**UNITED STATES OF AMERICA**
**BEFORE THE**
**FEDERAL ENERGY REGULATORY COMMISSION**

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| **Promoting Transmission Investment Through Pricing Reform** | **)** | **Docket No. RM06-4-000** |

**COMMENTS OF THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION ON NOTICE OF PROPOSED RULEMAKING**

The California Independent System Operator Corporation ("CAISO") hereby submits its Comments in response to the Notice of Proposed Rulemaking ("NOPR") issued by the Federal Energy Regulatory Commission ("Commission") in the captioned proceeding on November 17, 2005.

## I. BACKGROUND

The purpose of the proposed rulemaking is to promote increased capital investment in new transmission capacity. To address the need for new transmission capacity, the NOPR proposes price reforms applicable to the entire electric grid in both organized and other markets and to both vertically integrated utilities and Transcos. In particular, the Commission proposes to promote reliable and economically efficient transmission and generation of electricity by providing for a number incentives intended to increased capital investment (*e.g.,* allowing a return on equity that is sufficient to attract new investment in transmission facilities). Further, the Commission proposes to provide incentives to utilities that join Transmission Organizations *(e.g.,* authorizing a higher return on equity for public utilities that join Transmission Organizations than the Commission might otherwise allow). The Commission also seeks comments on what incentives the Commission can offer to stimulate the deployment of advanced transmission

technologies that increase the capacity, efficiency or reliability of transmission facilities. Finally, the Commission inquires as to how performance base regulation can be applied to non-profit ISOs and RTOs.

## II. EXECUTIVE SUMMARY

The CAISO appreciates the opportunity to comment on the proposed rules. The CAISO supports the efforts of the Commission to provide incentives for the construction of needed transmission facilities and to explore technologies designed to enhance the efficient use and expansion of the existing transmission grid. The CAISO agrees that it is imperative to develop a robust transmission system in order to ensure reliability and support the development of liquid and competitive wholesale electricity markets.

The CAISO supports granting rate incentives to public utilities that build new transmission capacity that reduces transmission congestion and ensures reliability.[1] The Commission's approval of certain rate incentives has stimulated investment in needed transmission expansions in California, and providing the rate incentives specified in the NOPR should promote transmission expansion nationwide. However, rate incentives should not be granted for all transmission projects; they should only be granted for projects that are justified on reliability or economic grounds. Further, Participating Transmission Owners ("Participating TOs") should be required to participate in the relevant ISO's or RTO's planning process such that the ISO or RTO will make a determination of need. To

[1] The proposed rate incentives should also be offered to public power or to consortia that work within an ISO's or RTO's transmission planning process to construct new transmission upgrades and expansions.

encourage such participation, the Commission should either deny or, at a minimum, carefully review, any proposal for rate incentives for transmission facilities that have not been found to be needed by the ISO or RTO.

The CAISO also supports the Commission's proposal to provide return on equity ("ROE") incentives, within the zone of reasonableness, to public utilities and municipal utilities that join an ISO or RTO. Such incentives will encourage transmission owners to join ISOs and RTOs. This, in turn, will result in more effective coordination with respect to transmission construction, improve reliability, and promote the development of more competitive and efficient markets.

The CAISO also supports the development of new technologies that can be deployed to maximize the efficient use of the existing transmission system. However, the CAISO cautions that any new technologies should be deployed in a careful, deliberate and coordinated manner that ensures that the use of such technologies does not unnecessarily jeopardize grid reliability.

Finally, the CAISO submits that the Commission should not consider implementing performance based regulation ("PBR") for non-profit ISOs and RTOs. Non-profit ISOs and RTOs do not earn a return on equity and do not have shareholder benefits that can be placed at risk to incent better performance; nor can they retain any of the financial rewards that might inure from implementation of PBR. In any event, sufficient incentives already exist for ISOs and RTOs to be accountable and efficient without the need for PBR. Management compensation at ISOs and RTOs such as the CAISO includes a pay for performance

component that is based on the achievement of corporate performance goals established by Boards, including cost containment goals.

Further, while the goal of standardized performance measures across ISOs and RTOs is laudable, it is important to recognize that individual RTOs and ISOs are at different stages of development and have different goals that reflect regional priorities and the unique circumstances facing them. To the extent the Commission desires to benchmark the performance of non-profit ISOs and RTOs against each other and against the performance of for-profit entities, the Commission must carefully consider the measures to be used so that meaningful "apples-to-apples" comparisons can be made.

## III. SPECIFIC COMMENTS

### A. The CAISO Supports The Regulations Authorizing Incentive-Based Rate Treatments for New Transmission Capacity that Reduces the Cost of Delivered Power and Ensures Reliability

The proposed regulations provide that the Commission will authorize the following incentive-based rate treatments for investments by public utilities (including Transcos) in new transmission capacity that "reduces the cost of delivered power by reducing transmission congestion and ensures reliability," as demonstrated in an application to the Commission:

(1) a rate of return on equity (ROE), within the zone of reasonableness, that is sufficient to attract new investment in transmission facilities;

(2) recovery of 100% of prudently incurred transmission-related Construction Work in Progress (CWIP) in rate base;

(3) recovery of prudently incurred pre-commercial operations costs by expensing these costs instead of capitalizing them;

(4) adoption of a hypothetical capital structure;

(5) accelerated recovery of depreciation expense;

(6) recovery of all prudently-incurred development costs in cases where construction of facilities may subsequently be abandoned as a result of factors beyond the public utility's control;

(7) deferred cost recovery; and

(8) any other incentives approved by FERC that are determined to be just and reasonable and not unduly discriminatory or preferential.

The Commission seeks comments regarding these incentives. In addition, the Commission invites commenters to identify any other potential incentives that will encourage capital spending that reduces congestion and ensures reliability.

The CAISO supports incentive-based rate treatments for new transmission capacity that reduces the cost of delivered power (by reducing transmission congestion) and ensures reliability. The rate incentives specified in the NOPR should be effective in stimulating increased transmission investment. This will, in turn, lead to the development of a more robust transmission system, ensure greater reliability and support the operation of liquid and competitive wholesale electricity markets. Based on the CAISO's experience (as reflected in the discussion below), incentive-based rate treatments are often necessary to stimulate investment in new transmission infrastructure designed to alleviate existing transmission constraints (and other limitations) that impact the ability to move power on the transmission grid. The CAISO is skeptical that market forces alone can drive adequate investment in transmission facilities that provide economic benefits to ratepayers.

However, the Commission should not simply "hand-out" rate incentives for all new transmission projects regardless of whether they provide demonstrable economic or reliability benefits. Participating Transmission Owners ("Participating TOs") should be required to participate in the relevant ISO's or RTO's planning process such that the ISO or RTO will make a determination of need. To encourage such participation, the Commission should either deny or, at a minimum, review in great detail, any proposal for rate incentives for transmission facilities that have not been found to be needed by the ISO or RTO. To be eligible to receive rate incentives, transmission owners should be required to demonstrate that their proposed transmission projects are justified on either reliability or economic grounds. It appears that proposed Section 35.35(d) imposes such a requirement, and such a requirement is appropriate. While the transmission system in general is in need of substantial upgrading, ratepayers should not be required to shoulder the costs of any rate incentives associated with projects that do not provide demonstrated reliability or economic benefits and which have not been found by the ISO or RTO to be needed.[2] Further, granting incentives for projects that are not needed for economic or reliability reasons could lead to inappropriate and inefficient development of the transmission system.

[2] For projects that cannot be justified on reliability grounds, project sponsors should be required to demonstrate that the economic benefits of the project to ratepayers will exceed the costs of the project. The CAISO believes that the Commission should not grant rate incentives to, or at a minimum be wary of granting such incentives to, transmission projects that have not been demonstrated to be economically beneficial and deemed "needed" by the relevant ISO or RTO.

The CAISO notes that the Commission's approval of rate incentives has been critical in enabling certain vitally needed transmission projects in California to move forward. For example, in order to alleviate congestion on Path 15, Western Area Power Administration, Sierra Nevada Region ("WAPA"), Pacific Gas and Electric Company ("PG&E"), and Trans-Elect NTD Path 15, LLC ("Trans-Elect") built a third 500kV transmission line parallel to the existing Path 15 transmission facilities and upgraded other associated transmission facilities. The Path 15 Upgrade increased capacity by 1,500 megawatts and eased a major western transmission bottleneck.[3] The Commission's approval of rate incentives was necessary not only to induce TransElect to move forward with the project, but also was a necessary predicate for TransElect to obtain financing for the project.[4] *Western Area Power Administration,* 99 FERC ¶ 61,306 at 62,280 (2002). The Commission also approved a 200 basis point ROE incentive for PG&E, as well as a 10-year depreciation life for PG&E's facilities.

Another example of how rate incentives have stimulated investment in needed transmission facilities is Trans Bay Cable, LLC's proposal to construct and operate an approximately fifty-five mile, high voltage transmission line from an existing substation in the City of Pittsburg, California, underneath San

[3] The United States Department of Energy's National Transmission Grid Study, released in 2002 found that constraints on Path 15 resulted in an estimated $222 million of congestion costs to California energy customers during the 16 months prior to December 2000. By contrast, the estimated cost of all of the proposed Path 15 upgrades was $306 million, and the actual costs were significantly less -- approximately $250 million .

[4] The Commission approved the following rate incentives for TransElect: (1) use of a target 50% equity, 50% debt capital structure for a 36-month period; (2) fixed rates for a 36-month period; (3) a 13.5% return on equity; and (4) a 30-year depreciable life for the project. The target capital structure was necessary for TransElect to obtain financing.

Francisco Bay, to a substation within the City of San Francisco. Trans Bay Cable LLC ("Trans Bay"), the City of Pittsburg, California, and Pittsburg Power Company are responsible for the development, financing, construction and operation of the project, which is expected to be placed into service in late 2008. The project should reduce congestion costs and reliance on RMR units in San Francisco and will increase system reliability by completing a transmission loop. In order to move forward with the project, Trans Bay requested, and the Commission approved, use of the same return on equity and target capital structure that the Commission approved for TransElect. *Trans Bay Cable, LLC,* 112 FERC ¶ 61,095 (2005).

Providing rate incentives similar to those granted TransElect and Trans Bay to other investors, subject to the principles discussed above, should stimulate investment in needed transmission facilities nationwide.

### B. The Commission Should Provide ROE Incentives To Utilities That Are Members Of An ISO OR RTO

The Commission states that it will continue to consider requests for ROE-based incentives for utilities that join an RTO in recognition of the benefits such organizations bring to customers. In addition, the Commission states that it will consider similar requests by utilities that join an ISO for an incentive ROE that, while still in the zone of reasonableness, is higher than the ROE the Commission might otherwise allow if the utility did not join.

The CAISO supports the proposal to grant ROE incentives to public utilities that turn over the operational control of their transmission facilities to an ISO or RTO. In addition, incentives should be available to municipal utilities that

join an ISO or RTO.[5] The CAISO is particularly encouraged by the Commission's proposal to provide an incentive ROE to public utilities that join an ISO given that the Commission had previously proposed to provide ROE incentives only to public utilities that join an RTO. *See Proposed Policy for Efficient Operation and Expansion of Transmission Grid,* 102 FERC ¶ 61,032 (2003). There is no justifiable basis to distinguish public utilities that join an ISO from public utilities that join an RTO for purposes of granting ROE incentives.

The Commission's proposal will encourage public utilities to join ISOs and RTOs. As the Commission has previously recognized, transmission facilities can be operated more reliably, efficiently and cost-effectively when coordinated over larger geographical areas. *Id.* Further, Incenting transmission owners to join ISOs and RTOs will promote the development of more competitive and efficient markets, reduce wholesale electricity costs, and improve reliability.

### C. Traditional Performance Based Regulation Is Not Appropriate For Non-Profit Entities

The NOPR seeks comments on ways performance-based regulation ("PBR") might apply to for-profit Transcos and traditional public utilities and not-for-profit ISOs and RTOs. In particular, the Commission seeks comments on whether and how executive performance measures might be relevant and whether and how the performance of non-profit ISOs and RTOs might be benchmarked to the performance of for-profit entities.

[5] In addition to any return on capital incentives, municipal utilities would benefit from a rate design that allows the costs of their transmission facilities to be spread to all users of the ISO or RTO grid. *See supra,* discussion in Section III.D.

Traditional PBR is not appropriate for non-profit ISOs and RTOs. In that regard, non-profit ISOs and RTOs do not earn a return on equity and do not have shareholder benefits that can be placed at risk to incent better performance. Further, non-profit ISOs and RTOs cannot retain any "extra" financial rewards that might result from PBR. PBR makes more sense for rate of return regulated entities where it might be desirable to link good performance to higher profits and poor performance to lower profits. That model does not apply -- and cannot be applied -- to non-profit ISOs and RTOs.

If The Commission's concern is that sufficient incentives exist for non-profit ISOs and RTOs to be accountable and efficient and to operate in a cost-effective manner, then the CAISO submits that such incentives already exist.[6] ISOs and RTOs such as the CAISO do not have any objectives that conflict with the goals of minimizing costs and maximizing reliability.[7] The mission statements of ISOs and RTOs are focused on these and other important goals. As such, ISO and RTOs already should be doing a good job of pursuing PBR goals without the need for express PBR incentives being in place. For example, in 2005, the CAISO undertook a comprehensive re-evaluation of its functions and operations which led to a significant reorganization of the company. That reorganization has resulted in a significant reduction in the CAISO's operating

[6] There are alternatives to ISOs and RTOs, and participating transmission owners generally have contractual rights that allow them to withdraw from an ISO or RTO upon notice after a specified period of time. Given this, and the competitive pressures in the electricity industry generally, there are sufficient checks and balances in place to ensure that ISO and RTOs continue to be efficient.

[7] For example, Assembly Bill 1890 which created the CAISO intended to create "a new market structure that provides competitive, low cost and reliable electric service" and required the CAISO to "ensure efficient use and reliable operation of the transmission grid" consistent with NERC and WECC criteria. The CAISO must operate in a manner consistent with these objectives.

costs (and a significant decrease in the CAISO's grid management charge for 2006). Further, the CAISO is in the process of developing a new transmission planning process that will enable the CAISO to move from the fairly reactionary role that it has historically played with respect to transmission planning to a more proactive role in which the CAISO will identify projects that should be built for economic and/or reliability reasons.[8] Thus, PBR is not needed to incent the CAISO to operate in a cost-effective manner, operate the grid reliably and promote transmission investment.

Performance measures, with links to employee/management compensation, are more appropriate and effective than PBR under the ISO/RTO model. For example, there are incentives to operate a cost-effective CAISO because a significant portion of every CAISO executive's and employee's compensation is based on the achievement of specified performance measures established by the CAISO Board of Governors. The performance measures for 2005 included goals for containing costs, operating the grid safely and reliably, and providing value added transmission services that promote informed investment in critical energy infrastructure. These performance measures were approved by the CAISO Board with input from stakeholders. Further, the CAISO's goals were consistent with the Commission's stated goal of "motivate[ing] transmission entities to operate their systems reliably and efficiently." NOPR at P 57. PBR is not necessary under these circumstances.

[8] The CAISO's proposed new transmission process is summarized in the CAISO's Comments on the Commission's so-called Order No. 888 NOPR that were filed in Docket No. RM05-25 on November 22, 2005.

Standardized performance measures are a laudable goal. However, the Commission should proceed cautiously for several reasons. The setting of executive performance measures and management compensation decisions are matters over which Boards have traditionally had control, and the Commission should not become involved in internal ISO/RTO management.[9] Governing boards are in the best position to determine individual ISO/RTO goals, performance measures and incentives, and they should be solely responsible for doing so.

To the extent the Commission seeks to establish performance criteria solely for the purpose of benchmarking the performance of ISOs and RTOs, there are significant challenges to developing standardized performance measures across-the-board for ISOs and RTOs at this time. RTOs and ISOs are at different stages of development in different regions, and they each have different goals and priorities that are reflective of the specific needs and priorities in their regions.[10] ISOs and RTOs are tackling different problems at different times. Boards are monitoring individual ISO/RTO performance with measures that matter most given these different circumstances. Given the diversity of current practices, there probably is not a single -- and hence inflexible -- set of performance standards that can be used for purposes of comprehensively and

[9] To the extent the Commission is contemplating prescribing compensation policies for ISO and RTO executives, it is doubtful that the Commission has the authority to do so. *See California Independent System Operator Corporation v. FERC*, 372 F.3d 395 at 403-04 (2004).

[10] Also, ISOs and RTOs often use different terminologies. Performance measures must be defined in a manner that ensures "apples-to-apples" comparisons.

successfully measuring ISOs' and RTOs' (and their executives') performance. Any prescribed set of specified performance measures applicable to all ISOs and RTOs would be inappropriate for at least some. In any event, such measures may provide a useful indicator of performance, but they will not be able to comprehensively measure ISO/RTO performance. To the extent the Commission desires to benchmark the performance of ISOs and RTOs vis-a- vis each other and/or against the performance of for-profit public utilities, the Commission must be flexible to ensure that meaningful "apples-to-apples" comparisons can be made. In particular, the Commission must take into account each ISO's and RTO's level of development and the totality of the circumstances confronting each ISO and RTO. There are significant differences between individual ISOs and RTOs and even more significant differences between ISOs/RTOs in general and regulated public utilities.[11] The differences between organizations (including the nature of the services they provide) make simple, straightforward comparisons difficult, and mechanical application of any benchmarks would not be useful. In that regard, there may be instances where an ISO or RTO can justify higher costs for a particular function compared to peer ISOs or RTOs given particular regional needs/priorities and/or the specific circumstances (including extraordinary circumstances) facing that ISO/RTO. Thus, cost comparisons alone may not be sufficient to make legitimate and valuable

[11] . For example, the transmission services provided by ISOs and RTOs differ significantly from the transmission services provided by other public utilities under the *pro forma* Open Access Transmission Tariff.

distinctions between regions. RTOs and ISOs should have an opportunity to explain expenditures that vary from the expenditure levels of other ISOs/RTOs.

Further, any type of benchmarking process adopted by the Commission should permit two types of comparisons. One would permit a comparison of ISO/RTO costs against the same functions being provided by transmission providers in non-ISO/RTO areas. That would enable persons to identify whether there are any efficiencies gained from having RTOs/ISOs performing control area functions. However, for this approach to be meaningful, it is necessary that costs be accounted for in a manner that ensures an apples-to-apples comparison. A second set of benchmarks could be established to permit a comparison of functions and costs among ISOs and RTOs. As indicated above, any benchmarks established by the Commission should not be strictly or mechanically applied.

### D. The Commission Should Provide Incentives For Public Power To Participate In New Transmission Projects

In the NOPR, the Commission recognizes that it is important to encourage needed transmission expansion from all sectors of the industry, including public power. The Commission asks what action the Commission should take in this rulemaking to encourage public power participation in new transmission projects. In particular, the Commission asks whether a consortium approach would help to promote expansion of the grid.

The Commission should encourage public power to participate in new transmission projects that expand an ISO or RTO grid. The Commission should

offer the same incentives to public power and consortia that it proposes to offer to Transcos and regulated public utilities that expand the transmission grid.

The CAISO notes that its transmission planning process has successfully accommodated the participation of public power in projects to expand the transmission grid. As indicated above, the recent Path 15 upgrade was a joint project involving the WAPA, TransElect and PG&E. WAPA served as the project manager, acquired needed land rights and owned the transmission line and the land. The CAISO's new transmission process will also facilitate the participation of public power because, to the extent Participating Transmission Owners decline to construct a project that the CAISO determines should be constructed, the opportunity will be offered to third parties.

The Commission also inquires as to what types of incentives -- other than those specified in the NOPR -- can be offered to consortia to invest in new infrastructure. NOPR at 39. Although not an "incentive" in the traditional sense, adoption of a transmission rate design similar to the CAISO's Commission-approved transmission Access Charge ("TAC") methodology might encourage consortia investments in transmission. In that regard, in late 2004, the Commission approved the CAISO's proposal to develop a single CAISO Grid-Wide High Voltage Access Charge ("HVAC") for recovery of each Participating TO's Commission-approved embedded high voltage transmission costs.[12] Specifically, the Commission approved a 10-year transition period during which the HVAC for the existing three TAC areas (the areas corresponding to the

[12] *California Independent System Operator Corporation,* 109 FERC ¶61.301 (2004), *order on reh'g. and clarification,* 111 FERC ¶61,337 (2005).

historical control areas of the three original participating transmission owners) would gradually merge to form a single CAISO Grid-Wide Access Charge. In addition, all New High Voltage Facilities, including capital additions to Existing High Voltage Facilities are immediately included in the CAISO's Grid-Wide Access Charge. Thus, by 2011, users of the CAISO Controlled Grid will pay a single charge for use of the high voltage system regardless of location of metered demand or export.

The aforementioned TAC rate design *is* intended, *inter alia,* to incent transmission expansion because it will allow the costs of new facilities and upgrades to be rolled-into a single grid-wide charge. Thus, the costs of expansions can be spread to all users of the transmission system not just to the users of a specific line. A uniform grid charge benefits the sponsors of high cost expansions and provides them with more certainty of cost recovery.

### E. A Deliberate, Coordinated Approach Should Be Pursued With Respect To The Adoption Of New Technologies

The Commission indicates that it desires to encourage the use of advanced technology in new transmission projects. Advanced transmission technologies are defined in Section 1223 of the Energy Policy Act of 2005 as technologies that increase the capacity, efficiency, or reliability of an existing or new transmission facility. The Commission expects that ROE-based incentives will stimulate investment in new transmission facilities which will, in turn, provide opportunities for the deployment of innovative technologies for those new facilities. The Commission seeks comments on what other incentives it might

offer to fulfill the goals of the Energy Policy Act regarding transmission technologies.

The CAISO agrees that public utilities should be encouraged to utilize new technologies. However, the CAISO believes that the process for adoption of new technologies requires a more coordinated approach than merely offering added incentives. Promising technologies must be identified, beta tested, and the results made publicly available so that other entities can have the opportunity to improve upon such technologies. The CAISO notes that the industry already undertakes collaborative work to promote these types of efforts under the auspices of a variety of organizations including the Electric Power Research Institute ("EPRI"). Nonetheless, the results of EPRI programs may be limited to EPRI members or in some cases only to the entities that participate in and fund the program. Thus, there may be a role for Federal Agencies including the Department of Energy ("DOE") and the Commission to cooperate with industry and the reliability organizations on programs to stimulate the development of, identify, test and disseminate broadly information regarding new technologies. Merely providing incentives will not distinguish between meritorious efforts and efforts that are ill advised and will not ensure that all aspects of the cycle for encouraging adoption of promising technologies are addressed in an effective sequence.

Moreover, any approach that provides incentives for the use of new technologies must also (1) consider the reliability implications of such use and the impact on grid operations, and (2) provide for measured and prudent

deployment of such resources. Because the reliability of the transmission grid could be compromised by the rushed deployment of new technologies, the use of new technologies should be coordinated with the relevant system operator.

## IV. CONCLUSION

For the foregoing reasons, the Commission should adopt a Final Rule consistent with the discussion herein.

Respectfully submitted,

**/s/ Anthony J. Ivancovich**
Anthony J. Ivancovich
Assistant General Counsel -Regulatory
Stacie Ford, Associate Counsel
California Independent System
Operator Corporation
151 Blue Ravine Road
Folsom, CA 95630
Tel: (916) 608-7135
Fax: (916) 608-7296

Counsel for the California Independent
System Operator Corporation

Date: January 11, 2006

January 11, 2006

***Via Electronic Filing***

The Honorable Magalie R. Salas
Secretary
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, D.C. 20426

**Re: California Independent System Operator Corporation**
**Docket No. RM06-4-000**

Dear Secretary Salas:

Transmitted herewith for electronic filing in the above-referenced proceeding is the Comments of the California Independent System Operator Corporation on Notice of Proposed Rulemaking.

Thank you for your attention to this matter.

Yours truly,

***/s/ Anthony Ivancovich***
Anthony Ivancovich

Assistant General Counsel-Regulatory
for the California Independent System
Operator Corporation

## CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of this document upon all parties listed on the official service list compiled by the Secretary in the above-captioned proceedings, in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and Procedure (18 C.F.R. § 385.2010). Dated this 11th day of January in the year 2006 at Folsom in the State of California.

***/s/ Anthony Ivancovich***
Anthony Ivancovich