

Memorandum

To: ISO Board of Governors
From: Nancy Saracino, General Counsel and Corporate Secretary
Date: May 13, 2008
Re: Regulatory Update

This is an update of key regulatory activities and requires no Board action.

FERC Matters and Related Decisions of the Court of Appeals

Market Redesign and Technology Upgrade (MRTU)

- **Order on Business Practice Manual Technical Conference (ER06-615, ER07-1257)**

On March 24, 2008, the Federal Energy Regulatory Commission issued its "Order on Technical Conference and Compliance." In this order, FERC generally accepted the CAISO's proposed tariff revisions incorporating additional details in the Business Practice Manuals (BPM) into the tariff. FERC directed the CAISO to make a compliance filing to incorporate specific additional tariff language within 60 days.

Responsible Attorneys: Mike Dozier, Anna McKenna and Sidney Davies

- **Quarterly Seams Report for the First Quarter of 2008 (ER06-615)**

On April 30, 2008, the CAISO filed a joint quarterly seams report for the first quarter of 2008. This report included joint reports with Western Area Power Administration, Sacramento Municipal Utility District, Turlock Irrigation District and the Bonneville Power Administration. The CAISO's report also included a summary of Seams-related activities and discussions facilitated by the Western Electricity Coordinating Council.

Responsible Attorney: Anna McKenna

Congestion Revenue Right Contingency Plan (ER08-519)

FERC issued an order on March 31 accepting the CAISO's January 31, 2008 tariff amendments to implement the Congestion Revenue Right Contingency Plan. The delay of the MRTU implementation date required tariff revisions to unwind Congestion Revenue Rights (CRRs) that would have been effective as of April 1, 2008 and to ensure that Firm Transmission Rights (FTRs) would be available until such time as MRTU is implemented. The CRR Contingency Plan provides for the orderly unwinding of auctioned CRRs as well as the creation of new FTRs, including a new FTR

auction, for the time period between April 1, 2008 and the implementation of MRTU. Pursuant to the March 31 order, the CAISO submitted its compliance filing on April 21, 2008.

Responsible Attorneys: Anna McKenna and Sidney Davies

Interconnection Queuing Practices (Docket No. AD08-2-000)

On March 20, 2008, FERC issued an order as a follow-up to a December 11, 2007 technical conference on interconnection queuing practices. In the order, FERC directed each Regional Transmission Organization ("RTO") and Independent System Operator ("ISO") to file a status report on the current status of the pending interconnection requests, any problems that may have led to queue backlogs and a summary of any stakeholder discussions relating to reforms. On April 21, 2008, the CAISO submitted its status report addressing each item. In addition to providing an update on the CAISO's ongoing Generation Interconnection Process Reform (GIPR) initiative and the difficulties caused by the proliferation of interconnection requests, the CAISO provided specific information on its queue. That information noted that there are 265 active projects in the CAISO's generator interconnection queue, including 35 submitted interconnection requests that await validation. The active projects represent approximately 77,614 MW with the pending interconnection requests awaiting validation accounting for 4,048 MW of that total. Over two-thirds of the active projects are renewable resources that total approximately 50,000 MW. For comparison, the CAISO's historic peak demand experienced during the summer of 2006 was 50,270 MWs. Based on these numbers the CAISO estimated that it would take a little more than 3 years to work through the existing backlog without queue reform.

Responsible Attorney: Grant Rosenblum

California ISO Bond Offering (ES08-36-000)

On March 17, 2008, the CAISO filed an application pursuant to Section 204 of the Federal Power Act requesting that FERC authorize CAISO's proposed issuance of variable or fixed rate bonds in an amount not to exceed \$206 million. On April 10, 2008, pursuant to the decisions made by the CAISO Board, CAISO filed an amendment to the March 17 filing requesting that the issuance be strictly fixed-rate bonds in an amount not to exceed \$215 million. Of this amount, \$70 million is allocated for funding projected capital expenditures for 2008-2009, and up to \$145 million will be used to refinance existing debt. FERC issued an order on May 1, 2008 authorizing CAISO to issue fixed rate bonds in an amount not to exceed \$215 million.

Responsible Attorney: Grace Arupo

Resource Adequacy Import Allocation Revisions (ER08-819)

On April 11, 2008, the CAISO submitted to FERC proposed amendments to Section 40.5.2.2.1 of the currently effective ISO Tariff. This section addresses the CAISO's allocation of import capacity for resource adequacy compliance purposes and will be superseded by the resource adequacy related provisions of the CAISO's Market Redesign and Technology Upgrade ("MRTU") Tariff. When Section 40.5.2.2.1 was originally filed with FERC, it was anticipated that the substantively equivalent MRTU provisions would replace Section 40.5.2.2.1 for conducting the import capacity allocation process for the 2009 Resource Adequacy Compliance Year, which commences in July 2008. However, because the "go live" date for MRTU has been rescheduled to fall 2008, the CAISO had to revise date references in Section 40.5.2.2.1 in the currently effective tariff to extend the CAISO's ability to allocate import capacity in July 2008 for

the 2009 Resource Adequacy Compliance Year. Thus, the amendments did not represent any substantive changes to the import capacity allocation process and no opposition to the amendment was filed.

Responsible Attorney: Grant Rosenblum

Settlements Charge for Excessive Declines on the Interties (FERC Docket No. ER08-628)

On April 29, 2008, FERC accepted the tariff amendment that establishes a new settlement charge for excessive declines of pre-dispatched bids for import or export energy, effective May 1. FERC's approval was conditioned on the CAISO clarifying that, while the anti-manipulation provisions will remain in force, other penalties provided by the Tariff will not apply to declines of pre-dispatched bids.

Responsible Attorney: Dan Shonkwiler

The Nevada Hydro Company, Inc. (Docket No ER06-278)

On March 24, 2008, FERC issued an *Order on Rate Incentives and Compliance Filing* that addressed, *inter alia*, the request by the Nevada Hydro Company, Inc. ("Nevada Hydro") to include the costs of its proposed Lake Elsinore Advanced Pump Storage project ("LEAPS") in the CAISO's transmission access charge ("TAC"). FERC ruled that the LEAPS pumped hydro storage facility may not be operated or managed by the CAISO and should not be functionalized as transmission for rate recovery purposes. Accordingly, FERC found that the costs of the LEAPS unit cannot be included in the CAISO's transmission access charge. FERC stressed that the purpose of the TAC is to recover the costs of transmission facilities under the CAISO's operational control; it is not to recover bundled services. FERC agreed with the CAISO that the LEAPS unit provides generation services and that the unit should not be treated differently than other pumped hydro units by providing LEAPS a guaranteed revenue stream. FERC also agreed with the CAISO that Section 1223 of the Energy Policy Act of 2005 does not require FERC to authorize the transfer of operational control of LEAPS to the CAISO or to allow the costs of LEAPS to be recovered through the TAC.

Responsible Attorney: Anthony Ivancovich

ER08-654-000 Nevada Hydro Unexecuted Large Generator Interconnection Agreement ("LGIA")

On March 11, 2008 the CAISO and San Diego Gas & Electric Company ("SDG&E") filed an unexecuted LGIA following nearly a year of negotiations with the Nevada Hydro Company ("Nevada Hydro"). The LGIA covers the interconnection facilities and network upgrades necessary to interconnect the LEAPS project to SDG&E's system through the proposed TE/VS 500 kV line. A separate LGIA between Southern California Edison Company and Nevada Hydro is currently under negotiation to connect the LEAPS project to SCE's system through the proposed TE/VS 500 kV line. The LGIA does not address questions associated with the TE/VS 500 kV line, which is being studied by the CAISO pursuant to a request made by Nevada Hydro on January 23, 2008. The issue of primary concern for the CAISO is that the November 2009 in-service date requested by Nevada Hydro is not achievable. The in-service date is when the generating facility would reasonably require back feed power from the utility. Nevada Hydro filed an intervention and protest arguing that the in-service date should be tied to the TE/VS line, not the LEAPS project. The CAISO filed an answer opposing such an interpretation of the in-service date as inconsistent with the LGIA as adopted by the Commission as part of Order 2003. SDG&E filed a similar answer and FERC is expected to issue an order shortly.

Responsible Attorney: John Anders

Transitional Capacity Procurement Mechanism (Docket No. ER08-760)

On March 28, 2008, the CAISO filed its Transitional Capacity Procurement Mechanism ("TCPM") tariff amendment with FERC. The TCPM will serve as a replacement for the Reliability Capacity Services Tariff ("RCST"). The CAISO proposed a June 1, 2008 effective date for the TCPM. The TCPM would expire on the effective date of MRTU implementation (on which date the proposed Interim Capacity Procurement Mechanism would go into effect). Under the TCPM, the CAISO would be able to procure additional capacity if a Scheduling Coordinator for an LSE fails to meet its Resource Adequacy requirements, either the Reserve Margin established by the CPUC or other Local Regulatory Authority, or the Local Capacity Requirement determined in accordance with the ISO Tariff. The CAISO would also be able to designate resources in order to respond to Significant Events. The CAISO proposed to increase the current RCST Target Annual Capacity Price from \$73/kW-year, less peak energy rents ("PER"), to \$86/kW-year, minus PER. Also, the CAISO proposed to increase the current daily Must Offer Capacity Payment from 1/17 of the Monthly RCST Capacity Charge to 1/8 of the Monthly RCST Capacity Charge. The CAISO filed its answer to comments and protests on May 5, 2008.

Responsible Attorney: Anthony Ivancovich

Startrans Asset Transfer Filing and Transmission Revenue Requirements (TRR) and Transmission Owner (TO) Tariff Filing (EC08-33, ER08-413)

On March 31, 2008, FERC issued orders conditionally accepting the January 4, 2008, filings by Startrans IO, L.L.C. of applications for (1) transfer of assets from the City of Vernon and (2) approval of its proposed TRR and TO Tariff to operate the transferred assets as a Participating Transmission Owner with the CAISO. FERC made Startrans' TRR effective immediately, subject to refund, and set several issues regarding Startrans' TRR for settlement negotiations and potential hearing. Following up on these orders, Vernon made a subsequent filing with FERC requesting a reduction in its TRR corresponding with the effectiveness of Startrans' TRR for these assets.

Responsible Attorneys: Dan Shonkwiler and Mike Dozier

Transmission Control Agreement Amendment Filing (EL08-52)

On April 1, 2008, the CAISO filed an application with FERC seeking an order accepting the CAISO's proposed revisions to the Transmission Control Agreement (TCA) to add Startrans as a new Participating TO for its Mead transmission rights obtained from Vernon and to remove the listing of those transmission rights from the TCA as belonging to Vernon. On May 7, 2008, the CAISO filed an answer to comments on the filing, requesting that (1) FERC accept the TCA revisions as filed, (2) establish an effective date of April 23, 2008 for the TCA amendments and associated TRR revisions, based on the effective date of the transfer of the Mead transmission rights from Vernon to Startrans, and (3) permit the CAISO to implement the addition of Startrans as a new Participating TO as of that date without any additional amendments to the ISO Tariff, on the basis that the current provisions of the ISO Tariff are sufficient.

Responsible Attorney: Mike Dozier

Reliability Standard Compliance and Enforcement in Regions with Regional Transmission Organizations or Independent System Operators (Docket No. AD07-12)

On March 20, 2008, FERC issued an Order Providing Guidance on Recovery of Reliability Penalty Costs by Regional Transmission Organizations and Independent System Operators. FERC declined to grant ISOs and RTOs a blanket exemption from penalties for violations of Reliability Standards. FERC indicated that it was mindful of the non-profit status of many ISOs and RTOs and confirmed that an organization's ability to pay a penalty is a factor in the Electric Reliability Organization's ("ERO") or Regional Entity's ("RE") determination of the appropriate penalty, which might include entirely non-monetary penalties. With respect to how ISOs and RTOs would recover monetary penalties assessed against them, FERC examined two situations: the direct assignment of reliability-related penalty costs to the entity that was responsible for, or contributed to, the violation (but which was not penalized by the ERO or RE) and the recovery of reliability-related penalty costs that cannot be directly assigned. With respect to the former, FERC ruled that in the event an RTO or ISO is assessed a monetary penalty, FERC would entertain a Section 205 filing by that RTO or ISO to directly assign the costs of the penalty to another entity that was responsible for the violation. With respect to the latter, in the situation where an ISO or RTO is found to be at fault for the violation of a Reliability Standard, FERC declined to allow ISOs and RTOs to adopt tariff mechanisms that provide for automatic recovery of penalties incurred for Reliability Standards violations. Instead, an ISO or RTO will be required to make a Section 205 filing with FERC if it desires to recover any penalty costs from its customers. FERC will address such filings on a case-by-case basis considering such matters as whether the RTO or ISO has a robust compliance program in place to prevent the violations (including, for example, personnel policies that place incentives on employees and management to comply with the rules or risk adverse actions), whether the violations were intentional or grossly negligent, rather than negligent, whether management was involved in the violations, the ability of the RTO or ISO to pay the penalty, and the fairness of the assessment mechanism proposed by the RTO or ISO.

Responsible Attorney: Anthony Ivancovich

Order Nos. 890 and 890-A Compliance (Docket Nos. OA08-12 and OA08-62)

On April 15, 2008, the CAISO made a filing to comply with Order No. 890-A. The CAISO amended its tariff, among other things, to allow non-generation resources to provide certain Ancillary Services, provided that they meet all applicable standards and technical requirements and are certified by the CAISO to provide such services. Non-generation providers of Ancillary Services will be subject to the same tariff requirements applicable to other providers of Ancillary Services. The CAISO also argued that most of the directives in Order No. 890-A were inapplicable to the CAISO Tariff and explained why the CAISO's service model is consistent with or superior to the *pro forma* Open Access Transmission Tariff, as revised by Order Nos. 890 and 890-A. Finally, the April 15 filing explained that the CAISO's December 21, 2007 filing to comply with the transmission planning requirements of Order No. 890 also satisfied the transmission planning requirements adopted in Order No. 890-A.

Responsible Attorney: Anthony Ivancovich

MMC Energy Inc. v. CAISO (FERC Docket No. EL08-46-000)

On April 14, 2008, the CAISO filed a motion for summary disposition and an answer to MMC's complaint filed with the Federal Energy Regulatory Commission on March 13, 2008. The motion points out that, contrary to MMC's claims, the Tariff definition of Spinning Reserve is clear on its face in that it requires the full capacity of generation bid to be unloaded, synchronized to the grid and immediately responsive to frequency. Since MMC's units were configured to have only a small amount of generation capacity operating while the vast majority of its capacity was off until dispatched, its product did not qualify as spinning reserve. On April 29, 2008, MMC filed a response to the motion and answer.

Responsible Attorney: Paul Dobson

Grid Management Charge Appeal (D.C. Circuit No. 04-1090)

On May 2, 2008, the United States Circuit Court of Appeals for the District of Columbia Circuit rejected a challenge to parts of the 2001 GMC and PG&E's authority to pass it through to existing contract customers. The CAISO, PG&E, and SCE filed a joint brief in support of FERC. The focus of the opinion was the Control Area Services charge which, from 2001 through 2003, was assessed to all gross load in the control area with a narrow exception intended for certain load that did not cause the CASO to incur costs. A coalition of publicly-owned utility petitioners argued that this exception was too narrow. The court upheld FERC's approval of the GMC allocation and the limited exemption. These petitioners also argued that PG&E's "Pass Through Tariff," which allocated portions of the Control Area Services charge to load served by existing contracts, improperly modified those existing contracts. The court also upheld the "Pass Through Tariff" as a new rate covering services provided by the CAISO that were not provided under the contracts.

Responsible Attorney: Dan Shonkwiler

CPUC Matters

CPUC-CEC Joint Greenhouse Gas Proceeding (GHG) (R.06-04-009)

In this Joint Proceeding, the California Public Utilities Commission and California Energy Commission are providing recommendations to the Air Resources Board (ARB) related to greenhouse gas regulation, under AB 32, of California's electricity and natural gas sectors. In March 2008, the CPUC and CEC approved a joint decision recommending what entities should be the "point of regulation."

Participation in cap and trade--The decision recommends including the electricity sector in a multi-sector cap and trade system, but excluding the natural gas sector for now. (Note that natural gas combustion for purposes of making electricity is categorized under the electricity sector, not the natural gas sector.)

Owner/Deliverers of Electricity are the Point of Regulation Deliverers are considered to be those entities that own and first deliver electricity to a point of delivery on California's the transmission grid.

This decision rejected the request by publicly-owned utilities that they be subject to "carve-out," which would allow them to achieve GHG regulation by direct measures and, therefore, opt-out of the cap and trade regulatory scheme. The Joint Proceeding is now focusing on fashioning recommendations on how emissions allowances should be distributed and how to allocate the proceeds from any auction of allowances. A recommendation to the ARB on these issues is expected in August 2008.

Responsible attorney: Bill Di Capo

Application for Approval of the Sunrise Powerlink Transmission Project (A.06-08-010)

On March 12, 2008 and March 28, 2008, the CAISO filed direct and rebuttal testimony in Phase 2 of the Sunrise Powerlink Transmission Project proceedings at the CPUC. Phase 2 was initiated with the issuance of the Draft Environmental Impact Report/Environmental Impact Statement (DEIR/EIS) by the CPUC and the Bureau of Land

Management on January 3, 2008. The DEIR/EIS identified seven "environmentally superior" alternatives to the Sunrise project as proposed by SDG&E, which was included as alternative number six. Issues addressed in Phase 2 include the identification of deficiencies in the DEIR/EIS, the costs of the various alternatives, and the environmental impacts of the alternatives.

In its direct and rebuttal testimony, the CAISO stated that the non-wires generation alternatives (Alternatives 1 and 2) and the transmission portion of the LEAPS project (TE/VS) (Alternative 3) will not meet the objectives of Sunrise, and that the proposed southern route for Sunrise presents reliability concerns. Other deficiencies in the DEIR/EIS were identified as well. The CAISO also updated its cost/benefit analysis to reflect updated project costs provided by SDG&E, and the results of its updated studies showed that Sunrise continues to provide the highest net benefits of the scenarios studied in Phase 1 of the case.

On April 11, 2008, the CAISO also filed comments on the DEIR/EIS, consistent with the testimony provided in the CPUC proceeding.

Responsible Attorney: Judi Sanders

Rulemaking re: Policies and Protocols for Demand Response (R.07-01-041)

In this proceeding, the CPUC is developing policies and protocols to evaluate utility Demand Response Programs. Phase 1 of the proceeding has focused on developing protocols containing methodologies that prescribe how utility DR programs will be evaluated to determine "Load Impact" (how the DR programs affect the load when dispatched) and cost-effectiveness. These protocols will be used by the utilities to prepare their filings due June 1, 2008 for DR Programs for the next program cycle (2009-2011). The CAISO has filed comments urging that the protocol should further refine the "right place," "right certainty" DR evaluation criteria that is set forth in the staff document to include, as a prime component, the degree to which a DR program avoids capacity and energy in specified geographic areas. In this regard, the CAISO has further suggested that the protocol should require the utilities to correlate proposed DR programs for the 2009-2011 cycle with the ten local capacity areas identified in the CAISO's 2009 Local Capacity Area Technical Study, and discuss the extent to which these programs address local reliability needs.

Responsible attorney: Bill Di Capo

Wind Resource Capacity Counting Rules for Resource Adequacy (R.08-01-025)

The CPUC initiated this rulemaking proceeding to evaluate needed refinements to the existing resource adequacy program as well as provide a procedural vehicle to adopt the CAISO's 2009 Local Capacity Area Technical Study. Included among the potential refinements to be addressed are revisions to the rules for determining the qualifying capacity of wind resources for resource adequacy counting purposes. Data from the first two years of the resource adequacy program shows that the counting rules result in assuming available production from wind resources that frequently and significantly exceed the actual production from such resources under peak demand conditions. Accordingly, the CAISO submitted comments proposing an alternative method to calculate the capacity from wind resources that better aligns with the reliability objectives of resource adequacy by accounting for the performance of wind resources during the appropriate peak demand periods.

Responsible Attorney: Grant Rosenblum

Advice Letter Filings of Qualifying Facility Standard Offer Contracts (PG&E Advice Letter 3197-E, SCE Advice Letter 2200-E, SDG&E Advice Letter 1958-E)

On April 4, 2008, CPUC staff issued a notice requiring PG&E, SCE, and SDG&E to prepare a single proposed new form of Standard Offer Contract for qualifying facilities (QFs) in response to a CPUC decision, for review by interested parties. The IOUs submitted their proposed form of contract on May 7, 2008. The CAISO, QF representatives, and other parties are required to submit their comments on the proposed Standard Offer Contract by May 19, and settlement negotiations are scheduled to extend from that date until June 23, at which time the IOUs are scheduled to file new Advice Letters with the final version of the contract.

Responsible Attorneys: Sidney Davies and Mike Dozier

REGULATORY FILINGS THROUGH APRIL 2008



