Decision **DRAFT DECISION OF ALJ WETZELL (Mailed 5/30/2006)**

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Consider Refinements to and Further Development of the Commission's Resource Adequacy Requirements Program.	Rulemaking 05-12-013 (Filed December 15, 2005)

OPINION ON LOCAL RESOURCE ADEQUACY REQUIREMENTS

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OPINION ON LOCAL RESOURCE ADEQUACY REQUIREMENTS

1. Summary

Taking another step towards full implementation of a comprehensive program of resource adequacy requirements (RAR) applicable to Commission-jurisdictional electric load-serving entities (LSEs), the Commission establishes a new local procurement obligation as a component of the broader RAR program. LSEs must demonstrate that they have acquired adequate amounts of generation capacity within defined, transmission-constrained areas beginning in 2007. Key determinations made herein include the following:

- The 2007 local capacity requirements (LCR) study by the California Independent System Operator (CAISO) provides an adequate basis for establishing local procurement obligations to be met by LSEs for 2007.[1] We provide for a supplemental review process to provide an opportunity to identify transmission improvements that were not confirmed when the CAISO completed its study as well as to address certain questions and concerns parties have raised concerning the study.

- The Commission approves LSE procurement obligations that are based on a level of reliability described as "Option 2" in the CAISO's LCR study report. For 2007, that option represents the most appropriate balancing of reliability objectives and the costs of attaining reliability based on information that is currently available. However,

[1] As used herein, "local capacity requirement" refers to the CAISO's requirement for capacity resources in a particular location and for a given level of reliability. "Local RAR" refers to the local procurement obligation of LSEs that is considered in this decision. "System RAR" refers to this Commission's RAR program as currently constituted.

for purposes of assigning procurement obligations to LSEs, we direct the Commission's Energy Division to adjust the LCRs for the local areas for which deficiencies in qualified generation capacity have been identified by the CAISO.

- While the CAISO's 2007 LCR study is found to be reasonable for purposes of establishing Local RAR for 2007, certain modifications and refinements to the LCR study process are found to be necessary for 2008 and future years. Among other things, we find that future LCR studies would benefit from the use a probabilistic rather than a deterministic approach.

- The Energy Division is authorized and directed to allocate LCRs to individual, Commission-jurisdictional LSEs, thereby establishing each LSE's local procurement obligation, using the allocation principles adopted herein.

- A proposal to aggregate certain transmission-constrained local areas for purposes of assigning procurement obligations to LSEs is adopted as a market power mitigation measure.

- LSEs shall demonstrate they have acquired 100% of their Commission-determined "year-ahead" local procurement obligation for the following calendar year, *i.e.*, the 12 months from January through December. These compliance demonstrations are made concurrently with the LSEs' annual System RAR "90% year-ahead" (May through September) compliance filings. We do not require LSEs to make month-ahead compliance filings for Local RAR.

- To facilitate coordination of the Local RAR program, the System RAR program, and the CAISO's Reliability Must Run (RMR) process, we adopt a detailed implementation schedule for Local RAR for 2007. Among other things this schedule changes the date for year-ahead Local and System RAR compliance filings from September 30 to October 25,

2006. It also requires preliminary Local RAR compliance filings to be made on September 22, 2006.

- We decide against adopting a proposed transfer payment mechanism whereby LSEs with more capacity than they need to meet their procurement obligations in a local area would receive "transfer payments" from LSEs with insufficient capacity. We find that the proposed mechanism would be unduly burdensome to administer.

- We adopt a waiver-of-penalties "trigger" of $40 per kilowatt-year (kW-year). If an LSE demonstrates that it was unable to procure local capacity at or below that trigger price, it will pay for backstop procurement but will not be penalized.

- In the event that an LSE does not meet its local procurement obligation and thereby causes backstop procurement by the CAISO to occur, and the LSE has not been granted a waiver, it will be subject to a penalty of $40 per kW-year on the amount of its deficiency, in addition to backstop procurement costs.

This decision addresses Local RAR issues. We will issue a separate decision in Phase 1 of this proceeding that addresses proposals pertaining to the development of a tradable capacity product as well as proposals for resolving certain technical issues that have arisen during the recent implementation of the system RAR program.

2. Background

2.1 Earlier RAR Proceedings

In a series of decisions issued over the past two and one-half years, (Decision (D.) 04-01-050, D.04-07-028, D.04-10-035, and D.05-10-042 as modified by D.06-02-007 and D.06-04-040), the Commission has established RAR-related

policies and regulations to ensure that there is adequate, cost-effective investment in electric generation capacity for California and that such capacity is made available to the CAISO when and where it is needed for reliable transmission grid operations. These policies are currently applicable to California's large investor-owned utilities (IOUs), *i.e.*, Pacific Gas and Electric Company (PG&E), San Diego Gas & Electric Company (SDG&E) and Southern California Edison Company (SCE), as well as the electric service providers (ESPs) and community choice aggregators (CCAs) that serve retail customers within the service territories of those IOUs.[2]

The RAR program now establishes aggregate or "system" procurement obligations for these LSEs. Under System RAR, each LSE is required to procure the capacity resources including reserves needed to serve its aggregate system load but is not required to account for local transmission constraints that could prevent the procured capacity from being available to the CAISO to serve load where the LSE's retail customers are located. Thus, under the current program, LSEs could be resource-adequate on an aggregate or system basis but transmission-constrained local load pockets could still be resource-deficient. It is this problem that Local RAR is intended to resolve.[3]

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[2] Later in this rulemaking, we will explore the means of implementing the legislative mandate of Assembly Bill (AB) 380 (Stats. 2005, Ch. 367) to establish RAR for all LSEs.

[3] Transmission system additions are an alternative means of resolving local reliability issues. We endorse the position that cost-effective transmission additions should be pursued, *i.e.,* those that can, at lower societal cost, supplant the need for local generation capacity. We also note, however, that transmission projects often tend to have multi-year planning and development horizons whereas the RAR program is currently focused on a shorter-term resource planning horizon. This mismatch of planning time frames may complicate efforts to weigh transmission and generation options. In future

Footnote continued on next page

The Commission has previously recognized the need to better address local reliability issues through LSE procurement obligations. In D.04-07-028, as the summer 2004 peak electric demand season was commencing, the Commission addressed urgent concerns about electric system reliability concerns in Southern California, particularly in the area South of Path 15 (SP 15). Noting operational difficulties that were being encountered by the CAISO and associated near-term reliability concerns, the Commission made clear that reliability is not solely the CAISO's role. Instead, the Commission determined, "…. it is also a utility responsibility to procure all the resources necessary to meet its load, not only service area wide but also locally." (D.04-07-028, p. 2.) Addressing the roles of all participants in assuring electric system reliability, the Commission stated the following with respect to the CAISO and its operational requirements:

> In particular, the CAISO is responsible for ensuring "efficient use and reliable operation of the transmission grid consistent with achievement of planning and operating reserve criteria…" [Citation and footnote omitted.] In pursuit of these objectives, the CAISO must each day ensure that sufficient generating capacity is on-line and available to meet the forecast system load. This means not only a sufficient amount of on-line

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RAR and other resource planning proceedings, we will pursue ways to better coordinate local procurement requirements and transmission planning to ensure that optimal solutions are pursued.

In addition to major transmission addition projects, local transmission constraints can, in some circumstances, be addressed by changes in how the transmission grid is operated. Such operational solutions have been considered by the CAISO in its 2007 LCR study, and by this decision we provide opportunity for further consideration before local procurement obligations for 2007 are finalized.

> generating capacity to satisfy the total system load, but also whether that capacity is in the right place. The CAISO, for example, must have a minimum amount of on-line generation available in certain locations in order to address transmission constraints or other specific operating requirements, such as maintaining proper voltage and other system-stability related requirements. Absent satisfaction of the CAISO's location-specific operating requirements, the CAISO may be unable to operate the grid reliably. (D.04-07-028, p. 3.)

The facts at issue in D.04-07-028 pertained to capacity availability in Southern California, but the Commission emphasized that the principles it adopted to ensure local reliability applied statewide.

As described in detail in D.05-10-042, at pages 76-82, the Commission determined that for 2007 and beyond, it would address local reliability concerns through the addition of a local procurement component to the developing RAR program. D.05-10-042 left open for further consideration several issues attendant to the establishment of Local RAR, including:

- Weighing the costs and benefits of achieving different degrees of local reliability so that an optimal level of local reliability is targeted.

- Whether local generation capacity is available to all LSEs, including those with small load shares.

- Market power mitigation through means such as a CAISO backstop procurement contract or tariff.

- Allocation of local capacity requirements to individual LSEs.

2.2 Rulemaking (R.) 05-12-013 – Summary of the Phase 1 Record

The order instituting this rulemaking (OIR) provided that this is the successor proceeding to R.04-04-003 as to RAR issues, and that the record of that prior rulemaking is available for consideration here. Although several important reliability issues are within the scope of this rulemaking, the OIR determined that implementing the earlier policy decision to establish Local RAR is the first priority of the proceeding. Accordingly, this Phase 1 decision addresses Local RAR. We will issue a separate decision in the near future that addresses other Phase 1 issues.

To facilitate timely implementation of Local RAR for 2007, starting with adoption of the program design in mid-2006, D.05-10-042 directed the IOUs and authorized other parties to file proposals for Local RAR within 75 days of the date of that order. Proposals were filed by (1) PG&E, SDG&E, and SCE (IOU proposal); (2) the Alliance for Retail Energy Markets (AReM); (3) the Independent Energy Producers Association (IEP); (4) Mirant California LLC, Mirant Delta LLC, and Mirant Potrero LLC (Mirant); and (5) the CAISO.[4] The CAISO's filing consisted of its LCR study report for 2006 (2006 LCR Study) along with supporting and explanatory documentation for the 2006 study as well as a proposal to conduct a new LCR study for 2007. The IOUs updated their proposal in comments filed on March 13, 2006. On April 5, 2006, PG&E filed a clarification to the IOUs' Local RAR proposal.

[4] On December 14, 2005, the Executive Director authorized an extension of time for these filings to January 24, 2006. Pursuant to authorization of the Administrative Law Judge (ALJ), the CAISO filed its LCR proposal on January 31, 2006.

In accordance with the schedule and procedures established by the ALJ, the CAISO performed the 2007 LCR study using input and assumptions and methodologies discussed at a "meet and confer" process conducted by the CAISO on February 17, 2006. The CAISO filed a report summarizing the meet and confer session on February 22, 2006 (Meet and Confer Report), and it issued errata to the report on March 10, 2006. The CAISO timely completed and reported on its 2007 LCR study on April 21, 2006, and on April 24, it filed the report with the Commission. On April 26, 2006, the CAISO convened a workshop on the completed 2007 study. It issued a corrected version of the LCR study on April 28, 2006 and filed it on May 1, 2006.

A prehearing conference was convened on February 3, 2006. The Energy Division led a series of workshops on Phase 1 topics on February 8, February 9, March 7, March 15, and March 27, 2006. The workshops held on February 8, February 9, and March 15 were transcribed. On April 3, 2006, SCE filed a report on the tradable capacity product issues that were discussed at the March 27 workshop. As noted above, those issues will be addressed in a separate decision. On April 10, 2006 the Energy Division issued a comprehensive report on Phase 1 issues (Staff Report). The Staff Report was incorporated into the record by an ALJ's ruling of the same date.

In addition to the filings described above, the Phase 1 record includes initial comments filed on March 13, 2006; post-workshop comments and replies filed April 21 and April 28, 2006, respectively; and comments and replies on the 2007 CAISO LCR study filed April 28 and May 3, 2006, respectively. Phase 1 was submitted for decision on May 3, 2006. The following table lists the commenting parties and the comments and/or replies they filed.

COMMENTING PARTIES

Commenting Party or Parties	Short Title for Party or Parties	Initial Comments (3/13/06)	Post-Workshop Comments (4/21/06)	Replies to 4/21/06 Comments (4/28/06) *	Comments on 2007 LCR Study (4/28/06) *	Replies to 4/28/06 Comments (5/3/06)
Aglet Consumer Alliance	Aglet		X	X	X	
Alliance for Retail Energy Markets	AReM	X	X	X	X	
California Independent System Operator	CAISO	X	X	X		X
California Manufacturers & Technology Association and California Large Energy Consumers Association	CMTA/CLECA	X	X			
California Municipal Utilities Association	CMUA	X	X	X	X	X
City and County of San Francisco	CCSF				X	
Constellation Energy Commodities Group, Inc. and Constellation NewEnergy, Inc.	Constellation	X	X	X	X	X
Division of Ratepayer Advocates	DRA	X	X	X	X	X
Energy Producers and Users Coalition	EPUC			X	X	
Good Company Associates on behalf of TAS	Good/TAS	X				
Independent Energy Producers Association	IEP	X	X	X	X	X
Mirant California LLC, Mirant Delta LLC, Mirant Potrero LLC; NRG Energy Inc., and West Coast Power (WCP did not join in 4/21 comments)	Mirant/NRG	X	X			
Pacific Gas and Electric Company	PG&E		X		X	X
Pilot Power Group, Inc.	Pilot Power		X			
Powerex Corp.	Powerex		X			
San Diego Gas & Electric Company	SDG&E		X	X	X	
Sempra Global	Sempra Global	X	X			
Southern California Edison Company	SCE	X	X	X	X	X
The Utility Reform Network	TURN	X	X	X	X	X
Western Power Trading Forum	WPTF	X	X			
PG&E, SDG&E, and SCE	IOUs	X				
APS Energy Services, CLECA, CMTA, Coral Power LLC, DRA, Energy Users Forum, J. Aron & Company, TURN, Silicon Valley Leadership Group, and Strategic Energy LLC (APS did not join in 4/21 comments)	Joint Parties	X	X			

* Aglet, AReM, EPUC, SDG&E, SCE, and TURN combined their April 28 replies and their April 28 comments into single documents.

3. Local RAR (Staff Report I.)[5]

3.1 Sustaining the Policy Objectives for Local RAR

As noted above, the Commission has stated its intention to add a local procurement obligation to the overall RAR program to ensure that sufficient local generation capacity is contracted for and available to the CAISO to meet local reliability needs. The Commission adopted this policy after it determined that LSE-based procurement of the capacity needed in transmission-constrained areas would be more effective in promoting RAR goals than continued reliance on CAISO procurement of such capacity through its RMR process:

> Concerns about local reliability and CAISO's reliance on RMR contracts led to consideration of localized RAR for all LSEs in Phase 1 [of R.04-04-003]. D.04-10-035 determined that adding a local component to the RAR program would be consistent with the Commission's prior decisions in which it has been held that LSEs are responsible for procuring the resources needed to meet their customers' needs. Discussing the costs of local RAR (higher procurement costs, higher forecasting and planning costs for LSEs, program complexity, and possible market power) as well as the benefits (contracts with longer terms than RMR contracts would assure revenue streams to generators, LSEs would be better able to identify cheaper and environmentally friendly alternatives to RMR contracts, and possible incentives for transmission upgrades) the commission determined that the likely benefits of local RAR outweigh the likely costs. (D.05-10-042, p. 77.)

Our primary task in this decision, then, is to refine and implement the Commission's policy for Local RAR. Questions remain about various aspects of

[5] Where applicable, section headings herein include cross references to the corresponding sections of the Staff Report.

the Local RAR program, including the best way to identify and define load pockets and to quantify the capacity needed within those areas to meet appropriate reliability standards. We intend to resolve these remaining questions in future proceedings. Nevertheless, nothing in the Phase 1 record persuades us that we should turn back from our objective to establish local procurement obligations for 2007. The Commission decided nearly two years ago that Local RAR is the most effective way to assure reliability in transmission-constrained load pockets, and we are concerned that further delay in its implementation for another year could thwart long-term achievement of the program goals. As IEP observes in its reply comments regarding the LCR study, "[t]his is one situation where the adage, 'The perfect is the enemy of the good,' applies." (IEP Reply Comments, May 3, 2006, p. 1.) We find that it is reasonable to implement Local RAR for 2007 using the record before us, and, for 2008 and beyond, to address the remaining questions about Local RAR in Phase 2 of this proceeding.

3.2 LCR (Staff Report I.A.)

3.2.1 The LCR Study Process (Staff Report I. A. 1.)

Local load pockets are defined by physical transmission constraints. If the transfer capability into a load pocket is less than the load demand within the area, then, depending on reliability criteria, additional generation capacity within the load pocket will be needed to satisfy the load demand. This amount of generation capacity is the LCR or Local Capacity Requirement. In simplest terms, the LCR study is the process of identifying the specific areas within the CAISO Controlled Grid that have local reliability problems due to transmission constraints and, for each area so defined, determining the generation capacity, in

megawatts (MW), that would be required to mitigate these local reliability problems.

The LCR study is the foundation for our establishment of local procurement obligations, the costs of which are borne by the LSEs and their retail customers. Therefore, this Commission must be reasonably assured that the LCRs it uses to establish those procurement obligations are reasonable. This requires consideration of the LCR study process as well as the study outcomes.

At the outset of this proceeding, parties suggested that an independent third party rather than the CAISO should be selected to perform the LCR study for 2007. While this suggestion may merit consideration in future proceedings, it could not reasonably have been pursued with any expectation of our adopting Local RAR in time for 2007. At this time, the CAISO—which, as the grid operator, has direct knowledge of system conditions and operations—appears to be particularly well positioned (if not uniquely so) to determine where load pockets exist and what their associated LCRs are. We note also that by the time this proceeding was underway, the CAISO had already completed an LCR study for 2006. It was clearly in a position to conduct the LCR study for 2007 within the expedited schedule for Phase 1. No party identified the means by which a third party could have been selected and funded to complete an LCR study for 2007 within the applicable time constraints.

In a ruling issued on February 10, 2006, the ALJ directed the CAISO, LSE respondents, and other interested parties to meet and confer to work towards agreement on study scenarios reflecting an array of input assumptions that the CAISO would use in the 2007 study. The ruling indicated that this approach could be expected to produce study results that would enable the Commission to make policy determinations in this proceeding about the appropriate level of

reliability and the LCRs associated with that reliability choice. This process allowed the parties to register concerns about study input assumptions and methodology, although it did not yield total agreement on how the study should proceed.

As described earlier, the CAISO convened a workshop shortly after the issuance of the 2007 LCR study report, and it issued a corrected report shortly after that workshop. Several parties have voiced concerns about the expedited review period that was necessary to enable implementation of Local RAR for 2007. However, a decision is needed now so that the LSEs' procurement obligations can be identified on a timely basis, enabling them to engage in procurement to meet the identified obligations. We find that the parties had an adequate opportunity to participate in the CAISO's post-study workshop, to submit comments and replies on the study, and to make their substantive concerns about the study known to the Commission. As explained below, moreover, we will provide an additional opportunity for such participation.

PG&E suggests that the 2007 LCR study process be kept open to require the CAISO to provide further information regarding the study methodology and inputs, and to provide parties additional opportunity to suggest corrections and transmission solutions that would lessen the LCRs determined by the CAISO without lessening reliability. We find this suggestion has merit in light of (1) the expedited review time that parties had before their comments on the LCR study were due, (2) the numerous comments indicating that questions remain about the study's application of industry reliability criteria, (3) the significant increases in LCRs from the 2006 study, and (4) the possibility that additional operational solutions may be available to reduce the need for generation procurement. While a cutoff date is needed as the CAISO suggests, it appears that there is a

window of time in the coming weeks for the CAISO to determine whether any opportunity exists to make corrections or adjustments to avoid local area generation procurement that, upon further review, may not be needed. We therefore ask that the Energy Division, after consulting with the CAISO, convene an additional workshop on the 2007 LCR study within 15 days of the service of this order and that it provide not less than 10 days' notice of such workshop to the service list for this proceeding.

While we adopt the CAISO's April 28, 2006 corrected LCR study as the basis for establishing Local RAR for 2007, we authorize the Energy Division to notify LSEs of revised, reduced local procurement obligations for 2007 that reflect any LCR reductions from the 2007 LCR study that are determined by the CAISO to be warranted. We direct the Energy Division to divide any such corrected LCRs among LSEs according to the principles adopted in Section 3.3.2 and to issue any such revised local procurement obligations at least 60 days prior to the due date for final Local RAR compliance filings for 2007. The Energy Division does not have authority to increase the LCRs and associated procurement obligations adopted by this decision.

In conclusion, we find that it was reasonable to rely on the CAISO to perform the 2007 LCR study and that the study process provided adequate opportunity for parties to participate. Further, subject to the additional review discussed above, we find that it is reasonable to use the study results as the basis for implementing Local RAR for the 2007 compliance period.

3.2.2 LCR Issues (Staff Report I. A. 2 and I. A. 3.)

3.2.2.1 Reliability Options for 2007

The meet and confer process described above resulted in a common understanding that the CAISO's LCR study would determine a range of LCRs

based on different service reliability levels. In addition, the CAISO agreed to incorporate transmission projects that were determined to be operational on or before June 1, 2007 as well as feasible operational solutions brought forth by Participating Transmission Owners (PTOs). Such operational solutions would result in an intermediate reliability option. The CAISO's LCR study report, which acknowledges the role of this Commission in adopting a reliability option, thus presented the Commission with three LCR options. These options reflect different service reliability levels that are driven by transmission grid operating standards that the CAISO must meet. The options are summarized as follows:

> Option 1 - Meet Performance Criteria Category B
> For each defined local area, this option represents the LCRs, and resource deficiencies that must be addressed, in order to achieve a service reliability level based on "Performance Criteria-Category B" as set forth in the Planning Standards established by the North American Electric Reliability Council (NERC).[6] Category B describes the system performance that is expected following the loss of a single transmission element, such as a transmission circuit, a generator, or a transformer, a condition referred to as "N-1." This option has a lower level of capacity required and will therefore have an expected lower level of reliability because less capacity is available to the CAISO.
>
> Option 2 - Meet Performance Criteria Category C and Incorporate Suitable Operational Solutions

[6] Pub. Util. Code § 345 provides that "[t]he Independent System Operator shall ensure efficient use and reliable operation of the transmission grid consistent with achievement of planning and operating reserve criteria no less stringent than those established by the Western Electricity Coordinating Council and the North American Electric Reliability Council."

This option represents LCRs and deficiencies associated with "Performance Criteria-Category C" with operational solutions. Category C describes the system performance that is expected following the loss of two or more system elements, expected to happen simultaneously. This condition is referred to as "N-2." By reflecting transmission operational solutions, this option allows for a lower generation requirement. However, long-duration outages would potentially subject load to extended outages.

Option 3 - Meet Performance Criteria Category C through Pure Procurement
This option provides the highest service reliability level. This option represents LCRs and deficiencies associated with "Performance Criteria-Category C" but without operational solutions. It relies instead on installed generation capacity rather than transmission operational solutions to address identified capacity deficiencies.

The following table, copied from the CAISO's LCR study report, summarizes the key LCR study results.[7] It shows the identified transmission-constrained areas and relevant resource and load data for Options 1 and 2. For 2007, the CAISO determined that Option 3 is relevant for only one of the nine identified local areas--the North Coast/North Bay area. The Option 3 LCR for that area is determined by adding 80 MW to the corresponding Option 2 data. The CAISO explains that this 80 MW difference reflects a recently confirmed new operating procedure. We understand that many other operating procedures are embedded within the transmission system configuration, and it would not be a

[7] *See* Attachment A, p. 2 of "Corrected 2007 Locational Capacity Technical Analysis and Errata of the California Independent System Operator Corporation," dated April 28, 2006 and filed May 1, 2006.

simple undertaking to identify Option 3 reliability LCRs based on the assumed removal of these procedures. We are confient that such LCRs would be significantly higher than the corresponding Option 2 LCRs.

Local Requirements Comparison

	Qualifying Capacity			2007 LCR Requirement Based on Category B Option 1			2007 LCR Requirement Based on Category C with operating procedure Option 2			2006 Total LCR Req.
Local Area Name	QF/ Muni (MW)	Market (MW)	Total (MW)	Existing Capacity Needed	Deficiency	Total (MW)	Existing Capacity Needed	Deficiency	Total (MW)	(MW)
Humboldt	73	133	206	202	0	**202**	202	0	**202**	162
North Coast / North Bay	158	861	1019	582**	0	**582****	582**	0	**582****	658
Sierra	1072	776	1848	1833	205	**2038**	1833	328	**2161**	1770*
Stockton	314	257	571	348	0	**348**	506	53	**559**	440*
Greater Bay	1314	5231	6545	4771	0	**4771**	5341	0	**5341**	6009
Greater Fresno	575	2337	2912	2530	0	**2530**	2534	68	**2602**	2837 *
Kern	978	31	1009	554	0	**554**	769	17	**786**	797*
LA Basin	3510	7012	10522	8843	0	**8843**	8843	0	**8843**	8127
San Diego	191	2741	2932	2781	0	**2781**	2781	0	**2781**	2620
Total	**8185**	**19379**	**27564**	**22444**	**205**	**22649**	**23391**	**466**	**23857**	**23420**

* Generation deficient areas (or with sub-area that are deficient) – deficiency included in LCR
** The North Coast/North Bay area requirement would have been higher by 80 MW, however a new operating procedure has been received, validated and implemented by PG&E and the CAISO.

DRA and TURN recommend that Option 1 be adopted for 2007. The CAISO recommends Option 2, and Constellation and PG&E provisionally support the CAISO's recommendation while IEP supports it without reservation. AReM believes that additional information is needed before an option can be selected, especially information regarding the probability of outage events, and EPUC agrees that additional information is needed.

Selecting one of these three reliability options invokes the Commission's policy of balancing reliability objectives against the cost of achieving a particular reliability level. We would prefer to have better quantitative information at our disposal regarding the probabilities of operational events as well as information

regarding the ratepayer and societal costs of service interruptions. Moreover, we expect that progress can and should be made towards producing such information for future LCR studies. However, AReM's recommendation for further study implies that we should suspend implementation of Local RAR indefinitely. We find this approach to be unnecessary, and therefore unreasonable given our stated intention to implement RAR for 2007. The record is adequate to support a decision at this time.

We note that no party recommends Option 3, which is the highest level of reliability identified by the CAISO and which, for 2007, applies to only one of the nine transmission-constrained areas identified by the CAISO. We find little justification for its adoption, so the choice before us between Option 1 (Category B) and Option 2 (Category C). The case for Option 2 is made by the CAISO in its description of the possible consequences of operating under Category B criteria:

> Option 1 is a service reliability level that reflects generation capacity that must be available to comply with reliability standards for NERC Category B given that load cannot be removed to meet this performance standard under Applicable Reliability Criteria. However, this capacity amount implicitly relies on load interruption as the **only means** of meeting any Applicable Reliability Criteria that is beyond the loss of a single transmission element (N-1). These situations will likely require substantial load interruptions in order to maintain system continuity and alleviate equipment overloads including load interruptions prior to the actual occurrence of the second contingency. [Footnote Omitted]. (LCR Study, p. 12, emphasis in original.)

The case for applying Option 1 in 2007 is made by TURN and DRA. TURN makes its recommendation with the expectation that there will be substantial backstop procurement by the CAISO in 2007. However, in deference

to the Commission's role in determining the appropriate service reliability level for retail customers, the CAISO makes clear that it does not intend to pursue backstop procurement to achieve Category C reliability if the Commission establishes LSE procurement obligations based on Category B. Also, while DRA supports Option 1, it appears to also support reliance on N-1-1 criteria, which, as the CAISO points out, are associated with Category C. We are mindful that the recommendations for Option 1 are advanced on behalf of customers who may be willing to accept a lower level of service reliability in return for reduced procurement costs. Nevertheless, we are not persuaded that these advocates fully and unequivocally support what the CAISO explains could be the consequences of their recommendation.

The most persuasive information before us is the CAISO's conclusion that a decision to adopt Category B criteria for purposes of local procurement obligations would likely result in substantial load interruptions when N-1 conditions occur. No party has presented information that would lead us to conclude that the risk of such interruptions is acceptable if that risk can be avoided or mitigated. The CAISO has determined that for 2007, the totals of the LCRs for the nine identified local areas are 22,649 MW and 23,857 MW under Options 1 and 2, respectively, a difference of about 5%. Given the reduced risk of interruptions expected under Option 2, we consider the required procurement of an additional 5% of needed capacity to be reasonable. We make this reliability determination for 2007 only. We leave for further consideration in this proceeding the appropriate reliability level for Local RAR for 2008 and beyond.

We conclude that Option 2 represents the appropriate reliability level for establishing LSEs' local procurement obligations for 2007, with one proviso: we direct the Energy Division to calculate reduced LCRs for those areas for which

the CAISO has identified a deficiency in qualifying capacity resources. These areas are identified as Sierra, Stockton, Greater Fresno, and Kern in the CAISO's LCR study report, although it is conceivable that supplemental review process described above could affect this list of deficient areas. We take this approach to deficiencies because we do not find it reasonable to require LSEs to procure capacity that, according to the LCR study, does not currently exist in an area. PG&E's contention (in its April 28 comments, p. 7) that "[w]hen adopting an LCR study the Commission should never accept a requirement greater than available resources (i.e., a determination that a local area is deficient), since that determination is, properly, part of the grid planning process," is apropos. Similarly, as AReM contends, LCRs should be "reasonable and attainable" to the extent that they are translated into local procurement obligations.

We wish to emphasize that we authorize this treatment of deficiencies for 2007 only in view of the limited time remaining in 2006 for LSEs to acquire the capacity needed to meet their 2007 obligations. Since one of the long-term objectives of RAR, including Local RAR, is to provide appropriate incentives for investment in generation resources where they are needed, we do not intend to continually approve a practice that could undermine this fundamental program objective. Finally, while we recognize that this waiver for deficiencies could reduce expected reliability in the affected local areas to less than that associated with Category C, we see no practical alternative for 2007.

3.2.2.2 Load Forecast

The CAISO's study used a 1-in-10 year summer peak load forecast. Aglet recommends that a less stringent 1-in-5 year forecast be used. According to Aglet's calculations, this could result in reduced ratepayer costs of about $41.45 million in 2007.

For all but one of the nine local areas identified by the CAISO, the LCR study shows that the difference between the applicable 1-in-5 and 1-in-10 load forecasts is less than 3%; the difference in the Greater Fresno area is less than 5%. The total difference for the nine areas is 2.4%. As a rule of thumb, using the less stringent 1-in-5 forecast would result in a corresponding one-for-one reduction in the LCR for an area. However, the CAISO notes, the exact reduction could be different due to load growth characteristics specific to each local area. Also, if the local area constraints are non-linear, or if the effectiveness factors between generation and load within the same area are significantly different relative to the worst thermal constraint, then the difference in LCR results would not mirror the difference in load forecast.

For purposes of establishing Local RAR for 2007 only, we accept the CAISO's judgment to use 1-in-10 load forecasts to calculate LCRs. At this time, we are not persuaded that the potential cost reduction of using a less stringent load forecast justifies the reduced reliability that may result from doing so. However, we are not satisfied that this issue has been fully vetted. Accordingly, parties may revisit this issue in Phase 2 for 2008 and beyond.

3.2.2.3 Commission-Jurisdictional LCRs

The CAISO's LCR study presented LCRs for the CAISO Control area, which also includes non-Commission jurisdictional LSEs. AReM believes that LCRs for Commission-jurisdictional LSEs should be separated out of the total LCRs on the basis of their proportional shares. AReM understands that the CAISO may not be able to perform the necessary calculations by local service area although it can do so by PTO service area. AReM is concerned that the PTO service area approach may create biases, and urges that the CAISO be required to

calculate, in the most accurate way possible, LCRs that are specific to jurisdictional LSEs. SCE concurs with this recommendation.

We fully concur that the total LCRs calculated by the CAISO should be allocated to jurisdictional LSEs on the most accurate basis possible. The CAISO should work with the Energy Division to perform this crucial calculation either on a local area basis, if possible, or otherwise on a PTO service area basis. The Energy Division will use this jurisdictional allocation in establishing Local RAR allocations to individual LSEs (*see* Section 3.3.2 below).

CMUA suggests that we use an LCR study that is applicable solely to jurisdictional LSEs, and that CMUA members continue to work with the CAISO on the technical analysis underlying the 2007 LCR study. Since we are concerned with the LCRs that are applicable to LSEs under our jurisdiction, we are not necessarily opposed to this suggestion. Moreover, we appreciate and welcome the CMUA's willingness to pursue improvements to the LCR study process, as it appears that the CMUA brings expertise that could lead to a more robust study process in the future. However, to the extent this proposal would require the CAISO to complete another LCR study before we adopt Local RAR for 2007, we reject it.

3.2.2.4 Generator Listing

The Staff Report noted the expectation that the LCR study would provide a list of generators that meet reliability needs in each local area, and it asked the CAISO to identify in the generator list the size (MW) and the owners of the units identified as qualifying capacity in local areas. Although the LCR study report did not include such a listing, the CAISO stated in its May 3, 2006 reply comments that it intended to publish a list of resources by local area and sub-area, including the unit qualifying capacity, before June 2006.

A complete listing of the qualifying resources, including the ownership and capacity information, is clearly crucial information for the LSEs' who will be obligated to purchase qualifying capacity. The Energy Division reports that the listing will be published no later than July 5, 2006.

3.2.2.5 Transmission Improvements

The Staff Report described the expectation that the CAISO's proposed LCRs for each local load pocket would include consideration of non-generation resources, including operational responses to contingencies identified in the 2007 LCR study (such as short-term equipment upgrades, reevaluation of line ratings, and demand response), as well as load shedding options. We concur that the solutions to the problem of transmission constraints should not be limited to generation alone. We address here how certain solutions ought to be addressed.

The LCR study identified a potentially higher rating for South of Lugo that, if not confirmed by SCE, could increase the LA Basin Area LCR. TURN expressed concern that this operational solution might not be reflected in the local procurement obligation to be met by LSEs in 2007. TURN asks that the Local RAR implementation process provide SCE an opportunity to formally confirm this upgrade. In its April 28 comments, SCE stated that it has confirmed that the path limit will be increased from 5,600 MW to 6,100 MW by June 1, 2007. This upgrade should be reflected in the LCR for the LA Basin Area.

IEP suggests there should be a transparent process for interested parties to learn about proposed operational solutions and verify that such solutions are superior to the option of adding generation. Constellation is similarly concerned about a lack of clarity regarding the CAISO's proposed use of operational solutions. As we noted earlier (*see* Footnote 3, *supra*), we recognize the importance of weighing the cost-effectiveness of generation and transmission

solutions so that the most cost-effective solution can be pursued. We therefore generally concur with IEP's belief that transparency regarding the availability and feasibility of transmission-related solutions is appropriate. Accordingly, we ask that the CAISO give careful consideration to IEP's request that the CAISO prepare a report detailing by local area the operational measures the CAISO expects to rely on to meet or reduce each area's LCR for 2007, and that similar reports be prepared for future LCR studies. We understand that the CAISO and PTOs work together to identify and confirm new operating procedures, and we think it would be beneficial if stakeholders are able to track that process.

While we generally agree that there is a need for transparency regarding operational solutions, we also recognize that, as the CAISO asserts, determining the feasibility of operating solutions is within the province of the CAISO and its PTOs. We strongly encourage the CAISO and the PTOs to continue their efforts to identify and implement cost-effective transmission-related solutions.

3.2.2.6 Hetch Hetchy Imports

CCSF is concerned that the CAISO's determination of transmission-constrained areas failed to consider San Francisco's firm transmission rights through an interconnection agreement with PG&E to deliver approximately 200 MW into the load pocket. CCSF thus believes that its Hetch Hetchy hydroelectric generation facilities and related transmission were inappropriately excluded, leading to an overstated LCR for the Greater Bay Area. The CAISO responds that the study takes into account energy imported into the load pockets, and that it identifies the capacity requirement that allows the energy to be imported while maintaining grid reliability.

We accept the CAISO's explanation and therefore do not find that the CAISO inappropriately excluded the Hetch Hetchy resource.

3.2.3 LCR Study Process for 2008 and Beyond (Staff Report I. A. 4.)

For 2008 and beyond, unless proponents of a third-party study show theirs to be a superior approach, we expect that we will continue to rely on the CAISO to perform annual LCR studies or study updates to identify load pockets and associated LCRs. We do not prescribe whether annual LCR determinations by the CAISO (or independent third party, if applicable) should be the product of a new study or the product of an update to an existing multi-year LCR study. Regardless of how the annual LCR determination is characterized, we seek reasonable assurance that the local procurement obligations that we establish are based on up-to-date information about the transmission grid and its operational characteristics. Therefore, an annual determination of LCRs through a process that allows meaningful party participation is appropriate. In this section we express our preferences and intentions for how future LCR determinations should occur.

PG&E notes the need for consistency in study methodology and approach to promote the willingness of LSEs to enter into long-term contracts. We concur, but at the same time we do not want the objective of consistency to prevent needed study improvements from being considered. Instead, we seek the appropriate balance between the sometimes competing objectives of consistency and accuracy. We expect that the CAISO and interested parties will do likewise.

One of the LCR study questions that needs to be resolved for 2008 and beyond is the degree to which the identified transmission-constrained local areas should remain fixed. We think it is clear that the areas should be fixed for at least one year to coincide with the annual Local RAR cycle, but whether the local areas designations should be fixed for several years at a time is less clear. On the

one hand, a fixed definition of local areas may promote long-term transactions; on the other hand, the transmission system is continually evolving, and transmission constraints are not necessarily fixed over time. We do not intend to promulgate procurement obligations that are based upon stale information, as that could lead to wasteful over-procurement or dangerous under-procurement. Future LCR determinations should reflect, as nearly in time as possible, the then-current state of the transmission system. We go no further at this time. We accept the Staff Report's recommendation that the duration of constrained local area determinations be taken up when we consider the 2008 LCR study.

Several parties, including the CAISO, have discussed the benefits of using a probabilistic rather than a deterministic approach to determining local capacity requirements. We support efforts to add components of such an analysis to the LCR study, as it should lead to more economically efficient decisions regarding the capacity that is needed at any particular location. At the same time, we understand that a probabilistic study approach may be very data-intensive, and that it may require more than one year to develop. We ask the CAISO and interested parties to take all reasonable steps to implement this approach as soon as practicable.

Constellation observes that a fixed and known schedule for the LCR update process should help the successful development of transparent, liquid, and stable markets that will provide the necessary incentives for infrastructure investment and minimize volatility. PG&E points to the importance of coordinating the work of the CAISO and that of the transmission and planning staffs of the PTOs. These and other comments underscore the need for a more developed plan for the LCR study process. Also, the experience of the parties in

Phase 1 of this proceeding underscores the importance of allowing sufficient time for stakeholder participation in the process and review of the study outcomes.

The Staff Report presented a proposed schedule for 2008 Local RAR that was designed to facilitate coordination of the LCR and Grid Planning processes, provide adequate time for market participants to meet their local procurement obligations, and provide sufficient time for review of the LSEs' compliance filings. Aglet supports this proposed schedule with minor modifications. Aglet suggests that the CAISO study be issued February 5, 2007 and that the CAISO host a meeting concerning the study one week later. Aglet also suggests that parties' comments on the 2008 study be due March 5, 2007. AReM concurs with the schedule as well, although it proposes that the due date for LSE compliance filings be extended on a day-for-day basis if for some reason the June 2007 date for notifying LSEs of their 2008 local procurement obligations is not met. AReM also notes that the one month interval for LSEs to procure "residual" capacity may be optimistic. Finally, AReM notes the need to coordinate Local RAR procurement and the CAISO's RMR process. IEP suggests that the date for notifying LSEs of their LCR allocations be moved forward from June 2007 to be concurrent with the Commission's adoption of local procurement obligations in May 2007.

Aglet's proposals for a CAISO meeting and dates certain for the LCR study's release and for comment strike us as reasonable. AReM's proposal for a day-for-day extension of time also strikes us as reasonable, and we direct the Energy Division to calculate and provide notice of any such extension. AReM's concern regarding coordination of the Local RAR procurement process and the CAISO's RMR process is addressed in Section 3.3.7.1. of this decision as to the 2007 Local RAR. IEP's suggestion to consolidate dates appears to be based on

the assumption that adoption of the 2008 procurement obligations and allocations to individual LSEs can occur concurrently. Our Energy Division informs us that coordinating the adoption of procurement obligations and notification to LSE's can be accomplished. We therefore adopt that change.

We approve in principle the proposed schedule and the suggested modifications to it, but we also recognize the need for some flexibility as the Local RAR program commences. For example, it may become necessary to revise the schedule to coordinate with the procedural events in Phase 2 of this rulemaking. Also, the detailed RMR coordination schedule for 2007 that is discussed in Section 3.3.7.1 may also affect this schedule. Accordingly, we leave to the Assigned Commissioner, the ALJ, and the Energy Division discretion to adjust the schedule as necessary or appropriate. We ask the CAISO to bring forward timing suggestions to synchronize the LCR and planning processes. The approved schedule, which includes adjustments for non-business days, is set forth below:

LCR/Local RAR Schedule for 2008

December 2006	PTOs submit base cases to CAISO
February 5, 2007	CAISO releases 2008 LCR study
February 13, 2007	CAISO hosts meeting on LCR study
March 5, 2007	Parties comment on 2008 LCR study
May 2007	Commission reviews CAISO's 2008 LCR study and adopts Local RAR for 2008
May 2007	Commission allocates 2008 Local RAR to all LSEs
October 1, 2007	LSEs file Local RAR showing and "Year-Ahead" System RAR
November 1, 2007	CAISO analyzes demonstrations for "residual" needs due to effectiveness factors and reports back to LSEs
December 3, 2007	LSEs demonstrate any additional procurement of "residual" through revised Local RAR, year ahead System RAR, and even December 2007 monthly System RAR, after which time the CAISO may engage in backstop procurement to resolve Local RAR deficiencies. (Date could be adjusted to coincide with

	monthly showing date.)

3.2.4 Zonal Capacity Requirements (Staff Report I. A. 5.)

During the Phase 1 workshop process, the CAISO reported that it had identified a need for "zonal" LSE procurement obligations. Consistent with the Assigned Commissioner's Scoping Memo, we will explore whether and how to establish zonal capacity procurement obligations later in this proceeding.

3.3 Local RAR Program Design Issues (Staff Report I. B.)

3.3.1 Adoption of Local RAR Annually (Staff Report I. B. 1.)

For 2008 and beyond, we anticipate the Local RAR program design will remain relatively fixed based on this decision and the refinements we expect to make in our Phase 2 decision in this rulemaking. On the other hand, as discussed earlier, LCRs will be determined each year to reflect the evolving transmission system and generation fleet. The Staff Report invited comment on whether annual formal proceedings should be instituted to consider and adopt the annual LCR determinations. The report posited that, at least initially, the approval of LCRs each year could not be delegated to the staff.

The LCR process for 2008 will be carried out under the umbrella of this proceeding. For the 2009 and subsequent LCR determinations, it appears that the annual determination of LCRs can possibly be made a through a ministerial process that is delegated to the staff, just as administration of the allocation process discussed in the following section is delegated to staff. We ask that the Energy Division as well as the CAISO and other parties present for our consideration in Phase 2 their recommendations on whether and how such a process can be implemented.

3.3.2 Allocation to CPUC-Jurisdictional LSEs (Staff Report I. B. 2.)

As we determined in Section 3.2.2.3, the first step for determining the procurement obligations for individual LSEs is to determine the portion of the total LCR in each area that is to be allocated to Commission-jurisdictional LSEs. Once such jurisdictional LCRs have been determined, and are adjusted for resource deficiencies as discussed in Section 3.2.2.1, they can then be translated into procurement obligations for the individual LSEs that are subject to our Local RAR program.

The Staff Report suggested that assigning Local RAR obligations by proportion of load served in existing IOU distribution service areas would provide administrative simplicity. By comparison, the report noted, there would be significant obstacles to implementing the alternative of identifying which load is located in each particular local load pocket. Under the staff's proposed approach, an LSE would have a local procurement obligation in each IOU distribution service territory in which it serves load. Each LSE's Local RAR would be a percentage of the total Local RAR adopted by the Commission based on that LSE's forecasted peak load in the applicable IOU distribution service area. The forecasted peak load would be based on the same basic load forecasting process used to determine System RAR. Staff's allocation method appears reasonable and non-controversial, and we hereby adopt it. Expressed as a formula, the local procurement obligation for an LSE will be calculated as follows:

[LSE IOU service area RAR/Total IOU service area RAR] * Total Jurisdictional Local RAR in IOU service territory = LSE Local RAR

AReM's Local RAR proposal recommended that LSEs should not be obligated to procure less than 1 MW. The Staff Report did not concur with this proposed exemption. We share staff's reluctance to exempt any LSE from local procurement obligations. On the other hand, the comments of several parties persuasively make the point that transactions of less than 1 MW are not commercially reasonable, at least at this time. Accordingly, we will adopt the proposed exemption as well as the rounding convention of AReM and other parties for both System and Local RAR. RARs of 0.5 and greater should be rounded up to the next highest MW and RARs of .49 and lower should be rounded down to the prior MW.

In its April 28 comments (at p. 7), AReM suggests that we consider subtracting IOU generation from LCRs to avoid the need for crediting, bilateral transactions, or transfer payments. According to AReM, this "off the top" method for allocating procurement obligations would resolve its concern that IOUs might hold back their units and instead seek CAISO backstop procurement payments. We find insufficient justification for AReM's off-the-top approach, and therefore reject it. We are not persuaded that the problem of IOUs withholding capacity exists and, if it does, that subtracting generation from LCRs would be the most effective solution.

We authorize and direct the Energy Division to perform the calculations necessary to establish local procurement obligations for individual LSEs employing the policies and procedures adopted herein.

3.3.3 Load Forecasting and Assignment Notification of Local RAR (Staff Report I. B. 3.)

The Staff Report anticipated that the Energy Division and the California Energy Commission (CEC) staff would coordinate to calculate each LSE's local

procurement obligation and notify the LSE by letter of its obligation. This notification would be made concurrently with the notice to LSEs of their System RAR year-ahead forecasts.

AReM raised a concern in its March 13 comments that this schedule may not be compatible with the schedule for this Phase 1 decision. The Staff Report concluded that this concern would not be an issue if we determine that LSE local procurement obligations are based on LSE load shares in IOU distribution service areas, which we have done. Several parties suggested that we approve a day-for-day extension of time for compliance filings should the June 30 notification date not be met.

The general approach described by the Staff Report is not contested, and we hereby approve it. We have already determined that a day-for-day extension of time is reasonable in connection with compliance filings for 2008 and beyond, and we make the same determination in principle here for the 2007 compliance filings. We recognize that LSEs need adequate time to meet their known procurement obligations, and we intend to preserve as nearly as possible the interval between official notification of the obligation and the compliance filing date. We note however, that we are adopting a revised implementation schedule to accommodate and facilitate coordination of Local RAR with the RMR process, as discussed below in Section 3.3.7.1. Also, we have established a supplemental LCR review process which could affect this schedule to the extent that the supplemental review results in reduced LCRs for 2007. Accordingly, as with the 2008 Local RAR schedule, we leave to the discretion of the Assigned Commissioner, the ALJ, and the Energy Division to make appropriate revisions to the schedule for 2007.

3.3.4 Aggregation of Local Areas (Staff Report I. B. 4.)

Several parties are concerned about market power issues that can arise when procurement obligations are established for small local areas. These parties have advocated aggregating the seven local transmission-constrained areas identified in the CAISO's 2006 LCR Report that are within PG&E's distribution service territory. The aggregation concept has two components: (1) determining each LSE's allocation of Local RAR based on its share of load in all of the local areas within the IOU distribution service area and (2) determining which qualifying capacity (generation) counts towards the Local RAR showing, if all the areas have been aggregated. Two major aggregation proposals have emerged, one by the IOUs in their joint Local RAR proposal (as modified in PG&E's April 5, 2006 clarification to the IOUs' proposal) and one by the Energy Division in the Staff Report. TURN has offered a variation of the Energy Division approach as a compromise proposal.

The IOU proposal would split PG&E's service territory into two sections, one consisting of local areas where 95% of local generators are needed and one where less than 95% of local generators are needed. The Energy Division proposal would aggregate all the local areas within the IOU's distribution service area to create a single local procurement obligation for the entire service area of that IOU. Thus, the seven local areas within PG&E's distribution service area would be aggregated as the "PG&E Local Areas." TURN's compromise proposal would limit the percentage of the PG&E Local Areas procurement obligation that could be fulfilled through procurement of capacity in the Greater Bay Area to 50%, while the remaining 50% of capacity needed to meet the Local RAR could be procured in any of the six remaining local areas in PG&E's service territory.

Because such aggregation of local areas could possibly lead to over-procurement in some areas and under-procurement (with CAISO backstop procurement required) in others, we would prefer to avoid any aggregation. However, the Phase 1 workshops and comments have shown persuasively that (1) significant market power concerns persist and (2) aggregation can mitigate these concerns. We therefore conclude that an aggregation approach is necessary and should be employed until and unless it is shown that other market power mitigation measures are available and can supplant the need for aggregation.

Several commenting parties agree that, compared to the IOU proposal, the Energy Division aggregation proposal would be more effective in mitigating the exercise of market power and would be administratively less complex. On the other hand, there is also general acknowledgment that the Energy Division proposal could lead to greater backstop procurement by the CAISO. This concern regarding backstop procurement is outweighed by the relative simplicity and more effective market power mitigation of the Energy Division approach. The TURN proposal to limit Greater Bay Area procurement to 50% has the potential to significantly mitigate the over-/under- procurement concern. This approach strikes the best balance of competing concerns in that it minimizes backstop procurement by the CAISO while also giving LSEs a degree of needed flexibility in where they obtain their local RAR capacity. We therefore approve and adopt the Energy Division's aggregation proposal along with TURN's proposal for limiting procurement in the Greater Bay local area to 50%. As a result, for local RAR compliance purposes, LSEs will have 1, 2, or 3 local procurement obligations depending on where they serve load – LA Basin Area, San Diego Area, and PG&E Local Areas.

Constellation proposes having a procedure whereby any use of CAISO backstop procurement to meet 5% or more of an LSE's overall local procurement obligation would lead to Commission evaluation of the aggregation mechanism. Given our underlying preference to avoid any aggregation approach in the first place, we agree that this program component should be subject to ongoing review and monitoring by stakeholders. We are not prepared, however, to adopt a formal 5% trigger for such evaluation. We will instead rely on our Energy Division, the CAISO, and interested parties to advise us if backstop procurement grows to excessive levels. Parties can do so, for example, through a petition for modification.

3.3.5 Compliance Demonstrations for Local RAR (Staff Report I. B. 5.)

3.3.5.1 Annual Showings

The Staff Report proposed that LSEs be required to make an annual compliance filing demonstrating that they have met 100% of the applicable local procurement obligation for each month of the next calendar year (January through December). This Local RAR compliance filing would be made concurrently with the LSE's "year-ahead" compliance filing for System RAR, which, pursuant to D.04-10-035, is due September 30 each year.[8] Resources that count towards meeting Local RAR would also count towards meeting System RAR. The Staff Report notes that these proposals reflect agreements reached in RAR workshops in the predecessor RAR proceeding, R.04-04-003.

[8] For the 2007 compliance year, the compliance filings would be made on October 2, 2006, the first business day following September 30. However, as discussed below, we are modifying the compliance filing schedule to accommodate coordination of the RAR and RMR processes.

The Staff Report identified several reasons for this "100%/twelve months" approach for Local RAR. First, it is possible that even if all LSEs procure their full allocation of Local RAR, they will not necessarily have procured all of the resources necessary to meet the reliability needs of a particular local load pocket. This outcome is possible because such a deficiency can only be determined after the CAISO has had the opportunity to analyze the effectiveness factors of all of the units actually procured to meet the Local RAR in a local load pocket. To the extent that additional units are needed to meet effectiveness factor concerns, the CAISO needs to identify the units, and LSEs should have the first opportunity to engage in this procurement, rather than automatically rely on CAISO backstop procurement mechanisms. Consequently, Local RAR demonstrations should be made in sufficient time to permit the CAISO to engage in such analysis and identify residual procurement needs. Second, the CAISO needs to be able to prepare for any necessary backstop procurement after the LSEs have made all of their procurement demonstrations, including those that may meet residual needs. The CAISO must have sufficient time to review any additional procurement demonstrations and determine if backstop or "supplemental procurement" is required. If so, the CAISO must have sufficient time to engage in a process to secure the resources it needs to maintain local area reliability. Third, a year-long procurement obligation should provide assurance of revenue adequacy to those units that are most needed to ensure the reliability of the CAISO grid, and encourage the type of longer term, LSE-based procurement that the CPUC supports.

A majority of parties supports these staff recommendations, which is consistent with the agreements reached on these issues in workshops in the predecessor RAR proceeding. Aglet, however, proposes that year-ahead Local

RAR showings mirror System RAR showings by demonstrating 90% of the obligation for the five summer months (May-September). Aglet believes this would allow some spot market purchases of capacity needed in local areas. Pilot Power takes a similar position both for program simplicity and because of its position that non-IOU LSEs should not be required to purchase 12 months of local capacity on behalf of customers they do not have under contract. Sempra Global believes that a January-December Local RAR adds complexity to the RAR program because the System RAR year-ahead obligation covers the summer months from May to September.[9] According to Sempra Global, the complexity of this mismatch of year-ahead compliance cycles would be burdensome for LSEs as well as the Commission, the CEC, and the CAISO. Sempra Global thus proposes that the Local RAR program be established on a June through May cycle for consistency with System RAR, which would result in the Local RAR program commencing five months later than under the Staff Report's proposal.

The parties opposing the staff recommendation do not adequately address the reasons discussed in the Staff Report for a 100%/12-month requirement. Although Local RAR is designed to serve the same basic objectives as System RAR, and simplicity is an important program design objective, there are sound reasons for tailoring the specific RAR program components to comport with their underlying circumstances. As noted in the Staff Report, the local program

[9] Sempra Global's discussion of this issue refers to a four-month, June through September compliance cycle for System RAR. However, D.04-01-050 established that the year-ahead procurement obligation for System RAR is for May through September. We note that for 2006 only, the procurement obligation is for June through September because D.04-10-035 adopted June 1, 2006 as the date for full implementation of the 15%-17% planning reserve requirement.

component entails an iterative process in which the CAISO evaluates nominated local resources and identifies deficiencies requiring either supplemental LSE or backstop CAISO procurement. Also, as TURN points out in its April 28 reply comments, the proposals for a five-month obligation ignore the fact that the CAISO's local reliability needs are not limited to the five summer months. We therefore will not adopt the alternative proposals for a 90% and/or a five month obligation. We also reject Sempra Global's proposal to defer implementation of Local RAR by five months. Parties have been on notice for nearly two years that we intend to adopt Local RAR, and we have already had to defer instituting Local RAR so that the concept could be fully vetted with the input of interested parties. An additional five-month deferral in the start of the program is unwarranted and, we believe, unwise in light of the need to achieve underlying program goals.

We recognize Pilot Power's concern that twelve-month resource commitments may not fit well with the business models of those LSEs that have relatively small customer bases and customers that are not under contract, and therefore, may have volatile load profiles. However, we are seeking through both System and Local RAR to provide the appropriate incentives for needed infrastructure investment, among other things. It does not appear that short-term resource commitments of less than a year will be sufficient to provide such incentives. Requiring LSEs to procure the resources needed to serve their own customers at the time a showing of such procurement is made is the best tool we have available at this time. In Section 3.3.6, we address the issue of load migration and a means of mitigating its impact on LSEs' procurement obligations.

3.3.5.2 Monthly Showings

AReM notes that the Staff Report does not include a proposal for requiring LSEs to make month-ahead compliance filings for Local RAR. Without specifically making such a proposal, AReM notes that the local procurement obligation could be accommodated with the monthly reporting obligation now required for System RAR. However, AReM contends that if a monthly compliance filing obligation is established for Local RAR, LSEs must be allowed to make adjustments for load migration. SCE urges clarification that there will only be annual compliance demonstrations for Local RAR.

We will not adopt a monthly compliance obligation for Local RAR. This is an area where, we believe, program simplicity is warranted. Section 3.3.6 addresses our policies that pertain to AReM's concerns regarding load migration.

3.3.5.3 Compliance Filing Process

The Energy Division proposes in the Staff Report that Local RAR compliance demonstrations be made by advice letter filings using a Commission-provided template and in accordance with a Local RAR Filing Guide, patterned after and possibly consolidated with the System RAR filing guide as updated and/or amended. The Local RAR template would include the LSE's local procurement obligation by service territory, the LSE's contracted-for units of qualified capacity within local areas, the name of the local area where the units are located, the MW of qualified capacity, the contract ID numbers, etc. The template would have adjustments for Demand Response programs and as well as for RMR units. We affirm this approach for implementation of the Local RAR program, and authorize the Energy Division to make appropriate revisions to the templates and filing guide as necessary for orderly program implementation and in accordance with this order.

3.3.6 Post-Compliance Sales of Capacity (Staff Report I. B. 5. and I. B. 6.)

As many stakeholders have repeatedly observed in this and previous RAR proceedings, and as we agree, a promising solution to the LSEs' concerns about load migration would be the ability of LSEs to buy and sell portions of resource commitments as load changes, provided such trades take place in a manner that preserves the availability of the underlying resource to the CAISO. It is for this reason, among others, that we intend to issue a decision facilitating the trade of capacity products in the near future, and to explore capacity markets in greater detail in a subsequent phase of this proceeding.

With one-time annual showings for Local RAR, no adjustment for incremental load migration during the year, and no monthly filings with true-ups for load migration, AReM maintains that LSEs must have flexibility to manage their local capacity resources as they see fit. In particular, AReM contends that an ESP that has fully met its local procurement obligation, as evidenced in an appropriate compliance filing, should not be subject to any further, after-the-fact evaluation. If the ESP then loses a large customer and wishes to off-load some or all of its local RAR capacity, AReM maintains it should be allowed to do so.

SCE opposes granting such flexibility to LSEs, arguing that LSEs should not be able to sell capacity during periods in which the capacity is reflected in the LSE's Local RAR demonstration. Alternatively, if such sales are allowed, SCE maintains that the selling LSE must be required to demonstrate that the capacity was sold to another LSE that has an obligation to make the sold capacity available to the CAISO for the same periods in which it was used in the selling LSE's Local RAR compliance showing. Otherwise, SCE notes, the annual Local

RAR demonstration process could be rendered meaningless if LSEs can sell their Local RAR capacity and not make it available to the CAISO. PG&E, essentially agrees with SCE's position, arguing that the LSE must uphold its obligation for the full extent and period identified in the compliance filing demonstration and not sell, trade, default, or otherwise undermine the intended availability of the resource.

We see no reason to prohibit the sale or trade of qualifying Local RAR capacity provided that the capacity remains fully available to the CAISO under the same terms and conditions, for the same periods, and in the same local area for which the capacity was nominated in fulfillment of the local obligation when the selling LSE made its compliance showing. Eventually, assurance of such continued availability may be realized through appropriate trading mechanisms. For now, we agree with SCE that assuring this full availability to the CAISO requires a positive demonstration by the selling LSE, in the form of a supplement to its monthly compliance filing, that the capacity was sold but remains fully available to the CAISO. We limit, therefore, sales to other LSEs so that they can balance their monthly system RAR demonstrations. Of course, if the acquiring LSE later proposes to sell the capacity, then it too would have to make the same demonstration of continued availability to the CAISO.

3.3.7 Counting Resources for Local RAR (Staff Report I. B. 6.)

We are adopting a program in which each LSE will demonstrate that it has met its local procurement obligation by showing, in annual compliance filings, its contracted-for capacity from qualifying generating units in the relevant local area or areas. Different units may be used to meet the Local RAR in different months, so long as compliance is demonstrated for every month. In large part, the

counting rules for determining which types of resources qualify towards fulfilling the local procurement obligation follow those for System RAR. In Section 3.3.7, we address issues that arose in the workshops regarding the appropriate treatment of certain resource categories.

3.3.7.1 RMR Resources

Through its Local Area Reliability Service (LARS) process, the CAISO identifies generators that must be available in or for a particular local area due to transmission constraints. To assure operational reliability, the CAISO enters into RMR contracts with those generators. RMR costs are paid by all load through CAISO uplift charges that are applicable throughout the service area of the PTO.

As their name implies, RMR units are those generation resources that the CAISO needs the most to ensure local reliability. PG&E explains that RMR units acquire their designation because their very necessity gives rise to an opportunity for their owners to exercise market power. PG&E also points out that these units are often expensive, even at cost-based RMR rates. The Commission has expressed a policy preference to minimize the use of RMR contracts. (D.04-07-028, p. 13.) On the other hand, the Commission has also agreed that RMR should remain in place for 2007.[10]

Consistent with the Commission's long-term policy objective to minimize the use of RMR, the Staff Report suggested that RMR units would not count

[10] On August 25, 2005, IEP filed a complaint with FERC, seeking to replace the Must-Offer Obligation with an alternative tariffed payment structure. The Commission participated in that proceeding, *Independent Energy Producers Assoc. v. California Independent System Operator Corp.*, FERC Docket No. 05-146 (IEP Complaint). Among other things, the Commission agreed to a proposed settlement provision of the IEP Complaint that called for RMR remaining in place through 2007.

towards Local RAR. The Staff Report noted that the CAISO's RMR process would not finalize RMR contracts for 2007 until on or about the planned October 2, 2006 Local RAR filing deadline. This timing issue, the report concluded, would preclude RMR Condition 1 and Condition 2 units from being eligible to count towards either Local RAR or System RAR demonstrations for 2007.

The comments in response to the Staff Report reveal that this proposal struck a collective industry nerve. Almost all commenting parties contend that RMR units should count for Local RAR, at least for 2007. Even the CAISO, which, "as a general principle wants to see the replacement of RMR sooner rather than later," would not object if the Commission were to credit RMR Condition 1 and Condition 2 resources against Local RAR as an interim step for 2007. (CAISO comments on Staff Report, April 21, 2006, p. 6.)

We continue to believe that reliance on LSE-based procurement fostered through Local RAR, rather than the RMR process, is the better long-term policy for addressing the reliability of transmission-constrained local areas. However, notwithstanding our policy preference to minimize the use of RMR contracts, it is apparent that both Condition 1 and Condition 2 RMR contracts should count for 2007. Not only is this consistent with the settlement of the IEP Complaint, pursuant to which RMR likely will remain a significant factor for 2007, it also gives recognition to the fact that the shift from predominant reliance on RMR to predominant reliance on LSE procurement will require a transition period with intricate coordination issues. It is clear from the comments that failure to allow RMR units to count for Local RAR for 2007 could lead to unnecessary and costly over-procurement to meet the reliability needs of local areas.

Fortunately, the timing issues that were described by the staff can be resolved. D.04-10-035 established September 30 as the date for annual RAR compliance filings by LSEs, and it would not be unreasonable to assume that that date should remain fixed for both System year-ahead and Local RAR filings. But that decision also indicated that an important part of the Local RAR process is to coordinate "the timing of LSE procurement efforts to acquire needed resources must be closely coordinated with the expiration of CAISO RMR contracts." (D.04-10-035, p. 33). It is the coordination of Commission and CAISO processes that should govern, not a particular filing date. If September 30 compliance filings are incompatible with such coordination, we are prepared to change our RAR program as necessary. We will therefore (1) allow RMR units to count for Local as well as System RAR for 2007 and (2) make several necessary adjustments to the RAR filing process as described in detail below.

In arriving at an improved coordination schedule, we first note that if the compliance showings occur simultaneously with the CAISO's RMR designations, two problems occur. First, there is little or no chance for LSE procurement to take the place of RMR. Second, there is no chance for the CAISO's RMR procurement to be credited against the LSE's Local RA obligation. Given that RMR procurement in 2006 was roughly 10,000 MW – it is in all customers' best interest to find a way to ensure appropriate local RA credit is given for RMR units. The CAISO's reply comments included a suggestion to move up the filing deadline for System "year-ahead" RAR and Local RAR compliance filings by one week. We adopt a modified version of the CAISO's proposed schedule, and we describe in greater detail the steps required to coordinate the timing of RMR and LSE procurement. This revised schedule allows for RMR credits to be assigned to LSEs as a reduction of their local procurement obligation.

We require that all LSEs file Preliminary Local RAR compliance showings on September 22, 2006.[11] This preliminary Local RAR demonstration can be as much as the LSEs full Local RAR demonstration, but, at a minimum, it must accurately show whether the LSE has, by September 22, 2006, entered into an RAR capacity contract with a unit that is among the list of units proposed for 2007 RMR Contracts. These demonstrations will not be used to determine compliance with local procurement obligations but they are required to be accurate. An LSE that has no 2007 RMR-proposed units under an RAR contract prior to September 22, 2006 would make a simple filing to that effect, as this information may help reduce CAISO RMR procurement. The IOUs are strongly encouraged to be as comprehensive as possible in their Preliminary Local RAR demonstrations because the IOUs control so many Qualifying Facility, nuclear, and hydro units that are assumed in many of the RMR studies.

To the extent that an LSE's Preliminary Local RAR showing contains any RMR units, the showing needs to indicate whether the LSE bought the RMR units outright or bought only the Local RAR counting benefits via a "wraparound" contract to the RMR contract. To qualify as meeting Local RAR, a wraparound contract must fully displace the RMR contract fixed costs. The wraparound contract also must allow the generator to set the Annual Fixed Recovery Cost (AFRC) or Fixed Option Payment Factor (FOPF) of Annual Fixed Revenue Requirements (AFRR) to zero, such that the contracting LSE is paying

[11] The CAISO suggested "one week" but we find that it is useful to put an actual date to the suggestion. All RAR showings are submitted to the Commission and concurrently copied to the CEC and the CAISO.

100% of the fixed costs and no other transmission customers are paying for that part of the RMR contract obligation.

In requiring a Preliminary Local RAR demonstration on September 22, 2006, we will be allowing the CAISO a week to review the filings prior to its issuing RMR contract renewal notices. If a unit is bought outright, there should be no CAISO RMR contract renewal at all. If a unit is bought by wraparound contract, then the CAISO may still execute an RMR contract renewal but the Local RAR capacity credit of the RMR contract would not be distributed to all LSEs as Local RAR credit; instead the Local RAR counting benefit would accrue only to LSE that is paying for the wraparound contract. If an LSE has a wraparound contract that does not set AFRC or FOPF of AFRR to zero (i.e., it does not fully displace fixed cost recovery), the Local RAR credit would be allocated as if it were an RMR unit without any wraparound contract. However, in that case the LSE that pays for the wraparound contract may receive System RAR credit for the unit.

We expect that when the CAISO sends renewal notices to its RMR contracts for 2007, it will only send them to those units that are on the CAISO Board-approved RMR list and that are not fully represented in the Preliminary Local RAR filings as having a separate RA capacity contract. We expect that this Preliminary Local RAR showing process will allow the CAISO to sign up for RMR those CAISO Board approved potential RMR units that have not been fully procured through our LSE RA procurement process.

After finalizing the RMR contracts for 2007 by October 1, 2006, the CAISO will know which RMR units are available and the total MW of RMR capacity. The CAISO, in coordination with the Energy Division, will then separate the total RMR contract amount (in MWs) by Commission-jurisdictional and non-

jurisdictional, RMR-paying entities, and also by the Local Areas. Working with the Energy Division, and using the preliminary Local RAR filings, the CAISO will determine the amount of Commission-jurisdictional RMR that can be allocated as "Local RAR" credit to all the RMR-paying LSEs. As already noted, some RMR contracts may not be available to be shared as "Local RAR" credit to all RMR-paying LSEs if they are procured for a specific LSE through a wraparound contract. The Energy Division will notify each LSE of the amount of RMR capacity that can be allocated to it as "RMR credit" in order to offset Local RAR. The allocation will be in proportion to their responsibility to pay for RMR contract fixed costs, which we expect to be a proportional load share basis. We expect the Energy Division to make this notification as expeditiously as possible, and not later than October 6, 2006.

In the case of traditional RMR, where all LSEs are paying for the RMR fixed costs through transmission rates in the form of (a) AFRC or (b) FOPF of AFRR, then all such LSEs receive a proportional credit of RMR as a credit allocation from the Commission. In the case of an RMR unit with a "RMR Cost-Displacing Wraparound" contract with one LSE, then that LSE receives the "Local RA counting credit." Stated another way, if any LSE has a resource adequacy capacity contract that sets the (a) AFRC or (b) FOPF of AFRR of a RMR unit to zero, such that the contracting LSE is paying the fixed costs and such that no other LSE pays any part of the fixed cost obligation, then the LSE would receive 100% of the Local RAR counting benefit.

As discussed further below, we envision that prior to making any backstop procurement decisions for local deficiencies in 2007, the CAISO will review the Local RAR demonstrations, the RMR resources as finalized, and the effectiveness

of any Local or System RAR resources that are filed in the "year ahead" demonstrations.

On October 25, 2006, all LSEs will make Local and System RAR compliance filings for 2007. These are the final, annual RAR showings for 2007 and they supplant the filings that were required on September 30. The compliance filings will include a demonstration that 100% of the local procurement obligation is satisfied for 12 months of 2007 and that 90% of the system RAR obligation for the five summer months of May through September is satisfied. Failure of an LSE to demonstrate it has met its Local and System RAR obligations in these filings would subject the LSE to Commission-imposed penalties.

For their Local RAR showings, LSEs will use the Local RA obligations allocated to them on July 25, 2006, in accordance with the schedule we approve below, and subtract the RMR credits provided to them by October 6, 2006. The remaining amounts represent their local procurement obligations, i.e., the Local RAR capacity that the LSE must have under contract for 2007.

For System RAR, LSEs may use the System RAR obligation allocated to them on July 25, 2006, subtract the provisional "RMR Condition 2 credit" allocations received around the same time. If a unit that was included in the "RMR Condition 2 credit" was not designated RMR by the CAISO for 2007, then the LSE may only use the updated Provisional "RMR Condition 2 credit" that is received anytime on or before October 6, 2006. Although the Commission and the CAISO will not know by October 25, 2006 that that the unit will select Condition 2 for 2007, we decide here to assume that it will do so for the purposes of the System "year ahead" showings. We explain further below how the LSEs must "make up" the Condition 2 units in their monthly system RA showings if a unit switches from Condition 2 to Condition 1 mid-year.

We have described a detailed procedure to accommodate the transition from an environment that relies mostly on CAISO procurement through the RMR process to one that relies mostly, if not entirely, on LSE procurement to meet local reliability needs. We recognize that this procedure may be seen as a diversion from the objective of program simplicity. However, we find it is necessary to coordinate the RMR and Local RAR processes in a manner that should avoid costly over-procurement of resources during the transition. The following schedule summarizes the procedure:

Schedule for Coordinating RAR and RMR Processes for 2007

June 29, 2006	Commission adopts Local RAR Decision.
July 21, 2006	Energy Division and CEC host staff workshop to discuss final CPUC-share of 2007 LCR, divided by local areas & aggregated in accordance with decision.
July 25, 2006	Energy Division notifies LSEs of their Local RAR for 2007 and their Provisional RMR Condition 2 system RA credit.
August 2006	CAISO's RMR study process complete.
September 6-7, 2006	CAISO Board meets to consider RMR contract designations.
September 22, 2006	LSEs file Preliminary Local RAR showings.
September 29, 2006	CAISO finalizes (by October 1, 2006) its RMR contract renewal process by sending renewal notices.
October 6, 2006	Energy Division notifies LSEs of their 2007 RMR credit for Local RAR.
October 25, 2006	LSEs make System "year ahead" and Local RAR showings for 2007.
November 1, 2006	LSEs make regular "monthly" showing for December 2006.
November 8, 2006	CAISO notifies all LSEs of any collective deficiencies to

	allow for additional LSE procurement.

December 1, 2006	Last date for LSE to file amended Local RAR or System "year ahead" RAR showing to reduce CAISO backstop for collective deficiency. LSEs make regular "monthly" showing for January 2007.
After December 1, 2006	CAISO engages in any backstop required to cure collective local deficiencies and notifies the Energy Division so that it can notify LSEs of their RAR credit to their monthly showings.

3.3.7.2 Dispatchable Demand Response Resources

The Staff Report proposed that dispatchable demand-response resources should count towards meeting Local RAR, provided that such resources are located within the defined local areas. The report noted, however, that implementing this proposal for 2007 would require that the CEC develop supplemental information about these resources. It therefore invited parties to comment on the feasibility of developing such information in a timely manner for 2007. Alternatively, if the information could not be obtained in time, this counting protocol would be implemented for 2008.

The comments reflect broad support for allowing dispatchable demand response to count for meeting local procurement obligations starting in 2007. SCE, however, states that it does not currently map the locations of its demand response program participants, and their associated curtailable load, to local areas. SCE recommends that this issue be deferred to the 2008 Local RAR filing cycle.

As AReM notes, SCE's service area has one load pocket whereas the service area of PG&E has seven load pockets. Yet, PG&E supports counting dispatchable demand response and has raised no issues regarding the

development of data to support doing so. Thus, even though SCE does not currently map demand response resources to local areas, it is not clear why it could not do so for 2007 since PG&E can. Nevertheless, the record does not provide an adequate basis upon which to order SCE to produce the data for 2007. We ask that SCE evaluate further whether this data could be developed for 2007.

We hereby determine that qualifying, dispatchable demand response resources should be allowed to count for Local RAR showings for 2007 to the extent feasible. We ask that the CEC pursue the collection and development of the data that are required to achieve this. We recognize that it may not be possible to implement this counting protocol until 2008 with respect to the SCE territory.

3.3.7.3 Distributed Generation

The Staff Report recommended that new distributed generation (DG) resources should count towards meeting Local RAR. D.05-10-042 addressed DG by adjusting the RAR forecast using a simple DG impact assessment methodology, and the Staff Report proposed similar treatment for Local RAR. Those parties who commented on this proposal support it. Constellation questions the qualification that only new DG resources would qualify, and recommends instead that all DG resources qualify in the same manner. We concur. We adopt the Staff Report recommendation with the qualifier for "new" DG resources removed.

3.3.7.4 Effectiveness Factors

A significant amount of workshop time was devoted to the question of whether a resource that is located outside of a designated local area should count as qualifying capacity within that area to the extent that it is effective in meeting the LCR for that area. The CAISO has indicated that it could develop resource

listings that show, for specific units, a range of effectiveness factors based on how effective those units would be in addressing various contingencies. As TURN states in its March 13, 2006 comments (at p. 5), it would be a "customer-friendly" policy to allow "generating units that are not located within the boundaries of a local area to contribute toward meeting that local area's LCR if the CAISO's modeling shows that such units meet some minimum 'effectiveness factor.'"

The Staff Report concluded that for 2007, notwithstanding the potential benefits of allowing units to count for local area obligations to the extent of their effectiveness, out-of-area resources should not count for purposes of meeting LSE's procurement obligations for that area. Staff came to this conclusion based on the fact that each generator has multiple effectiveness factors depending on the reliability of the system, the transmission contingency that needs to be addressed, and which other units are available to the CAISO. Staff also noted that fixing local area boundaries, and, therefore the generation units within the boundaries that can satisfy the Local RAR, would greatly simplify the administration of the Local RAR program. If out-of-area units were allowed to qualify based on their effectiveness factors, the Energy Division would have to deal with questions of which effectiveness factor to apply, and what system configuration to assume. The Staff Report noted that even with this counting protocol for 2007, effectiveness factors would be of use. Specifically, staff points out that the CAISO would be able to take into consideration all RAR resources, both inside and outside the local areas, when determining whether to engage in backstop procurement for 2007. This should allow the CAISO to optimize backstop procurement.

A number of commenting parties support the Staff Report's recommendations regarding effectiveness factors. This includes the recommendation that a list of qualifying resources within each local area be established and that only those resources count for Local RAR, as well as the report's observation that the CAISO should evaluate effectiveness factors in connection with backstop procurement. While DRA agrees with the Staff Report as to 2007 Local RAR, it also believes that efforts to incorporate effectiveness factors into Local RAR should be undertaken for future years. CMTA/CLECA likewise agrees with the report's recommendation for 2007, while also agreeing that this topic may appropriately be revisited in the future. Constellation recommends that the use of backstop procurement be monitored, and that if the CAISO engages in more than a minimal amount of backstop procurement, this issue should be revisited.

TURN contends that if a resource that lies outside the boundary of a local area is as effective as another resource within the area for meeting the area' local reliability needs, then such a resource should be countable for Local RAR. TURN refers to the example of Moss Landing, which is located outside of the Greater Bay Area but may be effective in meeting that areas needs. TURN believes this requires further study.

PG&E maintains that the CAISO should make effectiveness information available to LSEs for as many of the contingencies as possible, so that LSEs have a greater opportunity to meet the actual reliability needs.

We adopt staff's recommendation to disregard effectiveness factors for the 2007 Local RAR program, as attempting to incorporate them into resource qualifications would lead to undue program complexity. On the other hand, several comments underscore the need for further consideration of the extent to

which out-of-area resources ought to count towards meeting procurement obligations. We will therefore be willing to consider this topic in further proceedings for 2008 and beyond. We note that the problems of non-static effectiveness factors and administrative complexity would have to be overcome. We generally concur with PG&E's position that LSEs should have as much information about the effectiveness of resources as possible, and urge the CAISO to work with our Energy Division and stakeholders to provide such information.

3.3.8 Evaluation of Compliance Demonstrations and Actions Taken Due to Non-Compliance with Local RAR (Staff Report I. B. 7.)

3.3.8.1 CAISO Evaluation and Actions

The Staff Report described a process whereby the CAISO would review Local RAR compliance filings as well as (1) showings by non-jurisdictional entities and (2) RMR contracts to determine whether the amount of RAR capacity under contract in each local area meets or exceeds the Commission-adopted Local RAR level. If the adopted level is satisfied in the aggregate, the CAISO would not engage in backstop procurement even if one or more individual LSEs was deficient in its showing. Staff notes that "being satisfied in the aggregate" is limited to procurement of the MWs identified in the LCR study and does not address the technical requirement for maintaining voltage and frequency; provided, however, that the CAISO may need to engage in additional backstop procurement if an assessment of unit effectiveness for the total capacity procured by LSEs discloses that additional procurement is required. Staff notes that such an assessment would consider out-of-area units to the extent they are effective in addressing the area's needs. Staff proposes that LSEs be given first opportunity to engage in additional procurement rather than have no choice but to rely on CAISO backstop procurement.

Staff proposes that when the CAISO engages in backstop procurement, the costs would be allocated as follows:

-- If the deficiency is the result of an individual LSE's failure to make a compliant Local RAR showing, then the CAISO's costs for local resources procured on behalf of deficient LSEs (both CPUC-jurisdictional and non-jurisdictional) would be billed directly to the Scheduling Coordinators responsible for those LSEs.

-- If the deficiency is the result of collective error, i.e. under-procurement occurred in a particular local area even though all LSEs were compliant with their own Local RAR, then the costs for local resources procured on behalf of all LSEs would be allocated to all Scheduling Coordinators responsible for the LSEs in the PTO service territory on a load share basis.

Staff proposes that all LSEs would be notified of the CAISO's backstop procurement actions, and any backstop procurement would be made available to LSEs on a load share basis as a credit towards their monthly System RAR showings.

CAISO notes that the staff proposal for CAISO review and possible backstop procurement raises issues regarding the roles of the Commission and the CAISO that warrant further discussion between the agencies. CMUA is concerned that the scenario outlined by the staff could be read as a proposal whereby non-jurisdictional entities such as publicly-owned electric utilities (POUs) would make compliance showings pursuant to our Local RAR program, and POUS would incur CAISO backstop procurement costs for not complying with our Local RAR program.

We understand the concerns that were raised by the CAISO and by CMUA. We reiterate that we are establishing locally based procurement obligations that are applicable to the IOUs, ESPs, and CCAs under our jurisdiction, not POUs. We also recognize the distinction between the CAISO's

responsibility for grid reliability and our role regarding service reliability that is applicable to Commission-jurisdictional LSEs and their retail customers. We welcome and encourage, and are encouraged by, the ongoing dialogue between the CAISO and this Commission, and note further that such dialogue is essential to meet the mandate of Pub. Util. Code § 380(a) that we shall establish resource adequacy requirements in consultation with the CAISO.

Constellation appears to be concerned that some LSEs might have a disincentive to procure from high-effectiveness, high cost units if the CAISO engages in backstop procurement as a result of effectiveness concerns. We cannot discount this possibility, but we do not find it to be grounds for adopting an alternative approach at this time. We agree with Constellation that it will be important for staff and parties to monitor the extent of backstop procurement to ensure that any unintended consequences are detected and can be addressed. Constellation also notes that aggregation of local areas may lead to backstop procurement by the CAISO, and urges that the resulting costs should be allocated on a load share basis just as backstop procurement for effectiveness is. We concur.

SCE seeks clarification that the process of determining whether a local area deficiency was the result of collective error will not mean after-the-fact reasonableness review of any LSE's Local RAR procurement. SCE goes on to state the position that once an LSE has been deemed to have met its Local RAR, there should be no mechanism for changing that LSE's procurement target and areas where it needs to procure. SCE's position comports with our understanding. The Local RAR obligation is a one-time per year compliance filing obligation (as discussed earlier, divided into preliminary and final showings for 2007 to accommodate the RMR process). If an LSE has met its Local

RAR as evidenced in its compliance filing, any subsequent procurement obligation for the applicable compliance year would result from backstop procurement by the CASIO, not supplemental Local RAR obligations. LSEs would have an opportunity, but not an obligation, to engage in supplemental procurement in lieu of having to rely on CAISO backstop procurement.

PG&E agrees that LSEs should have an opportunity to procure to meet effectiveness needs prior to backstop procurement, and contends that RAR credit for backstop procurement should accrue to those LSEs that pay for it. We concur with this principle.

We believe that the Staff Report generally presents an appropriate mechanism for carrying out the Local RAR program. The essential elements of CAISO review and response, which we hereby approve, can be restated and summarized as follows.

-- Using the information available to it, including Local RAR compliance filings with the Commission, RMR contracts, POU procurement, and effectiveness factors of units nominated to fill the local needs, the CAISO will determine whether a local area has the needed local resources or is deficient such that additional capacity must be procured.

-- If the CAISO determines that a local area is deficient due to failure of a Commission-jurisdictional LSE to meet its Local RAR, the CAISO will engage in backstop procurement, the cost of which will be assigned to the deficient LSE's Scheduling Coordinator pursuant to CAISO tariffs. If the CAISO determines that a local area is adequately resourced, but notes that a Commission-jurisdictional LSE did not meet its local RAR, the CAISO would take no action with respect to that LSE.

-- If the CAISO determines that a local area is deficient due to "collective error" (for example, a deficiency results from the interplay of effectiveness factors) and not the failure of a Commission-jurisdictional LSE to meet its Local RAR, the CAISO

> will work with the Commission to provide the LSEs with an opportunity to procure the deficiency before the CAISO engages in backstop procurement. The cost of this backstop procurement would be assigned to the LSEs' Scheduling Coordinators pursuant to CAISO tariffs, provided, however, that any LSE that took advantage of the opportunity to procure local capacity in lieu of relying on CAISO backstop procurement would be credited for such voluntary procurement.
>
> -- The portion of any backstop procurement by the CAISO that is attributable to Commission-jurisdictional LSEs would be made available to those LSEs on a load share basis as a credit towards their monthly System RAR showings.

We understand and intend that the foregoing procedures are consistent with the respective roles of the Commission and the CAISO, and that they do not represent the imposition of any requirements of this Commission on non-jurisdictional entities. They also appear to be consistent with the CAISO's understanding of its role with respect to Local RAR. As the CAISO states:

> [O]nce the Commission elects the Local RAR based on an appropriate service reliability level, as stated previously, the CAISO will assess the adequacy of LSE procurement, both from CPUC and non-CPUC jurisdictional entities and engage in procurement only as a backstop measure to the desired level of service reliability. [Footnote reference omitted.] (Comments of CAISO, April 21, 2006, p. 10.)

3.3.8.2 Commission Evaluation and Actions

Commission review of Local RAR filings will include a determination of whether each LSE has met its procurement obligation and is otherwise in compliance with RAR program requirements. As with the System RAR program, staff expects the compliance review will be delegated to the staff.

The Staff Report put forth two options to ensure compliance in the situation where an LSE has not met its obligation but the local area is adequately

resourced because at least one other LSE is "long" on qualifying local capacity. The deficient LSE would either pay a transfer payment to the long LSE(s) in accordance with a transfer mechanism (discussed below) or it would be subject to a Commission-imposed penalty. In the situation where the local area is deficient, the Staff Report proposed that an LSE that has not met its obligation would be subject to (1) CAISO backstop costs directly allocated to its Scheduling Coordinator, as discussed above and (2) Commission penalties if no Commission waiver has been granted.

We approve the Staff Report's proposals for administration of the Local RAR program, including delegation of ministerial review responsibilities to the Energy Division.[12] As discussed in the following section, we are not adopting the IOUs' proposed transfer mechanism. Accordingly, an LSE's failure to demonstrate compliance with its local procurement obligation would subject that LSE to backstop procurement costs if the CAISO determines that the local area is deficient, and Commission-imposed penalties in the absence of a waiver. We address various issues pertaining to penalties and waivers later in this decision.

3.3.9 The IOUs' Transfer Payment Proposal (Staff Report I. B. 8.)

The IOUs' proposal for Local RAR included a recommendation for a transfer mechanism and payment process for the situation where an LSE does not meet its local procurement obligation with respect to a local area, yet the area

[12] As with System RAR, the Energy Division is tasked with notifying LSEs that their compliance filing was received and approved. If the Energy Division determines that an LSE is non-compliant and resolution of the LSEs compliance status is not resolved between the Energy Division and the LSE, the Energy Division would refer the issue to the Commission through the recommended institution of a formal proceeding.

is adequately resourced because one or more LSEs has procured local generation in excess of the Commission-adopted Local RAR. The Commission staff would identify such "long" and "short" LSEs and allocate or "transfer" credit for the local capacity from the long to the short LSEs. The long LSE would retain control over the resource since only the "local attribute" would be transferred to the short LSEs. The IOUs suggest a $24 per kilowatt-year (kW-year) "transfer payment" for such transfers from short to long LSEs. The total amount of the transfer payments owed by short LSEs would be allocated to the long LSEs in proportion to the size of the surplus demonstrated by each long LSE. Even though the proposal would allow transfers from any long LSE to short LSEs, the workshop participants and commenting parties generally acknowledged that IOUs are likely to be long, and ESPs are more likely to be short. The IOUs propose the transfer payment mechanism as an interim measure for 2007.

Proponents of the transfer payment mechanism argue that it would provide an incentive for LSEs to procure their own local resources, thus encouraging bilateral contracting with entities that have local capacity to sell. They also argue that in the absence of the mechanism, long LSEs may be tempted to hold their long positions rather than engage in bilateral contracting.

A number of parties stand in opposition to the transfer payment mechanism. The Staff Report questioned why a long LSE would prefer to hold excess local capacity, and suggested that IOUs with Commission-approved procurement plans should carefully consider the "least-cost/best-fit" procurement principle before deciding to hold on to local capacity that is not needed to meet its own local procurement obligation, yet could be of value to a short LSE. The Staff Report also noted a staff concern that the transfer mechanism would create administrative burdens, and that the costs may exceed

the benefits. Staff would be required to review compliance filings to determine whether transfer payments are required, determine from and to whom payments are made, track payments, and follow up if transactions are not completed. Moreover, staff notes, it is possible that some of these functions may not be delegated to the staff.

We conclude that the proposed transfer mechanism should not be adopted as it would be administratively complex and burdensome for our staff to administer. We recognize the offer by PG&E to propose further detail on how the program might be carried out, but we are not persuaded that any such proposal could be developed and considered in the time remaining before Local RAR is implemented. Moreover, we are not persuaded that the proposal is either necessary or justified by policy considerations. For example, it is not at all clear that the mechanism would provide any better incentive for long and short LSEs to engage in bilateral contracting prior to making Local RAR compliance filings than would the prospect of a combination of backstop procurement costs and Commission-imposed penalties. In fact, it strikes us that it is just as likely that the mechanism would act to discourage such trading, since parties could passively await administrative allocations rather than engage in commercial transactions to meet their obligations.

AReM suggests that IOUs should be required to sell off any long capacity to other LSEs at reasonable prices. This requirement, AReM maintains, would prevent IOUS from using an administrative allocation to sell their excess local capacity. We will not adopt this proposed requirement. There may be reasons for a long LSE to hold on to capacity even though it does not need the capacity to meet its own local procurement obligations. However, while we do not mandate such sales, we join the staff in calling upon IOUs to carefully consider whether

holding on to capacity that is not needed for Local RAR is in line with the "least-cost/best-fit" procurement principle. IOUs may wish to hold Requests for Offers (RFOs) for System RAR capacity concurrently with RFOs for their excess Local RAR capacity so that they can better determine the "least cost/best fit" mix of RAR resources.

3.3.10 Enforcement and Penalties for Failure to Meet Obligations (Staff Report I. B. 9.)

The Staff Report recommends that the Local RAR program include a penalty regime to promote compliance on the part of LSEs. Staff reasons that without the prospect of paying penalties in addition to paying backstop procurement costs, LSEs could freely rely on CAISO contracting to meet their local procurement obligations. Under the staff proposal, penalties would apply when an LSE fails to make a required compliance filing that shows that the LSE has met its local procurement obligation unless a waiver has been granted. (We discuss waivers later in this decision.)

We concur with the reasoning put forward by the Staff Report, and hereby adopt the principle that a penalty regime is necessary for Local RAR. It is clear that penalties over and above backstop procurement costs are necessary to deter non-compliance with the Local RAR program. If LSEs were free to rely on CAISO backstop procurement and simply pay the CAISO for that procurement (through the Scheduling Coordinator), and nothing more, the Local RAR program could be rendered ineffectual to the extent that LSEs elect such a course of action. This is fully consistent with our earlier determination that a penalty regime is needed for System RAR:

> [A] regulatory program that imposes significant procurement obligations upon LSEs cannot be expected to succeed unless those LSEs have reason to believe there are consequences for

> noncompliance that outweigh the costs of compliance.
> (D.05-10-042, p. 93.)

Since a major purpose of the program is to move away from significant reliance on CAISO backstop procurement, we do not intend to pursue any action, or tolerate inaction, that condones or promotes continued reliance on backstop procurement when capacity can be purchased by LSEs. With the latter point in mind, we will allow an exception to our policy on penalties with respect to any local area for which LSEs have fully procured the local area need and, therefore, no backstop procurement by the CAISO (or supplemental procurement by LSEs in lieu of backstop procurement) is needed. Since, in this case, a deficient LSE did not cause backstop or supplemental LSE procurement to occur, no harm is done to the policy objective. We envision that this circumstance might arise when the deficient LSE had good cause to believe that the local area in question would be long due to the particular nature of the resources available there, and not be due to any "gamesmanship."

Some parties have taken the position that penalties for failure to demonstrate fulfillment of the local procurement obligation should be used to defray the cost of backstop procurement by the CAISO. As the Staff Report correctly explains, however, the statutes pursuant to which the Commission may impose penalties upon LSEs provide that the proceeds from such penalties accrue to the State's General Fund. Additionally, the CAISO's tariff provisions for billing deficient LSEs on whose behalf it must engage in backstop procurement are independent from the Commission's enforcement process. Moreover, as noted above, we have determined that penalties over and above backstop procurement costs that an LSE pays for being deficient are necessary to

achieve program goals. If we allowed penalties to be used to defray backstop procurement costs, we could undermine this effect.

Having determined that penalties are needed to assure that the Local RAR program goals are met, we turn to the elements of a penalty regime. D.05-10-042 adopted the broad policy that for System RAR, a penalty equal to 300% of the cost for new capacity (150% for 2006 only) is an appropriate sanction for an LSE's failure to acquire the capacity needed to meet its System RAR obligation. Several commenting parties have observed that penalties of that magnitude are unnecessary for purposes of the Local RAR program; some parties consider that level of penalty to be excessive.[13] We are inclined to agree. It is our judgment that a penalty equal to 100% of the cost of new capacity is an appropriate penalty for failure of an LSE to meet its local procurement obligation.

TURN has presented in its April 21 comments a persuasive analysis that allows us to provide greater definition to the establishment of penalty levels. As discussed below in connection with waivers, we are adopting TURN's proposal to establish a price of $40 per kw-year as a trigger for granting Local RAR waivers. That trigger price was derived by TURN from a settlement of the IEP Complaint (*see* Footnote 10). We find it to be a reasonable and appropriate measure of the cost of new capacity for purposes of the RAR penalty regime. We make this determination for both Local and System RAR penalties for consistency between the two RAR program components.

[13] Some parties have made the observation that a penalty of 300% of the cost of new capacity is more than is needed in connection with System RAR.

It is possible that an LSE is deficient with respect to both System and Local RAR, in which case penalties could accrue for both program elements. We clarify here that the penalties are not to be added; instead, the larger System RAR penalty would apply. In other words, if an LSE's deficiency would lead to a 300% penalty for System RAR and a 100% penalty for Local RAR, then the penalty would be 300%, not 400%.

Some parties have observed that additional clarification of the RAR compliance and penalty process is needed. The Staff Report stated agreement that more definition of the process is needed, and it discussed the possibility of developing a new Commission general order that would provide such definition. We agree such a general order is needed, and commend this proposal to Phase 2 of this proceeding. As staff point out, it will be important to establish rules so that LSEs and interested parties understand not only the penalties for being deficient, but also the consequences for other compliance failures on the part of LSEs, such as failure to make timely filings and submitting false information.

3.3.11 Market Power (Staff Report I. B. 10.)

A constant theme throughout the workshops in both this proceeding and in the predecessor RAR proceeding has been the substantial concern that generators within local, transmission-constrained areas will have market power. Much of the generation available within such an area will be necessary to maintain reliability and serve load. Market power mitigation in the wholesale market is the jurisdictional responsibility of the Federal Energy Regulatory Commission. However, since market power is an inherent factor affecting the Local RAR program, we need to be assured that the program does not exacerbate market power concerns even as we seek to encourage appropriate and

reasonable revenue adequacy to encourage needed investment in generation and transmission solutions.

AReM has suggested that we excuse LSE from any local procurement obligations unless several conditions are found to have been met. These include determinations that (1) sellers in the local area have no market power, (2) generation is available for purchase, (3) creditworthy counter-parties are available, and (4) generation rather than transmission upgrades is the cost-effective option.

We agree with AReM's concerns in part. For example, it would not be reasonable to require LSEs to procure generation in an area if generation is demonstrably not available to be purchased. Also, as noted earlier, we prefer that transmission solutions that are cost-effective be pursued and implemented. However, to the extent that AReM would have us make findings that each of its four pre-conditions is met for each local area before the Local RAR program is implemented, AReM's position is without merit. The answer to each of the concerns is to implement the program in a manner that sets reasonably achievable requirements for LSEs and excuses LSE from meeting demonstrably unreasonable requirements. We are satisfied that the program we adopt today does so.

With respect to market power specifically, it is important to recognize that this is an inherent factor to be dealt with through mitigation rather than inaction in the form of suspending Local RAR before it even starts. Mitigation is accomplished in several ways through our adopted program. First, we are not proposing to eliminate reliance upon CAISO backstop procurement altogether. We are instead attempting to foster LSE procurement in a way that reduces procurement by the CAISO as much as possible. As the Staff Report observes,

our continued, though presumably minimal, reliance on backstop procurement will have the effect of capping how much generators may expect to receive if they do not execute RAR contracts. The waiver trigger that we adopt in the following section is the means by which this market power mitigation is accomplished. Another mitigation measure that we adopt today is the aggregation of local areas within the PG&E service territory. We have also determined that LCRs determined by the CAISO should be adjusted to account for corresponding resource deficiencies identified by the CAISO, which should reduce the ability to exercise market power as well as address AReM's principle that procurement obligations should be attainable.

The Staff Report points out that the CAISO's Market Redesign and Tariff Update process will also yield market power mitigation. The report notes this would provide mitigation not only with respect to the exercise of market power in the CAISO markets, but it should also have a mitigating effect in the RAR bilateral contracting markets.

3.3.12 Waivers (Staff Report I. B. 11.)

Several parties requested that we allow waivers from the local procurement obligation under certain conditions. The staff report noted that without such a waiver option, LSEs that are unable to bilaterally contract for local capacity needed to meet their assigned obligation would be subject to both backstop procurement costs and potential penalties. Under a waiver process, the Staff Report suggests, an LSE would be able to request relief from the procurement obligation with a demonstration that it has made every commercially reasonable effort to contract for Local RAR resources. As proposed by the IOUs, a waiver request would have to demonstrate that the LSE actively

sought products and either received bids with prices in excess of their proposed administratively determined local attribute price or received no bids.

The Staff Report invited comment on the questions of establishing a process for requesting waivers and reviewing and acting upon those requests, including (1) whether up-front standards could be adopted such that the process could be administered through staff action and (2) whether waiver requests would be made and acted upon prior to the Local RAR compliance filing or at or after the time of the compliance filing.

We find that a waiver process is necessary as a market power mitigation measure, and should therefore be adopted as a component of the Local RAR program. After reviewing the extensive workshop comments, we find that TURN has presented a fair, balanced, and credible approach that we will therefore adopt. As noted earlier, TURN has calculated a capacity cost of $40 per kw-year using data from the settlement of the IEP complaint.[14] We intend that this price would function as a trigger for availability of a waiver, not as a price cap on what LSEs might be willing to pay. We recognize that there may be situations where an LSE might want to pay more. We note also that we are not adopting a monthly price trigger; specifically, we are not adopting a trigger price of one-twelfth of the yearly price trigger ($3.33 per kW-month), as we would not expect RAR prices to be uniform throughout the year. Finally, we emphasize that the waiver applies to Commission-imposed penalties only. A deficient LSE

[14] TURN derived the $40 per kW-year figure by subtracting from the $73 per kW-year capacity price adopted in the settlement a conservative estimate of Peak Energy Rent of $33 per kW-year.

would be responsible for any applicable backstop procurement costs even if it received a waiver from penalties.

The following process for waivers will be followed. An LSE requesting a waiver would make such request at the time it files its Local RAR compliance showing. The waiver request would include (1) a demonstration that the LSE fairly and in good faith solicited bids for its RAR capacity needs along with accompanying information about the terms and conditions of the Request for Offer, and (2) a demonstration that it either (a) received no bids or (b) received no bids under $40 per kW-year. We agree with the principle that the showing must demonstrate that the LSE actively pursued all commercially reasonable efforts to acquire the resources needed to meet the local procurement obligation.

We find that administration of the ministerial aspects of this process may be delegated to our staff. Since formal enforcement actions begin with staff recommendations to the Commission, staff will be in a position to consider a waiver request along with any other pertinent information in making recommendations to the Commission on whether to institute formal enforcement proceedings with respect to a deficient LSE. The Energy Division will advise the LSE whether the Commission has accepted the waiver or will pursue the matter further. We ask that the Energy Division report to the Executive Director on the number of waiver requests and the number of such requests that are granted, and that a copy of such report be furnished to the Commissioners and the ALJ.

4. Other Issues (Staff Report IV.)

The Staff Report invited parties to comment on issues not specifically addressed in the Staff Report, provided that such issues are within the scope of Phase 1. The CAISO and IEP responded to this invitation.

The CAISO proposes that consideration be given to the resource mix in load pockets. In particular, the CAISO maintains that having quick-start capable resources in transmission-constrained load pockets can help replenish the capacity and energy lost due to an unexpected loss of a generating unit or transmission facility. The CAISO encourages the inclusion of this topic as part of the dialogue in RAR and long-term procurement proceedings. We appreciate the CAISO's raising this topic insofar as it pertains to later phases of this proceeding and to future planning proceedings. We concur with DRA that this is not a Phase 1 topic.

IEP proposes development of a timeline showing in detail the timing of the CAISO's RMR process and the timing of the Local RAR process. As discussed above in Section 3.3.6, we agree that coordination of these processes is critical for orderly program implementation and to avoid under-or over-procurement by LSEs.

5. Clarification of Order Instituting Rulemaking

The OIR named as respondents to the proceeding all electric corporations, all registered ESPs, and any CCA that becomes registered during the course of this proceeding. It has come to the Commission's attention that, after the ESP registration list used to prepare the OIR was compiled, three ESPs requested cancellation of their registration. These are BP Energy Company (ESP #1366), Modesto Irrigation District (ESP #1151), and Quiet Energy (ESP #1368). By ruling dated January 23, 2006, the ALJ excused these ESPs from required participation in this proceeding and determined that any other ESP whose registration is cancelled during the course of the proceeding would, upon

confirmation of such cancellation by the Energy Division, be similarly excused from further participation. We hereby affirm that ruling.

The ALJ's January 23 ruling also announced that a recommendation would be made that the OIR be modified to provide for the removal of such entities as respondents to the proceeding, which recommendation was made in the draft decision on Local RAR issues. No purpose is served by requiring the participation of ESPs that have elected to discontinue their operations, as evidenced by their cancelled registration. This order provides for such modification of the OIR.

6. Comments on Draft Decision

On May 30, 2006, the draft decision was filed and served on parties in accordance with Pub. Util. Code § 311(g)(1) and Rule 77.7 of the Commission's Rules of Practice and Procedure. Comments were filed on _____, and replies were filed on _____.

7. Assignment of Proceeding

Michael R. Peevey is the Assigned Commissioner and Mark S. Wetzell is the assigned ALJ for this proceeding.

Findings of Fact

1. As the Commission has recognized in previous decisions, there is a need to better address local reliability issues through LSE procurement obligations.

2. The Commission has stated its intention to add a local procurement obligation to the overall RAR program to ensure that sufficient local generation capacity is contracted for and available to the CAISO to meet local reliability needs.

3. Delay in the implementation of the Local RAR program for another year could thwart long-term achievement of the RAR program goals.

4. If the transfer capability into a load pocket is less than the load demand within the area, then, depending on reliability criteria, additional generation capacity within the load pocket will be needed to satisfy the load demand.

5. Using an independent third party rather than the CAISO to perform the 2007 LCR study was not feasible in light of the Commission's objective to implement Local RAR for 2007.

6. The CAISO has determined that, compared to Reliability Option 2 (NERC Category C), the lower level of capacity requirements associated with Reliability Option 1 (NERC Category B) would, in the event of a loss of a single transmission element (N-1), likely require substantial load interruptions in order to maintain system continuity and alleviate equipment overloads, including load interruptions prior to the actual occurrence of the second contingency.

7. For 2007, the totals of the LCRs for the nine local transmission-constrained areas identified by the CAISO are 22,649 MW and 23,857 MW under Options 1 and 2, respectively, a difference of about 5%.

8. Compared to a less stringent 1-in-5 year summer peak load forecast, a 1-in-10 year forecast as used in the CAISO's study is 2.4% greater for the nine local transmission–constrained areas studied by the CAISO.

9. As a rule of thumb, using a less stringent 1-in-5 forecast would result in a corresponding one-for-one reduction in the LCR for a local area.

10. A complete listing of qualifying resources, including the ownership and capacity information, is crucial information for the LSEs who will be obligated to purchase qualifying capacity.

11. SCE has confirmed that the South of Lugo path limit will be increased from 5,600 MW to 6,100 MW by June 1, 2007, which results in a reduction of the LA Basin Area LCR for 2007.

12. A transparent process for interested parties to learn about proposed operational solutions and verify that such solutions are superior to the option of adding generation would be beneficial to parties.

13. Determining the feasibility of operating solutions is within the province of the CAISO and its PTOs.

14. The CAISO's LCR study takes into account energy imported into the load pockets, and it identifies the capacity requirement that allows the energy to be imported while maintaining grid reliability.

15. Because the Commission seeks reasonable assurance that the local procurement obligations that it establishes are based on up-to-date information about the transmission grid and its operational characteristics, an annual determination of LCRs through a process that allows meaningful party participation is appropriate.

16. While a fixed definition of local areas may promote long-term transactions, the transmission system is continually evolving, and transmission constraints are not necessarily fixed over time.

17. Procurement obligations that are based upon stale information could lead to wasteful over-procurement or under-procurement that could degrade reliability.

18. A probabilistic rather than a deterministic approach to determining local capacity requirements could lead to more economically efficient decisions regarding the capacity that is needed at any particular location.

19. Compared to identifying which load is located in each particular local load pocket, assigning Local RAR obligations by proportion of load served in existing IOU distribution service areas would provide administrative simplicity.

20. Transactions of less than 1 MW are not commercially reasonable at this time.

21. Even if the problem of IOUs withholding capacity exists or arises, subtracting IOU generation from LCRs may not be the most effective solution to such problem.

22. LSEs need adequate time to meet their procurement obligations once those obligations are known, and we intend to preserve as nearly as possible the three-month interval between official notification of the obligation and the compliance filing date.

23. Market power issues can arise when procurement obligations are established for small local areas, and aggregation of such areas for the purpose of establishing local procurement obligations can mitigate market power; however, aggregation of local areas could possibly lead to over-procurement in some areas and under-procurement (with CAISO backstop procurement required) in others.

24. Compared to the IOU proposal for aggregation, the Energy Division aggregation proposal could be more effective in mitigating the exercise of market power, and would be administratively less complex; however, it could also lead to greater backstop procurement by the CAISO.

25. Even if all LSEs procure their full allocation of Local RAR, they will not necessarily have procured all of the resources necessary to meet the reliability needs of a particular local load pocket.

26. Whether a local area will be deficient can only be determined after the CAISO has analyzed the effectiveness factors of all of the units actually procured to meet the Local RAR in a local load pocket.

27. The CAISO needs to be able to prepare for any necessary backstop procurement after the LSEs have made all of their procurement demonstrations,

and it must have sufficient time to review any additional procurement demonstrations and determine if backstop or "supplemental procurement" is required.

28. A year-long local procurement obligation should help to provide assurance of revenue adequacy to those units that are most needed to ensure the reliability of the CAISO grid, and encourage longer-term procurement.

29. Unlike System RAR, the Local RAR program entails an iterative process in which the CAISO evaluates nominated local resources and identifies deficiencies requiring either supplemental LSE or backstop CAISO procurement.

30. The CAISO's local reliability needs are not limited to the five summer months.

31. A 90% and/or a five-month local procurement obligation and deferral of implementation of Local RAR by five months may not promote Local RAR objectives.

32. The ability of LSEs to buy and sell portions of resource commitments as load changes, provided such trades take place in a manner that preserves the availability of the underlying resource to the CAISO, should resolve the LSEs' concerns about the impact of load migration.

33. While it is the long-term policy preference of the Commission to minimize the use of RMR contracts, the Commission has agreed that RMR should remain in place for 2007.

34. The timing issue that could preclude RMR units from being eligible to count towards either Local RAR or System RAR demonstrations for 2007 can be resolved by adjustments to the RAR compliance filing schedule for 2007.

35. Allowing Condition 1 and Condition 2 RMR contracts to count for 2007 is consistent with the settlement of the IEP Complaint, gives recognition to the fact

that the shift from predominant reliance on RMR to predominant reliance on LSE procurement will require a transition period, and could prevent unnecessary and costly over-procurement to meet the reliability needs of local areas.

36. It may not be possible to count dispatchable demand response resources until 2008 with respect to the SCE territory.

37. Allowing generating units that are not located within the boundaries of a local area to contribute toward meeting that local area's LCR, if such units meet a minimum effectiveness factor, might reduce the burden of local procurement obligations; however, this would be difficult to administer because each generator would have multiple effectiveness factors depending on the reliability of the system, the transmission contingency that needs to be addressed, and which other units are available to the CAISO.

38. Fixing local area boundaries, and, therefore the generation units within the boundaries that can satisfy the Local RAR, would greatly simplify the administration of the Local RAR program.

39. The adopted Local RAR plan is based upon the expectation that if the local capacity made available to the CAISO by Commission-jurisdictional LSEs in Local RAR compliance filings and by RMR contracts meets or exceeds the Commission-adopted Local RAR level, the CAISO would not engage in backstop procurement even if one or more individual LSEs is deficient in its showing; provided, however, that the CAISO may need to engage in additional backstop procurement if an assessment of unit effectiveness for the capacity procured by LSEs discloses that additional procurement is required.

40. We are establishing locally based procurement obligations that are applicable to the IOUs, ESPs, and CCAs under our jurisdiction, not POUs.

41. Ministerial review of Local RAR filings will be delegated to the staff and will include a determination of whether each LSE has met its procurement obligation and is otherwise in compliance with RAR program requirements.

42. Under the transfer payment mechanism proposed by the IOUs, staff would be required to review compliance filings to determine whether transfer payments are required, determine from and to whom payments are made, track payments, and follow up if transactions are not completed.

43. The proposed transfer mechanism could act to discourage bilateral contracting since LSEs could passively await administrative allocations rather than engage in commercial transactions to meet their obligations.

44. Without the prospect of paying penalties in addition to paying backstop procurement costs, LSEs could freely rely on CAISO contracting to meet their local procurement obligations.

45. If, in the aggregate, LSEs have fully procured a local area, any LSE that is deficient with respect to that local area will not have caused backstop or supplemental LSE procurement to occur, and will not have caused harm to the policy objective to minimize backstop procurement.

46. The statutes pursuant to which the Commission may impose penalties upon LSEs provide that the proceeds from such penalties accrue to the State's General Fund.

47. The CAISO's tariff provisions for billing deficient LSEs on whose behalf it must engage in backstop procurement are independent from the Commission's enforcement process.

48. Because much of the generation available within local, transmission-constrained areas will be necessary to maintain reliability and serve load,

generator market power may be an inherent factor affecting the Local RAR program.

49. Market power mitigation is addressed in the adopted Local RAR program by (a) minimizing but not eliminating backstop procurement by the CAISO through the use of waivers, (b) aggregating local areas within the PG&E service territory, and (c) adjusting LCRs determined by the CAISO to account for corresponding resource deficiencies identified by the CAISO.

50. Without a waiver option, LSEs that are unable to bilaterally contract for local capacity needed to meet their assigned obligation would, despite good faith efforts to acquire such capacity, be subject to both backstop procurement costs and potential penalties.

51. No purpose is served by requiring the participation in this proceeding of ESPs that have elected to discontinue their operations, as evidenced by their cancelled ESP registration.

Conclusions of Law

1. It is reasonable to implement Local RAR for 2007 using the Phase 1 record.

2. Parties had an adequate opportunity to participate in the CAISO's post-LCR study workshop, to submit comments and replies on the study, and to make their substantive concerns about the study known to the Commission.

3. It is reasonable to rely on the CAISO to perform the 2007 LCR study and to use the CAISO's study results as the basis for implementing Local RAR for the 2007 compliance period.

4. For 2007, the required procurement of an additional 5% of needed capacity under Option 2, compared to Option 1, is reasonable in light of the reduced risk of interruptions expected under Option 2.

5. For purposes of establishing Local RAR for 2007 only, a 1-in-10 load forecasts should be used to calculate LCRs.

6. The total LCRs calculated by the CAISO should be allocated to jurisdictional LSEs on the most accurate basis possible.

7. The CAISO and the PTOs should be encouraged to continue their efforts to identify and implement cost-effective transmission-related solutions.

8. The objective of consistency in LCR study methodology and approach should not prevent needed study improvements from being considered.

9. Future LCR determinations should reflect, as nearly in time as possible, the then-current state of the transmission system.

10. The CAISO's LCR study did not inappropriately excluded the CCSF Hetch Hetchy resource.

11. It would not be reasonable to require LSEs to procure capacity that, according to the LCR study, does not currently exist in an area.

12. An LSE's Local RAR obligations should be a percentage of the total Local RAR adopted by the Commission based on that LSE's forecasted peak load in the applicable IOU distribution service area; the adopted formula for determining the local procurement obligation for an LSE is as follows:

> [LSE IOU service area RAR/Total IOU service area RAR] *
> Total Jurisdictional Local RAR in IOU service territory = LSE
> Local RAR

13. LSEs should be exempted from procurement obligations of less than 1 MW in a local area, and RARs of 0.5 and greater should be rounded up to the next highest MW and RARs of .49 and lower should be rounded down to the prior MW.

14. Energy Division should be authorized to perform the calculations necessary to establish local procurement obligations for individual LSEs employing the policies and procedures adopted herein.

15. The Energy Division's aggregation proposal in combination with TURN's proposal to limit Greater Bay Area procurement to 50% appropriately balances concerns about backstop procurement, administrative complexity, and market power mitigation, and should therefore be adopted.

16. LSEs should be required to make annual compliance filings demonstrating that they have met 100% of the applicable local procurement obligation for each month of the following calendar year (January through December) concurrently with the LSE's "year-ahead" compliance filing for System RAR.

17. Resources that count towards meeting Local RAR should also count towards meeting System RAR.

18. There is no reason to prohibit the sale of qualifying Local RAR capacity that was nominated in fulfillment of an LSE's local procurement obligation provided that the capacity remains fully available to the CAISO under the same terms and conditions, for the same periods, and in the same local area for which the capacity was nominated in fulfillment of the local obligation when the selling LSE made its compliance showing.

19. RMR units should be allowed to count for Local as well as System RAR for 2007, and the RAR filing schedule for 2007 should be adjusted as necessary to coordinate the RAR and RMR processes.

20. Qualifying, dispatchable demand response resources as well as DG resources should be allowed to count for Local RAR showings for 2007 to the extent feasible.

21. Staff's recommendation to disregard effectiveness factors for the 2007 Local RAR program should be adopted due to concerns about undue program complexity.

22. LSEs should be given first opportunity to engage in additional procurement rather than have no choice but to rely on CAISO backstop procurement.

23. The IOUs' proposed transfer mechanism should not be adopted as it would be administratively complex and burdensome for our staff to administer, and it may not promote bilateral trading.

24. An LSE should be subject to penalties when it fails to make a required compliance filing that shows that it has met its local procurement obligation; however, a penalty for being deficient may be waived if (a) a waiver has been granted or (b) with respect to any local area, LSEs have fully procured the local area need such that no backstop procurement by the CAISO (or supplemental procurement by LSEs in lieu of backstop procurement) is needed.

25. A penalty equal to 100% of the cost of new capacity is an appropriate penalty for failure of an LSE to meet its local procurement obligation.

26. A price of $40 per kW-year is a reasonable and appropriate measure of the cost of new capacity for purposes of both Local and System RAR penalties.

27. A waiver process is necessary as a market power mitigation measure, and should therefore be adopted as a component of the Local RAR program.

28. An LSE should be able to request relief from penalties for failure to meet its local procurement obligation with a demonstration that it has made every commercially reasonable, good faith effort to contract for Local RAR resources and that it either received only bids with prices in excess of $40 per kW-year or received no bids; however, such a deficient LSE would be responsible for any

applicable backstop procurement costs even if it received a waiver from penalties.

29. The OIR should be modified to provide that any respondent ESP or CCA whose registration is cancelled during the course of the proceeding would, upon confirmation of such cancellation by the Energy Division, cease to be a respondent and be excused from further participation.

30. The Energy Division should be authorized and directed to do the following:

a. Notify LSEs of reduced local procurement obligations for 2007, if any, that reflect any LCR reductions from the 2007 LCR study that are determined by the CAISO to be warranted.

b. Calculate and establish reduced LCRs for those areas for which the CAISO has identified a deficiency in qualifying capacity resources.

c. Make appropriate revisions to the current compliance filing templates and filing guide as necessary for orderly program implementation.

O R D E R

IT IS ORDERED that:

1. The Local Resource Adequacy Requirements (Local RAR) program is hereby established and shall be implemented in accordance with the foregoing discussion, findings of fact, and conclusions of law.

2. The following load-serving entities (LSEs) are subject to the requirements of the Local RAR program adopted herein and shall comply with all decisions, rulings, and directives pertaining to the program:

a. Pacific Gas and Electric Company (PG&E), San Diego Gas & Electric Company (SDG&E), and Southern California Edison Company (SCE) (collectively, investor-owned utilities or IOUS); and

b. Electric service providers (ESPs) and community choice aggregators (CCAs) that serve retail customers within the service territory of one or more of the IOUs through direct access or CCA transactions.

3. The "Option 2" Local Capacity Requirements (LCRs) set forth in the California Independent System Operator's (CAISO) corrected LCR study for 2007, dated April 28, 2006, are adopted as the basis for establishing Local RAR procurement obligations for LSEs, subject to the following:

a. The Energy Division may calculate and establish reduced local procurement obligations, if any, that may result from the supplemental LCR Study review process described in the foregoing opinion and as agreed to by the CAISO; and

b. The Energy Division may calculate and establish reduced local procurement obligations, if any, that may result from adjustments for resource deficiencies in particular local areas, as described in the foregoing opinion.

4. The Executive Director shall ensure that Commission staff undertakes the activities identified for staff in the foregoing discussion, findings, and conclusions.

5. Appendix A of the December 15, 2005 order instituting this proceeding is modified as follows:

a. At page 5 of Appendix A, at the end of the one-sentence paragraph that begins with "In addition, any electric service provider…" and ends with "…to this proceeding," the following sentence is added: "Any registered electric service provider whose registration is cancelled during the course of

this proceeding shall, upon confirmation of the cancellation by the Energy Division, cease to be a respondent."

b. At page 5 of Appendix A, at the end of the one-sentence paragraph that begins with "Any community choice aggregator…" and ends with "…to this proceeding," the following sentence is added: "Any registered community choice aggregator whose registration is cancelled during the course of this proceeding shall, upon confirmation of the cancellation by the Energy Division, cease to be a respondent."

6. This proceeding remains open for consideration of issues listed in the Scoping Memo that are not resolved by today's order.

This order is effective today.

Dated _____, at San Francisco, California.