

Memorandum

To: ISO Board of Governors

From: Jim Detmers, Vice President Operations
Nancy Traweek, Director of Operations Support
Brent Kingsford Senior Operations Regulatory Specialist

Date: May 21, 2007

Re: **NERC/WECC Mandatory Reliability Standards
Tariff Language Modifications and *Pro Forma* Agreement**

This memorandum requires Board action.

I. Executive Summary

On June 4, 2007, mandatory reliability standards adopted by the Federal Energy Regulatory Commission (FERC) and administered by the North American Electric Reliability Corporation (NERC) and the Western Electricity Coordinating Council (WECC) for the bulk power system will become effective. Instances of non-compliance with these standards can result in monetary penalties levied against the party causing the standard violation. Compliance with NERC and WECC reliability standards is a recurring corporate goal included in the Five-Year Business Plan, subject to approval by the Board of Governors.

As part of the standards implementation process, Management proposes that the Board of Governors approve the development and submission to FERC of clarifying tariff language and a *pro forma* agreement addressing both the allocation of compliance tasks and responsibilities between the CAISO and the transmission owners/operators, and the recovery of penalties stemming from non-compliance situations.

II. Background

On March 16, 2007 the FERC approved 83 mandatory reliability standards that will become effective on June 4, 2007 (Order 693, Docket No. RM06-16-000, *Mandatory Reliability Standards for the Bulk Power System*). In anticipation of the issuance of this order, a CAISO technical working group was

assembled both to review CAISO compliance with the standards and to work with NERC-registered transmission owners and operators (TOPs) to identify areas of overlapping compliance responsibilities. Based on the efforts of this CAISO TOP working group, Management has concluded that it would be appropriate to develop a *pro forma* agreement (Reliability Standards Agreement) that will allocate compliance tasks and responsibilities between the CAISO and other registered TOPs. This *pro forma* agreement will both facilitate the compliance audit process by providing a written document of compliance responsibilities and also serve as the basis to identify non-compliant parties in the event that penalties are assessed by WECC.

In addition, based on a review of the CAISO Tariff to determine whether existing language is broad enough to accommodate the Reliability Standards Agreement and the allocation of penalties to appropriate parties, Management has concluded that the basic tariff framework contemplates such a process, but that the language should be clarified.

III. The Stakeholder Process and Tariff Modifications

On April 5, 2007 the CAISO initiated a stakeholder process to form a legal working group of TOPs for the purpose of addressing the matter of enforcing the allocation of responsibilities for compliance with the reliability standards and the allocation of any resulting penalties. Because some TOPs may not be CAISO Market Participants, the CAISO and TOP representatives agreed that addressing this matter solely in the ISO Tariff would not be sufficient. Consequently, the legal working group has been working with the technical working group to develop the *pro forma* Reliability Standards Agreement to establish the legal basis for the allocation of compliance tasks and responsibilities between the CAISO and the TOPs, and the recovery of any non-compliance penalties from the responsible TOP. Both the technical and legal working groups are well along in the process of finalizing the *pro forma* agreement. Several drafts of the agreement have been distributed for review, and the agreement has been discussed at both a joint meeting of the technical and legal working groups and at separate meetings of the legal working group.”

A summary of the stakeholders that have participated in the legal working group and the general positions they have expressed is set forth below:

Stakeholder	Position
Pacific Gas and Electric Company	Supports approach, subject to completion of working group process
Southern California Edison Company	Supports approach, subject to completion of working group process
San Diego Gas & Electric Company	Supports approach, subject to completion of working group process
Metropolitan Water District	Supports approach, subject to completion of working group process
Western Area Power Administration	Actively participating in legal working group process
City and County of San Francisco	Initial participant in legal working group process; may not be affected
Southern Cities	Initial participant in legal working group process; may not be affected
Electricity Oversight Board	Actively monitoring working group process

As for tariff provisions to implement the mandatory reliability standards, the proposed clarifications to the tariff framework will provide that penalties can be assigned to non-complying entities if that non-compliance can be determined by the CAISO based on the Reliability Standards Agreement, and that all other penalty payments will be assessed to Scheduling Coordinators through the Grid Management Charge

(GMC) formula rate.¹ The CAISO has presented draft language to the legal and technical working groups, and intends to finalize this clarifying language and put it out for general stakeholder comment prior to submission to the FERC, which currently is expected in early to mid June, 2007.²

Management proposes to file the *pro forma* Reliability Standards Agreement with FERC – either for approval or for disclaimer of jurisdiction – once the technical and legal working groups have completed their processes, and proposes that the tariff modifications be filed once the stakeholder process is concluded.

Based on stakeholder response to the preliminary draft tariff language provided at the technical and legal working group meetings, it is possible that stakeholders may express concerns that an appropriate mechanism be established for the purpose of incenting CAISO compliance with the reliability standards if the penalty costs of non-compliance by the CAISO are to be recovered from Market Participants. However, as discussed in the next section, such a mechanism is already in place in the form of the Board-approved compensation incentive program and other less direct incentives.

IV. Existing CAISO Reliability Standards Compliance Paradigm.

In the proposed Five-Year Business Plan, Management is requesting the Board approve compliance with NERC and WECC reliability standards as part of the corporate pay-for-performance compensation incentive program. Management anticipates that the Board will approve this corporate performance metric, thereby reinforcing the incentive of the CAISO to ensure full compliance with the reliability standards. Additionally, the Board has broad discretion over personnel matters that would include disciplinary action under appropriate circumstances. In addition, failure by the CAISO to comply with NERC and WECC reliability standards would reflect negatively upon the CAISO and, depending on the magnitude and duration of such shortcomings, could give rise to general objections by stakeholders either before this Board or the regulatory authorities that enforce these reliability standards. Full compliance with mandated reliability standards is of the utmost importance to the CAISO and the proposed clarifying tariff language and *pro forma* agreement will assist Management in reaching its corporate goals.

V. Request for Board Approval.

The Reliability Standards Agreement will be a bilateral agreement between the CAISO and each individual TOP. This agreement is not required by NERC or FERC but is contemplated by the FERC Order adopting the mandatory reliability standards (Order 693). It is a compliance audit tool that will have legal ramifications should penalties be assessed. The proposed tariff changes are necessitated by the new mandatory reliability standards paradigm, but would be clarifying modifications rather than entirely new language. The Reliability Standards Agreement and the clarifying tariff language will be finalized and filed with FERC as soon as possible to coordinate with the CAISO's compliance efforts with the reliability standards that will become mandatory on June 4, 2007.

¹ Section 7 of the ISO Tariff currently contains general language addressing compliance with WECC reliability criteria, and Section 8 provides that the CAISO may flow WECC-imposed penalties through to specific non-complying parties under certain circumstances. Part C of Schedule 1 of Appendix F specifies that penalty payments by the CAISO for violation of WECC reliability criteria will be passed through the GMC (USOA Account 426.3).

² It is important for the CAISO to file the *pro forma* agreement and modified tariff language as close as possible to the effective date of the mandatory reliability standards in order to seek a contract effective date of June 4, 2007.

Management recommends that the Board of Governors approve the policies summarized in this memorandum and offers the following motion:

Moved, that the ISO Board of Governors approve the policy principles related to the development of tariff modifications and a *pro forma* agreement necessary to identify compliance tasks and allocate penalties arising from the mandatory reliability standards described in the memorandum dated May 21, 2007; and

That the ISO Board of Governors authorize Management to make all appropriate and necessary filings with the FERC in support of such policy proposals.