ELLISON, SCHNEIDER & HARRIS L.L.P.
ATTORNEYS AT LAW

2600 CAPITOL AVENUE, SUITE 400
SACRAMENTO, CALIFORNIA 95816
TELEPHONE: (916) 447-2166
FACSIMILE: (916) 447-3512
http://www.eslawfirm.com

CONFIDENTIAL AND PRIVILEGED ATTORNEY-CLIENT COMMUNICATION

MEMORANDUM

TO: Christopher Shaver, County of Mendocino

FROM: Andy Brown, Ron Liebert, Chase Kappel

RE: Analysis of Legal Questions Regarding Community Choice Aggregation.

DATE: February 4, 2016

This memorandum addresses the three legal questions regarding the potential development of a Community Choice Aggregation ("CCA") program for the County of Mendocino ("County").[1] Each of the specific questions and corresponding analysis are set forth below. Before addressing the specific questions, however, we briefly discuss the County's role under a program design that seeks to outsource the core activities to third party entities under a commercially-managed CCA design.

Should there be any questions about this memorandum, of if additional briefing would be useful to the County, we would be pleased to discuss these issues at your convenience.

I. The County's Responsibilities As The Community Choice Aggregator.

Should the County move forward with the adoption of a CCA program, it will be the entity ultimately responsible under applicable statutes and California Public Utilities Commission ("CPUC") implementing rules. Because the County does not intend to create a full-time professional staff to implement a CCA program but instead utilize the services of creditworthy and experienced companies, the County will nonetheless need to structure efficient and workable oversight mechanisms. Part of the design will be captured in the agreements that are negotiated between the counties and the provider, while there will be ongoing, periodic needs to review developments driven by market and regulatory changes while the program is operating. Moreover, because the CCA is intended for further County energy-related goals for the benefit of its constituency, the County will need to define goals and priorities for the CCA.

II. Questions Presented.

The questions to be addressed (from Appendix C of the August 25, 2016 representation agreement) and the responses to those questions are set forth below. Please note that a more

[1] See Appendix C of the August 25, 2016 representation agreement.

detailed explanation of the legal issues associated with the use of CCA Program Net Revenues is provided in section III of this memorandum.

- Use of CCA Program Net Revenues. Provide a legal opinion as to whether non-energy related use of program revenues constitutes an illegal fee or tax. Provide a legal opinion as to whether any operation of law or the CPUC may require that net program revenues be used solely for the Community's energy-related purposes as a condition of approval of the implementation plan.

  Response: To the extent that net revenues from the program operation exceed operational costs (including creation of operational reserves needed for risk management purposes), Proposition 26 may require that surplus program revenues either be returned to customers within the ratemaking process or applied toward other activities or programs that are energy related. Currently, the applicability of Proposition 26 to the use of surplus program revenues is an issue being considered by the California Supreme Court. Therefore, while specifying the use of program revenues is not a condition of approval of CCA implementation plans, we cannot advise at this time that surplus funding be transferred to the general fund for expenditures that have zero nexus to energy-related issues.

  Permissible energy related programs can be rather diverse, and should remain pertinent to the goals of the CCA program. Some existing CCAs are using funding from the CCA electricity sales for community efforts such as local renewables development, energy efficiency, electrification, or greenhouse gas reduction efforts which could include more efficient equipment. To our knowledge, no legal challenges have been raised regarding these uses of CCA revenues.

- Supply Adequacy and Security. Explore whether Mendocino County, as the Community Choice Aggregator, would be considered the provider of last resort (POLR). If so, identify and evaluate potential approaches to fulfilling the POLR function and managing the associated risks of serving the POLR role. If not, identify and evaluate what entity(ies) serve the POLR role and what activities, if any, Mendocino County can and should undertake to ensure that the POLR function is performed appropriately and that the associated risks are adequately managed.

  Response: As the CCA, the County program would operate within a geographically defined area consistent with the implementation plan that will be presented and reviewed by the CPUC. The CCA load is contestable, meaning that, subject to CPUC rules, the incumbent provider (PG&E) may retain customers who "opt out" of the CCA. In this way customers within the CCA footprint can decide to fall back to utility service and, therefore, it is PG&E that functionally operates as the POLR within its CPUC-approved service territory. There are rules applicable to the return of customers to the utility, and a viable CCA program should not be structured in a way that prevents customers from returning to PG&E service.

- Operational Integrity. Create and document how onerous Mendocino County's obligation is to take all necessary actions to secure and transfer to RFP respondents all CAISO Congestion Revenue Rights.

  Response: Appendix A to this memorandum provides a compilation of CAISO rules with respect to securing and transferring Congestion Revenue Rights ("CRRs"), and associated credit requirements. Process-wise, it is not a particularly onerous process. The primary issue is establishing the County's eligibility at CAISO and related creditworthiness.

III. Detailed Analysis of the Use of CCA Program Net Revenues

1. *Do non-energy related uses of CCA program revenues constitute an illegal fee or tax*?

There is no definitive answer to this question at this time. Prior to the passage of Proposition 26 in 2010, the answer presumably would have been yes, since the rules governing the question of what constitutes an illegal fee or tax were governed by Proposition 218, approved in November, 1996. In general, Proposition 218 revised California's Constitution to require taxpayer approval of the adoption, extension, or increase of general and special taxes and assessments. Proposition 218 defined a "special tax" as "any tax imposed for specific purposes, including a tax imposed for specific purposes, which is placed into a general fund." (Cal. Const., art. XIII C, § 1, subd. (d).) However, Proposition 218 contained a specific exemption for electrical and gas service. (Cal. Const. Art. XIII, D, § 3, subd. (b)).

In 2010, Proposition 26 added subdivision (e) to section 1 of California Constitution Article XIII C, broadly defining "tax" to include "any levy, charge, or exaction of any kind imposed by a local government." (Art. XIII C, § 1, subd. (e).) It also included seven exceptions to this definition of tax. More specifically, Proposition 26 requires that

> The local government bears the burden of proving by a preponderance of the evidence that a levy, charge, or other exaction is not a tax, that the amount is no more than necessary to cover the reasonable costs of the governmental activity, and that the manner in which those costs are allocated to a payor bear a fair or reasonable relationship to the payor's burdens on, or benefits received from, the governmental activity. (Cal. Const. Art. XIII C, § 1 [last paragraph.].)

In 2015, an appellate court held that regardless of the exemption for electric rates provided in Proposition 218, Proposition 26 can apply to electric rates and the use of revenues collected from those rates. Citizens for Fair REU rates v. City of Redding (2015) 233 Cal. App. 4th 402 ("Redding"). In Redding, the appellants argued that the City's annual budget transfer from the City's electric utility to the City's general fund was a "payment in lieu of taxes," (referred to as "PILOT") which increased the electric utility's electric bills, and so was a tax for purposes of Proposition 26. Therefore, two-thirds voter approval was required unless the City

could prove that the revenues collected were necessary to cover the reasonable costs of the City to provide electric service.

In its decision, the appellate court specifically rejected the City's arguments that its electric rates and the use of revenues "comports with Proposition 26 because Redding's electric rates are lower than those paid by others in California." The court held that "[e]ven if Redding's rates were the lowest in California, Proposition 26 would nonetheless require the PILOT to either reflect the city's reasonable cost of providing electric serviceor be approved by voters. An unconstitutional tax is not rendered lawful simply by being bundled with otherwise reasonable utility rates." Redding at 419-420. The court ordered that the case be remanded to the trial court to determine "the factual question of whether the PILOT reflects the reasonable costs borne by Redding to provide electric service."

However, the City of Redding appealed the decision and the California Supreme Court accepted the appeal, meaning the appellate decision no longer controls. One of the issues that parties filing amicus curiae have asked the Supreme Court to decide is whether Proposition 26 applies to the internal budgetary transfer of funds from the utility to the City's general fund or whether Proposition 26 applies only to the retail rates charged by the utility. This is an important distinction because prior cases have found that internal budgetary transfers of funds did not violate the prior legal requirements of Proposition 218.

For example, in Howard Jarvis Taxpayers Assn. v. City of Los Angeles (2000) 85 Cal.App.4th 79 (City of Los Angeles) the Howard Jarvis Taxpayers Assn. (Taxpayers Assn.) argued that Proposition 218 prohibited the City of Los Angeles (City) from transferring water revenue surpluses from the City's water revenue fund to the City's general fund. The Taxpayers Assn claimed that the City had been overcharging for its water services and that the overcharges resulted in a surplus in the City's water revenue fund, which the City had been illegally transferring to the City's reserve fund and then to the City's general fund. The Taxpayers Assn. argued that the water rates were, in effect, property-related user fees or special taxes and, therefore, pursuant to Proposition 218, the overcharges and transfer of surplus revenues from the City's water revenue fund to the City's general fund were illegal without voter approval.

The court disagreed, finding that water usage rates were basically commodity charges that did not fall within the scope of Proposition 218. Although this particular finding was overturned in a subsequent California Supreme Court decision that focused on the validity of voter referendums under Proposition 218, the appellate court also held that the Taxpayers Assn had failed to prove that the City's water rates were unreasonable, (for example, in comparison with other areas, past rates or actual costs), and so rejected the claim that the mere existence of surplus water revenues proved that the City had been overcharging for water. The appellate court also determined that since the City Charter authorized the City to transfer surplus funds from the water revenue fund to the reserve fund and then to the general fund, there was nothing prohibiting the City from making the transfers by the method it employed. City of Los Angeles at 84-85.

It is possible that the California Supreme Court may determine, when it issues its decision in Redding, that Proposition 26 does not apply to CCA electric rates and surplus

program revenues. In that event, transfers of surplus CCA revenues to the general fund for non-energy related purposes may withstand legal challenge, in the manner discussed in the City of Los Angeles. However, the California Supreme Court could determine that Proposition 26 does apply to CCA electric rates and revenues, or could fail to provide any clear guidance on the issue, leaving the issue open for further legal resolution. Considering the legal uncertainty at this time, we believe it to be reasonable and prudent for Mendocino County to ensure that all CCA net program revenues be used solely for energy-related purposes to avoid any future legal challenges. As noted above, there are a broad range of programs and investments that can be made that would reflect the required nexus to a CCA program's overarching goals if the County structures the program with such goals.

2. Are there any legal or regulatory requirements that net program revenues be used solely for the Community's energy-related purposes as a condition of approval of the implementation plan?

In large part, the answer to this question will depend on what the California Supreme Court decides in the Redding case, as described above. Currently, there are no legal or regulatory requirements that mandate a CCA describe the use of net program revenues as a condition of approval of the implementation plan. However, if the California Supreme Court determines that Proposition 26 does apply to CCA electric rates and revenues, it is very possible that legal and/or regulatory requirements could be changed to make this a condition of approval of future CCA implementation plans.

IV. Conclusion

This memorandum addresses those regulatory and legal questions related to the County's review of a potential CCA program. Please let us know if there are questions regarding the information presented here.

APPENDIX A

Summary of CRR Rules and Processes

The CAISO Tariff establishes rules for Congestion Revenue Rights ("CRR") in Section 36. See, http://www.caiso.com/Documents/Section36_CongestionRevenueRights_Oct1_2014.pdf.

The CAISO has two Business Practices Manuals for CRR topics: Business Practice Manual for Congestion Revenue Rights ("BPM CRR") posted at https://bpmcm.caiso.com/Pages/BPMDetails.aspx?BPM=Congestion%20Revenue%20Rights, and the Business Practice Manual for Candidate CRR Holder Registration ("BPM CRR Registration") See, https://bpmcm.caiso.com/Pages/BPMDetails.aspx?BPM=Candidate%20CRR%20Holder%20Registration). These three sources inform the summary below.

General Overview

Congestion Revenue Rights are financial instruments that enable CRR holders to manage variability in the congestion costs component of the CAISO locational marginal pricing. (BPM CRR, 1.3.) CRRs are made available through the CRR allocation, CRR auction and Secondary Registration System, which must be used for bilateral transfers. (See Tariff §§ 36.1, 36.7.3.) The CAISO allocates CRRs to load serving entities serving load internal to the CAISO balancing authority area. (Tariff 36.8.) CRRs are acquired primarily, although not solely, for the purpose of offsetting integrated forward market congestion costs that occur in the day-ahead market. (BPM CRR, 1.3).

CRRs fall into two categories: (1) CRR Obligations, and (2) CRR Options. (Tariff § 36.2.) CRR Options are only available for Merchant Transmission Facilities, and so will not be detailed here. (BPM CRR, 1.3). CRRs are also specified by their CRR Source, CRR Sink, the megawatt quantity, and the valid trading hours. (Tariff 36.2.) CRRs are defined as either for on-peak or off-peak hours. (Tariff 36.3.3.) Source and sink determine the direction of a CRR Obligation. (Tariff 36.2.) A CRR Obligation entitles the holder to receive a payment if the congestion in a trading hour is in the same direction as the CRR Obligation, and requires the CRR holder to pay a charge if the congestion is in the opposite direction. (Tariff 36.2.1.) CRRs may be sold or transferred in increments of at least 1/1000 MW. (Tariff 36.7.1.1.)

Registration & Creditworthiness

Any entity that holds or intends to hold CRRs must register and qualify with the CAISO. (Tariff 36.5.) At least 60 calendar days prior to the proposed commencement of the CRR Allocation, CRR Auction, or the effective date of the CRR Transfer through the Secondary Registration System, the Candidate CRR Holder applicant must submit a completed application form to the CAISO. (BPM CRR Registration 2.1; Tariff § 4.10.1.3.) The CAISO will then work with the registrant to ensure that all information is provided to have a complete application. (BPM CRR Registration 2.1.) If the application is accepted, then all certification requirements

and applicable contracts must be executed by the applicant and returned to the CAISO within approximately 30 days prior to the commencement of the CRR Allocation, CRR Auction, or the effective date of the CRR transfer through the Secondary Registration System. (BPM CRR Registration 2.1.)

Applicant's registration requirements include:

(1) Completion of the Candidate CRR Holder Application Form (See Attachment A of the BPM CRR Registration).

(2) CRR Entity Agreement Information Request Form (See Attachment B of the BPM CRR Registration).

(3) Submission of forms (1) and (2), along with $1,000 for new market participants to CAISO as instructed in the BPM for CRR Registration.

(4) An officer of each prospective and existing Market Participant with a direct financial relationship with the CAISO shall complete and provide to the CAISO, on an annual basis, an executed certified statement that follows the standardized format of the Officer Certification Form available on the CAISO's website. Each prospective or existing Market Participant that is a CRR Holder or a Candidate CRR Holder is also required to provide additional summary information and attestations relating to their risk management policies, procedures and controls as set forth in the Officer Certification Form. Each prospective or existing Market Participant that is a CRR Holder or a Candidate CRR Holder and that meets the net portfolio value criterion contained in the Officer Certification Form is additionally required to submit to the CAISO, at the time it submits its Officer Certification Form, a copy of its current governing risk management policies, procedures and controls applicable to its CRR trading activities. (BPM Registration 2.3.1.2; Tariff 12.1(b)(i)).

(5) The candidate CRR Holder must establish CAISO portal access. These applications are accessed through the CAISO's portal via the internet. (BPM CRR Registration 2.3.2.)

(6) The candidate CRR Holder applicant is required to complete CRR computer based training. (BPM CRR Registration 2.3.5.)

(7) The candidate CRR Holder must undergo an Electronic Funds Transfer test to ensure the party can submit payments to, and receive payment from CAISO. (BPM CRR Registration 2.3.6.)

(8) The candidate CRR Holder must complete an Affiliate Disclosure Form. (Tariff § 36.7.3, BPM CRR Registration 2.3.7.) This provides CAISO with information on all affiliates of the Candidate CRR Holder or CRR Holder, that are themselves Candidate CRR Holders, CRR Holders or Market Participants, any Affiliate that participates in an organized electricity market in North America, and any guarantor of any such Affiliate. This is an on-going requirement for as long as the CRR Holder owns CRRs. A CRR Holder must

notify the CAISO within five (5) business days of an Affiliate relationship change. (BPM CRR Registration 2.3.7.)

(9) A CRR Entity Agreement (CCREA) must be executed prior to becoming a Candidate CRR Holder. Based on the information provided in the CRR Entity Agreement Information Request Form), CAISO will generate a CRR Entity Agreement and send it to the Candidate CRR Holder applicant. A sample of the Pro forma agreement is available through the BPM for CRR Registration. (BPM CRR Registration 2.3.8.)

In addition to the registration requirements, all CRR holders and "Candidate CRR Holders" must satisfy the minimum participation requirements set out in FERC Order 741, and comply with the creditworthy requirements in CAISO Tariff Sections 12 and 12.6. (BPM CRR Registration 2.3.1.1; Tariff 36.5.1.) All CAISO Credit Requirements can be found in the BPM for Credit Management.

Most entities will satisfy these requirements if they can attest to one or more of the following: a net worth of $1 million; total assets of $10 million; or credit support in the form of a guaranty or Letter of Credit from another entity that qualifies as an "appropriate person". (BPM CRR Registration 2.3.1.1.) Candidates that do not should review Section 12 of the CAISO Tariff to determine if they can meet the creditworthy and capitalization requirements, which are reviewed every six months by CAISO staff. (See Tariff 12(b)(iii)(3).)

In regards to creditworthiness, the CAISO's Tariff requires that Market Participants, such as CRR Holders, secure financial transactions with the CAISO by maintaining an Unsecured Credit Limit and/or by posting Financial Security. (Tariff 12.1(a).) For each Market Participant, the sum of its Unsecured Credit Limit and its Financial Security Amount shall represent its Aggregate Credit Limit, and the Aggregate Credit Limit must be maintained at an amount that is at least equal to the Estimated Aggregate Liability. (Tariff 12.1(a).) For CRR Holders using the Secondary Registration System, the CAISO Tariff provides the following:

> In cases where the ownership of a CRR is to be transferred through the Secondary Registration System, the CAISO shall evaluate and adjust the credit requirements for both the current owner of the CRR and the prospective owner of the CRR as appropriate prior to the transfer. If additional Financial Security is required from either the current or prospective owner, the transfer will not be completed until such Financial Security has been provided to and accepted by the CAISO. CRRs transferred through the Secondary Registration System will be treated like auctioned CRRs for the purpose of calculating the credit requirements for holding the CRRs, regardless of whether the CRRs were originally allocated or purchased at auction or acquired through the Secondary Registration System.

(Tariff 12.6.3.1(d).)

Bilateral Transfers and the Secondary Registration System

The SRS portion of the CRR system is provided to facilitate the buying and selling of CRRs acquired through the CRR allocation or CRR auction. (BPM CRR 13.2.1.) CRR holders must report to the CAISO all bilateral CRR transactions through the Secondary Registration System. (Tariff 36.7.3.) Both the transferor and the transferee must register the transfer in the system. (Tariff 36.7.3.) The entity receiving the CRRs may be any entity eligible to be a CRR Holder. (BPM CRR 13.1.)

Transfers must be for at least a full day term consistent with the on-peak or off-peak specification of the CRR (also called "TOU") and must be in increments of at least a thousandth of a MW. (BPM CRR 13.1.) CRRs cannot be traded on an hourly basis. (BPM CRR 13.2.) Both the transferor and the transferee of the CRRs must register the transfer of the CRR with ISO using the SRS five business days prior to the effective date of transfer of revenues associated with a CRR, or with sufficient time necessary for the ISO to evaluate the creditworthiness of the transferor and transferee, whichever is shorter. (BPM CRR 13.2.)

Both the transferor and transferee must submit the following information to the SRS:

- The effective start and end dates of the transfer of the CRR,
- The identity of the transferor,
- The identity of the transferee,
- The quantity of CRRs being transferred,
- The CRR Sources and CRR Sinks of the CRRs being transferred, and
- The time of use period of the CRR.

(BPM CRR 13.2)

ISO does not assess any CRR Settlement charges or make any CRR Settlement payments with any entity other than the CRR Holder of record until the CRR transfer is successfully recorded through the SRS and the transferee meets all the creditworthiness requirements specified in ISO Tariff § 12. (BPM CRR 13.2)

Within the SRS there is a functionality that performs a creditworthiness check of all SRS trades to ensure that the receiving party of the transaction has sufficient collateral to cover the ownership of the CRR. (BPM CRR 13.2.1.) If the projected value of the CRR is negative, i.e., the expected revenue stream is negative and the CRR Holder would be expected to owe ISO for holding that CRR, then the new CRR Holder needs to have sufficient collateral posted with ISO to cover the term of the CRR. (*Id*.) If sufficient collateral is available, then the trade is confirmed. (*Id*.) If there is not sufficient collateral, the trade is rejected until such time as the entity can post the additional required collateral. (*Id*.) For Long Term ("LT") CRRs the CRR Holder may sell or transfer only the term corresponding to the current calendar year as well as the calendar year covered by the most recently completed annual CRR Allocation. (*Id*.)