it is difficult to ascertain whether the CAISO's unilateral pricing and modeling proposal may impact the continued reliable operations of neighboring balancing authority areas impacted by the proposal, for instance, by creating a single hub price, it may send improper price signals within the neighboring balancing authority areas.

(3) The CAISO's proposal results in the discriminatory application of its proposal to the Parties.

The CAISO claims consistency with the approaches taken by other organized locational marginal pricing (LMP) markets. However, the circumstances in this instance are clearly different. The Parties take particular exception to the CAISO's failure to address this supposed issue on a global, as opposed to a piecemeal basis, as was the case with the other organized LMP markets. In other words, the application of the so-called "proxy bus" concept was done more comprehensively and not, as the CAISO proposes here, incrementally, with what appears to be minimal consideration for any deleterious impacts upon the affected parties. Additionally, the CAISO's references to the problems in the Pennsylvania-Jersey-Maryland (PJM) and the post-market fixes were done to address an *actual* identified problem(s), with the full benefits of doing so within the context of a functioning market and real bids, not to address the *speculated* problem(s) as claimed by the CAISO.

As to MRTU, the Parties are not asking for special treatment; rather, they seek similar treatment to the other control areas interconnected to the CAISO. Indeed, we remain

puzzled as to why the CAISO has singled out the Parties when Attachment A of the December 6<sup>th</sup> Letter implies that other balancing authority areas should have been included as well. For example, in Point 4 of Attachment A, the CAISO states:

In examining the prevailing "individual tie line" scheduling approaches currently in use, and projecting these practices to a post-MRTU system, the CAISO observes that when there is more than one scheduling point between adjacent Balancing Authorities, there arises the potential to arbitrage any systemic price differences which may emerge due to prevailing scheduling practices and impedance differences between the individual tie points. Attachment A at 2.

After a discussion of problems that were encountered between two RTOs in the Eastern Interconnection, the CAISO further notes:

The CAISO would be negligent to ignore the potential for these occurrences and therefore seeks to limit the number of scheduling points to a single point for multiple free-flowing single ties and explicit points for controlled tie lines such as HVDC controlled or phase-shifter controlled ties which are operated in a manner to insure that physical flows are consistent with accepted schedules. Id. at 3.

The parties have the following concerns with this rationale.

First, the problems identified by the CAISO were actually between two Independent System Operators/Regional Transmission Organizations (ISO/RTOs) that were not coordinated. They did not address an issue where a traditional Balancing Authority area adjacent to an ISO/RTO caused a problem. This critical distinction aside, the CAISO has not articulated a rationale explaining why other adjacent Balancing Authorities, all of which have multiple tie points and therefore would seem to create an equal, if not greater, concern to the CAISO (i.e., due to the relative magnitude of transactions compared to that of the SMUD/Western and TID BAs), are not also being included in an overall CAISO proposal to resolve operational seams. At a minimum, we are aware of at least five other adjacent control areas with multiple scheduling points:

- Arizona Public Service (APS) - Three geographically diverse ties or scheduling points: North Gila in Southern Arizona and El Dorado in Northern Arizona, in addition to CAISO's transmission adjacency to multiple parties in eastern Arizona at Four Corners.
- Western Area Power Administration Lower Colorado (WALC) - Three tie points: Parker, Blythe and Mead 230 kilovolt (kV).
- Imperial Irrigation District (IID) - Three tie points: Imperial Valley, Mirage, and Devers.
- Nevada Power – Three tie points: El Dorado 230 kV, Mojave 500 kV, and Laughlin 69kV.

- Los Angeles Department of Water and Power (LADWP) - Four tie points: Sylmar AC, Lugo, McCullough, and Inyo.

Second, the CAISO schedules the use of transmission that reaches beyond its geographic boundaries and provides the ability for adjacent entities at those terminals to take advantage of different scheduling points. For example, the CAISO “touches” PacifiCorp at Mona in Utah and PacifiCorp can deliver the same energy adjacent to the CAISO at Four Corners, where they have a direct tie at the 345 kV bus. Sierra Pacific can deliver to CAISO at Gonder, via transmission through LADWP’s system or at the Summit tie-point. Thus, the Parties are hardly unique in their ability to utilize more than one tie point with the CAISO or match schedules with actual flows.

We believe that the CAISO has had more than enough time since the December 2006 technical seams conference to engage in a comprehensive approach with other similarly-situated balancing authority areas. It was the CAISO’s choice to approach parties on a bilateral basis, rather than collectively and it has not shown any compelling or factual basis as to why the Parties should be treated differently or why the CAISO should implement its changes incrementally, on a piecemeal basis, rather than on a more comprehensive approach. The lack of any supporting data and analysis begs the question as to why the SMUD/Western and TID balancing authority areas need to be implemented separately and why the whole concept is to be implemented piecemeal. The CAISO has also not provided us with an implementation plan showing how this conceptual approach will be applied to the rest of the other balancing authority areas in the state. This heightens our concern that the CAISO’s proposed approach is not only discriminatory, but that any impacts upon our respective operations were neither considered nor analyzed.

(4) The CAISO is incorrect in its assertion that the Parties failed to articulate their concerns about the impact of the CAISO’s proposal on the allocations of congestion revenue rights (CRRs):

The Parties must also correct the record as to the assertion that our concerns regarding CRR nominations were never raised in seams discussions. The letter inaccurately states:

[I]n many of its seams discussions with neighboring control [balancing authority] areas, as reflected in the multiple joint seams reports filed with the Commission over 2007, the CAISO discussed the benefits of modeling embedded and adjacent control areas more accurately provided the greater availability of data.

...

These discussions with the various control [balancing authority] areas and SMUD were initiated in an effort to coordinate the exchange of data that would enhance the CAISO’s modeling capability. *At no point did any party articulate a concern regarding the coincidence of these discussions with the allocation of CRRs.*

December 6th Letter, Attachment A, at 4, (emphasis added).

This is not only inaccurate, it directly conflicts with representations the CAISO has made to FERC. In Attachment B to the CAISO's Quarterly Seams Report filed with the FERC on October 30, 2007 (Third Quarter Seams Report),<sup>4</sup> there was significant reference to this exact issue:

SMUD and Western also raised a concern as to the impact of the CAISO's pricing proposal on the ACAs' congestion revenue rights (CRRs) nominations. Western noted that the CAISO had finalized its white paper reflecting its revised approach only after the initial due date for submissions for Tier 1 and on the date Tier 2 CRR nominations opened for submissions. Western accordingly requested consideration from the CAISO for modification of its CRR allocations and allocation requests in the event the changes in the CAISO's approach turned out to have a material effect on Western's nominations. *SMUD similarly noted that it was planning to nominate CRRs in the upcoming CRR nomination process, commencing in September 2007, based upon its established assumption that its CRR sinks were Scheduling Points. Thus, it questioned how a hub nominated as a CRR sink might differ from a Scheduling Point. More specifically, it questioned whether such a change might negatively impact SMUD's CRR nominations or allocations.* Third Quarter Seams Report at 3 (emphasis added).

Indeed, the entire letter dated September 14, 2007, from the CAISO's Debi LeVine to Steve Sorey of SMUD, which you yourself reference in your December 6th Letter, was in direct response to this concern raised by SMUD. This too was noted in the Third Quarter Seams Report:

The CAISO responded to SMUD, by letter from Deborah LeVine, dated September 13, 2007 (Letter), assuring SMUD "that it [SMUD] has certainty its pricing settlement option ultimately adopted through the resolution of the ACA issue will not be inconsistent with its CRR settlement." Letter at 2. However, SMUD believes there are two primary CRR-related issues associated with moving from intertie-specific pricing to a hub. The first pertains to the financial settlement of CRRs that would result from such a change. This, the CAISO has assured SMUD by its Letter, will not be affected. In SMUD's view, what has not been addressed is the question as to how SMUD's CRR nominations might have changed with a hub (aggregation) rather than a Scheduling Point as its CRR Sink. That is, whether SMUD would wish to nominate an entirely different set or quantity of CRRs had it compared the marginal congestion price differences between a specific source and sink, when that sink is an aggregated hub, versus a specific Scheduling Point. This question, SMUD stated, has not been addressed by the CAISO and in SMUD's view remains open. Id. at 4.

The Third Quarter Seams Report was not unilaterally filed by the Parties. It was, in fact, originally drafted, edited, and filed by CAISO. Thus, it is simply false that the Parties

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<sup>4</sup> CAISO Joint Quarterly Seams Reports for the Third Quarter of 2007, ER06-615-002, Attachment B, at 3 (emphasis added).

never raised concerns or objections about the possible impacts of the CAISO proposal on CRR allocations. The record is clear on this point.

In light of our concerns we recommend that the CAISO reconsider its present course of action and wait until you can implement all of your changes in a comprehensive and coordinated manner to avoid unnecessarily disadvantaging small subsets of market participants such as ourselves.

Sincerely,

Sacramento Municipal Utility District

A handwritten signature in cursive script that reads "James R. Shetler". The signature is written in black ink and is positioned above a horizontal line.

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