UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Duke Energy Moss Landing LLC	**)**	**Docket No. ER98-2668-000**
Duke Energy Oakland LLC	**)**	**Docket No. ER98-2669-000 (not consolidated)**

MOTION TO FILE ANSWER AND ANSWER OF THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION

To the Commission:

Pursuant to Rules 212 and 213 of the Commission's Rules of Practice and Procedure, 18 C.F.R. §§ 385.212 and 385.213, the California Independent System Operator Corporation (ISO), hereby requests that the Commission accept its answer to Duke Energy Moss Landing LLC's and Duke Energy Oakland LLC's (collectively Duke), Pacific Gas and Electric Company's (PG&E), and Houston Industries Power Generation Inc. (HIPG) filings of May 28, 1998, in the captioned proceedings.

The Commission Should Accept the ISO's Answer in Order to Clarify Facts and Assist It in Understanding the Issues Raised

Rule 213(a)(2) of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.213(a)(2), provides that while an answer may not generally be made to a protest or to an answer, the Commission may allow an otherwise impermissible answer for good cause. The Commission will accept an answer under Rule 213(a)(2) if the answer assists the Commission in understanding the issues raised. *See Pacific Gas and Elec. Co.*, 77 FERC ¶ 61,204, at 61,808 (1996); *Public Serv. Co. of New Hampshire v. New Hampshire Elec. Coop., Inc.*, 83 FERC ¶ 61,224 (1998). Duke, PG&E and HIPG have raised arguments in their pleadings that unnecessarily obfuscate the issues in these dockets.

They have also misstated several facts.[1] Therefore, the ISO requests that the Commission accept this Answer to assist the Commission's understanding of the issues in these proceedings, and to correct the misstatement of important facts.

ISO'S ANSWER

Duke's answer is deficient in several respects, however, most of the deficiencies are part of an overarching problem and that is, Duke repeatedly either obfuscates or completely ignores the factual circumstances of the restructured market in California. Despite the detail of the pleading, or perhaps because of it, Duke fails to adequately respond to the main issues raised in the ISO's intervention. Those issues are: (1) that the use of non-uniform RMR contracts can pose a threat to reliability, (2) that Duke's filing, if accepted by the Commission, will increase the ISO's costs by putting the ISO in default of its financing arrangements, and (3) that Duke's proposed acquisition adjustment of $182 million is not just and reasonable. While the ISO responds herein to each of the specific arguments made by Duke, the ISO highlights a couple of the overarching deficiencies of Duke's pleading below.

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[1] For example, on page 61 of its Answer, Duke claims that "[s]ignificantly, *no party* requests that Applicant's must-run rate schedules be suspended for the maximum period." (emphasis in original). This statement is incorrect. In its protests in these proceedings, the ISO clearly stated that if the Commission does not reject Duke's filings, then "[a]t the very least, the Commission should suspend the filing for a full five months and set for expedited hearing whether a termination and transfer to an entity with different terms and conditions is connected with a public interest and just and reasonable, and defer acceptance of Duke's filing until the issue is resolved." ISO Moss Landing Protest at 9; ISO Oakland Protest at 10. A similar statement is made at ISO Moss Landing Protest at 8; ISO Oakland Protest at 9.

NON-UNIFORM CONTRACTS

As noted in the ISO's Motion to Intervene, the restructured market in California is unique in that it seeks to use, in the first instance, market mechanisms to maintain and enhance reliability. As a result of this design, the ISO must rely on a multitude of contractual arrangements, including contracts for the purchase of RMR services. In order to administer these contracts and operate the transmission system in a efficient and reliable manner, the ISO requires a certain level of uniformity of contractual provisions.

In its answer, Duke asserts that other companies previously have administered different contracts without any discernable impact on reliability. Duke's analogy is inappropriate and is a prime example of how Duke's arguments simply ignore the changed circumstances in the California market. The short answer is that the ISO has responsibilities that go beyond the previous responsibilities of the three investor-owned utilities in California. The details of these responsibilities are explained in the attached affidavit of Mr. Kellan Fluckiger. Mr. Fluckiger is the Director of Operations for the ISO and in his affidavit he explains how non-uniform RMR rate schedules can pose a threat to system reliability.

In addition, much of Duke's pleading discusses whether its filing is "substantially similar" to PG&E's rate schedule. Although the ISO definitely believes the Duke's filing does not contain substantially the same terms, Mr. Fluckiger notes that over time, with successive transfers of an RMR unit to new owners, even the "substantially the same" requirement may lead to the existence of very different contractual provisions. Again, this highlights one of the reasons for the ISO's need to rely on *pro-forma* agreements.

INCREASE IN ISO COSTS

As discussed in the affidavit of Charles A. Smart, Chief Financial Officer for the ISO, the ISO will incur substantial costs if the Commission accepts Duke's filings. Once again, before addressing the relative merits of Duke's arguments, it is important to note that, in general, Duke's pleading deliberately ignores the restructured environment in which the ISO operates. Nowhere in Duke's pleading is there a recognition, much less a discussion of: (1) the circumstances and relationships between the ISO and PG&E prior to the divestiture of the Moss Landing and Oakland units, and (2) how those relationships changed after divestiture. Prior to divestiture, Reliability Must-Run service and payment obligations were contained within the ISO's relationship with PG&E. After divestiture, the ISO is an intermediary between Duke and PG&E with regard to the acquisition, use and payment for RMR services. The provisions of section 2.2(a)(iii) of PG&E's RMR Agreement A explicitly address the hardship on the ISO as a purchaser of RMR services if a new owner can file a rate schedule that does not contain "substantially the same terms." Indeed, the section contemplates FERC approval of the contract between the ISO and the new owner. In addition, nowhere in its answer does Duke directly respond to the fact that its filing will put the ISO in default of its financing arrangements. For example, no bank would issue a letter of credit to the ISO regarding RMR payment risk because there would be no source of repayment.

1. The Commission Should Treat Duke's Submissions As Initial Rate Filings Under Section 35.12 and Reject Them.

Duke filed its proposed rate schedules for the Moss Landing and Oakland units as initial rates under section 35.12 of the Commission's regulations. As initial rates they cannot be suspended. Federal Power Act, Section 205(e), 16 U.S.C. § 824d(e); *Middle South Energy v. FERC*, 747 F.2d 763, 772 (D.C. Cir. 1984), *cert. dismissed*, 473 U.S. 930 (1985).[2] Thus, as filed, the Commission can either accept the filings or reject them. The Commission should reject the filings because PG&E's transfer of the reliability must-run (RMR) units did not comply with PG&E's rate schedule and thus, PG&E's obligation to serve the ISO cannot be transferred to Duke. Moreover, there is no Commission precedent for the filing of an initial rate that is not also an agreed upon rate. No entity should be allowed to make an initial rate filing containing rates and terms that are in dispute between the parties. Duke, whose RMR units possess locational market power, should not be permitted to use this procedural mechanism to force its own rates and terms on the ISO. Of utmost importance is the fact that the ISO should not be forced to accept rates and terms for RMR service that may seriously impair transmission reliability. Thus, the Commission should reject Duke's initial rate filings.

The ownership of RMR units is not static. For example, PSE&G Resources has purchased a leasehold interest in one of San Diego Gas & Electric Company's must-run units. In addition, AES, which purchased units from Southern California Edison (SCE) has assigned its must-run responsibilities pursuant to the must-run agreement to Williams

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[2]It is well-established that the Commission may not suspend initial rates. *See TECO Power Services Corp.*, 52 FERC ¶ 61,191, at 61,198-99 (1990) (rejecting an initial rate filing, reasoning that the rates in the filed agreements had not been shown to be just and reasonable because of a failure by the applicants to demonstrate (i) a lack of undue preference in affiliate pricing and (ii) that the pricing in one of the agreements, even though negotiated between non-affiliate parties, was just and reasonable). *See also Portland General Exchange, Inc.*, 51 FERC ¶ 61,108, at 61,244 (1990) (rejecting an initial rate filing without prejudice to the applicant's right to refile and demonstrate that it has not granted its affiliate any undue preference; *Terra Comfort Corp.*, 52 FERC ¶ 61,241 (1990).

Energy Services. These continual changes in who owns, and how must run units are operated is likely to continue as the competitive California energy market evolves.

Moreover, the design used to restructure the electric industry in California seeks to use market mechanisms to maintain and enhance reliability. As a result, the ISO must rely on a multitude of contractual arrangements, including contracts for the purchase of RMR services. Standard terms and conditions and a standard way to calculate rates for RMR agreements are required to support a fair and efficient market. The ISO continues to pursue uniformity of terms and conditions for RMR service with new owners and the existing IOUs using the collaborative process that has been a hallmark of the California restructuring process. If the Commission accepts and suspends Duke's filings, it will amount to a significant departure from the collective effort in California to establish and rely on uniform terms and conditions for RMR service.[3] Acceptance of Duke's filings will lead to filings by other RMR owners seeking terms and conditions that are narrowly tailored to their specific needs. The Commission must consider the ISO's ability to reliably and efficiently operate the transmission system and should reject attempts to implement individual terms and conditions. Absent rejection, the ISO believes that reliability will be seriously impaired. In addition, accepting or suspending Duke's filings will expose the ISO to substantial financial liability and will greatly increase the ISO's operating costs. The Commission should promptly reject Duke's filings.[4]

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[3]As discussed below, suspension of Duke's rates with refund protection is not adequate because the reliability concern arises from the difficulty of administering individual, non-uniform RMR agreements.

[4]The Commission has on occasion treated initial rates as changes in rates under section 35.13 of its regulations. Viewed as such, the Commission could accept the filings subject to refund or suspend the filings for up to five months. The ISO reiterates its position that the Commission

The arguments of Duke and PG&E deliberately ignore the circumstances and relationship between the ISO and PG&E prior to the divestiture of the Moss Landing and Oakland units. Prior to divestiture, the must-run service and payment obligations were contained within the ISO's relationship with PG&E. After divestiture, the ISO is an intermediary between PG&E and Duke with regard to the acquisition, use and payment for RMR services. The provisions of section 2.2(a)(iii) of PG&E's RMR Agreement A explicitly address the potential hardship on the ISO as a purchaser of RMR services if the new owner can file a rate schedule with different terms. Indeed, the section contemplates FERC approval of the contract between the ISO and the new owner.

2. PG&E Did Not Comply With The Filed Rate Doctrine; Duke's Filings Are Patently A Nullity And Should Therefore Be Rejected.

The basis of Duke's and PG&E's arguments appears to be that, because there is no contractual relationship between the ISO and Duke, Duke is not bound by the terms of PG&E's RMR Agreement. Duke Answer at 17-19. Both Duke and PG&E further claim that because the PG&E agreement is simply a rate schedule, which was unilaterally filed by PG&E, and not a contract between PG&E and the ISO, and because this rate schedule has not been found to be just and reasonable by the Commission, PG&E should not be bound by its provisions. Duke Answer at 17; PG&E DEML Opposition at 9; PG&E DEO Opposition at 9.

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should not treat the filings as changes in rates that could be accepted or suspended because such acceptance or suspension will cause operational and financial burdens on the ISO. However, in the alternative, should the Commission not grant the ISO's request to reject the filing, the Commission should order a full five-month suspension. This suspension will coincide with the suspension and expedited hearing on PG&E's Notice of Termination, assuming that Notice of Termination is not rejected, as requested by the ISO.

PG&E's RMR rate schedule clearly provides that PG&E cannot terminate its rate schedule unless it sells to a purchaser who "executes a contract with ISO or files a rate schedule with FERC to provide ISO the right to purchase Energy and Ancillary Services from the Unit *under substantially the same terms as this Agreement.* . . ." PG&E RMR Agreement "A", section 2.2(a)(iii) (emphasis added). As such, before PG&E may terminate its obligation to the ISO for must run service, the ISO is entitled, as a matter of law, to the rights provided for under the FERC filed and accepted rate schedule, *i.e.*, to have a rate schedule on file that contains substantially the same terms and conditions as PG&E's filed and accepted rate. PG&E and Duke attempt to confuse this central issue. Because Duke's filing does not contain terms and conditions that are substantially the same as PG&E's filed and accepted rate (and, therefore, does not comply with the filed rate). PG&E's notice of termination and Duke's filings should be rejected.

Regardless of how PG&E's agreement is characterized, PG&E must comply with its terms.[5] Under the filed rate doctrine, both the purchaser and seller are bound to the terms of the rate schedule accepted for filing by the Commission, and it does not require a Commission finding that the rates are just and reasonable before the parties are bound by the provisions of the filing. *See Northwest Pipeline Corp.*, 70 FERC ¶ 61,243, at 61,751 (1995) (holding that "even if the Commission mistakenly accepts a rate filing . . . the Commission's acceptance is binding, under the filed rate doctrine, for the period when that tariff is in effect.") (footnote omitted). PG&E's RMR filing was accepted by

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[5] *See* ISO Moss Landing Protest at 12 n.5, where the ISO states that "[a]lthough not a contract between the parties, PG&E must nevertheless comply with the terms of that agreement, including the termination conditions until the Commission accepts a superceding agreement." *See also* ISO Oakland Protest at 13 n.5.

the Commission and set for hearing, and PG&E is therefore bound by its terms. *See Public Serv. Co. of New Mexico*, 52 FERC ¶ 61,068, at 61,273 n.7 (holding that "under the filed rate doctrine, [the rate accepted for filing] will be regarded as the rate on file . . . unless and until either: (1) a subsequent rate is accepted for filing, or (2) a subsequent rate is established by the Commission after a complaint."). In interpreting the filed rate doctrine, the Commission does not make a distinction between filed contracts and filed rate schedules.[6] PG&E must therefore comply with the terms of its accepted RMR rate schedule, including the termination provision, until the Commission accepts a superceding agreement, even though the Commission has not yet determined whether the filed rate schedule is just and reasonable.[7]

The Commission may reject a filing where "the filing is so patently a nullity as a matter of substantive law, that administrative efficiency and justice are furthered by obviating any docket at the threshold rather than opening a futile docket." *Municipal Light Boards v. FPC*, 450 F.2d 1341, 1346 (D.C. Cir. 1971), *cert. denied*, 405 U.S. 989 (1972). As previously stated, PG&E did not comply with its RMR termination

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[6] *Kansas Gas and Elec. Co.*, 27 FERC ¶ 61,009 (1984). *See also Missouri Utilities Co.*, 10 FERC ¶ 61,048, at 61,113 (1980) (holding that "[a]lthough the service agreement [which the Commission determined to be a rate schedule] was not executed, the Commission's acceptance of the service agreement for filing binds [the buyer and seller] to its terms under the filed rate doctrine").

[7] Assuming, *arguendo*, that PG&E and Duke can show that their rate schedules are overall "substantially the same," Duke's RMR rate schedule uses terms different than PG&E's in its termination provisions. Under Duke's proposed rate schedule, if Duke transfers the RMR facilities to a nonaffiliated third party, there is *no requirement* that the new owner have terms and conditions "substantially the same" as Duke's. Rather, the facility can be transferred if the new owner simply files with FERC a rate schedule for the Delivery of Energy and Ancillary Services to the ISO and such rate schedule is in effect. Thus, by accepting the Duke filing, at the end of the day, the ISO could be forced to administer an RMR rate schedule that is not "substantially the same" as the original PG&E rate schedule. The Commission should disallow this dynamic by rejecting the Duke filing.

provisions. PG&E RMR Agreement "A", section 2.2(a)(iii). Therefore, PG&E's Notice of Termination must be rejected. Consequently, Duke's filings are patent nullities because Duke cannot unilaterally file a rate schedule for the Moss Landing and Oakland units because Duke cannot be authorized to provide RMR service until PG&E is relieved of that obligation.[8] As patent nullities, Duke's RMR filings must be rejected.

In the alternative, if there is a question of fact whether Duke's filing satisfies the ISO's rights under PG&E's filed and accepted rate, then the ISO is entitled to a hearing in PG&E's Notice of Termination proceeding. During the pendency of that hearing, PG&E's obligations under the filed and accepted rate should remain in effect.

3. Consistent RMR Terms and Conditions are Necessary to Maintain Grid Reliability.

The use of a *pro forma* must-run agreement is a fundamental precept to the California restructuring process. The Commission recognized this concept in its December 17, 1997 order setting the companies' *pro forma* agreements for hearing, where it stated that:

> *[t]he Companies [PG&E, SCE and SDG&E] explain that the intent of the WEPEX stakeholder process was that the ISO would file a pro forma must-run agreement that would be a model for facility-specific must-run agreements* and that the owners of the must-run facilities would negotiate the terms of the individual, facility-specific must-run agreements with the ISO before those facility-specific agreements were filed with the Commission.

Pacific Gas and Elec. Co., 81 FERC ¶ 61,322, at 62,486 (1997) (emphasis added). Until the Duke filing, the proposal for RMR owners to abide by one set of terms and conditions

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[8] Contrary to PG&E's argument, at 9-10 of its Oppositions, the ISO did not support its request that the Commission reject Duke's filing on grounds that Duke did not comply with the "RMR contract."

has not been contested. In fact, stakeholders are currently in the process of creating a uniform set of terms and conditions for RMR service.

PG&E now characterizes the *pro forma* must-run agreement as an adhesion contract. PG&E Oppositions at 3, 12. An adhesion contract is defined as:

> A standardized contract, which, imposed and drafted by the party of *superior bargaining strength*, relegates to the subscribing party only the opportunity to adhere to the contract or reject it.

17 C.J.S. § 10 (emphasis added). Under California law, a "contract is classified as one of adhesion when it limits the duties or liabilities of the stronger party, and the weaker party experiences coercive pressure to sign." *King v. Larsen Realty, Inc.*, 175 Cal.Rptr. 226, 232 (1981) (citation omitted) (holding that a contract with an arbitration provision is not an adhesion contract because there was no demonstration of an "economic coercion to contract"). The Commission has determined that it is the must-run units, and not the ISO, that may have locational market power. *Pacific Gas and Elec. Co.*, 81 FERC ¶ 61,122, at 61,537 (1997). At present there are 117 RMR units in the ISO's control area. If the ISO was forced to secure RMR service under 117 different agreements, the reliability of the ISO-controlled grid would be severely compromised. The ISO's demand for a *pro forma* RMR agreement with a uniform set of terms and conditions, is born out of its obligation to reliably and efficiently operate the system, not out of a desire to coerce RMR owners into a contract that restricts their rights under the FPA. Because the ISO is a nonprofit entity and because it treats the must-run costs simply as a passthrough, it does not have the requisite incentive to economically coerce Duke to sign a must-run agreement with substantially the same terms as the PG&E agreement. PG&E's claim that the ISO can

impose an adhesion contract on Duke, when Duke is the party in the position of economic power and the ISO has no economic incentive to coerce Duke, is therefore misplaced.

As documented in the attached Affidavit of Kellan Fluckiger, Director of Operations and Engineering for the ISO, administering must-run units on a daily basis is a time-consuming process, often requiring four hours. If Duke's filing is accepted, the possibility of a flood of new filings, all with different terms and conditions, will increase. Such a flood will further increase the complexity of the must-run process. Increased complexity will further increase the time required to administer the must-run units. In addition to burdening the operations staff, and increasing the chances of a dispatch error, this will decrease the amount of time available to complete other tasks related to reliability.

Two terms and conditions of Duke's filing will, in particular, impact reliability. First, Duke proposes to be able to consider economic factors when deciding whether to dispatch units in excess of their service limits and in mitigating the impacts of a Force Majeure event, when directed to do so by the ISO. Since the ISO is held to a best efforts standard to try to avoid calling on a unit under these conditions, it is presumed that under those conditions the ISO has no other choice but to call on that unit to ensure system reliability. For the owner to consider economics when deciding to comply with that request is unacceptable.

Second, Duke proposes to be able to suspend critical must-run service if the ISO fails to maintain a letter of credit backstopping the RMR payments—a letter of credit which the ISO, as a nonprofit corporation, could not acquire, as explained in the next section, and which the ISO is under no obligation to do under any other RMR filing except Duke's. Service from a must-run unit should only be suspended in the most extreme circumstances, such as nonpayment, not simply for the failure to maintain a letter of credit.

4. The ISO Could Not Have Avoided the Irreparable Financial Harm It Will Suffer if Duke's Filing is Not Rejected.

Duke's statements demonstrate a fundamental lack of understanding about the ISO's financial position, yet as early as January 1998, the ISO discussed that position with Duke and PG&E. Duke Answer at 9-12. Duke suggests that the ISO should have established a reserve account to cover contingencies.[9] Duke suggests that this must-run reserve account would provide funds for the ISO to use in the event of a nonpayment of a must-run invoice. Assuming this reserve account had to be of the same magnitude as Duke's proposed letter of credit—$75,000,000—to accumulate that level of reserves in one year to cover one RMR unit alone, the Grid Management Charge (GMC) would have to increase by approximately $0.3846/MWh, or 49%. Smart Affidavit at 5. An increase in the GMC of this magnitude would be unacceptable to the ISO and stakeholders. Moreover, unlike the operating and reserve account currently maintained by the ISO, which benefits all grid users, such a must-run reserve account would benefit only Duke, yet all grid users would have to pay for it.

[9]The ISO has established a 15% operating and reserve account to cover day-to-day operating contingencies and to satisfy certain bond covenants contained in the ISO's permanent financing. This operating and reserve account benefits all users of the ISO grid. Initially, the ISO's proposal for the operating and reserve account met with strong opposition by users of the grid because of its affect on the GMC. Therefore, the ISO expects that if it even attempted to establish a must-run reserve account of the magnitude that would be required to cover nonpayment of a must-run invoice, the affect on the GMC would be many times greater than the existing operating and reserve account. Moreover, the proposed must-run reserve account would benefit only Duke, yet all grid users would have to pay for it.

Duke also proposes that, in lieu of a must-run reserve account, the ISO provide each must-run owner with a letter of credit in the amount of $75,000,000 and give each must-run owner a security interest in the ISO's accounts receivable for the amounts a PTO owes for must-run service. If the ISO defaults on its payment to the owners, the owners could collect the amounts owed from the proceeds of the letter of credit and the security interest before collecting directly from the ISO. Duke Answer at 9-10. Duke's proposal is neither practicable nor feasible.

The ISO cannot issue a letter of credit to a must-run owner due to the fact that no bank would issue a letter of credit on behalf of the ISO absent a source of repayment. All of the ISO GMC revenues are restricted to funding ISO operations and the repayment of the bonds issued as part of the ISO's permanent financing. Smart Affidavit at 5. The only other source of revenue would be the market revenues from imbalance energy and ancillary services markets. However, these revenues are assets of the market participants and not available to the ISO for any use. Smart Affidavit at 5. Consequently, it is impossible for the ISO to implement the letter of credit mechanism espoused by Duke.[10]

Consequently, it is impossible for the ISO to implement the credit terms proposed by Duke. Furthermore, the ISO cannot implement any arrangement that forces the ISO to bear any payment risk because such an arrangement would degrade the ISO's credit position and increase the ISO's cost of financing, and ultimately the GMC, as described below.

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[10] Duke suggests that it be permitted to have a security interest in the ISO's accounts receivable for PG&E. Duke Answer at 10. The ISO does not object to such an interest and, indeed, has provided similar protection in the agreements that it has reached with the new must-run owners of SCE's units, SCE and SDG&E regarding payment risk. Smart Affidavit at 3, Smart Exhs. 1 & 2.

The ISO currently has two types of financing. Its temporary financing is a $215,000,000 line of credit established by the ISO Restructuring Trust and guaranteed by the IOUs. As of June 1, 1998, the ISO Trust has drawn $206,000,000 on the line of credit. Smart Affidavit at 2. The ISO's permanent financing allows the ISO to issue $310,000,000 of variable rate demand bonds, backed by a letter of credit. By May 15, 1998, the ISO had issued a total of $301,400,000 in bonds. The syndication of banks providing the letter of credit placed restrictions on the use of bond proceeds. The bond restrictions permit the ISO to use $76,872,000 for working capital and for the completion of the ISO infrastructure. The remaining $224,528,000 of bond proceeds are restricted and used as collateral for the letter of credit until PG&E agrees to pay all must-run invoices submitted by the ISO and until Duke agrees that it will not have recourse to the ISO in the event that payment has not been received from PG&E. Smart Affidavit at 2, 7. These lending restrictions are necessary due to the potential liability of the ISO for RMR payments. The RMR payments are very large relative to the ISO's overall operating budget. Smart Affidavit at 7.

If the ISO cannot comply with the syndication's requirement respecting payment risk, then the ISO will be in default and be subject to severe financial consequences. Smart Affidavit at 7-8; Smart Exhibit 4. One possible consequence of default could be that the syndication would give notice that all drawings, all loans and all interest thereon, are immediately due and payable. In addition the syndication could give notice of a mandatory tender for the purchase of all outstanding bonds.

In the event of default, it is Mr. Smart's opinion that (1) the ISO's interest costs will increase by at least $1,729,620, recognizing that the $76,872,000 of bond proceeds to be used for working capital and completion of the infrastructure must be paid in a fully amortized, one year, term loan in 1999 at a substantial increase in interest rates; (2) the 1999 GMC will have to be increased by over 60% over the 1998 GMC in order to pay off the $76,872,000 term loan, and to finance approximately $15.5 million in capital expenditures that can no longer be funded with the bond proceeds; (3) the ISO will have to make net interest payments on the $206,000,000 in its temporary financing, as well as the $301,400,000 in permanent financing of approximately $2,060,000; and (4) until the payment risk issue is resolved, the ISO will not have use of the restricted bond proceeds and, therefore, will not be able to pay down the $206,000,000 in temporary financing which is guaranteed by the IOUs, and the IOU guarantees will not be released. Smart Affidavit at 8.

If this payment risk issue is not resolved to the satisfaction of the syndication, the ISO may be required to use all restricted bond proceeds to retire the outstanding bonds. This would require the ISO to initiate a new permanent financing arrangement at a higher cost. Smart Affidavit at 8.

Duke argues that if it agrees to a non-recourse provision, then it would be left without any recourse for payment in the event of a payment dispute between PG&E and the ISO. Duke Answer at 9. Duke claims that because it would not be in privity with PG&E, it could not sue PG&E for breach of contract if PG&E fails to pay the ISO. *Id.* Duke is wrong. If PG&E and Duke enter into agreements with the ISO similar to those executed between the ISO and SCE and SCE Owners, as well as between the ISO and SDG&E, then Duke, as a third-party beneficiary, would be given the ability to take action against PG&E. Smart Affidavit at 6, Smart Exhibits 1 & 2.

PG&E claims that its transfer of RMR facilities to Duke will not alter the ISO's financing arrangements from the *status quo* because PG&E has not yet agreed to a "non-recourse" arrangement. PG&E DEML Opposition at 18; PG&E DEO Opposition at 18. To the contrary, the ISO's financing arrangements will be negatively affected because when the Participating Transmission Owner (PTO) is also the must-run owner, the ISO does not have any payment risk since any payment default by the PTO would be offset against the corresponding payment to the must-run owner, which is the PTO.

Even without the payment risk restrictions imposed by the syndication, it remains unreasonable for the ISO to shoulder such risk. The ISO is a passthrough conduit for must-run payments. They flow from the PTO through a must-run trust account managed by the ISO to the must-run owner. The ISO does not have any payment risk in performing its duties as an agent for imbalance energy and ancillary service payments in the market and, likewise, should not have any payment risk in performing its duties as an agent for must-run payments. Smart Affidavit at 3-4. The ISO is essentially an escrow agent facilitating invoicing and payments between the seller and buyer of must-run generation and should not be forced into default due to a PTO default of its payment obligations. It is unreasonable for the ISO to be forced to accept the payment risk and additional financing costs when it is the seller and buyer of a must-run generation unit that reap the benefits of the transaction. It is also unreasonable for other entities, *i.e.*, those that pay the GMC, to bear the additional financing costs. Thus, Duke's filing must be rejected to avoid the previously described financial harm.

5. The Commission Has Section 203 Jurisdiction Over Generation that Serves a Transmission Function.

The ISO previously argued that there are important public policy considerations here that dictate that the Commission require PG&E and Duke to file for Commission approval under Section 203 of the Federal Power Act. Duke and PG&E argue that there are no jurisdictional assets being transferred to warrant Commission action under Section 203. Duke Answer at 27; PG&E Oakland Opposition at 19; PG&E Moss Landing Opposition at 21. Duke states that the Commission has already rejected the ISO's argument in *Transmission Agency of Northern California v. PG&E*, Docket No. EL98-26-000, where the Commission declined to enjoin PG&E's transfer of the Morro Bay generating unit. In that case, the Commission stated in a two paragraph letter order that the Commission does not have jurisdiction "over facilities used for the generation of electric energy." Letter Order issued on April 29, 1998. However, unlike Morro Bay, the Moss Landing and Oakland are Reliability Must-run units, which, in part, serve a critical transmission function to maintain reliability on the ISO Controlled Grid. As such, these units perform a jurisdictional transmission function. Thus, the facts in this case are not "literally identical to those of the Morro Bay case" as Duke states. Duke Answer at 27.

Reliability Must Run service is a substitute transmission service. The ISO must have the ability to call on RMR units for supply of generation and ancillary services that are not provided for in the market and that are necessary for transmission reliability. It is well-established that ancillary services are necessary for transmission reliability and are thus transmission-related services.[11] The RMR units provide ancillary services when

[11] In Order No. 888, the Commission required that transmission providers offer six ancillary services in their open access transmission tariffs (Scheduling, System Control and Dispatch;

necessary and also, by their nature, take the place of transmission upgrades or new facilities, in order to maintain reliability.

In contrast with the Commission's recent pronouncement in *Sithe Framingham LLC,* 83 FERC ¶ 61,106 (1998), the provision of RMR service is clearly jurisdictional. In *Sithe,* the Commission found that sales of ancillary services (Spinning Reserves and Supplemental Reserves) by Sithe were merely incidental to wholesale sales service.[12] 83 FERC at 61,504. Sales pursuant to an RMR agreement, however, are not *incidental* to wholesale sales service. Rather, as discussed above, the sole purpose of the RMR contracts is to maintain transmission system reliability. RMR service is critical to maintaining system reliability and the stability of the transmission system.

Because RMR contracts are not the same as wholesale sales arrangements, the transfer of these facilities is not strictly a transfer of nonjurisdictional generation facilities

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Reactive Supply and Voltage Control; Regulation and Frequency Response; Energy Imbalance Service; Spinning and Supplemental Reserves). According to the Commission, these services are needed to accomplish transmission service while maintaining reliability within and among control areas affected by the transmission service. *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, 61 Fed. Reg. 21,540 (May 10, 1996), FERC Stats. & Regs., Regs. Preambles ¶ 31,036 (1996); *order on reh'g*, Order No. 888-A, 62 Fed. Reg. 12,274 (March 14, 1997), FERC Stats. & Regs., Regs. Preambles ¶ 31,048 (1997), *order on reh'g,* Order No. 888-B, 62 Fed. Reg. 64,688 (1997), 81 FERC ¶ 61,248(1997).

[12]EWGs must be exclusively engaged in wholesale sales of electricity to qualify under Section 32(a)(1) of the Public Utility Holding Company Act. The Commission stated, for the benefit of prospective EWG applicants, that the sale of other ancillary services (such as Reactive Supply and Voltage Control, Regulation and Frequency Response and Energy Imbalance Service) for resale is also a by-product of wholesale electric energy sales and a permissible activity under Section 32(a)(1) of PUHCA, "*as long as the sale of such services is incidental to the sale of electric energy at wholesale.*" 83 FERC ¶ 61,106 at 61,504 n.8 (emphasis added); *see also* Order No. 888-A at 30,237 (finding that "a QF arrangement for receipt of Real Power Loss Service or ancillary services from the transmission provider or a third party for the purpose of completing a transaction is not a sale-for-resale of power by a QF transmission customer that would violate our QF rules."). Both of these orders make the point that a provider of ancillary services is not the same as a wholesale seller of energy.

outside the scope of the Commission's jurisdiction under Section 201 of the FPA. The Commission's pronouncements in this matter will have broad ramifications not only in California, but everywhere that a transmission grid operator does not own or directly control generation and must instead rely on must-run contracts to maintain the reliability of the transmission system. The Commission has jurisdiction over the transfer of RMR contracts and should exercise that jurisdiction to ensure that the transfer of these facilities is consistent with the public interest.

Moreover, contrary to Duke's contentions, if the Commission were to conduct a Section 203 analysis in this case, it would find that the transfer will have an adverse effect on competition and rates. As discussed above in sections 1, 3 and 4, PG&E's transfer of the Moss Landing and Oakland RMR units under terms that are not substantially the same as the terms in PG&E's rate schedule will harm the ISO and consumers by imposing operational and financial burdens on the ISO. Thus, the Commission should find that the transfer is not consistent with the public interest.

6. Because The Alternate Service Proposed By Duke Is Not A Satisfactory Alternative, PG&E's Request To Terminate RMR Service To The ISO Must Be Summarily Denied, Or, In The Alternative, Must Be Suspended For The Maximum Period And Duke's Filing Should Be Rejected[13]

Duke and PG&E claim that, contrary to the cases cited in the ISO Protest, Duke will be providing a satisfactory alternative service to the ISO such that PG&E's Notice of Termination must be accepted. Duke Answer at 59-60; PG&E DEO Opposition at 21-23; PG&E DEML Opposition at 24-26. Duke and PG&E are wrong.

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[13]Duke's filing should be rejected because, as an initial rate, it cannot be suspended. Federal Power Act, Section 205(e); *Middle South Energy v. FERC*, 747 F.2d 763, 772 (D.C. Cir. 1984), *cert. dismissed*, 473 U.S. 930 (1985). If the Commission finds that Duke's filing is not an initial rate, then it should either reject the filing or suspend it for the maximum period.

A satisfactory alternative service to the ISO is not provided because Duke's proposed RMR rate schedule does not include terms that are "substantially the same" as PG&E's—a condition precedent to PG&E's termination of RMR service. PG&E claims that "substantially similar terms exist in the Duke RMR because the ISO will receive substantially the same service, under cost-based rates." PG&E DEO Opposition at 22; PG&E DEML Opposition at 24. PG&E's interpretation is illogical and contrary to the plain meaning of PG&E's own RMR provision. PG&E ignores the difference between the service being provided and the terms of that service. Its currently effective RMR Agreement states that it cannot be terminated unless the new agreement (filed by the new owner of the RMR facilities) has "substantially the same terms." PG&E's Agreement "A", section 2.2(a)(iii). That Duke would provide must-run service alone, is not the criterion by which to judge whether the terms of PG&E's rate schedule have been met by PG&E. The ISO's protests provide an in-depth explanation of how the two agreements differ. ISO Oakland Protest at 18-20 & Attachment A; ISO Moss Landing Protest at 15-17 & Attachment A; Fluckiger Affidavit. Yet, both RMR Agreements are intended to provide must-run service. Therefore, because the transfer provisions of PG&E's own RMR schedule have not been met, PG&E cannot be permitted to terminate its service to the ISO. Consequently, the proposed transfer to Duke of PG&E's obligation to serve the ISO is invalid, making Duke's filing a nullity, as previously discussed.

Another reason why a satisfactory alternative does not exist in Duke's current proposal is because in accepting PG&E's Notice of Termination without suspension and necessarily allowing Duke's RMR to take effect, the Commission would allow Duke to impose burdensome operational features that, due to the absence of competitive alternatives to Duke's RMR units, the ISO must accept. ISO Oakland Protest at 10-11; ISO Moss Landing Protest at 9-10. These burdensome operational features are fully set forth in the ISO's protests and herein. *See* Fluckiger Affidavit. Thus, for these reasons, PG&E's Notice of Termination must be rejected, and consequently, so must Duke's filing.

7. Duke is Not Entitled to Recovery of its Acquisition Premium for Moss Landing as a Matter of Law

Although Duke claims that any inquiry into its acquisition premium is necessarily "intensely factual", Duke Answer at 31, it cannot point to any improvement in service or new public use that could justify rate recovery of an acquisition premium under settled Commission precedent. Duke has not identified any tangible and quantifiable benefit to consumers that will result from its purchase of the Moss Landing unit, and is therefore not entitled to recovery of its acquisition premium as a matter of law.

Duke correctly notes that the Commission does not have a *per se* bar against recovery of an acquisition adjustment. Duke Answer at 31. However, the lack of a bar against recovery does not necessarily equate to a right to hearing on the issue, as Duke's Answer suggests. Instead, recovery of an acquisition adjustment has never been favored by the Commission, and has only been authorized in cases where specific, tangible benefits to all consumers can be demonstrated. *See, e.g., Arkla Energy Resources,* 61 FERC ¶ 61,004, at 61,038 (1992), *modified,* 65 FERC ¶ 61,235 (1993); *Mid-Louisiana Gas Co.,* 7 FERC ¶ 61,682 (1979), *aff'd sub nom. Transcontinental Gas Pipe Line Co. v. FERC,* 652 F.2d 179 (D.C. Cir. 1981). Thus, the Commission has consistently rejected rate recovery for an acquisition premium where "the same customers would be served by the same facilities" with "no benefit whatever to [customers] by reason of the turnover of the facilities at a price higher than the original cost less depreciation." *Commonwealth Edison Co. and Central Illinois Light Co.*, 51 FPC 2179 at 2189 (1974).

As was noted in the ISO's Moss Landing Protest, virtually the only circumstance in which the Commission has allowed ratepayers to pay for an acquisition premium is where the purchaser converted the facilities to a new public use. ISO Moss Landing Protest at 32-33, citing *Longhorn Pipeline Partners*, 73 FERC ¶ 61,355 (1995) and *Cities Services Gas Co.*, 4 FERC ¶ 61,269 (1978). However, Duke claims that its proposal does not violate this Commission precedent because (a) the Commission does not require a new public use as a prerequisite to recovery of an acquisition adjustment, and (b) even if it did, must-run service would qualify as a new public use. Duke Answer at 34-37.

With respect to its first argument, Duke notes that the "two principal cases involving electric acquisition premiums" never refer to a new public use test. Duke Answer at 34, citing *Minnesota Power & Light Co.*, 43 FERC ¶ 61,104, *reh'g denied*, 43 FERC ¶ 61,502 (1988); *Baltimore Gas & Elec. Co.*, 44 FPC 1601 (1970) [hereinafter *BG&E*]. Even assuming that the two cases cited by Duke qualify as the "principal" electric acquisition adjustment cases, neither supports Duke's conclusion. *Minnesota Power & Light* was a Section 203 proceeding in which the Commission was asked to rule on the propriety of the future recovery of an acquisition premium through wholesale rates. Although the Commission noted that there was no *per se* bar to recovery, it made no ruling on the propriety of recovery in that case. 44 FPC at 1602.

Likewise, *BG&E* does not support Duke's claim that the new public use test is irrelevant to electric cases. In that case, the Commission allowed PEPCo to recover from ratepayers (through above-the-line amortization) PEPCo's acquisition premium in acquiring a transmission line from BG&E. In so doing, however, the Commission noted that the line transferred was no longer useful to BG&E, and that PEPCo's customers would be better off if PEPCo purchased the line from BG&E at the market price than if it built a new line. 44 FPC at 1602. Thus, in contrast to the instant case, the customers asked to pay for the acquisition premium in *BG&E* had not already paid for the acquired facilities at their original cost, and were in fact receiving *new or improved services* (*i.e.,* transmission across the BG&E line) as a result of the acquisition. In essence, PEPCo's new transmission line was being converted to a new public use from the perspective of PEPCo's customers.

Duke also argues that the new public use test should not apply to electric cases because such an application would effectively preclude electric utilities from recovering acquisition premia in every case. Duke Answer at 35-36. However, in citing to *BG&E,* Duke has itself identified the kind of electric facility transfer that might warrant rate recovery for an acquisition premium, *i.e.* where the customers paying the premium were not previously served by the acquired facilities, and where the acquiring utility could not have obtained the facilities or provided the needed services through a lower-cost alternative. Likewise, as Duke admits in footnote 12 at p. 35 of its Answer, transfers from a public agency such as TVA might qualify as a new public use. Although Duke claims that this result would be illogical, there is in fact every reason to treat newly jurisdictional property differently than property that has historically been regulated. *See, e.g., Cities Service Gas Co., supra* (allowing recovery of an acquisition adjustment where the pipeline had not been devoted to gas utility service as defined in the Uniform System of Accounts).

Despite its claim that the new public use standard does not apply to electric cases, Duke attempts to make the alternative argument that the provision of must-run service qualifies as a new public use. However, Duke cannot create a new product or service simply by attaching a new label to the same reliability service that California customers previously enjoyed—and paid for—as part of their bundled electric service. Unlike the pipeline cases involving a new public use (and unlike *BG&E*), Duke is asking the very customers that have already paid for reliability services from the Moss Landing unit at the original cost rate to foot the bill for Duke's acquisition of the unit without any improvement in service. The Commission has never before allowed such a result and should not now permit Duke to use restructuring as the vehicle for abandoning well-settled precedent governing regulated rates.[14]

Even if, as Duke argues, there is no requirement of a new public use, or the must-run services could be considered such a new use, Duke's request for recovery of its acquisition premium still fails as a matter of law. [15] Duke cannot identify one single quantifiable benefit *that flows from its acquisition of the PG&E units.*[16] Instead, the

[14]The Commission has expressly determined that reliability must-run service may still be subject to locational market power and must, therefore, remain subject to cost-based regulation. *Pacific Gas and Elec. Co.*, 81 FERC ¶ 61,122, at 61,537 (1997).

[15]Despite its claim that a new public use is not a predicate for recovery of an acquisition adjustment, Duke apparently believes it is automatically entitled to recovery of its acquisition premium if it can prove that must-run service is such a new use. *See* Duke Answer at 38. However, situations involving a new public use appear to be the only ones in which it has been possible to meet the burden of showing that an acquisition adjustment has resulted in tangible and quantifiable benefits for all customers. It does not necessarily follow that a new public use renders the acquisition adjustment reasonable—for instance, the acquisition of an oil pipeline for conversion to natural gas service does not provide a benefit which would justify recovery of any acquisition premium, if the acquiring pipeline could have built the pipeline for less.

[16]The only benefit that arguably results from the sale is the increase in the number of competitors providing generation in California—a benefit that Duke has not even attempted to quantify.

benefits Duke purports to "quantify" rest on the erroneous assertion that any extra dollars PG&E receives from the Duke purchase will necessarily reduce the amount that PG&E's customers must pay for stranded costs, and that Duke's purchase of the facilities has provided this new value to PG&E's customers.

8. It is Against the Public Interest to Set the Acquisition Adjustment Issue for Hearing

Duke's portrayal of the impact of summary rejection of its proposed acquisition adjustment on future divestitures is misleading, and will simply provide a windfall for Duke and any other purchaser who knowingly purchases a must-run unit at a price above book value. Although the ISO agrees that the Commission's ruling in this case may affect the behavior of bidders in future divestitures, it strenuously disagrees with Duke's conclusion as to the best result for ratepayers. Contrary to Duke's assertion, requiring purchasers of identified must-run generating units to adhere to the cost-based methodology they knew would govern their must-run service provides an *accurate* signal to potential purchasers. To the extent that some portion of the unit's generation is restricted to must-run service (and therefore to a cost-based rate), the purchaser's bid will, necessarily, reflect that limitation. Neither consumers, nor the purchasers of identified must-run units, are harmed. By contrast, allowing purchasers of generating units to use their own, subjective bids to set the rate base for any newly acquired facilities will directly harm consumers by increasing the cost for must-run service, without any corresponding increase in the quality of the service provided.

Notably, Duke never claims that its bid for the units was based on an expectation of recovering more for its must-run services than would be possible under an original cost-based rate. Instead, Duke's willingness to pay more than book value for the units can easily be ascribed to its expectation that a portion of the energy generated could be sold at market-based rates. In order to capitalize on these opportunities, Duke has already filed for authorization to make sales at market-based prices from all three units. Docket Nos. ER98-2680-000, ER98-2681-000, and ER98-2682-000. Thus, even for the two units that are subject to certain cost-based restrictions, Duke recognizes the immediate opportunity for market-based sales. Moreover, as Duke noted in its April 24, 1998 Transmittal Letter, California's current approach to must-run service may be altered or abandoned in the future, leaving Duke free to sell all of the output of its units at market prices. *See Transmittal Letter* at 1.

Duke claims that the ISO takes a subjective approach when it asks the Commission to consider Duke's own estimate of the value of the three units in assessing these public policy issues. Duke Answer at 38. This statement is misleading. In its Moss Landing Protest, the ISO repeatedly asked the Commission to adhere to Commission precedent, and to refrain from injecting any subjective judgments into the valuation of assets for setting cost-based rates. The only reason the ISO refers to Duke's bid formulation is to refute Duke's assertions about the incentives needed to encourage successful divestiture. Quite the opposite of Duke's assertions, public policy would not be served in setting this matter for hearing, and would instead inject additional uncertainty into the divestiture process to the ultimate detriment of consumers.

CONCLUSION

WHEREFORE, the ISO requests that the Commission accept this Answer and reject Duke's filings in these proceedings because they are not just and reasonable.

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Date: June 12, 1998

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the official service lists compiled by the Secretary in Docket Nos. ER98-2668-000 and ER98-2669-000, in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.2010 (1997).

Dated at Washington, D.C. on this 12th day of June, 1998.

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Linda L. Walsh