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METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

November 18, 1997

To: Board of Directors (Water Planning and Resources Committee--Information) (Electric Industry Restructuring Ad Hoc Committee -- Information)

From: for General Manager

General Counsel

Subject: Implementation of California's Restructured Electric Utility Industry on January 1, 1998

RECOMMENDATION(S)

For information only.

EXECUTIVE SUMMARY

On October 30, 1997 the Federal Energy Regulatory Commission (FERC) issued an order conditionally authorizing commencement of operations by the California Independent System Operator (ISO) and the California Power Exchange (PX) on January 1, 1998. The order also approved California Investor Owned Utility (IOU) transfer of transmission facilities to the ISO. A number of issues raised by public power entities, including Metropolitan, were resolved in their favor. Most importantly, the Commission indicated it would not tolerate ISO or IOU abrogation of existing contracts. The order also directs the ISO and PX to complete various studies by January 1, 1999 to ascertain whether and to what extent the problems envisaged by certain parties, including Metropolitan, actually occur. The Chief Executive Officers of the ISO and PX have each indicated they are "cautiously optimistic" regarding their respective organization's ability to commence operations January 1, 1998.

In the new restructured environment, Metropolitan will continue to operate under its Service and Interchange Agreement with Southern California Edison. At this time it is not anticipated that Metropolitan's Colorado River Aqueduct System will incur adverse economic or operational impact. The State Water Project (SWP), operated by the California Department of Water Resources, and Metropolitan have averted cost-shifting arising from imposition of retail costs onto wholesale service. However, the SWP may incur approximately $3 million in annual additional transmission service costs resulting from increased revenue requirements.

DETAILED REPORT

On October 30 FERC issued its long-awaited order conditionally authorizing commencement of operations by the ISO and PX on January 1, 1998. As a result, California can embark upon implementation of its plan for a restructured electric utility industry on time and in substantial conformance with the original restructuring order issued by the California Public Utilities Commission in December, 1995 as modified by the legislature through its enactment of AB 1890 (Stat. 1996, Chap. 854).

Achieving California's vision of a restructured electric utility industry has required an extensive and at times intensive investment of time and energy by the ISO, the PX and interested parties, including Metropolitan. Starting early last year, Metropolitan commenced active participation in the Western Power Exchange or "WEPEX" process, which resulted in the development of the original detailed ISO and PX tariffs and associated documents filed at FERC on March 31, 1997. This filing exceeded 1600 pages, for which parties were required to submit comments in early June. After the parties and the ISO and PX exchanged reply comments, it became apparent that neither the ISO nor the PX would have the capability to function in strict accordance with their respective tariffs, due to operational limitations arising from software development restraints. On July 30, FERC issued an order directing the ISO and PX to modify and re-file their tariffs and associated documents on August 15, 1997 to reflect their anticipated operational capabilities on January 1, 1998. The order also adopted a procedural schedule and indicated the Commission's concurrence with certain fundamental aspects of the ISO tariff such as transmission planning and expansion, congestion pricing, and deferral of firm transmission rights until 1999. Responsive comments to the revised tariffs were due in early September, to which the ISO and PX each filed reply comments. These referenced filings have formed the basis for FERC's decision.

Although the 292-page order resolves a number of issues raised by the 100+ parties that filed comments on the ISO and PX filings, a number of issues remain unresolved pending the outcome of various studies FERC has ordered the ISO and the PX to complete by January 1, 1999 to ascertain whether and to what extent various problems envisaged by the parties actually come to fruition. FERC ordered the studies on issues where it appeared sympathetic to parties' concerns, but needed further information and analysis prior to making a final determination. As to such issues, FERC thus has authorized the ISO and the PX to operate as proposed, but left final resolution open until the studies have been completed and operational experience obtained.

Existing Contracts Remain Protected

Probably the most important issue resolved by the October 30 order concerns the treatment of rights and obligations arising under existing contracts in a post-restructuring environment. FERC was clear and unequivocal on this important issue: the existing contracts of parties who do not elect to join the ISO must be honored in their entirety, and for their duration.[1]/ No abrogation of existing contracts will be tolerated, even where enjoyment of such rights and

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[1]/ FERC approved the ISO tariff provision requiring a participating transmission owner to convert its scheduling protocols under its existing contracts to conform to those applicable under the tariff by the end of the five-year transition period.

privileges conflict and even interfere with ISO tariff and protocol provisions. The Commission agreed with Metropolitan that a party who elected to "join" the ISO but did not convert its contract rights to conform with ISO tariff and protocol requirements would continue to enjoy such contract rights if it withdrew from the ISO within the five-year transition period. Such a determination comports with sensible public policy, for it encourages ISO participation by decreasing the risk that would otherwise arise from participation: if a party is dissatisfied, it can withdraw from the ISO and fall back on its existing contract rights, as long as those rights have not been converted. FERC also clarified that parties to existing contracts will not be required to pay duplicative charges for transmission service under such contracts and the ISO tariff.

Full protection of existing contract rights was the most compelling issue facing Metropolitan, as it sought to protect its rights under its Service and Interchange Agreement (Agreement) with Southern California Edison (Edison), which terminates in 2017 unless earlier terminated upon the expiration of five years' advance written notice. After January 1, 1998 and pursuant to the terms of said Agreement, Edison will continue to have the responsibility to schedule Metropolitan's Colorado River Aqueduct (CRA) pump load, and to provide (or cause to be provided) ancillary services for operation of Metropolitan's system for its CRA pumps. Thus, so long as Edison upholds its obligations under the Agreement, Metropolitan should be held harmless from any cost increase for the CRA that would otherwise arise from restructuring of the electric utility industry. Pursuant to the terms of the ISO tariff and the Agreement, Edison will transfer its right to residual transmission capacity on Metropolitan's 230kV transmission line to the ISO upon commencement of ISO operations.[2]/

Avoidance of Cost-Shifting

Metropolitan's other major restructuring issue concern involved the potential for cost-shifting. Significant cost-shifting can occur as costs associated with retail service are shifted to wholesale users such as Metropolitan and the California Department of Water Resources (DWR) with respect to their CRA and State Water Project loads, respectively. It can also occur if otherwise discrete costs are not assessed against the parties that are causing them to occur in proportion to their causation. Clearly, restructuring affords an opportunity for massive cost-shifting as the industry embarks on a sea change in the way it does business. Fortunately, Metropolitan was successful in resisting the imposition of cost-shifting or at least deferring a final resolution of some pricing schemes that may result in cost-shifting. Even if cost-shifting occurs in the short-term, Metropolitan should be protected against it for so long as its Agreement with Edison is honored.

Schedules Must Be Balanced; Reserve Requirements Must Comply with Industry Standards

The Commission responded to the concerns of many public power entities that cost-shifting would occur if the proposal for resolving "overgeneration" (excess generation relative to demand) was allowed to stand. Now, the PX cannot potentially reduce or eliminate lower cost

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[2]/ Under the Agreement, Edison has the right to residual or unused transmission capacity on Metropolitan's line. Pursuant to the ISO tariff, each IOU must transfer to the ISO all transmission rights and obligations. Edison will thus receive payment from the ISO for third party use of Metropolitan's line.

generation of other scheduling coordinators[3]/ in favor of more expensive "must-take"[4]/ generation bid into the PX, as each scheduling coordinator must submit a "balanced" schedule, where its scheduled generation (purchased or produced) equals its scheduled demand. Metropolitan was also successful in drawing into question the potential inequity resulting from the ISO's proposal for pricing of transmission losses. Although the Commission let stand the ISO's proposal, it shared Metropolitan's concern regarding the accuracy of the ISO's transmission loss pricing, and ordered the ISO to file a study examining alternative methods of assigning transmission losses to scheduling coordinators. This may be an important issue in the future if Metropolitan's Agreement is terminated because the size of Metropolitan's load (and therefore the magnitude of the potential assigned loss) is significant, and the ISO's current methodology is believed to assign greater costs to Metropolitan than would occur the existing system. Additionally, FERC ordered the ISO to conform its operating reserve requirements to match those established by applicable industry standards. This works to Metropolitan's benefit since it permits a lower reserve requirement for hydroelectric generation, which serves approximately 70% of Metropolitan's load.

Governance of ISO and PX Approved; ISO and PX Tariffs Must Reside under FERC Jurisdiction

The order also resolves other important issues. For example, it generally affirms the governance scheme for the ISO and the PX, in which Metropolitan worked hard to ensure for itself either direct or close indirect representation on the ISO and PX Governing Boards. As anticipated, FERC struck the California residency requirement for Governing Board membership and the California Oversight Board's jurisdiction over the ISO. The Commission also clarified that neither the ISO nor the PX have the ability to unilaterally change their tariffs without first submitting proposed changes to the Commission, which will then notice the filing and provide opportunity for interested parties to submit written comments. While this will necessarily lengthen the time necessary to achieve changes to the tariffs, it should also ensure the effects of such proposed changes are fully considered.

Public Power Retains the Authority to Set Rates and Tariffs

In another issue of significant concern to the public power community, FERC affirmed the ability of a public power entity to set its own rates under the current transmission owner-specific pricing scheme. On the issue of the successor transmission access charge methodology that must be filed at FERC in late 1999, the Commission declined the opportunity to express support for off-peak pricing, despite the urging of Metropolitan and DWR.[5]/ Incorporation of this pricing feature will be particularly important to efforts to limit DWR's transmission costs in a post-restructuring environment as off-peak use is considerably less costly than on-peak, and DWR designed its system to largely operate off-peak.

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[3]/ A scheduling coordinator is the entity that interfaces with the ISO on behalf of a market participant.

[4]/ "Must-take" primarily consists of generation resulting from the IOUs' stranded investments.

[5]/ Metropolitan pays approximately 70% of DWR's transmission costs.

With respect to the PX, FERC responded to the concern raised by a number of public power transmission owners that their eligibility to do business with the PX should not be conditioned upon the requirement that they have a FERC-approved open access transmission tariff. The Commission agreed, and struck the relevant provision from the PX tariff. Additionally, FERC required the PX to file its market activity rules for Commission approval, as it concluded that such rules have "a significant effect" on energy rates. The Commission also required the PX to prepare and file several studies designed to determine whether it is designed to provide an efficient, least-cost dispatch of energy.

With respect to the Transmission Control Agreement, which is the agreement executed between the ISO and participating transmission owners, the Commission agreed with many public power owners who argued that inasmuch as they are not subject to FERC jurisdiction, neither should their tariffs be subject to the ISO's Alternate Dispute Resolution process, even though the ISO is FERC-jurisdictional. This will result in greater autonomy continuing to reside in local jurisdictions with respect to resolution of their disputes, at least for as long as the transmission access charge is transmission owner-specific and they are not subject to FERC jurisdiction. If Metropolitan joined the ISO under the foregoing conditions, the Board would have final authority over Metropolitan's transmission rates.

Staged Implementation

The Commission approved the request by the ISO and the PX to "stage" implementation of certain aspects of their tariffs until such is technically feasible. Staged implementation will occur over the next year as software and other technical constraints are resolved. However, implementation of the successive stages will not occur until proposed tariff changes reflecting such changes are filed for Commission approval. With respect to the PX, there initially will be a single, day-ahead auction for energy. Sometime in 1998 the PX hopes to implement iterative or multi-part bidding for energy in a day-ahead auction, and to implement an hourly auction. The ISO proposes to stage seventeen relatively important aspects of its operation throughout 1998.

Other Issues Raised

The Commission indicated that any issues raised by parties in prior comments and not specifically discussed in the order are deemed denied. Metropolitan and other parties had previously raised a number of other issues regarding, for example, ISO/PX billing and payment procedures, ISO authority over interconnection standards, exemption (from compliance with ISO rules) for generators, compensation for critical transmission grid protective systems, and other miscellaneous issues. Metropolitan and other parties will likely file a request for rehearing with FERC by December 1, 1997, which filing will preserve such issues for appeal. Similarly, counsel to the ISO and the PX have recommended that each entity file a request for rehearing on several issues where they will either contend that FERC has erred, or that they are currently technically incapable of complying with the Commission's order. Unfortunately the issue of technical capability, particularly with respect to the ISO, is not resolved and probably will remain alive until the eleventh hour because operational testing is scheduled to continue through the end of December. Nevertheless, the CEOs of the ISO and the PX have each indicated they are "cautiously optimistic" regarding their respective organization's ability to commence operations on January 1, 1998.

Other Proceedings Remain

Much remains to be done. The ISO and the PX filed operational protocols and implementing agreements at FERC on October 31, 1997, to which Metropolitan will submit comments on November 21. Additionally, on October 31 PG&E filed a motion to increase its transmission service rates under existing contracts, including DWR's, to reflect the increased costs it anticipates under ISO operation. Edison filed a similar motion on November 14. If PG&E and Edison are successful, DWR may incur additional transmission service costs of $3 million per annum. Finally, FERC has yet to respond to the Transmission Owner Tariffs filed by the three California IOUs on March 31, 1997. A scheduling order is expected soon.

In short, the details of ISO and PX operations are very complex, remain a moving target, and will likely stay that way for several years. Staff will continue to endeavor to ensure that Metropolitan's interests remain protected as restructuring moves forward.

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