UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

OPINION NO. 479

City of Vernon, California	Docket Nos. EL00-105-007
California Independent System Operator Corporation	ER00-2019-007

OPINION AND ORDER AFFIRMING INITIAL DECISION AS MODIFIED

Issued: April 19, 2005

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APPEARANCES

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Before Commissioners: Pat Wood, III, Chairman;
Nora Mead Brownell, Joseph T. Kelliher,
and Suedeen G. Kelly.

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OPINION NO. 479

OPINION AND ORDER AFFIRMING INITIAL DECISION AS MODIFIED

(Issued April 19, 2005)

1. This case is before the Commission on exceptions to the December 29, 2004 Initial Decision issued in this proceeding.[1] This proceeding will determine the appropriate base Transmission Revenue Requirement (TRR) for the City of Vernon, California (Vernon), a New Participating Transmission Owner in the California Independent System Operator Corporation (ISO or CAISO). Vernon is reimbursed for its TRR by the CAISO through the CAISO's collection of a Transmission Access Charge (TAC) from all users of the CAISO grid. The TAC rate is a formula rate based on the TRRs of all Participating Transmission Owners.[2] In this order, the Commission affirms the result of the Initial Decision on the issue of the appropriate standard of review for Vernon's TRR, but employs different reasoning. With respect to the remaining issues, we affirm the Initial Decision in its entirety, with discussion on (1) the determination of the date on which the CAISO took Operational Control over the facilities in question; and (2) Vernon's rate of return.

[1] *City of Vernon, California*, 109 FERC ¶ 63,057 (2004) (Initial Decision).

[2] *See California Independent System Operator Corp.*, Opinion No. 478, 109 FERC ¶ 61,301 (2004).

2. This order benefits customers by ensuring that just and reasonable rates will be charged by the CAISO.

Background

3. On August 30, 2000, Vernon filed a petition for declaratory order requesting that the Commission determine that its TRR was acceptable for the purpose of becoming a Participating Transmission Owner in CAISO.[3] Vernon proposed an annual TRR of $13,080,189. The Commission found, in an order issued on October 27, 2000, that Vernon's proposed rate methodology and resulting high voltage TRR were just and reasonable subject to certain modifications.[4]

4. Vernon then re-filed its TRR on November 9, 2000, incorporating the Commission's required modifications. On March 28, 2001, the Commission accepted the November 9, 2000 Filing and the modified TRR of $10,216,178 as consistent with the methodology previously approved by the Commission.[5]

5. Pacific Gas and Electric Company (PG&E) appealed the Commission's orders to the United States Court of Appeals for the District of Columbia Circuit (D.C. Circuit). On October 15, 2002, the D.C. Circuit remanded to the Commission the question of whether the review conducted by the Commission of the TRR of a non-jurisdictional entity – Vernon – which is a part of the rate of a jurisdictional independent system operator – CAISO – was sufficient to ensure that the CAISO's rates will be just and reasonable under section 205 of the FPA.[6]

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[3] Because Vernon is a municipality not subject to the Commission's jurisdiction under the Federal Power Act (FPA), its submission was voluntary, pursuant to a modification of the CAISO Tariff directed by the Commission. *California Independent System Operator Corp.*, 93 FERC ¶ 61,104 (2000).

[4] *City of Vernon, California*, 93 FERC ¶ 61,103 (2000) (October 2000 Order), *order on reh'g, California Independent System Operator Corp.*, 94 FERC ¶ 61,148 (2001).

[5] *City of Vernon, California*, 94 FERC ¶ 61,344, *order on reh'g*, 95 FERC ¶ 61,274 (2001).

[6] *Pacific Gas & Electric Co. v. FERC*, 306 F.3d 1112 (D.C. Cir. 2002) (*PG&E*).

6. On December 23, 2003, the Commission initiated settlement procedures in response to the Vernon remand.[7] The Commission also consolidated the Vernon proceeding with the petition of four other southern California Cities[8], finding that the dockets raised similar issues.[9] Vernon filed a petition for rehearing of the consolidation order, requesting that the Commission provide further explanation of its previous approval of Vernon's TRR (prior to settlement procedures).

7. On May 6, 2003, Vernon, PG&E, Southern California Edison Company (SoCal Edison), and San Diego Gas & Electric Company jointly filed a motion to terminate the settlement proceedings in the consolidated dockets. Vernon asserted that progress in settlement negotiations could not be made absent the Commission's providing further guidance. On May 20, 2003, the Chief Administrative Law Judge temporarily suspended negotiations with respect to Vernon until such time as the Commission issued an order on the merits of Vernon's request for rehearing and clarification.

8. On February 17, 2004, the Commission denied Vernon's request for rehearing and set Vernon's TRR for hearing.[10] On February 23, 2004, the Chief Judge issued an order severing Vernon from the Southern Cities' ongoing settlement proceedings in Docket Nos. EL03-15-000, *et al.*, and designating a presiding judge.

9. The hearing was held from September 21-27, 2004. Initial briefs were submitted on October 25, 2004 and reply briefs on November 22, 2004. Initial briefs were filed by: Vernon, SoCal Edison, PG&E, the Cities of Redding and Santa Clara, California and the M-S-R Public Power Agency (collectively Cities/M-S-R), the Transmission Agency of Northern California (TANC), the CAISO, the Cities of Anaheim, Azusa, Banning, Colton and Riverside, California (Southern Cities), and Commission Trial Staff (Trial Staff). Reply briefs were filed by Vernon, SoCal Edison, PG&E, Cities/M-S-R, TANC, CAISO, the Southern Cities, the California Department of Water Resources State Water Project (SWP), and Trial Staff.

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[7] *City of Vernon, California*, 101 FERC ¶ 61,353 (2002) (Remand Order).

[8] These are the Cities of Anaheim, Azusa, Banning, and Riverside, California.

[9] *City of Azuza, California*, 101 FERC ¶ 61,352 (2002). The four other cities had filed petitions requesting a determination on their TRRs.

[10] *City of Azuza, California*, 106 FERC ¶ 61,143 (2004) (February 2004 Order).

10. As referred to above, on December 29, 2004, the presiding judge issued the Initial Decision at issue here. The Initial Decision held that: (1) Vernon's TRR should be subject to a section 205 like review, in order to ensure that its inclusion in the TAC results in just and reasonable TAC rates; (2) the Mead-Adelanto Project (MAP) and Mead Phoenix Project (MPP) should be included in Vernon's TRR as of January 1, 2003, the date on which the CAISO assumed operational control of those facilities; (3) Vernon is not entitled to increase its asset accounts for Allowance of Funds Used During Construction (AFUDC); (4) the California-Oregon Transmission Project (COTP) facility entitlement must be depreciated beginning in March, 1993; and (5) Vernon's overall rate of return should be 9.29 percent.

11. Briefs on exceptions were filed by Vernon, SoCal Edison, the Southern Cities and TANC.[11] Vernon, SoCal Edison and Trial Staff filed briefs opposing exceptions.

12. Having fully evaluated the Initial Decision, the parties' briefs, and the record before us, the Commission summarily affirms the Initial Decision's findings that: (1) Vernon is not entitled to increase its asset accounts for AFUDC; and (2) the COTP entitlement must be depreciated beginning in March 1993. We find that the Initial Decision properly decided these issues and the arguments on exceptions have failed to persuade us that the Initial Decision erred or that additional discussion is necessary.

Discussion

I. Standard of Review

A. The Court's Remand

13. The Commission's previous review of Vernon's TAC in the TAC Order and the Rehearing Order was reversed by the Court Of Appeals. In its decision, the court first determined that "Vernon's TRR need not be independently subjected to the just and reasonable standard of [section] 205" of the FPA, as the petitioner had contended.[12] In reaching this conclusion, the court was guided by the fact that "[t]he CAISO's TAC

[11] PG&E and Cities/M-S-R filed briefs that incorporated by reference arguments and positions taken by other parties.

[12] *PG&E*, 306 F.3d at 1113.

methodology is a formula rate through which the TRR of each participating transmission owner is collected."[13] Thus, the court reasoned, a participating transmission owner's TRR is a *cost* of the CAISO, rather than its own *rate*. As the court went on to explain,

> [w]hile FERC does subject the TRRs of jurisdictional participating transmission owners to an independent § 205 just and reasonable review, FERC may take a different approach as to Vernon, over which FERC lacks independent jurisdiction, so long as FERC can ensure by examining Vernon's TRR that the CAISO's rates will ultimately be just and reasonable.[[14]]

14. Nonetheless, the court observed, "FERC may analyze and consider the rates of non-jurisdictional utilities to the extent that those rates affect jurisdictional transactions."[15] In this case, the opinion emphasized, there was no question that the Commission was not barred from reviewing Vernon's TRR "to the extent necessary to ensure that the CAISO's rates are just and reasonable."[16]

15. The court went on to determine that, in approving Vernon's TRR, the Commission had failed to ensure that the CAISO's rates would be just and reasonable under section 205. The specific deficiency stemmed, the court concluded, from the Commission's failure to enunciate the standard by means of which it had "reviewed Vernon's TRR to ensure that a pass through of its costs by the by the CAISO would be just and reasonable."[17]

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[13] *Id.* at 1116.

[14] *Id.*

[15] *Id.* at 1114, *citing Public Utilities Commission v. FERC*, 660 F.2d 821, 826 (D.C. Cir. 1981); *South Carolina Public Service Authority*, 75 FERC ¶ 61,209 at 61,696 & n.7 (1996).

[16] *Id.* at 1117

[17] *Id.*

16. Thus, the court remanded the matter to the Commission for further proceedings. In doing so, however, the court emphasized that it was

> not unmindful of the complexities underlying Order No. 2000 and FERC's regional approach, and that FERC may wish to retain flexibility regarding the nature of its review of the TRRs of individual non-jurisdictional entities. . . . Nevertheless, while FERC has discretion in formulating its approach with respect to a nonjurisdictional entity, the choice it makes must ensure that the CAISO's rates meet the just and reasonable standard of [section] 205.[[18]]

17. In our February 2004 Order, therefore, we established hearing procedures "to explore the appropriate TRR for Vernon that will ensure that the CAISO's rates after the inclusion of Vernon's TRR are just and reasonable."[19]

B. The Initial Decision

18. In the Initial Decision, the presiding judge saw the central question with respect to this issue as "what method should be used to review Vernon's TRR to ensure that the resulting TAC rate is just and reasonable after the inclusion of Vernon's TRR?"[20]

19. The judge agreed with TANC that a "strict section 205 review" of Vernon's TRR was not appropriate, as the court had "already rejected that approach."[21] However, she disposed of TANC's proposal that the deference and comparability standard employed by the Commission in Order No. 888[22] should be employed in reviewing whether a

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[18] *Id.* at 1121 (citations omitted).

[19] February 2004 Order, 106 FERC ¶ 61,143 at P 20.

[20] Initial Decision, 109 FERC ¶ 63,057 at P 23.

[21] *Id.* at P 24.

[22] *Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, Order No. 888, FERC Stats. & Regs. ¶ 31,036 (1991-1996), 61 Fed. Regs. 21540 (1996) (hereinafter "Order 888"), *on reh'g*, Order 888-A, FERC Stats. & Regs. ¶ 31,048, 62 Fed. Regs. 12274 (1997) (hereinafter "Order 888-A"), *order on reh'g*, Order No. 888-B, 81 FERC ¶ 61, 248 (1997), *order on reh'g*, Order No. 888-C, 82 FERC ¶ 61,046 (1998), *aff'd in relevant part sub nom., Transmission Access Policy*

(continued)

Participating Transmission Owner's TRR should be recovered in the CAISO's TAC as "neither appropriate nor workable:"

> Order 888 is clearly distinguishable from this case. First, Order 888 does not involve a non-jurisdictional rate being passed through to a jurisdictional one. Second, the Commission in Order 888 provided deference to state Commission recommendations regarding certain transmission/local distribution matters that arise when retail wheeling occurs only if state regulators evaluated using seven technical factors adopted by this Commission. Order 888 at 31,784. In this case the Commission has not adopted such technical factors.[[23]]

20. The judge went on to emphasize that "Vernon is not situated in the same position as a state commission."[24] For this reason, she rejected Vernon's assertion that because the Vernon City Council is a ratemaking body analogous to the Commission, the Commission could not adopt a review standard more stringent than that mandated by the California Code of Civil Procedure. Rather than a neutral ratemaking body, the judge explained, the Vernon City Council "has a vested interest in the outcome of the TRR setting process."[25] As Vernon itself acknowledged, its goal was to set rates competitive with SoCal Edison's, in order to retain or attract industrial customers, so that "nothing that the Vernon City Council does with respect to setting rates is done with the CAISO ratepayers' interests in mind."[26] The judge was also influenced, in this regard, by what she termed the "very little time" spent by the Vernon City Council on the proposed TRR.[27]

21. The Initial Decision next evaluated and found wanting Vernon's position that the Commission cannot review individual components of the TRR, but only the TRR's

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Study Group v. FERC, 225 F.3d 667 (D.C. Cir. 2000), *aff'd sub nom.*, *New York v. FERC*, 535 U.S. 1 (2002).

[23] Initial Decision, 109 FERC ¶ 63,057 at P 24.

[24] *Id.*

[25] *Id.* at P 25.

[26] *Id.*, *citing* Exh. VER-7 at 32.

[27] *Id.* at P 27.

aggregate level. Rather, the judge reasoned, "[i]t is only by reviewing the individual cost elements of Vernon's TRR that determinations can be made as to the ultimate issue in this case," a procedure the court had endorsed in *PG&E*.[28]

22. The judge concluded that the court's opinion as well as the record developed before her supported employing "a [s]ection 205 like review of Vernon's costs . . . to determine whether the inclusion of Vernon's TRR will result in a just and reasonable TAC rate."[29] To meet the standard required by the court, she reasoned, a "level of review . . . ensures that there is substantial evidence to support the Commission's findings" with respect to the TRR was necessary.[30]

23. The Initial Decision then enunciated the standard that should be applied to reviewing the TRR of a non-jurisdictional entity:

> In conformance with the policies enunciated by the Commission promoting RTO participation, and as a matter of comity, it is found that some deference should be given to Vernon. This deference relates to the fact that the non-jurisdictional entity need not comply with the requirements of section 35.13 (rate filings) in its TRR filing. 18 C.F.R. §35.13 [2004]. The level of deference, however, will depend entirely on the facts and record evidence presented in each case.[[31]]

24. In this case, the judge explained, close scrutiny was warranted because the Vernon City Council spent little time setting the TRR, and did so solely for purposes of the CAISO rate, separate from determining the retail rates for its ratepayers. Thus, she concluded,

> each element of Vernon's TRR must be closely scrutinized using a method approximating a section 205 review in order to determine whether or not

[28] *Id.* at 26, *citing PG&E*, 306 F.3d at 1120.

[29] *Id.*

[30] *Id.*

[31] *Id.* at P 28.

> inclusion of Vernon's TRR in the TAC rate will result in just and reasonable TAC rate.[[32]]

C. <u>Briefs on Exceptions</u>

25. Vernon and TANC take exception to this portion of the Initial Decision. Vernon initially complains that it "would apply a '[s]ection 205 like' standard" without articulating a definition for such a standard.[33] Vernon sets out its own preferred standard in these terms:

> The proper standard of review for the Commission to apply to Vernon's TRR, or any nonjurisdictional [Participating Transmission Owner's] TRR, is (1) whether the Vernon City Council's determinations were arbitrary and capricious and not based upon substantial evidence, and (2) whether substantial evidence in fact demonstrates that the ISO's rates will be just and reasonable after the inclusion of Vernon's TRR.[[34]]

26. Vernon contends that the Initial Decision's approach, essentially subjecting Vernon to a section 205 review, is beyond the Commission's FPA authority because Vernon is a nonjurisdictional entity. Vernon maintains that its position was endorsed by the court in *PG&E* as in keeping with judicial precedent,[35] and recognized by the Commission.[36] Vernon further asserts that the California Code of Civil Procedure provides a review standard in keeping with these precedents, *i.e.*, that deference should be given to the state ratesetting body unless its decision is arbitrary and capricious.

27. According to Vernon, the presiding judge's failure to accord the City Council appropriate deference runs afoul of the undisputed fact that the Council "set the Vernon

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[32] *Id.* at P 29.

[33] Vernon Brief on Exceptions at 13.

[34] *Id.*

[35] *Id.* at 18-19, *citing PG&E*, 306 F.3d at 1117; *FPC v. Texaco, Inc.*, 417 U.S. 380 (1974); *Environmental Action v. FERC*, 996 F.2d 401, 408 (D.C. Cir. 1993).

[36] *Id.* at 16-17 & n.35, *citing California Independent System Operator Corp.*, 104 FERC ¶ 61,062 at P 22 (2003) (*2003 CAISO Order*). In this regard, Vernon also relies on representations made in the Commission's brief to the court in *PG&E*.

TRR in full compliance with applicable state law."[37] Vernon argues that the judge's concern about the alleged lack of time spent by the City Council on the TRR is unsubstantiated, and in any event unreasonably intrudes into the municipal ratemaking process. Vernon also takes issue with the judge's concern that the TRR was set independent of retail rates. Nothing in judicial or Commission precedent, Vernon contends, "hint that Vernon's TRR must be established in connection with retail rates," or, if not, that they "are to be subject to a different, more intense standard of review."[38]

28. Vernon argues that its proposed TRR should have been upheld by the presiding judge based on its evidence that its facilities are equivalent to parallel SoCal Edison facilities, and that SoCal Edison's TRR on those facilities would be higher than Vernon's proposed TRR. This evidence is sufficient to prove, Vernon maintains, that the CAISO's rates after inclusion of the Vernon TRR will be just and reasonable.

29. TANC also argues that the Initial Decision's review of Vernon's TRR unnecessarily intrudes on the jurisdiction of local regulatory authorities. More specifically, TANC believes that the presiding judge erred in rejecting its proposed standard for review of nonjurisdictional TRRs based on "a framework similar" to the Commission's comparability standard for nonjurisdictional rates established by Order No. 888.[39]

30. TANC next attacks the judge's tying of deference to the local regulatory authority to excusing Vernon's compliance with section 35.13 of the Commission's regulations. Rather, TANC asserts, "[t]he principal reason deference should be granted is that the Commission does not have [s]ection 205 authority to establish or to revise non-jurisdictional entities' rates."[40]

31. Turning to the standard established by the Initial Decision for review of nonjurisdictional TRRs, TANC complains that the judge failed to properly define the applicable criteria to determine whether deference is warranted. In this regard, TANC claims, an appropriate standard of review must allow "the local regulatory authority a reasonable opportunity to consider all of the facts and legal arguments in determining"

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[37] *Id.* at 22.

[38] *Id.* at 24.

[39] TANC Brief on Exceptions at 16-18.

[40] *Id.* at 22.

the rate for a nonjurisdictional TRR.[41] TANC further maintains that judge's granting of deference when a municipal utility's TRR is developed solely for CAISO purposes should only apply to the initial TRR of such an entity. Finally, TANC objects to the judge's view that deference will be accorded "when the local rate-setting process is acceptable to the Commission."[42] Rather, TANC believes, "the Commission should simply ensure that the local regulatory authority has met its obligation to undertake a proper rate-setting process."[43]

32. TANC further objects to the presiding judge's "close scrutiny" of Vernon's proposed TRR, on the ground that it exceeds the Commission's statutory authority by indirectly regulating nonjurisdictional rates, which it cannot regulate directly.[44] Rather, according to TANC, if for some reason deference to the local regulatory authority is not warranted, the Commission should return the proposed TRR to that authority "for further review, and if necessary, revision by the local regulatory authority."[45]

33. Briefs opposing the exceptions by Vernon and TANC were filed by PG&E, SoCal Edison and Staff. Additionally, Vernon opposed TANC's proposed standard of review on the grounds that it could not be implemented on this record and was inappropriate for Vernon.[46]

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[41] *Id.* at 24.

[42] *Id.* at 26.

[43] *Id.*

[44] *Id.* at 29 & n.61, *citing Sunray Mid-Continental Co. v. FPC*, 364 U.S. 137, 142 (1960) (*Sunray*); *National Fuel Gas Supply Corp. v. FERC*, 909 F.2d 1519 (D.C. Cir. 1990); *Richmond Power & Light v. FERC*, 574 F.2d 610, 620 (D.C. Cir. 1978).

[45] *Id.* at 29.

[46] On March 4, 2005, Vernon filed a motion to strike portions of SoCal Edison's brief for alleged factual misstatements regarding Exh. SCE-49, or alternatively, for leave to respond concerning the exhibit. The Commission denies Vernon's motion. The contents of the exhibit will, obviously, speak for itself. On March 7, 2005, Vernon filed another motion for leave to respond, this one seeking to answer allegedly erroneous or misleading statements in the briefs opposing exceptions of SoCal Edison, PG&E and Trial Staff, regarding the role of the Vernon City Council in approving Vernon's TRR. The Commission also denies this motion. The issue of the Vernon City Council's

(continued)

D. Commission Determination

34. The Commission denies the exceptions of Vernon and TANC and affirms the Initial Decision on this issue. However, we modify the standard of review of Vernon's TRR developed by the presiding judge.

35. In *PG&E*, the court gave the Commission discretion concerning the review of Vernon's TRR, so long as that review "ensure[s] . . . that the CAISO's rates will ultimately be just and reasonable."[47] Contrary to the parties' position, the court did not rule out the possibility of a strict section 205 review. Rather, it gave the Commission discretion to conduct, if possible, a less thorough review of Vernon's TRR. In this case, we agree with the presiding judge that the *only* way to ensure this result is by examining whether each component of Vernon's TRR is just and reasonable by the same type of rate review we perform for a jurisdictional utility.

36. At the outset, the Commission sees no need to establish a formal standard to be applied to all non-jurisdictional TRR cases, beyond what our decision today establishes as precedent. By making clear the standard we are applying to our review of Vernon's TRR, we will comply with the court's mandate, and provide substantial guidance for further cases involving nonjurisdictional TRRs.

37. We begin our analysis with several findings that are not in dispute here. First, the CAISO's TAC rate is subject to the Commission's jurisdiction, and we must review it under section 205 to make certain that it is in all respects just and reasonable. Second, the TAC rate is established by including the individual TRRs of all Participating Transmission Owners into the CAISO's rate design. Third, because the CAISO's rate design is simply an inclusion of all TRR costs, there is no mechanism in place for the Commission to evaluate the justness and reasonableness of the TAC rate itself; rather, our statutory review must be accomplished by examining the individual TRRs.[48] Thus, it is not open to question that we can and must review the TRRs of the jurisdictional Participating Transmission Owners pursuant to section 205.

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approval of the TRR has been fully briefed by the parties and requires no further exposition.

[47] *PG&E,* 306 F.3d at 1116.

[48] Our review of the actual rate is limited solely to whether the CAISO has correctly applied and calculated its filed rate formula in conjunction with the individual TRRs of each Participating Transmission Owner.

38. The question then becomes whether the Commission can ensure that the TAC rate is just and reasonable without reviewing the individual components of Vernon's TRR by means of a section 205 review. In this case, at least, we agree with the presiding judge that the answer is no.

39. The pivotal issue determining how thorough our review of Vernon's TRR will be is the level of deference to which the Vernon City Council's determination is entitled. Of course, the Commission respects state and local regulatory authorities and makes every effort not to intrude on their jurisdiction. However, the Commission agrees with the presiding judge that the Vernon City Council is not due any deference with respect to its review of the TRR. The reason for this is that Vernon is an interested party in this proceeding, and its City Council was not acting as a disinterested ratemaking authority with respect to setting Vernon's TRR.

40. Vernon has no obligation to the CAISO ratepayers who will foot the bill for the TRR, and does not represent them. Indeed, Vernon concedes that it competes for retail load with, among others, SoCal Edison.[49] Furthermore, under the cost-shift mechanism in the TAC, Vernon receives significant annual payments from the CAISO ratepayers.[50] Thus, Vernon has every incentive to increase its TRR at the expense of non-Vernon CAISO ratepayers, as their subsidy grows with the TRR and inures to Vernon's benefit (for example, it can be used to lower the retail rates of Vernon's ratepayers). The fact that Vernon developed its TRR separate and apart from its retail rates is another indication that it had no incentive to disinterestedly develop its TRR.[51]

41. Fundamental concepts of due process, therefore, prevent the Commission from giving the findings of the Vernon City Council deference in this situation. To do so would be nothing less than an abdication of our FPA responsibility. These considerations clearly outweigh any particular status conferred upon the Vernon City Council by California law. It follows that we agree with the presiding judge's rejection of TANC's proposal that standards of deference built into Order No. 888 were not appropriate as a model for this case. Putting aside the judge's legitimate concerns about the workability

[49] Exh. VER-7 at 32; Tr. 425.

[50] This amounts to approximately 70 percent of the Vernon's current TRO. Exh. SCE-3 at 2; Tr. 523-525.

[51] We decline to be drawn into a debate about the amount of time that the Vernon City Council spent on considering the TRR. Thus, unlike the presiding judge, we do not rely on this factor in reaching our conclusion that no deference is warranted.

of such a model, deference such as contemplated by Order No. 888 simply does not apply to a situation in which a local authority is a party with a direct financial interest in a proceeding.

42. Of course, Vernon is not subject to the Commission's section 205 jurisdiction. Absent Vernon submitting its TRR for our review, we would have no authority to review Vernon's rates, and we have no authority to review Vernon's rates other than with respect to the TRR it has submitted. But Vernon having voluntarily made its TRR part of a jurisdictional rate, the TRR is subject to our section 205 jurisdiction and both can and must be reviewed thereunder.

43. The contention of Vernon and TANC that a review by the Commission of this nature is beyond our statutory authority is foreclosed by the court's mandate in *PG&E*. As mentioned above, the opinion took as a premise that the Commission has statutory authority to review Vernon's TRR "to the extent necessary to ensure that the CAISO's rates are just and reasonable."[52] Vernon's contrary reading of *PG&E* strikes us as wishful thinking rather than analysis.[53] And Vernon's claim that the Commission has taken the position that it does not have such authority is simply incorrect.[54]

44. To be very clear, the Commission is performing here a section 205 review of Vernon's TRR. While we understand and appreciate the judge's jurisdictional concerns that led her to the terminology of a "section 205 like" proceeding, we find that her apprehension on this point was unnecessary. As we have already stated, Vernon in and of itself is not subject to section 205. It is for this reason we affirm the judge's excusing

[52] *PG&E*, 306 F.3d at 1117.

[53] We find that the decision and mandate of the court in *PG&E* also moots TANC's attempt to rely on the *Sunray* line of cases. *See* n.44, *supra*.

[54] In the *2003 CAISO Order*, on which Vernon relies, the Commission made it eminently plain that while "some level of rate review" of the TRRs of nonjurisdictional Participating Transmission Owners "is required by the FPA," the question would "not be decided" there but in this very case. In this regard, Vernon also relies on representations made by agency counsel during *PG&E*. Suffice it to say, such representations cannot bind the Commission. *See, e.g*, *Florida Power & Light Co. v. FERC*, 85 F.3d 684, 689 (D.C. Cir. 1996).

Vernon from the Commission's regulatory filing requirements.[55] Nonetheless, Vernon's TRR, voluntarily submitted as a component of a jurisdictional rate, is necessarily subject to a full and complete section 205 review as part of our section 205 review of that jurisdictional rate. There is no point to obscuring the issue with essentially meaningless ameliorative language. Again, though, we emphasize that this course is necessary because there is no other feasible manner in which to make certain that the jurisdictional CAISO TAC rate is just and reasonable.

45. Finally, the Commission denies Vernon's contention that evidence comparing its facilities to parallel SoCal Edison facilities should form the basis of a finding that its TRR is just and reasonable. The problem with Vernon's proposal is that the proportional relationship between Vernon's TRR and SoCal Edison's TRR does not provide the Commission a basis upon which to determine whether the costs contained within Vernon's TRR should become part of the CAISO's jurisdictional rate. Only by examining the actual components of Vernon's rate can we make this determination.

II. Operational Control

A. The Initial Decision

46. The Initial Decision ruled that the CAISO did not assume Operational Control over Vernon's MAP and MPP capacity until January 1, 2003, so that the costs associated with these facilities should not be recovered from CAISO ratepayers through the TAC rate. According to the judge, the basic facts pertaining to this issue were undisputed:

> [T]he evidence shows that the Commission approved the application to transfer Operational Control over non-jurisdictional facilities on January 9, 2001. On February 21, 2001, the Transmission Control Agreement executed by Vernon was approved by the Commission, effective January 1, 2001. The ISO did not establish means of scheduling Vernon's MAP and MPP facilities until January 1, 2003. Ex. ISO-1 at 6. Thus, the facilities did not have ISO scheduling points associated with them and did not appear in the ISO Scheduling Infrastructure until January 1, 2003.[[56]]

[55] Of course, there must be a sufficient record developed upon which the Commission can evaluate the justness and reasonableness of the Participating Transmission Owner's TRR, as there was in this case.

[56] Initial Decision, 109 FERC ¶ 63,057 at P 45 (footnotes omitted).

Thus, the judge explained, the CAISO could not and did not schedule Vernon's use of these facilities, which are located outside of the CAISO Control Area. However, since January 1, 2001, Vernon's TRR, including costs associated with MAP and MPP, has been recovered from CAISO ratepayers through the TAC rate.

47. The Initial Decision begins by setting out the position of Vernon, the CAISO and the Southern Cities that, by the terms of CAISO's Tariff, Operational Control begins "for the purposes of determining when a new [Participating Transmission Owner] is entitled to begin collecting TRR on an entitlement" when the rights to schedule entitlements are transferred to the CAISO, "without regard to whether or when these rights are exercised."[57]

48. In deciding this issue, the presiding judge placed significant weight on several Commission decisions. First, she referred to *Opinion No. 445*, where the Commission had stated that "in order to receive credits for their facilities, the Municipals 'must join the California ISO and thereby allow scheduling and control of the facilities by the transmission provider.'"[58] She found particularly relevant *Opinion No. 445*'s statement that under prior Commission precedent,

> for facilities to be considered integrated, the transmission provider must be able to provide transmission service to itself or other transmission customers over these facilities . . . Under these circumstances, until and unless the Municipals join the California ISO and turn over control of their facilities to the California ISO, the California ISO can have no operational control over Municipal's facilities. If the California ISO has no operational control over these facilities, it can not use

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[57] *Id.* at P 47, citing Tr. At 562, 579-80, 582-84; Exh. VER-16 at 23. The CAISO tariff defines "Operational Control" as follows:

> The Rights of the ISO under the Transmission Control Agreement and the ISO Tariff to direct Participating TOs how to operate their transmission lines and facilities and other electric plant affecting the reliability of those lines and facilities for the purpose of affording comparable non-discriminatory transmission access and meeting Applicable Reliability Criteria.

CAISO FERC Electric Tariff, Appendix A, Third Revised Sheet No. 336.

[58] Initial Decision, 109 FERC ¶ 63,057 at P 48, *citing Southern California Edison Company*, *Opinion No. 445*, 92 FERC ¶ 61,070 at 61,256 (2000) (*Opinion No. 44*5).

> them to provide transmission service to its customers. In fact, the California ISO would not even be able to transmit power over the customer facilities to the Municipals.[[59]]

49. The presiding judge next cited *Opinion No. 466*, which "found that only the costs of those facilities that are under the Operational Control of the ISO should be included" in a Participating Transmission Owner's TRR.[60] There, the judge noted, the Commission found that the "determining factor" in deciding this question was whether "actual, physical operational control of the facilities" had been turned over to the CAISO, not whether a "legal mechanism" had been "employed to transfer control," in that case a filing under FPA section 203.[61]

50. The judge also relied on *Southern California Edison Company*,[62] which held that for customer-owned facilities to be integrated into a transmission system and entitled to credits, "the transmission provider must be able to provide transmission service to itself or other transmission customers over these facilities, *i.e.* the transmission provider must have operational control over these facilities."[63] As evidence of such operational control, the judge observed, the Commission emphasized that the facilities in question must "provide additional benefits to the transmission grid in terms of capability and reliability, and be relied upon for the coordinated operation of the grid."[64]

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[59] *Id.*, *quoting Opinion No. 445*, 92 FERC ¶ 61,070 at 61,256.

[60] *Id.* at P 49, *citing Pacific Gas and Electric Company*, *Opinion No. 466*, 104 FERC ¶ 61,226 at P 1, 13, n. 21 (2003), *order on reh'g*, *Pacific Gas and Electric Co.*, *Opinion No. 466-A*, 106 FERC ¶ 61,144 (2004); *order on reh'g*, *Pacific Gas and Electric Co.*, *Opinion No. 466-B*, 108 FERC ¶ 61,297 (2004), *appeal docketed sub nom.*, *California Department of Water Resources v. FERC*, D.C. Cir. No. 04-7613 (filed Nov. 22, 2004).

[61] *Id.*, *citing Opinion No. 466*, 104 FERC ¶ 61,226 at P 13, n.21.

[62] 108 FERC ¶ 61,085 (2004).

[63] Initial Decision, 109 FERC ¶ 63,057 at P 50, *citing Opinion No. 446*, 108 FERC ¶ 61,085 at P 8.

[64] *Id.*, *citing Opinion No. 446*, 108 FERC ¶ 61,085 at P 10.

51. In view of this case law, the Initial Decision concluded that whether or not the CAISO physically controls the assets was the key question in deciding whether it had operational control of them. Here, the judge stated, the evidence demonstrated that because Vernon's facilities are outside the CAISO's Control Area, the CAISO cannot "push buttons and turn switches," but had to model the entitlements by creating Branch Groups.[65] The CAISO acknowledged, the judge determined, that it did not accomplish these tasks during the two years after it acquired the "rights" to do so.[66] Thus, the judge concluded, "[f]or the period January 1, 2001 through December 31, 2002, the ISO did not have a specific Branch Group to allow scheduling in the ISO's Scheduling Infrastructure (SI) for Vernon's capacity on the MAP and MPP."[67]

52. The judge also relied on the evidence of Staff witness Gross to conclude that the CAISO "did not know, and had no ability to control (cut or increase) schedules on the MAP or MPP transmission lines."[68] Additionally, this evidence demonstrated that the CAISO did not schedule, coordinate schedules or offer transmission access over Vernon's MAP and MPP entitlements for any market participant in 2001-2002, and that transactions on Vernon's entitlements during this period were not done through the CAISO's scheduling system.[69] In addition, she observed, the CAISO admitted that it was not able to provide comparable non-discriminatory transmission access to the CAISO market participants to the transmission capacity on MAP and MPP.[70] As a result, the presiding judge found that these facilities could not provide service to anyone except Vernon, and did not provide reliability benefits to the CAISO grid.

53. The Initial Decision rejected a number of arguments raised by the CAISO. She denied the CAISO's contention that the California energy crisis provided a sufficient excuse for the two year delay in taking operational control of the facilities in question. She dismissed as irrelevant CAISO's claim that alleged lack of demand for use of the MAP and MPP entitlements should be a factor in deciding whether or not it had

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[65] *Id.* at P 51.

[66] *Id.*

[67] *Id.*

[68] *Id.* at 52, *citing* Exh. SCE-9 at 3-5.

[69] *Id.*, *citing* Exh. SCE-9 at 3-5.

[70] *Id.*, *citing* Exh. SCE-9 at 6; SCE-43; Exh. S-16 at 14.

Operational Control. Rather, she concluded, in an open access tariff environment, all available capacity must be posted so that all market participants are aware of their options. The judge also found irrelevant the CAISO's assertion that it had the authority to direct Vernon, as Vernon nevertheless continued to use the MAP and MPP entitlements for its own benefit to the exclusion of the other customers, exactly the same way as before the Transmission Control Agreement (TCA) was signed.

54. The judge also dismissed Vernon's assertion that it gave up some limited rights when it claims it transferred Operational Control to the CAISO, in view of the fact that Vernon did not schedule through the CAISO.[71] On the contrary, the judge observed, "Vernon did not give up the ability to exercise the most fundamental right of all: the ability to schedule the entitlements."[72] In the judge's view, scheduling is the key to the CAISO's exercise of Operational Control to provide non-discriminatory transmission access. Thus, the record established that the CAISO was not able to provide comparable and non-discriminatory access to the CAISO market participants to the MAP and MPP transmission capacity. Market participants could not use the facilities, she reasoned, because the CAISO could not accept or accommodate any schedules submitted by market participants with respect to these facilities.[73]

55. Turing to the equities of the situation, the presiding judge rejected the argument that Vernon was being improperly penalized by denying recovery for these facilities in its TRR for action (or inaction) by the CAISO, over which it had no control. In the judge's view, "the equities lie in favor of the other Market Participants who were required to pay for access to transmission facilities when they had no actual access."[74] In this regard, she also observed "it is not possible to compensate for errors in one TRR by adjusting another [Participating Transmission Owner's] TRR."[75]

[71] *Id.* at P 56.

[72] *Id.*

[73] *Id.*, *citing* Exhs. SCE-43 and SCE-9 at 7.

[74] *Id.* at P 57.

[75] *Id.*

56. The judge summed up her decision on this issue in these terms:

> The evidence demonstrates that, in effect, although contracts had been signed and the Commission had approved the transfer of facilities, nothing changed. Vernon continued to schedule its facilities just as it had done before it joined the ISO and the ISO did not model Vernon's facilities. Therefore, it is found that the ISO did not assume Operational Control of the MAP/MPP entitlements until January 1, 2003, when the CAISO established scheduling points, and Vernon may not include the costs of these entitlements in its TRR until that date.[[76]]

57. Finally, the judge noted Vernon's argument that because of its jurisdictional status, it could not be ordered to make refunds. According to the judge, no refunds were being ordered, as the overcollection of Vernon's TRR "can be netted out in the ISO's balancing account."[77]

B. <u>Briefs on Exceptions</u>

58. Vernon, the Southern Cities and the CAISO argue that the Initial Decision erred in its decision that the CAISO did not assume operational control of the MAP and MPP capacity entitlements until January 1, 2003. They claim that the CAISO assumed Operational Control on January 1, 2001.

59. Vernon emphasizes that the CAISO tariff and the TCA define Operational Control in Appendix A as

> [t]he *rights of the ISO* under the Transmission Control Agreement and the ISO Tariff to direct Participating TOs how to operate their transmission lines and facilities and other electric plant affecting the reliability of those lines and facilities for the purpose of affording comparable non-discriminatory transmission access and meeting Applicable Reliability Criteria.[[78]]

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[76] *Id.* at P 58 (footnote omitted).

[77] *Id.* at P 58 n.41 (citation omitted).

[78] Vernon Brief on Exceptions at 60, *citing* Exh. VER-20 at 15 (Emphasis added by Vernon).

Vernon, the CAISO, and the Southern Cities argue that, under this definition, the CAISO had operational control over the MAP and MPP capacity. The CAISO contends that nothing in the Commission's orders or the CAISO Tariff suggests that the CAISO's ability to provide transmission service, for the purpose of the existence of operational control, is dependent upon the existence of scheduling points. Rather, it claims that "Operational Control is established by the ISO's *legal* ability, *i.e.*, *authority* to use the capacity of the transmission facilities or Entitlements to provide transmission services to its customers."[79]

60. In addition, both Vernon and the Southern Cities dispute the Initial Decision's determination that nothing has changed as a result of the Commission's approval of the transfer of facilities. They argue that Vernon no longer had the ability to sell transmission, to change its schedules in real-time and it could not sell the capacity.[80] In addition, the Southern Cities contend that the fact that Vernon had turned over its facilities to the CAISO deprived it of its Firm Transmission Rights and congestion payments.[81]

61. The Southern Cities argue that the Initial Decision's finding that the CAISO must actually provide access to a Participating Transmission Owner's transmission facilities or entitlements in order for the Participating Transmission Owner to recover its costs, if adopted by the Commission, could also result in cost disallowances whenever a Participating Transmission Owner's transmission capacity is unavailable for other operational reasons.[82] They argue that, assuming that the Participating Transmission Owner does not impede the ability of the CAISO to make its transmission facilities available to all market participants on a non-discriminatory basis, the Participating Transmission Owner should not be subject to a cost disallowance due to the CAISO's operational decisions regarding the timing or manner in which the facilities and entitlements are in fact made available to the market.

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[79] CAISO Brief on Exceptions at 9 (emphasis in original).

[80] Vernon Brief on Exceptions at 64, *citing* Tr. 583-84; Southern Cities Brief on Exceptions at 8-9.

[81] Southern Cities Brief on Exceptions at 9, *citing* Exh. VER-16 at 36:7-10.

[82] *Id.* at 9. The Southern Cities state that, for example, transmission costs could become unrecoverable under a Participating Transmission Owner's TRR if the CAISO posts inaccurately low Available Transmission Capacity (ATC) for transmission lines or fails to indicate the availability of transmission capacity on its OASIS site.

62. Vernon and the Southern Cities argue that the Initial Decision alters the respective responsibilities of the CAISO and Participating Transmission Owners. The Southern Cities contend that a Participating Transmission Owner's responsibility is to relinquish control of its transmission facilities and entitlements by signing the TCA and to not impede successful modeling and scheduling of its facilities and entitlements, whereas the CAISO's responsibility is to provide open access transmission under its tariff. Vernon and the Southern Cities state that, while it may be arguable whether the CAISO properly performed its role in this case, there is no dispute that Vernon lived up to its end of the bargain and that there is no evidence that Vernon impeded in any way the CAISO's ability to make Vernon's transmission entitlements available to the market.[83] As a result, they argue that Vernon is entitled to full TRR recovery for its MAP and MPP entitlements.

63. Vernon argues that it has assigned its scheduling rights in its MAP and MPP capacity to the CAISO and that it had no supervisory authority over the CAISO and had no legal standing to contest the CAISO's management of CAISO system resources. Vernon states that CAISO witness Le Vine testified that she believes that the CAISO has the complete discretion when to establish scheduling points.[84] Thus, Vernon maintains, the record demonstrates that Vernon had no legal obligation or ability to instruct the CAISO as to when to establish scheduling points for the MAP/MPP capacity.

64. Vernon argues that no party was harmed by the CAISO's choice and that this is evidenced by the fact that there was no complaint by those who knew that the computer programming had not been accomplished. It also contends that the Trial Staff witness Goss admitted that Vernon completed the transfer of operational control within the meaning of the CAISO tariff, but that the CAISO did not actually exercise control.[85]

65. Vernon claims that the long-standing test of whether a facility may be included in the utility's cost of service is whether it was used and useful and that its MAP and MPP capacity was used and useful to the CAISO transmission grid in 2001-02. It argues that any finding regarding Operational Control may not be used to deny Vernon its costs for its MAP/MPP capacity.

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[83] *Id.* at 10-11, *citing* Exh. ISO-1 at 574:15-19 and 1062:1-8.

[84] Vernon Brief on Exceptions at 47, *citing* Tr. at 530, 580-81.

[85] *Id.* at 48, *citing* Exh. VER-70, Tr. 1042-43.

66. Vernon further asserts that the MAP and MPP capacity was used and useful to the CAISO control area in 2001-02. It contends by instructing Vernon to schedule its own requirements over its MAP/MPP entitlements during the period in question, the CAISO was effectively appointing Vernon to take action for the CAISO in discharging its responsibilities under the CAISO's tariff. Moreover, Vernon states that it paid the CAISO High Voltage Access Charge for the service it was receiving over the MAP/MPP facilities as CAISO customer, and that if the MAP and MPP facilities had not been available to the CAISO or Vernon in 2001-02, Vernon's requirements that were scheduled over the MAP and MPP facilities would have imposed an additional burden on other CAISO facilities.[86] Additionally, Vernon contends the MAP/MPP facilities were used and useful to the CAISO by providing back up (reliability protection) for other facilities over which the CAISO had Operational Control, as well as scheduling capability, if necessary.[87]

67. Vernon argues that there is no showing that it has been negligent or took any action or failed to take action that could lead to depriving it of cost recovery for its MAP and MPP recover. It objects to the judge's statement that it is incumbent on Vernon to show that it met the Operational Control requirements of the CAISO's Tariff. Rather, in Vernon's view, while other market participants needed access to Vernon's MAP/MPP capacity they could have requested it, none did so.

68. Vernon argues that it was not benefited by the CAISO's delay of computer scheduling points for MAP and MPP capacity. Moreover, as it gave up certain rights in ceding control to the CAISO; namely the ability to provide transmission service to third parties and to wheel power.

69. Vernon further contends that the Commission's January 9, 2001 and February 21, 2001 Orders[88] bar the Commission from denying Vernon cost recovery for its MAP and MPP capacity. It states that the January 9 Order was a final order which provided for the transfer of operational control to the CAISO. On February 28, 2001 the CAISO sent a letter informing the Commission that the disposition of the jurisdictional assets was

[86] *Id.* at 50-51, citing Exh. VER-16 at 29.

[87] *Id.* at 51.

[88] *California Independent System Operator Corporation*, 94 FERC ¶ 62,016 (2001) (January 9 Order); *California Independent System Operator Corporation*, 94 FERC ¶ 61,141 (2001) (February 21 Order).

consummated on January 1, 2001.[89] Vernon argues that the January 9 Order required notification of the transfer of assets not the notification of the establishment of scheduling points. It also argues that all of the Participating Transmission Owners were aware that the CAISO had not established scheduling points for the MAP and MPP, but believed that those facilities were under the CAISO control.[90]

70. Finally, Vernon observes that, contrary to the judge's view, "netting out" the disputed overcollection would in reality cause Vernon to make refunds. Vernon goes on to argue on various grounds that the Commission is without authority to order refunds to the CAISO market participants.

71. The CAISO argues that the delay in the establishment of scheduling points was not unreasonable. In this regard, the CAISO relies on its uncontradicted testimony that the delay in the establishment of Scheduling Points was due to the need to devote resources to issues raised by the California energy crisis and that there is no record evidence contradicting that testimony.[91]

72. The CAISO further attacks the Initial Decision's reliance on *Opinion Nos. 445 and 466*. *Opinion No. 445*, the CAISO asserts, merely, in its view, stated that facilities owned by utilities that were not Participating Transmission Owners were not subject to the CAISO's Operational Control.[92] Similarly, *Opinion No. 466* did not hold that legal control of facilities was insufficient to establish Operational Control or that legal authority to exercise operational control is insufficient or even that it is distinguishable from physical control. In this regard, the CAISO contends that it had complete legal authority to exercise physical control of the facilities during the disputed period.

C. <u>Commission Determination</u>

73. The Commission denies the exceptions filed by Vernon, the Southern Cities and the CAISO and affirms the Initial Decision. We agree with the presiding judge that the

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[89] Vernon Brief on Exceptions at 58, *citing* Exh. VER-16 at 18 and Exh. VER-21.

[90] *Id.* at 59, *citing* Edison's September 9, 2002 letter to Ms. Le Vine, Exh. VER-28.

[91] CAISO Brief on Exceptions at 12, *citing* Exh. ISO-1 at 7-8; Tr. 529, 570, 579-80.

[92] *Id.* at 9-10, *citing Opinion No. 445*, 92 FERC ¶ 61,070 at 61,255.

CAISO did not assume Operational Control over MAP and MPP capacity until January 1, 2003. The essence of open-access is the ability of all market participants to access all available capacity in a non-discriminatory manner. This was not the case as to Vernon's MAP and MPP capacity. As the record demonstrates, for a period of two years, only Vernon had access to that capacity, which was not posted as available on the CAISO's SI. The contention that any market participant could have requested use of the capacity from the CAISO is inconsistent with the very basis of the Commission's open access policy. In an open access environment, market participants should not be forced to inquire about available facilities.

74. The Commission rejects Vernon's argument that the CAISO's definition of "Operational Control" supports its position. The purpose of the CAISO's right to direct the facilities of Participating Transmission Owners is an integral part of its having operational control. Vernon's reading of the definition could allow the CAISO unfettered discretion as to when to allow open and non-discriminatory access to facilities over which the CAISO has agreed to take control. Under this interpretation, the CAISO could also charge market participants for capacity to which they have no access and for facilities over which the CAISO has no actual obligation to provide service.

75. That certain of the CAISO market participants may have had knowledge that these facilities is irrelevant to this issue. The existence of Operational Control is not determined by what any market participant knew or did not know – it is determined by the relevant tariff and the standards and guidance provided by the Commission. Furthermore, the very purpose for which the CAISO assumes Operational Control is to provide open access to its transmission facilities. This was not the case with respect to Vernon's MAP and MPP capacity during the period in question.

76. Contrary to Vernon's contention, the failure to provide scheduling points for the MAP and MPP was not similar to the temporary unavailability of transmission facilities that are out of service because of technical problems or for maintenance. First of all, a temporary delay does not last two years. Secondly, temporary problems of that nature affect all market participants equally. In the instant case, the failure to provide scheduling points affected all participants except one, Vernon. Although Vernon argues that there was no showing of discrimination, the discrimination lies in the very fact that the CAISO was supposed to have control over facilities to which only one market participant, in reality, had access.

77. Vernon contends that the CAISO cannot remove facilities from its control through action or neglect. We agree. However, Vernon misses the point. The Initial Decision found, and we affirm, that the CAISO never had Operational Control over the facilities in question. Although the CAISO may not be able to remove facilities from its control through inaction, its inaction has proven that it did not have control in the first place.

78. The Commission concurs with the presiding judge on the interpretation of *Opinion Nos. 445 and 466*. *Opinion No. 466* stated that “the actual, physical operational control of the facilities is the determining factor” in deciding whether the costs of particular facilities should be included in the CAISO’s rate.[93] Here, on the other hand, the CAISO did not even have the capability to direct Vernon as to its use of the MAP and MPP capacity, other than to tell it to schedule its own capacity, as it had been doing before it became a Participating Transmission Owner. Thus, we agree with the judge that for all practical purposes, the CAISO grid also did not receive additional reliability benefits from the MAP and MPP capacity. The CAISO had no knowledge concerning any capacity Vernon scheduled over the MAP or MPP transmission lines. It, therefore, was not able to direct Vernon to alter its use of those lines in the case of an unusual event which would impact reliability over the CAISO grid. The reliability benefits of the MAP and MP facilities referred to by Vernon’s witness Mr. Bashir, in the form of voltage and dynamic stability support to the CAISO transmission lines, were realized at the time that the facilities were built, not when Vernon became a Participating Transmission Owner. Therefore, the alleged transfer of operational control did not enhance CAISO grid reliability. In sum, we do not accept that the facilities in question were used or useful to the CAISO until it controlled their scheduling.

79. The Commission denies Vernon’s contention that our order providing for the transfer of operational control to the CAISO can decide this issue. Nor does the CAISO’s statement that the facilities had been transferred and that it had assumed Operational Control have any relevance. As stated above, Operational Control entails actual physical control over the facilities, which the CAISO did not have.

80. This brings us to the matter of remedy. We acknowledge that this situation was caused by the CAISO, rather than Vernon. It is also true that because of the manner in which the system operates, the CAISO cannot be held financially responsible for its failure to act, whether or not it was the product of negligence.[94]

81. On the other hand, assuming, *arguendo*, that refunds were permissible and appropriate, Vernon would be deprived of a portion of its TRR (though this is somewhat mitigated by the fact that Vernon continued to use the facilities during the period at issue). Moreover, Vernon complied with all the CAISO’s requirement to join the CAISO. Additionally, Vernon did not have notice that its TRR was subject to refund.

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[93] *Opinion No. 466*, 104 FERC ¶ 61,226 at P 13, n.21

[94] Because the CAISO is a not-for-profit entity, there is no way to make it pay refunds, because the costs would simply be passed on to its customers.

Nor did it have a clear vehicle to pursue questions about the CAISO's inaction. In addition, it may not have realized that the delay on the part of the CAISO would result in denial of recovery.

82. Nonetheless, the Commission finds that the deciding factor in this equivocal situation is that CAISO ratepayers are entitled under the FPA to a just and reasonable TAC rate, which should not, as a matter of regulatory principle, include the cost of facilities which do not benefit them. Thus, in the future, our policy will be to hold the Participating Transmission Owner financially responsible in a situation of this nature.

83. However, in view of the fact this is a case of first impression, and the equities favoring Vernon described above, we will apply our policy only on a prospective basis, and not to Vernon in this case.[95] In this regard, the Commission would like to emphasize that the CAISO should take steps to avoid such a situation from arising in the future. However, Participating Transmission Owners are now on notice that if the CAISO fails to take actual operational control of facilities, as discussed in this opinion, the costs associated with the facilities will not be considered by the Commission to be part of the Participating Transmission Owners' TRRs. In other words, a Participating Transmission Owner may not be allowed to recover its TRR until the CAISO has established that the capacity is available to all market participants.

III. <u>Rate of Return/Return on Equity</u>

84. The Initial Decision considered a number of different arguments concerning the various components of the overall rate of return that would be used in calculating Vernon's TRR. The following discussion will examine the presiding judge's findings and the arguments made by various parties on the issues relating to the appropriate return. We will summarily affirm the presiding judge's findings with respect to the appropriate capital structure and debt cost. Moreover, to the extent that there were sub-issues present in the return on equity issue, those sub-issues will be discussed separately.

85. The issue regarding the appropriate return on equity for Vernon was addressed by Vernon, SoCal Edison and Trial Staff. The other parties to this proceeding did not take a position on this issue.[96] The Initial Decision found that the appropriate return on equity

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[95] Thus, we do not reach any of Vernon's arguments concerning refunds.

[96] PG&E stated in its reply brief that it was not taking a position as to the proper overall rate of return for Vernon; however, PG&E encouraged the presiding judge to reject Vernon's arguments that it is entitled to a higher rate of return.

for Vernon should be set at the level established by the Commission in *Opinion No. 445* for SoCal Edison. The presiding judge found that, using Trial Staff's taxable debt alternative, Exhibit S-30, Schedules 1-3, the return on equity should be 11.60 percent. Exceptions were raised under the sub-issues below which, indirectly, impact the return on equity component and, therefore, we will discuss them in greater detail under each sub-section.

A. Sub-Issue: Averaging of Returns

1. Initial Decision

86. The first sub-issue was a position taken by Trial Staff which advocated an "averaging" of returns for Vernon. Specifically, Trial Staff argued that Vernon's overall return, including the return on equity, should be based on an averaging approach in order to take into account both the data underlying Vernon's initial TRR filing and substantial changes that have occurred since that time,[97] and in accordance with the Commission-approved return on equity for SoCal Edison in *Opinion No. 445*. The data used in this proceeding dates back to the period 1994 to 1998. Trial Staff also noted that Vernon's TRR and its return on equity would become effective January 1, 2001 and continue in effect indefinitely. Trial Staff reasoned that during the regulatory lag in this proceeding, certain factors have substantially influenced Vernon's proposed return on equity and these factors should be reflected in Vernon's return component. Thus, Staff witness Green developed a beginning-of-the-period analysis and a most recent or current period analysis, and then averaged the results of those two analyses in deriving his recommended return on equity.

87. The presiding judge found that Mr. Green's averaging proposal was not based on Commission precedent and, thus, concluded that the record in this case lacks compelling reasons to deviate from Commission precedent with respect to this issue. Therefore, the presiding judge found that Trial Staff's averaging proposal would not be entitled to substantial weight nor be followed in this case.

2. Exceptions

88. No exception to the presiding judge's determination was filed by Trial Staff or any intervening party.

[97] Initial Decision, 109 FERC ¶ 63,057 at P 93, *citing* Staff Initial Brief at 27.

3. **Commission Determination**

89. We will summarily affirm the presiding judge's finding on this issue, *i.e.*, the presiding judge's decision to disavow Trial Staff's averaging approach, for the reasons provided in the Initial Decision.

B. **Sub-issue: Whether the Discounted Cash Flow (DCF) model is appropriate for a municipal entity like Vernon.**

1. **Initial Decision**

90. The Initial Decision acknowledged Vernon's view that although it does not issue public shares, the use of the DCF methodology is appropriate to apply to Vernon because it is based upon proxy companies, follows the method used by the Commission for entities that do not issue stock, and is the method favored by the Commission in *Opinion No. 445*. In the Initial Decision, the presiding judge noted that Vernon supported its claimed 11.60 percent return on equity with several DCF analyses. Vernon stated that its witness Hanley utilized the specific DCF methodology employed for SoCal Edison in *Opinion No. 445*. The presiding judge determined that witness Hanley applied the *Opinion No. 445* method using the same four proxy companies used for SoCal Edison. Mr. Hanley also applied that method to another set of five electric companies that were selected based on the criteria intended to be closer to Vernon's specific situation, in particular, size. Furthermore, Vernon witness Hanley applied that method to a select combination of gas and electric companies of even smaller size. Vernon also used other common equity cost rate models: the Risk Premium Model (RPM), the Capital Asset Pricing Model (CAPM) and the Comparable Earnings Model (CEM). Vernon states that these models produced results that were consistent with the DCF model. Vernon concludes that a fair return on equity would be 12.065 percent, but that it does not propose to change its requested 11.60 percent return on equity.

91. In its initial brief, Trial Staff's return on equity for the initial or beginning period used the DCF analysis provided by Vernon witness Hanley. The presiding judge noted that Trial Staff found that the use of Mr. Hanley's proxy groups for this period was not unreasonable in light of the Standard and Poor's (S&P) bond rating for Vernon. Specifically, Trial Staff witness Mr. Green developed midpoint DCF returns for each of Mr. Hanley's proxy groups, as well as a single average DCF return for all his proxy groups. Next, Mr. Green averaged Mr. Hanley's high DCF results for each of his proxy groups to arrive at a single high DCF result for all proxy groups. Mr. Green then averaged the single midpoint DCF result for Mr. Hanley's proxy groups with single high DCF result for Mr. Hanley's proxy groups to arrive at a single return on common equity

for Vernon that is midway between the average of the three proxy groups' midpoints and their average high DCF return. Trial Staff's return on equity under this methodology was 11.57 percent.[98]

92. The presiding judge summarily found that the both Vernon and Trial Staff correctly used the DCF methodology for establishing the return on equity. The presiding judge observed that this standard constant growth DCF model has been used by the Commission for electric utilities. The presiding judge rejected Vernon's use of alternative models, as well as SoCal Edison's use of the CAPM model, because they have been previously rejected by the Commission or are inconsistent with *Opinion No. 445*.

2. Exceptions

93. SoCal Edison argues that the use of the DCF model is inappropriate in this case. SoCal Edison states that, while it agrees that the Commission's general policy is to use the DCF model to determine cost of equity, the Commission's task here is to set a return on equity for an entity that does not issue stock and pay dividends. It elaborates that in order to properly conduct a return on equity analysis with the DCF model, one must have both dividend and price data in order to calculate a market yield, which can then be combined with a dividend growth estimate. SoCal Edison states that the market yield is critical because it corrects observed returns to risk-adjusted levels. SoCal Edison notes that dividend and price data do not exist for municipal utilities as they do not issue common or preferred stock and, thus, there is no way for market forces to reveal a risk-adjusted return. Therefore, SoCal Edison concludes that a municipal utility cannot be modeled like an investor-owned utility, and that it is not reasonable to calculate Vernon's return on equity using the DCF model.

94. SoCal also states that the RPM and CEM suffer from similar deficiencies when applying it to a municipal utility like Vernon, because of the lack of a market adjustment to correct observed returns to market levels. Therefore, SoCal Edison argues that the CAPM is the appropriate model to determine Vernon's return on equity. SoCal Edison calculates that the CAPM produces a return on common equity of 9.42 percent and, the ECAPM, produces a return on common equity of 10.71 percent. The average of these two estimates, 10.06 percent, is SoCal Edison's recommended return on equity for 1999, the most recent year calculated by SoCal Edison.

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[98] *See* Exhibit S-2, Schedule 1A.

95. Trial Staff and Vernon filed Briefs Opposing Exceptions in which they take issue with SoCal Edison's proposal to use the CAPM. Staff argues that the CAPM return on equity estimation produces a much less accurate estimate of investors' required return on equity than the forward-looking DCF model, which uses estimates of future growth in its calculations. Trial Staff also argues that SoCal Edison's witness arbitrarily and subjectively made adjustments to the CAPM data that further reduced the reliability of SoCal Edison's CAPM results for Vernon. Vernon makes similar arguments.

3. **Commission Determination**

96. We find that the DCF model for a non investor-owned entity such as Vernon is appropriate. As staff correctly points out in its Brief Opposing Exceptions, it is possible, in fact, to perform a DCF analysis for Vernon, utilizing a proxy group of similar-risk publicly traded companies. Trial Staff witness Green correctly observed that although Vernon does not have securities that are traded in the marketplace, companies with similar bond ratings do and can serve as an appropriate proxy for Vernon's cost of common equity. Additionally, we agree with Trial Staff's argument that Vernon's bond rating should be used as a basis to develop a group of proxy companies that have a similar level of risk. Finally, we find that for the "beginning period" or test period, the proxy group used by Vernon and Trial Staff was reasonable given the S&P bond return for Vernon. Therefore, we conclude that the problems cited by SoCal Edison, do not render the DCF model inappropriate in this proceeding.

C. **Sub-issue: Whether Vernon has less, more, or the same risk as SoCal Edison.**

1. **Initial Decision**

97. In its initial brief, Vernon argued that its risk profile is riskier than SoCal Edison or any of the proxy companies utilized. Vernon witness Hanley testified that Vernon's size, its geographic limits, and the fact that Vernon's customer base is so highly industrial were all well-recognized factors demonstrating that Vernon is of higher risk than any of the proxy companies.[99] Specifically, Mr. Hanley noted that Vernon's customer base was more than 80 percent industrial, a percentage four to five times higher than any of the proxy companies. Mr. Hanley also stated that Vernon's bond rating supported the

[99] Vernon Initial Brief at 43, *citing* Exh. VER-1 at 11.

conclusion that it was perceived by the financial markets as riskier than SoCal Edison. Vernon concluded that since Vernon was more risky than SoCal Edison, it was entitled to a higher return on equity, 12.065 percent, than SoCal Edison's 11.60 percent.[100]

98. The presiding judge stated that the evidence in this case provided an ample range of possibilities concerning Vernon's risks vis-à-vis SoCal Edison (and the four proxy companies). The presiding judge notes that Trial Staff witness Green testified that the only risk factor published by an investor service for Vernon that is available to the public indicates that Vernon's risk profile was not likely to have been significantly different from that of SoCal Edison in 1999.[101] Specifically, Trial Staff pointed to three series of tax-exempt bonds issued by Vernon in 2003 to finance the construction of the Malburg Generating Station whose S&P's rating ranged between AA- and BBB+ depending on the terms of each series issued.

99. The presiding judge found that, solely on bond ratings, SoCal Edison and Vernon, are of comparable risk. Additionally, the presiding judge noted that since the Commission in *Opinion No. 445* found SoCal Edison's rating made it riskier than the proxy group, Vernon would also be riskier than the proxy group and that finding would warrant Vernon being entitled to a return in the upper half of the zone of reasonableness, 11.73 percent. However, the presiding judge noted other arguments, as cited above, that made Vernon less risky than SoCal Edison. The presiding judge concluded that Vernon's return on equity should not be set at the higher end of the zone of reasonableness, but rather at the level established by the Commission in *Opinion No. 445* for SoCal Edison, 11.60 percent, because Vernon was less risky than SoCal Edison.

2. **Exceptions**

100. SoCal Edison argues that Vernon is less risky than it is and thus, should be entitled to a lower return on equity. SoCal Edison argues that Vernon possesses certain privileges that are not available to investor-owned utilities, namely the ability to regulate itself and the ability to levy taxes, which is a source of income completely unavailable to investor-owned utilities. SoCal Edison also states that Vernon has the ability at any time to raise its retail rates to make up for any shortfall if Vernon's TRR is insufficient to recover costs. SoCal Edison also argues that since regulatory risk is more critical to a regulated utility than its size or its customer mix, Vernon's ability to regulate itself makes it substantially less risky than SoCal Edison. Furthermore, SoCal Edison states that

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[100] Initial Decision, 109 FERC ¶ 63,057 at P 97, *citing* Vernon Initial Brief at 43.

[101] *Id.* at P 124.

Vernon, like other municipals in the United States, has traditionally been sheltered from competitive forces. SoCal Edison also notes that Vernon was able to obtain a long-term bond rating of AAA, which is the highest long-term rating that Moody's bestows, for its Malburg Generating Station, which clearly indicates that Vernon is less risky than SoCal Edison. Finally, SoCal Edison notes that Vernon has less nuclear generation than the proxy groups used by Vernon's witness, which further indicates that Vernon is less risky than SoCal Edison.

3. Commission Determination

101. We find that Vernon is similar in risk to SoCal Edison. First, we note that SoCal Edison's argument that Vernon's ability to levy taxes makes it considerably less risky is not convincing, especially for an entity such as Vernon whose customer base is over 80 percent industrial. We agree with Vernon's arguments that industrial customers view taxes the same as any other expense, so that Vernon cannot simply raise taxes anytime its TRR is less than anticipated without some risk that these industrial customers could relocate. We also agree that Vernon's size as compared to the companies in the proxy group makes it more risky. However, we note that the record evidence shows that Vernon's transmission operations are not riskier than the composite operations of the companies in the proxy group which are involved in riskier unregulated business and competitive generation operations. On balance, these factors tend to offset each other.

102. Therefore, we conclude, as the presiding judge did, that a remaining factor to measure whether Vernon is less or more risky than SoCal Edison is how the financial community assesses Vernon's risk. The S&P bond ratings assigned to Vernon indicate that Vernon is of comparable risk to SoCal Edison. While SoCal Edison argues that Moody's ratings support the position that Vernon is less risky than SoCal Edison, we find that the Moody's ratings, as relied on by SoCal Edison, were not comparable to those relied on by the presiding judge. Accordingly, we find that Vernon and SoCal Edison are of comparable risk. Therefore, we find that the proper return on equity for Vernon for the locked in period from January 1, 2001 until the issuance date is 11.60 percent.

103. The Commission rejects SoCal Edison's claim that the presiding judge erred by only considering bond ratings in the evaluation of risk. As discussed above, the presiding judge considered Vernon's small size in comparison to the proxy group of investor-owned utilities, its customer profile, its ability as a municipal utility to compete for financing, and certain offsetting factors before determining that Vernon was less risky than SoCal Edison. While we find that Vernon and SoCal Edison are of comparable risk, the factors that convinced the presiding judge that Vernon was less risky are relevant.

D. <u>Sub-issue: Should Vernon's return on equity be updated</u>?

1. Initial Decision

104. The presiding judge noted the Commission precedent in *Opinion No. 363*,[102] where the Commission used updated data in setting a company's return on equity due to changed market conditions between the time the record closes and the date the Commission issues a final decision. Trial Staff's Initial Brief also stated that Vernon witness Hanley recognizes that updating data may be appropriate in a normal situation where the delay in reaching a decision is between six months and eighteen months.

105. The presiding judge also noted the Commission's statement in *Opinion No. 363* that "because the period that a rate will be in effect may extend beyond the record based data and the date of Commission action, we may elect to consider extra-record evidence to set a return allowance, so long as it remains within the record-based range of reasonable returns."[103] The Commission also stated in *Opinion No. 363* that where the rate under consideration is "open-ended," as is the case with Vernon's rate, the time period from when the rate went into effect, up to the date before the issuance date of the Commission's opinion, is a locked-in period to which a single return allowance is applied. The Commission further explained that a different return allowance, calculated using the most recent capital cost data, may then be permitted to go into effect prospectively. The presiding judge noted that staff witness Green demonstrated that the yield on 10 year Treasury Notes has dropped 1.42 percent from 1999 to May 2004 and that the Commission could take this information into account when it issues its final decision in this matter regarding Vernon's return on equity.

2. <u>Exceptions</u>

106. Trial Staff's Brief Opposing Exceptions argues that the Commission should adopt the presiding judge's recommendation to update Vernon's return on equity. The Trial

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[102] *Blue Ridge Power Agency v. Appalachian Power Company, Opinion No. 363,* 55 FERC ¶ 61,509 (1991); *order on reh'g*, 57 FERC ¶ 61,100 (1991) (a section 205 filing during a section 206 proceeding created three locked-in periods for updating purposes: (1) first refund effective date until effective date of proposed rate increase; (2) effective date of proposed rate increase until issuance of *Opinion No. 363*; and (3) open-ended period commencing date *Opinion No. 363* was issued); *further order on reh'g*, 58 FERC ¶ 61,193 (1992).

[103] *Opinion No. 363*, at 62,785.

Staff argues that the record in this proceeding contains extensive evidence supporting updating Vernon's return on equity. Trial Staff notes that the interest rates on ten year Treasury notes, which the Commission has used to denote changes in the cost of common equity, have declined in the years 2000 and 2003 from 6.03 percent to 4.01 percent. Trial Staff also argues that Vernon's approach completely ignores any market changes that have occurred over the past several years that Vernon's TRR has been in effect.

107. Trial Staff also argues that the proxy group utilized in *Opinion No. 445* and upon which Vernon witness Hanley relied, is no longer viable as a basis for calculating investors' current required return on equity. Trial Staff also argues that Mr. Hanley admitted at hearing if Vernon were to file a new TRR in developing a rate of return, he would not use the *Opinion No. 445* proxy group but would instead use a different proxy group relying on more recent data.

108. Vernon opposes updating its return on equity. Vernon argues that the presiding judge's findings approve exactly the same return on equity that the Commission first approved in October 2000. Vernon continues that had the D.C. Circuit Court affirmed the Commission's orders, the rate of return would have become final. Thus, Vernon argues that the result should be the same where the D.C. Circuit questioned but did not reverse or vacate the Commission's approval of a return on equity. Vernon also argues that the TRR, including the return on equity, for a jurisdictional utility that has been finally approved cannot be changed unless that utility seeks to change under section 205 of the FPA or the rate is challenged under section 206 of the FPA. Furthermore, Vernon argues that a review of Commission precedents reveals that the Commission has "updated" return on equity after a remand from the Court of Appeals only once and then in very unusual circumstances. Vernon concludes that the Commission should not update its return on equity but if an update were justified, an adjustment to Vernon's return on equity based on SoCal Edison' return on common equity, would be much more accurate than any Treasury bond rate adjustment would produce.

3. **<u>Commission's Determination</u>**

109. Our review indicates that Commission precedent supports updating of Vernon's return on equity. As the Commission stated in *System Energy Resources, Inc.*,[104] because capital markets often change substantially between the time an electric public utility files its case-in-chief and when the Commission issues a final decision, it has been our policy to update the return on equity. Given the lengthy history of this proceeding, a substantial amount of time has passed since Vernon first filed its case-in-chief. Furthermore, we

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[104] 92 FERC ¶ 61,119 (2000).

disagree with Vernon's position that this case should not be updated because it was remanded. We find no basis for such a conclusion. The Commission, in setting this matter for hearing after the Court remand, did not limit that investigation.

110. Therefore, we will update the return on equity by adjusting for the yields on 10 Year Treasury Notes. However, we will decline to update the return by adjusting the proxy groups as advocated by staff. We find this proposal to go beyond an adjustment to reflect current Treasury yields. Accordingly, based on the record evidence, Vernon's return on equity for the period from January 1, 2001 (the effective date of Vernon's TRR) through the day before the date of issuance of this opinion should have been 10.72 percent.[105] This represents the low end of the zone of reasonableness found by Trial Staff witness Green and Vernon witness Hanley and its use is consistent with Commission precedent that requires that updates be within the zone of reasonableness in the record.[106]

111. Additionally, Vernon's updated return on equity on a prospective basis shall be 10.72 percent. This is based on the difference of the *average* most recent six months of Treasury bond data available and the average of the six month Treasury bond yield during the period used to develop both Greens and Hanelys six month dividend yield for their recommended ROE. Specifically, the 10.72 percent is the result of using the low end of the zone of reasonableness and is reasonable because the current difference between these two average Treasury yields, 1.43 percent, subtracted from the 11.60 percent return would yield a result outside of the zone of reasonableness.

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[105] The question of what, if any, remedy may be necessitated by the Commission's updating of Vernon's rate of return can be addressed in the compliance phase of this proceeding.

[106] This calculation employs a comparison between the average yield on ten-year U.S. Treasury bonds for six-month period covered by the DCF analysis at issue (base-line) and the period the rates were in effect and results in a reduction of 1.13 percent, which, when subtracted from the 11.60 percent, would yield a result that is outside the zone of reasonableness.

The Commission orders:

(A) The Initial Decision is hereby affirmed, as modified, as discussed in the body of this order.

(B) Vernon is hereby ordered to make a compliance filing reflecting the conclusions contained in the body of the order, within 30 days of the date of the issuance of this order, unless any request for rehearing of this order is filed, in which case the compliance filing should be made within 30 days of the issuance of an order on rehearing in this proceeding.

By the Commission.

(S E A L)

Linda Mitry,
Deputy Secretary.