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A LIMITED LIABILITY PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

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December 9, 2002

TO: New York Transmission Owners
FROM: LeBoeuf, Lamb, Greene & MacRae, L.L.P.
RE: Recovery of Administrative Costs by Independent System Operators

You have asked us to review the processes and mechanisms under which existing independent system operators ("ISOs") recover administrative costs and the degree to which such costs or increases in such costs are submitted to the Federal Energy Regulatory Commission ("FERC" or "Commission") for approval or information. The answers below are based on a review of the tariffs and other documents submitted to the Commission or otherwise made public by the ISO New England Inc. ("ISO-NE"), PJM Interconnection, L.L.C. ("PJM"), Midwest Independent Transmission System Operator ("Midwest ISO"), as well as on conversations with the staff of some of the ISOs and the California Independent System Operator Corporation ("California ISO").

The California ISO and ISO-NE both make filings under Section 205. Pursuant to a settlement, California only made an informational filing for his year but will make an extensive Section 205 filing this year to prospectively revise the entire grid management charge. ISO-NE files under Section 205 but claims that the filing relates to the resulting rate and not the budget. While this amounts to a distinction without a difference, it is also not a distinction that would hold up. Recent court decisions make clear that the FERC must review the reasonableness of cost components that make-up the rate before it can find the rate to be just and reasonable. PJM and the Midwest ISO do not appear to make related FERC filings. Finally, keep in mind that the NYISO tariff does not currently provide for Section 205 filings for cost increases. Therefore, a Section 205 or 206 filing would be required to change this mechanism. Politically, it may be difficult for the NYISO to oppose a proposal for FERC review of its costs particularly in light of past increases and the potential for organizational changes.

Copies of the relevant tariff provisions and other documents associated with the budget process and recovery mechanism of each of these ISOs that are referenced below are available on request.

ISO-NE

Budget Process

The ISO-NE prepares two budgets in advance of each upcoming year: a "core operating budget" and a "capital budget." These budgets are submitted to the ISO Board of Directors' Audit and Finance Committee, and to NEPOOL's Budget and Finance Committee for review and

analysis. The budgets are subsequently submitted to the NEPOOL Participants Committee and to the ISO Board of Directors for approval. The budget preparation and review processes are set forth in Section 8 of the Interim Independent System Operator Agreement.

Recovery Process

The ISO-NE recovers its operating and maintenance costs through a self-funding tariff (the "ISO Tariff") by which the costs of providing services are allocated to three separate schedules.¹ Each schedule is billed separately using various volumetric and/or transaction units. The rate design for the ISO Tariff reflected in the Settlement Agreement approved in 2001 is in effect through December 31, 2003.

Under the Settlement Agreement, tariff sheets reflecting the proposed revenue requirement for the corresponding upcoming calendar year for each of the three schedules to the ISO Tariff, with certain true-ups and adjustments, are filed with FERC under Section 205 of the Federal Power Act on or before November 1 ("November 1 Filings").²

A copy of the most recent FERC filing for recovery of ISO-NE's 2003 administrative costs, submitted by the ISO-NE on November 1, 2002, is attached ("2002 Filing"). Exhibit 3 to the 2002 Filing is a copy of the Settlement Agreement. Exhibit 5 to the 2002 Filing is the testimony of Gary W. Pire, Manager of Financial Reporting and Budgeting of ISO-NE. Mr. Pire's testimony describes the operating budget process and the administrative expenses recovery mechanisms in detail.

Finally, a copy of the most recent FERC filing associated with the 2003 capital budget also is attached for your reference.

PJM

Budget Process

Under Section 7.5.2 of the PJM Operating Agreement, the PJM Board adopts, upon consideration of the advice and recommendations of the Finance Committee, operating and capital budgets for the LLC, and distributes to the Members for their information final annual budgets for the following fiscal year not later than 60 days prior to the beginning of each fiscal year of the LLC.

¹ See Settlement Agreement among ISO-NE and other parties in Docket No. ER01-316-000, approved by letter order, 96 FERC ¶ 61,261 (2001) ("Settlement Agreement"). The three schedules are: Schedule 1 - Scheduling Service; Schedule 2 - Energy Administration Service ("EAS"); and Schedule 3 - Reliability Administration Service ("RAS").

² Deviations between tariff collections and the ISO's actual expenses are reconciled through a year-to-year, prospective true-up set forth in section 2.3(2) of the ISO Tariff. The November 1 Filings reflect these true-ups. In addition, the November 1 Filings include other adjustments. For example, the 2003 Operating Budget includes both the "core operating budget" and debt service on Commission-authorized capital and working capital borrowings.

Recovery Process

Under Section 3B of the PJM OATT, the costs of the operation of PJM Interconnection, L.L.C. and the Office of the Interconnection are recovered from Transmission Customers, and from other users of the various PJM services, under Schedule 9 “PJM Interconnection, L.L.C. Administrative Services.” A copy of the PJM Schedule 9 and subsidiary Schedules is attached.

Although revisions to tariff provisions in Schedule 9 are submitted to FERC for approval under Section 205, no FERC filing (informational or otherwise) is made to obtain approval of the actual rates. The current Schedule 9 mechanism was established through a settlement agreement among the market participants, FERC staff and the ISO that was approved by letter order dated July 31, 2000 in Docket No. ER00-298 ("Settlement Agreement"). A copy of the Settlement Agreement and letter order is attached.

Schedule 9 provides that the cost of operating the PJM Interconnection, L.L.C., including principal and/or depreciation expense, interest expense and financing costs, shall be recovered from users of the various PJM services under Schedule 9 and its subsidiary Schedules which correspond to categories of services (“Service Categories”) provided by PJM. The charge in any month to any user of PJM’s services under Schedule 9 is the sum of the charges under each subsidiary Schedule of Schedule 9, to the extent PJM determines those to be applicable to such user in such month:

- Schedule 9-1: “Control Area Administration Service”
- Schedule 9-2: “Capacity Adequacy Administration Service”
- Schedule 9-3: “Fixed Transmission Rights Administration Service”
- Schedule 9-4: “Market Support Service”
- Schedule 9-5: “Regulation and Frequency Response Administration Service”
- Schedule 9-6: “Internal Energy Transaction Administration Service”
- Schedule 9-7: “Capacity Resource and Obligation Management Service”

Schedule 9 also includes a subsidiary Schedule 9-8, "Management Services Cost," which governs the determination and allocation of certain overhead and administrative costs among subsidiary Schedules 9-1 through 9-7.

Each of the subsidiary Schedules 9-1 through 9-7 of Schedule 9 contains a formula for determination of the rate or charge thereunder. The rates and charges for Schedules 9-1 and 9-2 are determined monthly based on the costs incurred in such month, pursuant to the formulas set forth in such schedules. The rates and charges for Schedules 9-3 through 9-7 are determined annually pursuant to the formulas in such schedules, effective January 1 of each calendar year, based on PJM’s budget applicable to such calendar year and on projected billing determinants

forecasted in connection with such budget. The variance each month between the actual costs incurred to provide the services under Schedules 9-3 through 9-7 in such month and the actual revenues from Schedules 9-3 through 9-7 in such month are added to, or subtracted from, the total amount to be recovered under Schedule 9-1 in the month immediately following the month in which such variance occurred, pursuant to the formula set forth in Schedule 9-1.

By October 31 of each calendar year, PJM posts on its Internet site the recalculated rates and charges determined under Schedules 9-3 through 9-7 that will be effective during the subsequent calendar year. At such time, PJM also posts on its Internet site PJM's estimate of the monthly rates under Schedules 9-1 and 9-2 that will be effective for each month of the subsequent calendar year. Additionally, at such time, PJM posts on its Internet site the amount of annual operating projects, capital projects, operating reserves, working capital reserves, and financial covenant requirements assigned to each subsidiary Schedule under Schedule 9. PJM must provide supporting details and workpapers, including billing determinant projections and the alignment of PJM's assets, operating projects, and capital projects with the Service Categories, to any user upon request and upon such user's execution of a confidentiality agreement provided by PJM, as necessary to protect personnel data, trade secrets, or other sensitive or confidential data. A copy of the Approved 2003 Budget and Service Category Rates as posted on the PJM Internet site is attached.

Midwest ISO

Budget Process

The Midwest ISO Agreement provides that the management of all property, business and affairs of the Midwest ISO is vested in the Board of Directors. Midwest ISO Agreement, Article Two, Section III.B.1. The Board is the entity in charge of controlling the costs associated with the provision of ISO services. See Midwest Independent Transmission System Operator, Inc., 101 FERC ¶ 61,221 (2002) at ¶ 3 (attached). The budget process is not specifically described in the Midwest ISO Agreement or the Midwest ISO OATT.

Recovery Process

The Midwest ISO submits a monthly bill to each of its transmission customers for the ISO Cost Adder, a service charge for recovering costs associated with operating the Midwest ISO not covered under Schedule 1 of the Midwest ISO tariff.³ Cost Adder costs are recovered under Schedule 10 of the Midwest ISO OATT and include: (1) costs associated with the Midwest ISO control center, including capital costs and operating expenses and (2) costs for administering the Midwest ISO OATT. The monthly rate is calculated based on budgeted costs and estimated MWhs of transmission service, true-up the following month and capped at 15 cents/MWh.⁴ A copy of the Midwest ISO OATT Schedule 10 is attached. Although the Midwest ISO has made

³ The Midwest ISO has recently proposed to recover the costs associated with the implementation of financial transmission rights and energy markets through two separate schedules: Schedules 15 and 16 under the Midwest ISO OATT. See Midwest Independent Transmission System Operator, Inc., 101 FERC ¶ 61,221 (2002) at ¶ 8. These costs also will be excluded from recovery under Schedule 10. Id. at fn. 35.

⁴ Id. at fn. 12.

filings under Section 205 to modify tariff provisions in Schedule 10, I found no filings seeking FERC approval under Section 205 for the specific level of the charges under Schedule 10.

Schedule 10 includes two subsidiary schedules, 10-A, submitted on October 16, 2001 in Docket No. ER02-111-000, and 10-B, submitted on December 28, 2001 in Docket No. ER02-652-000. Schedule 10-A is the "Alternative Administrative Cost Adder" that applies to transmission customers that have paid the capital portion of Midwest ISO's start-up costs in advance through special arrangements with the Midwest ISO. Schedule 10-B is the "Interim ISO Cost Recovery Adder" intended to apply for an interim period.

By Settlement Agreement in Dockets ER02-111 and ER02-652, the Midwest ISO has committed to initiate a stakeholder process to seek input on whether Schedule 10 should be revised to develop a menu of services or unbundling of services applicable to all customers or loads paying the Schedule 10 charges by no later than March 1, 2003. By June 1, 2003, the Midwest ISO will engage in good faith negotiations with the parties to the proceeding to develop a filing regarding such revisions. See Midwest Independent System Operator, Inc., 99 FERC ¶ 63,040 (2002) at ¶ 20 (attached). The Settlement Agreement also prohibits the Midwest ISO from filing, absent certain circumstances, to change Schedule 10 or to establish a new cost recovery mechanism that would increase the Schedule 10 charges paid by the parties to the Settlement Agreement for the period of January 1, 2002 to December 31, 2003. Id. at ¶ 28.

Because the Settlement Agreement did not dispose of all issues related to the Midwest ISO Schedule 10, a hearing has been scheduled to commence on April 15, 2003 in Dockets ER02-111 and ER02-652. The issues set for hearing relate to the ability of Independent Transmission Companies ("ITCs") that join the Midwest ISO under Appendix I of the Midwest ISO Agreement to contract with the Midwest ISO for unbundled Regional Transmission Organization ("RTO") services. See Report By Settlement Judge Recommending Termination Of Settlement Proceeding issued on August 28, 2002 in the same dockets. Additionally, the issue of whether certain amounts paid to the Midwest ISO by transmission customers under Schedule 10 should be treated as regulatory assets is pending before the Commission.

California ISO

Budget Process

The California ISO budget is prepared and presented to the ISO Governing Board and to stakeholders, for comment. The budget is approved by the Governing Board.

Recovery Process

The California ISO collects its administrative costs through a grid management charge ("GMC") assessed on the ISO's customers.

Pursuant to a Settlement Agreement among the California ISO and active parties in Docket No. ER02-250, submitted to the FERC on October 17, 2002 and certified by the Presiding Administrative Law Judge on November 12, 2002, the California ISO's operating budget has been unbundled in three service categories: (a) Control Area Services ("CAS"), (b) Congestion Management ("CONG"), and (c) Ancillary Services and Real-Time Energy

Operations ("ASREO" or "Market Operations"). A copy of the Settlement Agreement and certification is attached.

The Settlement Agreement determined the ISO's GMC rates for calendar year 2002 and provided a mechanism through which the ISO would be allowed to make changes to the GMC in 2003 without a Section 205 filing. On November 8, 2002 the California ISO made an informational filing with the FERC to set forth the basis for the ISO's GMC rates effective January 1, 2003. A copy of the informational filing is attached.

The California ISO and its ratepayers are committed to a complete and thorough reevaluation of the GMC structure during 2003, as mandated by Judge Bobbie J. McCartney in the Initial Decision in Docket Nos. ER01-313, attached.⁵ The reevaluation process is intended to publicly consider and address the structure of the ISO's GMC.

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⁵ California Independent System Operator Corporation, 99 FERC ¶ 63,020 at 65,154 (2001).