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October 2, 2006

## VIA ELECTRONIC FILING

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

Re: The Nevada Hydro Company, Inc.  
Docket No. ER06-278-004

Dear Secretary Salas:

Attached please find the Answer, Motion for Technical Conference, and Request for Expedited Action of the California Independent System Operator Corporation, submitted today in the captioned docket.

Please contact the undersigned with any questions regarding this matter.

Respectfully submitted,

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

**The Nevada Hydro Company, Inc.       )       Docket Nos. ER06-278-004**

**ANSWER, MOTION FOR TECHNICAL CONFERENCE, AND REQUEST FOR  
EXPEDITED ACTION OF THE CALIFORNIA INDEPENDENT SYSTEM  
OPERATOR CORPORATION**

Pursuant to Rules 212 and 213 of the Commission's Rules of Practice and Procedure, 18 C.F.R. §§ 385.212, 385.213 (2006), and the Commission's September 15, 2006, notice of filing in the captioned docket, the California Independent System Operator Corporation ("CAISO")<sup>1</sup> respectfully submits this answer, motion for a technical conference, and request for expedited action in response to the "Supplemental Response" that The Nevada Hydro Company, Inc. ("TNHC") submitted in this proceeding on September 11, 2006. As explained herein, although the CAISO Planning Staff believes the transmission and pumped storage project proposed by TNHC has the potential to provide significant benefits, the TNHC Supplemental Response raises important policy and factual questions pertaining to the "non-wires" component of the project that should be addressed through a technical conference. The CAISO respectfully requests that the Commission take expeditious action to schedule the technical conference and resolve such issues. As discussed below, the Commission should defer action on the request for incentives for the "non-wires" component

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<sup>1</sup> Capitalized terms not otherwise defined herein have the meanings set forth in the Master Definitions Supplement, Appendix A to the ISO Tariff.

of the project proposed by TNHC until after this technical conference, but need not wait to act on the request for incentives for the wires component of the proposed project.

## **I. BACKGROUND**

On December 1, 2005, as supplemented on December 22, 2005, TNHC filed its “Rate Request” with the Commission in this proceeding. In the Rate Request, TNHC proposed to pursue completing the development, financing, construction, and operation of TNHC’s proposed Talega-Escondido/Valley Serrano 500 kV Interconnect (“TE/VS Interconnection”) project and Lake Elsinore Advance Pump Storage (“LEAPS”) project (collectively, the “Project”). The proposed Project would be located in southern California. As described by TNHC, the TE/VS Interconnection project is the “wires” (transmission) component of the Project and the LEAPS project is the “non-wires” (generation) component of the Project. TNHC stated that it anticipated that the Project would be placed into service, and the incremental capacity created thereby would be transferred to the CAISO’s operational control, in stages beginning in late 2007. TNHC requested that both the TE/VS Interconnection project and the LEAPS project be treated as “Commission jurisdictional transmission assets” and requested the following rate treatment for the combined Project: (1) an initial post-tax return on equity of 14.5%; (2) an assumed or target 50/50 capital structure for at least the first three years of service; and (3) a three-year rate moratorium, during which “the revenue required to make debt service payments and to pay a return to the equity investors [in the Project] is certain.” TNHC

stated that it “will file a full cost-of-service rate filing shortly before the commencement of the three-year period so that the transmission revenue requirement to be recovered by the [CAISO] and remitted to TNHC will reflect actual and current costs.” TNHC asserted that the rate treatment it is requesting is similar to that approved for the upgrade of the Path 15 transmission lines in California.<sup>2</sup>

A number of parties submitted motions to intervene and other filings concerning the Rate Request. On January 18, 2006, the CAISO moved to intervene out of time and submit comments in the proceeding. The CAISO stated that it has significant concerns with several aspects of TNHC’s Rate Request and urged the Commission to recognize that a number of issues about the combined transmission and pumped storage project proposed by TNHC must be resolved before the Commission should grant the approvals sought in the Rate Request. The CAISO stated that it had not yet made any of the necessary determinations under its Tariff for evaluating whether it should approve the wires component of the Project, and that the Commission should not grant incentive rate treatment to transmission projects (including the TE/VS Interconnection project) before the CAISO determines whether the project is justified on either reliability or economic grounds. The CAISO also stated that TNHC had failed to justify its request for cost-based rates for the non-wires component of the Project. The CAISO noted that the CAISO had not yet developed a general position on whether it is appropriate to give a project such as LEAPS cost-based rate

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<sup>2</sup> Transmittal Letter for TNHC Rate Request at 1-5.

treatment and that, under TNHC's proposal, it was unclear to the CAISO how the LEAPS project would function within the context of the CAISO's market-based environment.<sup>3</sup>

Subsequently, the Commission issued a deficiency letter in which it directed TNHC to amend the Rate Request by providing responses to several Commission data requests. TNHC provided responses to the data requests.<sup>4</sup> TNHC also filed CAISO letters stating that the CAISO Planning Staff was granting preliminary approval for the interconnection of the LEAPS project to the ISO Controlled Grid.<sup>5</sup>

On September 11, 2006, TNHC submitted the Supplemental Response, which included a pair of exhibits: Exhibit No. TNHC-13, a CAISO memorandum dated August 31, 2006, from Dariush Shirmohammadi, Director of Regional Transmission – South, to the ISO Governing Board, concerning the status of CAISO's findings on the Project ("CAISO Memorandum"); and Exhibit No. TNHC-14, the Prepared Direct Testimony of Jaleh Firooz on behalf of TNHC ("Firooz Direct Testimony"). TNHC stated that it submitted its Supplemental Response to

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<sup>3</sup> CAISO Motion to Intervene Out of Time and Comments at 6-9.

<sup>4</sup> Commission Deficiency Letter from Steve P. Rogers, Director, Division of Tariffs and Market Development – West, to David Kates, Representative for TNHC, Docket Nos. ER06-278-000 and ER06-278-001 (Feb. 17, 2006); Response of TNHC to Commission's Letter Dated February 17, 2006, Docket Nos. ER06-278-000 and ER06-278-002 (Mar. 20, 2006); Response of TNHC to Commission's Letter Dated February 17, 2006, Docket No. ER06-278-002 (Mar. 29, 2006); Supplemental Response of TNHC to Commission's Letter Dated February 17, 2006, Docket Nos. ER06-278-001 and ER06-278-003 (Apr. 7, 2006). See also Comments of San Diego Gas & Electric Company on Applicant's Responses to Deficiency Order, Docket No. ER06-278-003 (Apr. 28, 2006) (providing comments on TNHC's responses); TNHC's Response to Comments of San Diego Gas & Electric Company, Docket No. ER06-278-000 (May 16, 2006) (responding to comments submitted on April 28, 2006).

<sup>5</sup> TNHC Filing, Docket No. ER06-278-000 (May 30, 2006).

address concerns raised by the CAISO regarding the Project and to “update[ ] its rate incentive request to conform to the Final Rule” issued by the Commission in July 2006 concerning the encouragement of transmission investment.<sup>6</sup>

As to the CAISO’s concerns about the Project, TNHC stated that “[t]he CAISO supports LEAPS but has not supported TNHC’s rate filing.”<sup>7</sup> According to TNHC, “there remains one issue that the CAISO wishes to see resolved,” namely, that the CAISO “is concerned with how it would exert functional control of LEAPS without becoming a *de facto* market participant in, and thereby potentially intruding into, competitive markets.”<sup>8</sup> TNHC suggested three alternative approaches for incorporating the LEAPS project into the CAISO system without causing market interference. Under the first approach, the CAISO would assume operational control of the LEAPS project and, with a firewall between relevant market and transmission personnel, the CAISO would bid the LEAPS project into the market with an objective of minimizing ratepayer costs. Under the second alternative approach, the CAISO would auction off to Market Participants the right to operate the LEAPS project. Under TNHC’s third alternative approach, the CAISO would contract with a third party, independent of any Market Participant, to operate the LEAPS project for the benefit of the grid.<sup>9</sup>

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<sup>6</sup> TNHC Supplemental Response at 1, 2, citing *Promoting Transmission Investment Through Pricing Reform*, 116 FERC ¶ 61,057 (2006) (*i.e.*, Order No. 679, 71 Fed. Reg. 43,294 (July 31, 2006), FERC Stats. & Regs., Regs. Preambles ¶ 31,222 (2006)) (“Order No. 679”).

<sup>7</sup> TNHC Supplemental Response at 2.

<sup>8</sup> *Id.*

<sup>9</sup> TNHC Supplemental Response at 16; TNHC Supplemental Response, Exh. No. TNHC-14 (Firooz Direct Test.) at 17:16-26:22.

In the September 11 Supplemental Response, TNHC further stated that it was updating its request for rate incentives by asking the Commission to “grant TNHC full recovery of prudently incurred construction work in progress (‘CWIP’).<sup>10</sup> TNHC also described in specific terms its proposed means of capital cost recovery for the TE/VS Interconnection project and the LEAPS project: TNHC noted that the recovery of the capital costs for transmission which is under CAISO operational control is through the CAISO’s Commission-jurisdictional transmission Access Charge (“TAC”) mechanism. TNHC proposed that, with the Commission’s approval, the CAISO would collect from its transmission customers the annual revenue requirements (including a Commission-authorized return) associated with the investments in the TE/VS Interconnection project and the LEAPS project, and the collected funds would be used to pay the investors in those projects.<sup>11</sup>

The Commission issued its notice of filing concerning TNHC’s amended proposal regarding the Project, as embodied in the TNHC Supplemental Response, on September 15, 2006, with filings concerning the amended proposal due by October 2, 2006.

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<sup>10</sup> TNHC Supplemental Response at 2-3.

<sup>11</sup> TNHC Supplemental Response, Exh. No. TNHC-14, at 10:2-23. TNHC had also described its proposed means of cost recovery in earlier filings in this proceeding. See, e.g., Transmittal Letter for TNHC Rate Request at 4-5; Response of TNHC to Commission’s Letter Dated February 17, 2006, Docket Nos. ER06-278-000 and ER06-278-002 (Mar. 20, 2006), at 11 (“The Project would be turned over to CAISO operational control consistent with TNHC’s request that the Commission provide cost recovery and return on equity through CAISO’s transmission rates.”).

## **II. SUMMARY OF CAISO ANSWER, MOTION FOR TECHNICAL CONFERENCE, AND REQUEST FOR EXPEDITIOUS ACTION**

Based on its interim findings, the CAISO Planning Staff believes that the LEAPS Project has the potential to provide significant economic and reliability benefits. However, the proposed treatment of the non-wires component of the Project raises a number of significant factual and policy issues that have not been resolved and that require further review.<sup>12</sup> Among the issues that need to be resolved are: (1) Whether it is appropriate to include the costs of the LEAPS pumped storage unit in the CAISO's cost-of-service TAC or whether the LEAPS pumped storage unit should be treated like other similar resources in California; (2) Whether is it appropriate for the CAISO to be operating the LEAPS pumped storage unit and/or bidding and scheduling the unit into the CAISO's markets; (3) If the CAISO is to operate the LEAPS pumped storage unit, under what terms should that control/operation be effectuated; and (4) Whether the treatment of the proposed LEAPS pumped storage unit will establish a precedent for the treatment of other pumped storage units in California.

The three alternative approaches that TNHC proposes for incorporating the non-wires component into the CAISO system raise a number of additional questions that have not yet been fully analyzed by the CAISO. Also, there may be other possible approaches for "handling" the non-wires component of the Project. The CAISO believes it is imperative not only to further and more fully analyze all of the options but also to vet these issues fully with stakeholders.

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<sup>12</sup> As explained in more detail below, contrary to TNHC's belief, there is more than one open issue to be resolved concerning the non-wires component of the Project. TNHC Supplemental Response at 2.



As such, the Commission should not act on the TNHC conceptual rate request for the non-wires component of the Project until these issues have been resolved with the input of stakeholders. The CAISO is willing to work with TNHC and others to address these questions in a manner that resolves the CAISO's concerns while allowing California customers to realize the potential benefits of the Project. The CAISO therefore respectfully requests that the Commission schedule, on an expeditious basis, a technical conference to allow the CAISO to work with TNHC and other interested parties on a mutually acceptable resolution of these significant issues. The Commission should defer action on the appropriate rate treatment of the base and incentive rates for the non-wires component of the proposed Project until these important issues are resolved.

The CAISO believes that the request for incentive rate treatment for the wires component of the Project can and should be put on a separate track that will not postpone its consideration by the Commission. The CAISO notes, however, that the transmission line component of the Project still must be approved through the transmission planning procedures of the CAISO Tariff. As such, the Commission should condition the approval of any incentive rate treatment for the transmission component of the Project upon ultimate CAISO approval of the transmission line.

### III. ANSWER

#### A. **Although the LEAPS Project Potentially Has Significant Benefits, the Issues Concerning the Non-Wires Component of the Project Must Be Resolved Before the ISO Governing Board Can Act on That Component of the Project.**

TNHC cites the CAISO Memorandum as demonstrating the CAISO Planning Staff's support of the Project,<sup>13</sup> but as that memorandum states, it is intended to present the *interim* findings of the CAISO Planning Staff.<sup>14</sup> The CAISO Planning Staff believes the approval and construction of the LEAPS project might well have economic benefits and will not be detrimental to reliability. However, the benefits of the non-wires component of the Project are largely dependent upon a determination of how the non-wires component of the Project and will be operated and how the costs for that component will be recovered. The CAISO Memorandum provided no recommendation on the Project to the ISO Governing Board, because the CAISO Planning Staff is "waiting to hear from the FERC on operational control of the LEAPS power plant and . . . the final economic analysis of the . . . Project will depend on its operational arrangement."<sup>15</sup> For these reasons, the ISO Governing Board has not yet acted on the Project.

As explained in the CAISO Memorandum, the CAISO Planning Staff has determined that in general the Project will not create reliability concerns, except under one scenario, which can be addressed through various mitigation

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<sup>13</sup> TNHC Supplemental Response at 15.

<sup>14</sup> CAISO Memorandum at 1, 3.

<sup>15</sup> *Id.* at 6.

measures.<sup>16</sup> The CAISO Planning Staff agrees with TNHC that, under appropriate operating terms and conditions, the LEAPS project is likely to promote system reliability,<sup>17</sup> especially due to the operational flexibility the project would offer and in light of the large volume of intermittent resources being added in the same Control Area.

The CAISO Planning Staff has not completed its full assessment of the economic benefits of the Project but has completed a preliminary economic assessment, which concludes that the Project is likely to have benefits in the following areas: Energy, Local Capacity Requirement (“LCR”)/Reliability Must-Run (“RMR”), capacity, Ancillary Service benefits, Black Start, and reactive reserve.<sup>18</sup> However, that preliminary economic assessment is based on assumptions that may or may not be valid, depending upon the resolution of operational and functional control issues with respect to the non-wires component of the Project.

In particular, the preliminary evaluation of the economic benefits of the LEAPS project by the CAISO Planning Staff is based on a scenario in which the CAISO has full control of the output of the Project and dispatches the pumped storage facility to minimize production costs across the Western Electricity Coordinating Council (“WECC”) based on the CAISO’s knowledge of the system and market operation. But the assumption that the LEAPS project will be

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<sup>16</sup> *Id.* at 4-5.

<sup>17</sup> TNHC Supplemental Response at 5-6.

<sup>18</sup> CAISO Memorandum at 5-6.

operated in this manner cannot be confirmed until the issue of who will operate the LEAPS project, and under what conditions, can be resolved. As discussed in Section III.B, below, there are important policy questions that need to be resolved regarding (1) whether the LEAPS pumped storage unit can be rate-based and included in the CAISO's TAC rates, and (2) whether it is appropriate for the CAISO to control/operate/bid/schedule the LEAPS pumped storage unit and, if so, how this would be effectuated. In particular, there is a question as to whether it is appropriate for the CAISO to operate the non-wires component of the LEAPS Project under the assumptions reflected in the preliminary economic analysis of the CAISO Planning Staff.

Also, it should be noted that the assumptions that served as the basis for the CAISO Planning Staff's preliminary economic analysis are different than the assumptions underlying the three alternatives for the operation of the LEAPS pumped storage unit proposed in the TNHC Supplemental Response. Under TNHC's first alternative, a hypothetical "bidding unit" of the CAISO, separated from the operations staff by a firewall, would bid the unit into the markets without access to non-public information. This differs from the approach modeled in the CAISO Planning Staff's preliminary economic analysis, which assumed a dispatch of the unit based, in part, on historic data. The second and third alternative approaches that TNHC suggests for incorporating the LEAPS project into the CAISO system are significantly different than the assumptions made by the CAISO Planning Staff because under those two approaches, an entity other than the CAISO would be operating the LEAPS project. In any event, as

discussed in Section III.C, below, all three of the alternative approaches that TNHC suggests require further analysis and development. In addition, there may be other viable alternative approaches that should be examined.

Also, the CAISO Planning Staff has preliminarily evaluated the economic benefits of the LEAPS project based on the assumption that the CAISO's operational control of that project would not cause a material change in the behavior of Market Participants. Presumably, before the CAISO would assume operational control of the LEAPS project, the Commission would want to see the results of a comprehensive assessment of whether an ISO/RTO having long-term control of a power plant's output could result in long-term changes in market behavior.

**B. Important Questions Exist as to How the CAISO Would Treat a Proposed Rate-Based Pumped Storage Device Such as the LEAPS Project for Operational and Cost Recovery Purposes.**

The CAISO takes no position on the specific incentives requested by TNHC for the LEAPS project, but notes that the proposal for cost-based rate treatment and inclusion in the TAC of the non-wires component of the Project raises many new and important issues that need to be discussed with stakeholders. The CAISO does not currently have operational control of any rate-based pumped storage devices. At present, pumped storage devices in the Control Areas are dispatched by Load-Serving Entities ("LSEs") on behalf of their customers. Direct dispatch of pumped storage devices by the CAISO at the CAISO's own discretion (rather than, for example, pursuant to a market bid or contract) could be viewed as an inappropriate direct CAISO intervention into the

markets the CAISO administers. Such direct dispatch of pumped storage devices by the CAISO could also raise concerns about the CAISO's independence, because the CAISO is required to be "independent of any market participant or any one class of participant."<sup>19</sup>

In addition, the Commission needs to resolve the question of whether it is appropriate to grant cost-based rates to the non-wires component of the Project and include such costs in the CAISO's TAC. There is no precedent for including generation costs in the CAISO's transmission Access Charge. On this issue, TNHC incorrectly states that RMR contracts are an example of non-wires costs that are already included in the CAISO's transmission rates.<sup>20</sup> RMR costs are not included in the transmission Access Charge, and are instead allocated to customers through a separate, non-transmission mechanism.<sup>21</sup>

If the Commission were to conclude that the costs of the non-wires component of the Project should be included in the TAC, then the Commission would also have to determine how the costs of the LEAPS pumped storage facility should be allocated under the TAC. Cost responsibility for the non-wires component of the Project is unclear because the existing cost allocation

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<sup>19</sup> *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, Order No. 888, 61 Fed. Reg. 21,540 (May 10, 1996), FERC Stats. & Regs., Regs. Preambles ¶¶ 31,036 (1996), at 31,730 ("Order No. 888"). See also *California Independent System Operator Corp.*, 112 FERC ¶¶ 61,010 (2005) (finding that the ISO Governing Board, as currently constituted, meets the independence requirements of Order No. 888).

<sup>20</sup> TNHC Supplemental Response, Exh. No. TNHC-14 (Firooz Direct Test.) at 11:1-18.

<sup>21</sup> See ISO Tariff, §§ 42.1.8, 42.1.9 (stating that RMR costs are charged to each Scheduling Coordinator pro rata based on same proportion as the Scheduling Coordinator's metered hourly Demand (including exports) bears to the total metered hourly Demand (including exports) served in that hour).

provisions of Section 24.7 of the ISO Tariff are based on traditional transmission facilities.

**C. The Three Alternative Approaches Proposed by TNHC for the CAISO to Assume Operational Control of the LEAPS Project Require More Analysis and Development and Raise Issues That Need To Be Vetted Fully With Stakeholders.**

The Firooz Direct Testimony states that the CAISO's concern about the LEAPS project was that the project could have a negative impact on market prices if the CAISO were to bid it into the CAISO's markets.<sup>22</sup> The CAISO has identified more issues than the single issue identified in the testimony of Ms. Firooz. As discussed herein, TNHC's proposal raises several general policy issues that need to be resolved in the first instance: (1) whether it is appropriate to include in rate base the costs of the LEAPS pumped storage unit and recover them through the TAC; (2) whether it is appropriate for the CAISO to control and operate the LEAPS pumped storage unit, the assumptions that served as the basis for the CAISO Planning Staff's preliminary economic analysis; and (3) whether each of the three alternative approaches suggested by TNHC as a means by which the LEAPS project could be incorporated into the CAISO system are appropriate or even permissible under the CAISO Tariff or the Commission's ISO/RTO regulations and policies. These are fundamental issues that need to be vetted with stakeholders and resolved by the Commission before the CAISO can evaluate the non-wires component of the Project.

In addition, each of TNHC's alternatives raises specific issues and requires further analysis and development. As to TNHC's first alternative

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<sup>22</sup> TNHC Supplemental Response, Exh. No. TNHC-14 (Firooz Direct Test.) at 5:6-6:10.

approach, under which the CAISO would assume control of the LEAPS project and bid it into the market to benefit ratepayers, there is no precedent for the CAISO to bid generation into CAISO markets. The establishment of a “bidding arm” of the CAISO, as proposed by TNHC, could also raise significant concerns about the independence of the CAISO. Such a bidding arm could be viewed as contrary to one of the reasons the Commission created ISOs and RTOs in the first place – the benefits of eliminating reliance on Standards of Conduct and other “firewalls” to ensure independent operation and oversight of the transmission system.<sup>23</sup> In particular, there is a question of whether it would be appropriate for the CAISO to adopt a strategy of maximizing the profits of the LEAPS unit, as TNHC suggests,<sup>24</sup> because even if such profits offset TAC payments, they could increase overall Market Clearing Prices (“MCPs”). As discussed in Section III.E, below, the proposal also raises issues regarding the CAISO’s tax-exempt status.

The second alternative approach suggested by TNHC, under which the CAISO would conduct an auction and the winning bidder would operate the LEAPS project under terms specified by the CAISO, raises significant questions as well, including issues regarding the CAISO’s tax-exempt status. The CAISO

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<sup>23</sup> See Order No. 888 at 31,731 (“An ISO and its employees should have no financial interest in the economic performance of any power market participant. . . . In addition, an ISO should not undertake any contractual arrangement with generation or transmission owners or transmission users that is not at arm’s length.”); *Regional Transmission Organizations*, Order No. 2000, 65 Fed. Reg. 809 (Jan. 6, 2000), FERC Stats. & Regs., Regs. Preambles ¶ 31,089, at 31,063, 31,065 (1999) (“Order No. 2000”) (“We reaffirm the NOPR proposal that an RTO, its employees and any non-stakeholder directors must not have any financial interests in market participants. . . . An RTO must be independent in both reality and perception.”).

<sup>24</sup> TNHC Supplemental Response, Exh. No. TNHC-14 (Firooz Direct Test.) at 20-6-7.



has no auction mechanism of the type proposed by TNHC. Developing a special auction process to facilitate incentive rates for a single project developer could be perceived as contrary to the principle (reflected in Section 24 of the ISO Tariff) that all Project Sponsors should have an equal opportunity to address transmission needs and the requirement that the CAISO not show favoritism toward or discriminate in favor of any Project Sponsor. In addition, the CAISO notes that, under this alternative, there is no guarantee that the auction revenues would exceed the cost-based rates for the LEAPS project that TNHC proposes to collect.

Even if these issues did not exist, there are pragmatic reasons why the second alternative approach proposed by TNHC presents concerns. Under this proposal, there is no assurance that the LEAPS project will be operated for the benefit of all ratepayers.<sup>25</sup> As a result, this alternative may be inconsistent with the assumptions underlying the preliminary conclusion of the CAISO Planning Staff that the project has economic benefits.

TNHC's third proposed alternative approach, under which the CAISO would directly contract with an independent third party to operate the LEAPS project, also raise a number of issues. The third proposed alternative also suffers from the same questions raised by the first proposed alternative with regard to the proposed "strategy" of maximizing the profits of the LEAPS project. In addition, the "independent third party" under the third proposed alternative will likely expect to earn an additional profit on the operation of the LEAPS project.

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<sup>25</sup> *Id.* at 25:4-26:3.

**D. The Inclusion of Pumped Storage Devices on the List of Advanced Transmission Technologies in the Energy Policy Act of 2005 Does Not Resolve the Questions Raised By the Proposed Treatment of the Project.**

TNHC notes that, in Section 1223 of the Energy Policy Act of 2005 (“EPAAct 2005”),<sup>26</sup> Congress “expressly defined ‘advanced transmission technologies’ to include pumped hydro devices . . . .”<sup>27</sup> However, the inclusion of pumped storage devices (as well as other devices, such as distributed generation and other equipment or assets, not traditionally considered transmission technologies) in the definition of “advanced transmission technologies” under EPAAct 2005 does not mean that such devices necessarily must be treated as transmission facilities for purposes of ISO/RTO operations, that such devices must be operated by the ISO/RTO, or that such equipment or assets should be included in the cost-based transmission rates of an ISO/RTO. EPAAct 2005 is silent on the operational treatment of such equipment and assets. EPAAct 2005 also does not specify whether the incentives for such “advanced transmission technologies” should be based on cost-based rates. Although one commenter in the Commission’s subsequent rulemaking proceeding concerning the establishment of transmission incentives (which resulted in Order No. 679) requested incentives for pumped storage devices, Order No. 679 did not address the treatment of such devices.<sup>28</sup> Thus, the treatment of incentives for pumped

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<sup>26</sup> Energy Policy Act of 2005, Pub. L. No. 109-58 § 1223, 119 Stat. 594 (2005).

<sup>27</sup> TNHC Supplemental Response at 4.

<sup>28</sup> Order No. 679 at PP 285, 288-93.

storage devices in an ISO/RTO environment and the associated operational treatment of such devices remain open issues.

Moreover, the CAISO has never previously assessed a pumped storage device as a transmission asset.<sup>29</sup> Section 24.1 of the ISO Tariff authorizes the CAISO to determine the need for a “transmission addition or upgrade,” but the phrase “transmission addition or upgrade” in the ISO Tariff has not previously been interpreted to include pumped storage devices. It is unclear whether the inclusion of pumped storage devices in the definition of “advanced transmission technologies” under Section 1223 of EPCRA 2005 changes the meaning of a “transmission addition or upgrade” under the ISO Tariff.

**E. The Inclusion of Pumped Storage Devices Raises Concerns With Respect to the CAISO’s Status Under Section 501(c)(3) of the Internal Revenue Code.**

Organizations described in Section 501(c)(3) of the Internal Revenue Code of 1986 are exempt from federal income tax in respect of their charitable activities. They also qualify for federal tax-exempt financing and are candidates to receive other important financial benefits, including exemption from State income tax, franchise tax, and property tax.

The CAISO was organized in 1997 under California law as a public benefit non-profit corporation. On March 31, 1998, the CAISO received a determination letter from the Internal Revenue Service (“IRS”) recognizing that the CAISO was a charitable organization described in Section 501(c)(3). That determination letter was issued in response to an application for recognition of exemption filed

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<sup>29</sup> CAISO Memorandum at 2.

by the CAISO (the “Application”). The Application described in detail the CAISO’s planned operations, governance, and sources of funding.

In general, a non-profit organization is entitled to Section 501(c)(3) status provided (i) it is organized and operated exclusively for charitable or other specified purposes, (ii) no part of its net earnings inures to the benefit of any private person, and (iii) it does not carry on substantial lobbying activities or participate in political campaigns. As described in the Application, the CAISO was created pursuant to Assembly Bill 1890 (Chapter 854, California Statutes of 1996) to act as the system operator of an integrated statewide transmission grid. The IRS determined that the activities of the CAISO described in the Application would “lessen the burdens of government,” which is considered a charitable purpose under the Treasury Regulations. See Treas. Reg. § 1.501(c)(3)-1(d)(2).

In 1998, when the Application was submitted to the IRS, pumped storage devices were not generally considered part of the advanced transmission technologies as may now be possible pursuant to the EPAct 2005. Consequently, the Application did not describe operating pumped storage devices as part of the CAISO’s planned operations, nor did the Application disclose, for example, that the CAISO might hold auctions pursuant to which the CAISO might re-sell to for-profit entities the right to take operational control over pumped storage or other facilities controlled by the CAISO as proposed by TNHC. The apparent disconnect between the CAISO’s Application and the CAISO assuming Operational Control of the LEAPS project causes the CAISO significant concern that there indeed may be a real risk of losing the CAISO’s

Section 501(c)(3) status and the inherent benefits afforded the CAISO and its ratepayers.

Treasury Regulations provide that the CAISO may rely upon the Section 501(c)(3) determination letter received from the IRS so long as there are no substantial changes in the CAISO's character, purposes, or method of operations. See Treas. Reg § 1.501(a)-1(a)(2). The IRS requires an organization that changes its purposes, character, or operations from those described in its application for exemption to notify the IRS and seek confirmation that such changes are consistent with Section 501(c)(3) and its determination letter. The notification and reconfirmation process with the IRS can be an extremely lengthy process, and there is no guarantee the outcome will be favorable.

The CAISO views reliance on the notification and reconfirmation process as potentially required in light of the significant risk presented by TNHC's proposals. The Commission is no doubt familiar with this particular risk, and the CAISO cannot underscore enough its significance for the CAISO. Accordingly, the CAISO urges the Commission to only consider options that maximize mitigation of the risk to the CAISO's Section 501(c)(3) status and, in any event, to provide an opportunity for the CAISO to pursue the notification and reconfirmation by the IRS prior to assuming Operational Control of the LEAPS project if the CAISO determines this pursuit to be appropriate under the circumstances.

#### **IV. MOTION FOR TECHNICAL CONFERENCE AND REQUEST FOR EXPEDITED ACTION**

Although the CAISO believes there are significant questions concerning the operational and market impacts described above regarding the non-wires component of the Project, the CAISO is willing to work with TNHC and Market Participants to resolve these concerns. The CAISO supports a technical conference process to determine mutually acceptable resolutions of the issues the CAISO raises above, in order to allow customers to realize the potential benefits of the LEAPS project. The CAISO also believes it is critical to obtain the input of interested stakeholders on the important policy issues described above. The CAISO therefore requests that the Commission schedule, on an expedited basis, a technical conference to allow the CAISO to work with TNHC and other interested parties on a mutually acceptable resolution of these issues. The CAISO will consider acceptable options to address the operational and other issues identified herein.<sup>30</sup> Because the issues raised by TNHC appear to be issues of first impression, at least in the CAISO context, the CAISO believes this technical conference will benefit from the input of Commission staff, stakeholders, and possibly other ISOs/RTOs. The CAISO believes that this technical conference could be followed by additional stakeholder meetings, if necessary and appropriate. In any event, an expeditious resolution of these issues should be sought. At a minimum, the Commission should defer action on the issue of whether the non-wires component of the proposed Project is entitled

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<sup>30</sup> In addition to the three approaches identified by TNHC, other alternative rate and operational treatments for the LEAPS pumped storage unit should also be identified and evaluated.

to cost-based rates and inclusion in TAC until the issues associated with the proposed treatment of the Project are resolved.

The interim assessment of the Project by the CAISO Planning Staff indicates that there is likely to be economic and reliability value in the wires component of the Project<sup>31</sup> independent of the LEAPS pumped storage facility. Therefore, the CAISO requests that the Commission consider the request for incentives for the wires component of the Project on a track that is separate from the track for considering the non-wires component of the Project (discussed above). The CAISO does not oppose the requested incentives for the wires component of the Project and believes that the Commission should not postpone ruling on the wires component while it considers the non-wires component. The CAISO notes that if the Commission determines that the wires component should be considered on a separate track, the wires component would still need to proceed through the CAISO's process for approval of CAISO-controlled facilities. The Commission should therefore make any approval of incentive rate treatment for the Project conditioned upon ultimate CAISO approval of the Project. This is consistent with Commission approval of Path 15 incentives subject to additional Commission approvals once "ISO Tariff procedures required for new participating transmission owners" have been satisfied.<sup>32</sup>

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<sup>31</sup> See CAISO Memorandum at 4-5.

<sup>32</sup> *Western Area Power Administration*, 99 FERC ¶ 61,306, at 62,281 (2002).

**V. CONCLUSION**

For the reasons explained above, the CAISO respectfully requests that the Commission take action consistent with the CAISO's answer and expeditiously schedule a technical conference as described herein.

Respectfully submitted,

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Dated: October 2, 2006



## CERTIFICATE OF SERVICE

I hereby certify that I have served the foregoing document upon all parties on the official service list compiled by the Secretary in the above-captioned proceeding, in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and Procedure (18 C.F.R. § 385.2010).

Dated at Folsom, California this 2<sup>nd</sup> day of October, 2006.

/s/ Anthony J. Ivancovich  
Anthony J. Ivancovich