UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

San Diego Gas & Electric Company, Complainant, v. Sellers of Energy and Ancillary Services Into Markets Operated by the California Independent System Operator and the California Power Exchange, Respondents.	)))))))))	Docket No. EL00-95-017
Investigation of Practices of the California Independent System Operator and the California Power Exchange	)))	Docket No. EL00-98-016
Arizona Public Service Company	)	Docket No. ER01-1444-000
Automated Power Exchange, Inc.	)	Docket No. ER01-1445-000
Avista Energy, Inc.	)	Docket No. ER01-1446-000
California Power Exchange Corporation	)	Docket No. ER01-1447-000
Duke Energy Trading and Marketing, LLC	)	Docket No. ER01-1448-000
Dynegy Power Marketing, Inc.	)	Docket No. ER01-1449-000
Nevada Power Company	)	Docket No. ER01-1450-000
Portland General Electric Company	)	Docket No. ER01-1451-000
Public Service Company of Colorado	)	Docket No. ER01-1452-000
Reliant Energy Services, Inc.	)	Docket No. ER01-1453-000
Sempra Energy Trading Corporation	)	Docket No. ER01-1454-000
Mirant California, LLC, Mirant Delta, LLC, and Mirant Potrero, LLC	))	Docket No. ER01-1455-000
Williams Energy Services Corporation	)	Docket No. ER01-1456-000

APPLICATION FOR REHEARING OF THE
CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION

The California Independent System Operator Corporation ("ISO")[1] respectfully submits this application for rehearing of the Commission's Order Directing Sellers To Provide Refunds of Excess Amounts Charged for Certain Electric Energy Sales During January 2001 Or, Alternately, To Provide Further Cost or Other Justification for Such Charges issued March 9, 2001 in the above-captioned dockets, 94 FERC ¶ 61,245 ("March 9 Order"), pursuant to section 313(a) of the Federal Power Act ("FPA" or "Act"), 16 U.S.C. § 825l(a) (1994), and section 713 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.713 (2000).

I. INTRODUCTION AND SUMMARY OF POSITION

The ISO recognizes the importance of the March 9 Order. For the first time in the California electricity crisis, the Commission has identified specific refund obligations for suppliers whose sales reflect windfall profits due to the exercise of market power. Nevertheless, the March 9 Order does not properly fulfill the Commission's mandate under the Federal Power Act to protect consumers from unjust and unreasonable rates. Assuming that the Commission does not accept further cost justifications provided by suppliers, the March 9

[1] Capitalized terms not otherwise defined herein are used in the sense given in the Master Definitions Supplement, Appendix A to the ISO Tariff.

Order provides refunds only of approximately 1.3 percent of over $5.2 billion spent by Californians on electricity costs in January.[2]

In its December 15, 2000 Order Directing Remedies for the California Wholesale Electric Markets, the Commission adopted a $150/MWh soft price cap. *San Diego Gas & Electric Company, v. Sellers of Energy and Ancillary Services Into Markets Operated by the California Independent System Operator Corporation and the California Power Exchange, et al.*, 94 FERC ¶ 61,294 (2000), *reh'g pending* ("December 15 Order"). Sellers below the $150/MWh "breakpoint" would be eligible for the market clearing price. *Id.* at 61,996. The Commission also committed to analyze individual bids above the breakpoint to "give purchasers the assurance that these cost factors have contributed to the higher spot prices rather than the exercise of market power." *Id.* As Commission Massey noted in his dissenting opinion concerning the March 9 Order, the March 9 Order represents an unexplained and improper departure from the $150/MWh soft cap methodology. *See* March 9 Order at 61,865-66. Rather than a review of individual bids in all hours, the March 9 Order adopts a "rate screen" representing the hypothetical costs of running the *least efficient* gas turbines of the investor owned utilities ("IOUs") and applies it only to those time periods in which the ISO was in a Stage 3 emergency. *Id.* at 61,862-63.

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[2] The ISO recognizes that a portion of these costs reflect sales by governmental agencies not subject to the Commission's authority under Sections 205 and 206 of the Federal Power Act, 16 U.S.C. §§ 824d and 824e (1994), respectively. Nevertheless, as explained below, the ISO believes that the Commission should work with its sister agencies such as the Bonneville Power Administration under the Department of Energy umbrella to ensure that any unjust sales have been remedied.

In effect, the March 9 Order establishes a hard cap of $273/MWh for Stage 3 emergencies and provides no mitigation whatsoever against the exercise of market power for all other system conditions. The result is to improperly condone the exercise of market power, to permit the collection of unjust and unreasonable wholesale rates, and to fail to realize the full scope of the relief promised in the December 15 Order.

Moreover, even if it were appropriate for the Commission to utilize a "rate screen" the Commission's implementation of this surrogate market clearing price in the March 9 Order is fundamentally flawed. First, the limitation of refund exposure to Stage 3 emergencies is arbitrary and capricious. Past studies have found that suppliers routinely exercise market power outside of Stage 3 conditions. Recent studies by the ISO's Department of Market Analysis ("DMA") have found the rampant exercise of market power under *all* system conditions. Furthermore, the limitation of refunds to Stage 3 emergencies is directly contrary to the ISO's responsibility under Commission-approved contracts, the ISO Tariff, and state law to maintain specific reserve levels. These reliability concerns force the ISO to purchase supplies to attempt to prevent conditions deteriorating to Stage 1 and Stage 2 emergencies, not just Stage 3. The Commission's exclusive focus on Stage 3 is completely without any legal or evidentiary basis. It sends incorrect price signals, purporting to mitigate or lower prices at the times of highest needs.

The Commission's proxy price lacks foundation in the established record of this proceeding in other ways. While the ISO recognizes the importance of

encouraging new generation in California, the rates approved in the March 9 Order go impermissibly beyond what is necessary to accomplish that objective. In particular, the NOx element of the rate screen is unsupported. The March 9 Order fails to recognize that the need for such credits only relates to facilities in certain locations within California and fails to take into account actions that state officials have taken to lower the prices generating units pay for NOx credits. In addition, the Commission's gas price may overstate what a prudent generator's actual production costs should be.

As described below, the Commission should work to ensure that sales by sister federal agencies were made at just and reasonable rates. Additionally, as explained herein, the Commission must ensure that generators provide the ISO and State officials with cost data necessary to determine the unlawful exercise of market power. To establish an appropriate record, the Commission must hold hearings regarding the extent of market power and ensure that refund authority is preserved.

II. SPECIFICATIONS OF ERROR

The ISO respectfully submits that the March 9 Order errs in the following respects:

1. The Commission's use of a "rate screen" to establish a surrogate Market Clearing Price represents an unsupported departure from prior Commission findings with respect to the current crisis facing the wholesale California electricity market and an unwarranted

retreat from the obligation assumed by the Commission in its December 15 Order to implement the generator-specific mitigation measures reflected in that Order.

2. Even if the Commission finds that use of a rate screen is appropriate, it is arbitrary, capricious, an abuse of discretion, and contrary to the law for the Commission to limit refunds to Stage 3 emergency conditions.

3. The Commission has failed to provide a reasoned basis for its proxy price. Use of the proxy price reflected in the March 9 Order results in unjust and unreasonable rates for sales for resale in interstate commerce.

4. It is unjust and unreasonable and contrary to the Commission's prior approval of the Market Monitoring and Information Protocol ("MMIP") of the ISO Tariff for the Commission not to order generators to supply their cost data to the ISO and appropriate State officials.

5. Given the dysfunctional California wholesale electric market, it is arbitrary and capricious and an abuse of discretion for the Commission to fail to establish hearings to determine just and reasonable rates based on the actual cost of service.

III. ARGUMENT

A. The Use of a Surrogate Market Clearing Price Approach Is Contrary to the Commission's December 15 Order and Will Result In Unreasonable Rates To California Consumers

In the December 15 Order, the Commission established a $150/MWh breakpoint methodology – only sellers whose bids below $150/MWh that are accepted by the ISO would be eligible for the Market Clearing Price. December 15 Order at 61,983. The Commission also committed to analyze individual bids above the breakpoint and required public utility sellers to submit on a weekly basis detailed data, including information on their marginal costs (fuel quantity, fuel costs, NOx emissions rates, NOx costs, variable operations, and maintenance expenses). *Id.* at 62,011. The intent behind the soft cap approach was clear: "[b]y establishing a $150 breakpoint and not pricing every MWh at the clearing price, spot prices will no longer be magnified." *Id.* at 61,996. As noted above, the Commission took this action to "give purchasers the assurance that these cost factors have contributed to the higher spot prices rather than the exercise of market power." *Id.*

In the March 9 Order, the Commission departs from the December 15 Order's methodology. Now, the Commission establishes "a just and reasonable 'rate screen' above which refunds will either be required or further investigation will be undertaken." March 9 Order at 61,862. This rate screen is not at $150/MWh but at $273/MWh. *Id.* at 61,862-63. The Commission states that it developed this screen by "establishing the market clearing price that would have occurred had the sellers bid their variable costs into a single price auction." *Id.* at

61,862. The screen is based on the weighted average of the *least efficient* gas turbine for each of the three California IOUs. *Id.* at 61,863 (emphasis added). The Commission only applies this screen during periods when the ISO is experiencing Stage 3 emergencies. *Id.* at 61,862-63.

The order inexplicably transforms the soft cap of $150/MWh into a hard cap of $273/MWh (applied only in extreme emergency conditions and subject to still further increases if cost support is submitted). Whereas the December 15 Order had a section entitled "Limitations on the Single Price Auction,"[3] the March 9 Order used its proxy clearing price to set a single price standard. The result is to vitiate the protections specified in the December 15 Order.

The adoption of the soft cap appropriately recognized that large segments of California End-Use Customers were unjustly exposed to the spot price. The March 9 Order fails to identify any change in circumstance warranting any different conclusion. Indeed it could not have done so as deteriorating financial conditions limited the ability of California's two largest investor-owned utilities ("IOUs") to engage in forward contracts to meet their customers' needs.[4]

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[3] December 15 Order at 61,995-96.

[4] As explained in the affidavit of Spence Gerber attached to the Amendment No. 38 filing letter, approximately 15 percent of the IOUs' load continues to be scheduled in the spot market. *See* Amendment No. 38 Filing, Docket No. ER01-1579-000 (Mar. 20, 2001), at Attachment E. This level is three times the amount the Commission anticipated in the December 15 Order and suggests that further protection is warranted to reduce customer exposure to the exercise of market power in the spot market. There is no basis in the record to assume that the Commission's 5 percent spot market target is being achieved at present or will be achieved in the near future. In fact, in its April 6, 2001 Order in Docket No. EL01-34-000, the Commission cites a report prepared by the California Department of Water Resources ("DWR") indicating that DWR has executed contracts for only 2,247 MWs of electricity and that "[i]f this report is correct and a substantial amount of new forward contracts are not signed for this summer, a significant amount of load will continue to be supplied in the most volatile spot market." *Southern California Edison Company and Pacific Gas and Electric Company*, 94 FERC ¶ 61,025, slip op. at 6.

When the Commission established the $150/MWh level, then-current gas and NOx allowance prices were at approximately $50/MMBtu and $50/lb., respectively. December 15 Order at 61,996. As demonstrated in the DMA's February 28, 2001 Report on Real Time Supply Costs Above Single Price Auction Threshold: December 8, 2000 - January 31, 2001 ("DMA December/January Report"), the spot price of gas fell sharply in the second week of December 2000 and remained below $20/MMBtu for the remainder of December 2000 and all of January 2001. DMA December/January Report at 4.[5] Similarly, DMA documented that NOx allowance prices had declined to approximately $18/lb. in mid-January 2001. *Id*. Despite this 60 percent reduction in the price of gas and a 64 percent reduction in the price of emission credits, the Commission has effectively increased the acceptable wholesale price by 82 percent and has refused to scrutinize 7,793 transactions above even the Commission's own $273/MWh proxy price because they did not take place during Stage 3 conditions.

The ISO recognizes that the Commission intends to apply the rate screen methodology only on an interim basis, pending the adoption of longer-term mitigation measures. Nevertheless, the ISO is greatly concerned about the potential harm to California's consumers during the interim period, which has extended for many months. The March 9 Order may encourage, rather than restrain, the exercise of market power. Generators will know that, despite the

[5] A copy of the DMA January/February Report was attached to the joint ISO and California Electricity Oversight Board ("EOB") March 1, 2001 Motion for Issuance of Refund Notice To Sellers, Request for Data, Request for Hearing, and Request for Expedited Action filed in this docket.

reporting requirements of the December 15 Order, their bids during non-Stage 3 conditions will not be subject to any effective scrutiny whatsoever.

The courts have stated that "[f]or the agency to reverse its position in the face of precedent it has not persuasively distinguished is quintessentially arbitrary and capricious." *Louisiana Public Service Commission vs. FERC*, 184 F.3d 892, 897 (D.C. Cir. 1999). Here, the Commission has inexplicably departed from its earlier orders in these very proceedings. The Commission has offered no justification for its departure from the analysis of individual bids above the $150/MWh breakpoint proposed as a mitigation measure in the December 15 Order.

While the Federal Power Act accords the Commission some discretion in setting rates, the Commission must exercise its oversight responsibility under sections 205 and 206 in pursuit of the statutory aim "to protect consumers from exorbitant prices and unfair business practices."[6] Moreover, the latitude afforded to the Commission in applying the just and reasonable standard does not extend to authorizing the agency to abdicate its statutory responsibility to review jurisdictional rates. *See Federal Power Commission v. Texaco, Inc.*, 417 U.S.

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[6] *Public Systems v. FERC,* 606 F.2d 973, 979 n.27 (D.C. Cir. 1979). *See also Atlantic Refining Co. v. Publ. Serv. Com'n of State of New York,* 360 U.S. 378, 388 (1959) (the corresponding provisions of the Natural Gas Act "afford consumers a complete, permanent and effective bond of protection from excessive rates and charges"); *Pennsylvania Water & Power Co. v. FPC,* 343 U.S. 414, 418 (1952) (describing the Commission's primary duty to "protect power consumers against excessive prices").

380, 394 (1974). In particular, reviewing courts have noted that "the most useful and reliable starting point for rate regulation is an inquiry into costs."[7]

While the Commission is not obliged to apply a cost standard in all circumstances, it must justify a decision to depart from that standard by articulating a basis for concluding that an alternative standard nevertheless results in just and reasonable rates. As the United States Court of Appeals for the District of Columbia Circuit held in the *Farmers Union* case in rejecting an attempt by the Commission to depart from the cost standard in its regulation of oil pipelines under the Interstate Commerce Act: "Departures from cost-based rates must be made, if at all, only when the non-cost factors are clearly identified and the substitute or supplemental ratemaking methods *ensure* that the resulting rate levels are justified by those factors." *Farmers Union*, 734 F.2d at 1530 (emphasis added). Market-based rates can satisfy the statutory standard "when there is a competitive market," i.e., where the Commission has "specifically found that [the relevant] markets are sufficiently competitive to preclude [a jurisdictional seller] from exercising significant market power in its merchant function."

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[7] *Farmers Union Cent. Exch., Inc. v. FERC*, 734 F.2d 1486, 1502 (D.C. Cir.), *cert. denied sub nom. Williams Pipe Line Co. v. Farmers Union Cent. Exch., Inc.*, 469 U.S. 1034 (1984) ("*Farmers Union*"). *See also City of Detroit, Michigan v. FPC*, 230 F.2d 810, 818-19 (D.C. Cir. 1955), *cert denied. sub nom. Panhandle Eastern Pipe Line Co. vs. City of Detroit*, 352 U.S. 829 (1956):

> [W]hen we refer to an "increase" we mean an increase in the rates above those which would result from the use of the conventional rate-base method. For, though we hold that method not to be the only one available under the statute, it is essential in such a case as this that it be used as a basis of comparison. It has been repeatedly used by the Commission, and repeatedly approved by the courts, as a means of arriving at lawful – "just and reasonable" – rates under the Act. Unless it its continued to be used at least as a point of departure, the whole experience under the Act is discarded and no anchor, as it were, is available by which to hold the terms "just and reasonable" to some recognizable meaning.

Elizabethtown Gas Co. v. FERC, 10 F.3d 866, 870-71 (D.C. Cir. 1993) (citation omitted). In those circumstances, "competition in [the] relevant markets will operate as a meaningful constraint" on sellers' prices. *Buckeye Pipe Line Co.*, 44 FERC ¶ 61,066, 61,186 (1988).

When the Commission finds that markets are not sufficiently competitive to constrain the exercise of market power, the just and reasonable rate it prescribes – and the level of revenues above which refunds must be required – must be based on the wholesale seller's costs of producing the power. *Farmers Union, supra; see also Entergy Services, Inc.*, 59 FERC ¶ 61,369 (1992) (requiring utility to file cost-based rates for transaction where market power has not been adequately mitigated).

In the DMA December/January Report, the ISO provided a cost review of accepted bids and out-of market purchases by the ISO during December 2000 and January 2001. The DMA analysis demonstrated that during January, even accounting for the spot market gas and NOx emission prices that some generators may have incurred, the operating costs of most thermal capacity owned by the major non-utility owners within the ISO Control Area were significantly below the $150/MWh breakpoint. Significantly, the March 9 Order points to no contrary evidence in the record and does not dispute this finding. Rather, the Commission seeks to minimize the clear import of the DMA Report by asserting that the DMA analysis applied to all hours and not just Stage 3 conditions, that the DMA analysis included certain non public utility sellers, and that the DMA analysis did not utilize a market clearing price. March 9 Order at 6-

7. These distinctions, however, do not justify the Commission's acceptance of substantially higher wholesale rates in disregard of substantial record evidence showing that just and reasonable rate levels would be *below* $150.

The Commission's December 15 Order directed public utility suppliers to provide the Commission with specific data regarding their costs of production. The entire purpose in requesting these data was for the Commission to examine the specific exercise of market power by individual generators for all bids over the $150/MWh breakpoint. To that end, the central conclusion of the DMA December/January Report is that numerous sellers were able to establish prices at levels substantially above levels that may be considered just and reasonable based on a detailed analysis of supply costs, current market conditions, and revenues earned as a result of the uncompetitive conditions and outcomes in California's marketplace.[8] In the face of this overwhelming evidence, and given the decline in gas prices and emission costs in January, the Commission is obligated to order refunds at a minimum for all transactions above the $150 level, unless the Commission's analysis of the data already made available to it provides a substantial basis for exceptional treatment of a specific generator. In such a case, the Commission must state the basis for the supplier-specific exemption. Absent such findings, the Commission's attempt to implement a novel "rate-screen" methodology in a market that undeniably is dysfunctional constitutes a clear abuse of discretion. As the court cautioned in *Farmers Union*: "'[R]egulation' by such novel 'standards' is worse than an exemption simpliciter.

[8] DMA December/January Report at i.

Such an approach retains the false illusion that a governmental agency is keeping watch over rates, pursuant to the statue's mandate, when it is in fact doing no such thing." *Farmers Union*, 734 F.3d at 1510 (citation omitted).

B. Even If It Is Appropriate For the Commission To Adopt the Surrogate MCP Methodology, the March 9 Order Implements the Approach In an Arbitrary and Capricious Manner

1. Limitation of Refund Exposure To Stage 3 Emergencies Is Unreasonable

In the March 9 Order, the Commission limited refund exposure to the hours when the ISO was in a Stage 3 emergency. March 9 Order at 61,862-63. This had the effect of limiting the Commission's review to only 13,149 transactions above the $150/MWh breakpoint for January 2001 out of a total of 70,300 transactions during the same period. *Id.* at 61,865 (dissenting opinion of Commissioner Massey). Thus, the Commission categorically excluded approximately 81 percent of the transactions above the $150/MWh breakpoint.

The March 9 Order arbitrarily focuses on the most dire operational circumstances. The reliability requirements imposed on the ISO and Good Utility Practice, however, mandate that the ISO use all available resources to avoid the occurrence of Stage 3 emergencies. As a consequence, sellers have just as much opportunity to exercise market power whenever the ISO must take action to maintain necessary reserves, even prior to the declaration of a Stage 1 emergency.

The limitation of market mitigation to Stage 3 emergencies is inconsistent with: (1) prior studies by the ISO's Market Surveillance Committee ("MSC") that found evidence of market power during non-Stage 3 conditions; (2) the recent

studies by DMA that found market power since May 2000 at virtually all times and under all conditions; (3) the reliability requirements imposed on the ISO and Good Utility Practice that mandate that the ISO use all available resources to prevent the occurrence of Stage 3 emergencies. Furthermore, the limitation of refunds to Stage 3 conditions sets perverse price signals, mitigating prices at the times of the most acute shortages, when a competitive market would be expected to yield comparatively higher prices, and leaving unchecked market power that improperly inflates prices during periods when, but for the exercise of market power, prices should be significantly lower. Against this overwhelming evidentiary and legal backdrop, the Commission offers no justification whatsoever for its Stage 3 limitation.

a. Prior MSC Studies Demonstrate that Market Power Is Being Exercised Even When There Are No Stage 3 Emergencies

Prior studies by the ISO's MSC of the ISO's markets have established that market power was exercised in tight supply conditions over the periods prior to December 2000. These exercises of market power, however, did *not* occur only or even predominantly during Stage 3 conditions.

In its October 19, 1999 Report on the Redesign of the California Real-Time Energy and Ancillary Services Markets, the MSC stated,

> We find that significant market power remains in California's wholesale energy markets during periods of high total system load, which primarily occur during the summer months.
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> * * * *

> During these periods, price movements across hours of the day are significantly in excess of the increased costs of supplying power during these hours. . . . This is a direct indication of market power.[9]

The MSC found that actual costs during the summer of 1998 were approximately 20 percent above those predicted by the MSC's benchmark market analysis. *Id.* at 8.

On September 6, 2000, the MSC issued its analysis of the June 2000 Price Spikes in the California ISO Energy and Ancillary Services Markets,[10] finding that,

> During the months of May and June 2000, wholesale revenues from sales of total ISO load (less must-take energy) for all hours of the month in the California energy market were approximately 37% and 182%, respectively above monthly revenues under perfectly competitive pricing.

Id. at 2. The MSC concluded that the California electricity market,

> Is composed of a relatively small number of firms, some of which own a sizable fraction of the total electricity generating capacity located in the ISO Control Area. The geographic distribution of generation unit ownership can allow some owners to exercise locational market power during certain system conditions. In addition, the amount of generating capacity owned by some market participants allows them to exercise market power during high load conditions, *when there is not a physical scarcity of available generating capacity to serve this load.*

Id. at 5 (emphasis added).

These tight supply conditions, exercises of market power, and unjust and unreasonable prices *all* took place outside of Stage 3 conditions.[11] There is no

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[9] Report on the Redesign of the California Real-Time Energy and Ancillary Services Markets, Docket Nos. ER98-2843-000, *et al.* (Oct. 18, 1999), at 1 and 7-8.

[10] An Analysis of the June 2000 Price Spikes in the California ISO's Energy and Ancillary Services Markets. This report and other MSC reports cited in these comments can be found on the ISO Home Page at <http://www.caiso.com/surveillance/overview/Committee.html>.

reason to believe that these conditions did not persist through January 2001 and contribute to exorbitant bids that occurred outside of Stage 3 conditions. Certainly, the Commission has cited no evidence on which a contrary conclusion could be based. In short, the Commission makes no attempt to distinguish bidding behavior in Stage 3 emergencies as compared with Stage 2 or Stage 1 emergencies.

b. Recent DMA Studies demonstrate that Market Power Is Being Exercised At All Times Under All Conditions

More recent analysis clearly demonstrates that the problems of market power are more pervasive, occurring at all times and under all conditions. In an affidavit filed with the Commission in this proceeding on October 20, 2000, Dr. Eric Hildebrandt of DMA presented results of a more systematic, quantitative analysis of market power and scarcity over the first two and one half years of ISO operations. Results of this analysis showed that a significant degree of market power was exercised during the months of May to September 2000. Dr. Hildebrandt noted that:

> While a significant portion of the increase in wholesale costs above this competitive baseline have been incurred during hours of potential absolute resource scarcity, the bulk of these additional costs are attributable [to] a lack of competition, rather than scarcity. In addition, prices continued to significantly exceed competitive levels even after the ISO's real-time price cap was lowered to $250 in August.[12]

Furthermore, a DMA report submitted with the ISO's comments on the Commission's November 1 order presented the results of a quantitative analysis

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[11] The first Stage 3 emergency declared by the ISO occurred on December 7, 2000.

by DMA staff of the impact of market power and other factors on market costs. As explained in this report:

> [S]ince late May of this year [2000], the combination of very tight supply and demand conditions – in conjunction with very limited ability of consumers to reduce consumption in response to high prices – has created the opportunity for the persistent exercise of market power in California's wholesale energy markets. The exercise of this market power has inflated wholesale energy costs significantly above levels that would have resulted under competitive market conditions, even after taking into account fundamental market factors driving up costs and hours of potential scarcity of supply. While some degree of market power may be tolerable from the perspective of defining a workably competitive market, the exercise of market power since late May of this year has clearly exceeded the level that may be considered consistent with a workably competitive market. Since additions of new supply are likely to merely keep pace with or even fall short of demand growth over the next two years, the exercise of significant market power can be expected to continue – if not worsen – over the next two years absent action to more effectively mitigate system-wide market power.[13]

The studies by Dr. Hildebrandt and Dr. Anjali Sheffrin attached to the ISO's March 22, 2001 Comments in these dockets on Staff's Recommendation on Prospective Market Monitoring and Mitigation for the California Wholesale Electric Power Market provide further evidence that market power is being widely exercised under all market conditions.[14] Specifically, these studies demonstrate that Market Participants can affect market prices in California by altering output

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[12] Declaration of Eric Hildebrandt filed with Proposed Offer of Settlement in Docket Nos. EL00-95 *et al.* on October 20, 2000 at pp. 5-7.

[13] Analysis of Market Power in California's Wholesale Energy Markets, Attachment A to the ISO's November 22 Comments on the November 1 Order in Docket Nos. EL00-95 *et al.*, at 9.

[14] For convenience, the ISO provides a copy of Dr. Hildebrandt's study as Attachment A to this rehearing request and Dr. Sheffrin's study is contained in Attachment B. Pursuant to a March 30, 2001 letter from Mr. Daniel Larcamp, the Director of the Commission's Office of Markets, Tariffs and Rates, the ISO is providing additional supporting material pertaining to these studies. The ISO incorporates this additional data by reference.

or bid prices during a wide range of system conditions, and not just those hours where a deficiency in Operating Reserves requires the ISO to declare a System Emergency. In addition, these studies show that the incidence of strategic bidding behavior has increased considerably over the periods studied. Thus, rather than being confined to Stage 3 emergencies, or even to Stage 2 or Stage 1 conditions, the problem of market power *under all system conditions* has continued to worsen.[15]

On April 2, 2001, the ISO filed a protest of the compliance filing of Williams Energy Marketing & Trading Company ("Williams") in Docket No. ER99-1722-004. The ISO attached additional analyses from the DMA showing that Williams engaged in either physical or economic withholding during *every* hour of the May 2000 through November 2000 period, and that subsequent to the Commission's termination of the ISO's price cap authority, William's exercise of market power was even more pronounced, resulting in ISO real-time market revenues for the months of December 2000 through March 2001 that were almost twice (173 percent) its estimated operating costs.

As discussed below, the Commission must initiate a hearing to permit detailed examination of the bidding behavior of Williams and other public utility

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[15] Dr. Eric Hildebrandt found that 30 percent of the wholesale energy prices over the last year can be attributed to the exercise of market power and on an annualized basis wholesale prices since January 2000 exceed the cost necessary for new investment by approximately 400 percent and would allow recovery of an investment in new supply in a period of just over one year. Dr. Sheffrin found withholding, especially economic withholding, plagued the market for most hours from May to November 2000. Of the 25,000 hourly biding profiles studied, fewer than 2 percent displayed no clear pattern of withholding. The study provides direct evidence that many large suppliers actively have engaged in strategic bidding efforts, consistent with oligopoly pricing behavior, with a direct and substantial impact on market prices.

suppliers. In the context of pipeline regulation, the Commission has stated that, "if a company can sustain an increase in its rates in the order of 10 percent or more without losing significant market share, the company is in a position to exercise market power to the detriment of the public interest." *Alternatives to Traditional Cost-of Service Ratemaking for Natural Gas Pipelines*, 74 FERC ¶ 61,067, 61,232 (1996). The evidence is clear and compelling that suppliers to California's wholesale electricity markets are exercising market power during all hours and all conditions.

c. Equating Supply Shortage Conditions With Stage 3 Conditions Is Contrary to Reliability Requirements

The limitation of remedial measures to Stage 3 emergencies is also contrary to the ISO's Commission-approved contractual commitments and Tariff obligations, state law and good utility practice. The ISO must use all available resources to meet reserve requirements. Accordingly, sellers have the same opportunities to exert market power in non-emergency conditions and in Stage 1 and Stage 2 emergency conditions that they have under Stage 3. The March 9 Order fails to recognize or even discuss these ISO responsibilities.

Like all utilities, the ISO implements graduated levels of system emergencies. A Stage 1 condition occurs when an Operating Reserve shortfall exists or is unavoidable and available market and non-market resources will be insufficient to maintain Operating Reserves in compliance with the Western Systems Coordinating Council ("WSCC") Minimum Operating Reliability Criteria. If Operating Reserves are currently or are forecast to be below 5 percent, a Stage 2 emergency is declared. The ISO enters Stage 3 when Operating

Reserves are currently or forecast to be below 1.5 percent. By only providing the potential for refunds during Stage 3 conditions, the March 9 Order improperly fails to recognize that the ISO must take affirmative action to maintain its full reserve obligation, attempting to *avoid* the occurrence of even Stage 1 events. *Accordingly, sellers often know even before a Stage 1 is announced that their resources will be required*.[16]

The ISO's obligations in this regard arise in part out of its adherence to the FERC-approved reliability criteria of the WSCC. In its declaratory order concerning the WSCC's Reliability Management System ("RMS"), under which transmission operators would agree, through contracts, to comply with WSCC reliability criteria, the Commission "acknowledg[ed] the longstanding role of WSCC in formulating regional reliability standards" and gave "substantial deference to WSCC in the development of reliability standards." *Western Systems Coordinating Council*, 87 FERC ¶ 61,060, 61,234 (1999). The ISO is committed to comply with the WSCC RMS by virtue of: (1) its contract with the WSCC,[17] (2) the provisions of the ISO Tariff,[18] and (3) California state law.[19]

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[16] In accordance with ISO Operating Procedure E-504, the ISO may issue Alert and Warning notices, even before issuing emergency notices.

[17] The ISO agreement is designated by the Commission as WSCC Rate Schedule No. 5.

[18] Section 2.3.1.1.6 of the ISO Tariff states that the ISO should be the WSCC security coordinator for the ISO Controlled Grid. Under Section 2.3.1.3.1, the ISO is to exercise Operational Control over the ISO Controlled Grid "to meet planning and Operating Reserve Criteria no less stringent than those established by WSSC and NERC as those standards may be modified from time to time . . . ." *See also* Section 2.1 of the Dispatch Protocol of the ISO Tariff which provides:

> The ISO shall exercise Operational Control over the ISO Controlled Grid in compliance with all Applicable Reliability Criteria. Applicable Reliability Criteria are defined as the standards established by NERC, WSCC and Local Reliability

The WSCC RMS requires that the ISO (and all other transmission providers in the WSCC) maintain Spinning Reserves and Non-Spinning Reserves equal to the greater of:

(1) The loss of generating capacity due to forced outages of generation or transmission equipment that would result from the most severe single contingency, or

(2) The sum of five percent of the load responsibility served by hydro generation and seven percent of the load responsibility served by thermal generation.[20]

In the case of the ISO it is the latter 5 percent and 7 percent reserve responsibility which is applicable.

Accordingly, the ISO must use all available sources of imbalance energy in order to maintain its reserve levels. If the ISO Controlled Grid is in a Stage 2 condition, then the ISO must use these resources to prevent entering a Stage 3. Similarly, it must use these resources in a Stage 1 to prevent a Stage 2 situation, or even to prevent the occurrence of a Stage 1. There is no basis for the March 9 Order to differentiate between the Generator's ability to exercise market power under Stage 1 conditions and under Stage 3 conditions.

Criteria and include the requirements of the Nuclear Regulatory Commission (NRC).

[19] Chapter 345 of Assembly Bill 1980 provides:

The Independent System Operator shall ensure efficient use and reliable operation of the transmission grid consistent with achievement of planning and operating reserve criteria no less stringent than those established by the Western Systems Coordinating Council and the North American Reliability Council.

[20] WSCC Rate Schedule No. 1 First Revised Sheet No. 27.

d. The Commission's Order Establishes Improper Price Signals

Under the March 9 Order, mitigation occurs only when shortages are most acute (and prices would be high even under fully competitive conditions). Therefore, the Order skews the relationship between off-peak and on-peak prices under competitive market conditions by mitigating prices during peak hours (when scarcity typically would result in higher prices) and letting off-peak prices remain unmitigated and high. As the Commission has recognized,

> Managerial actions that affect efficiency do not take place in a vacuum. They are influenced by our regulation and that of the state commissions. We recognize that our rules and policies can sometimes have unintended consequences that produce higher costs and higher rates. Consumers do not benefit from dysfunctional regulation.

Public Service Company of New Mexico, et al., 25 FERC ¶ 61,469, 62,033 (1983) (citation omitted). By limiting its market power mitigation to Stage 3 conditions the Commission sends incorrect price signals to the wholesale energy market – reducing prices in times of scarcity and failing to mitigate bids that reflect the improper use of withholding.

2. There Is No Foundation For the March 9 Order's Proxy Price

In the March 9 Order, the Commission develops a proxy price of $273/MWh based upon a hypothetical simple-cycle combustion turbine unit with a heat rate of 18,073 Btu/kWh. March 9 Order at 61,862-63. The Commission used a natural gas rate of $12/mmBtu based on the average reported January midpoint prices for "Southern California Gas Company large package" transactions as reported in Financial Times Energy's "Gas Daily" publication,

average January NOx allowance costs from the Southern California Air Quality Management District NOx auction of $22.50/lb. as reported by Cantor Fitzgerald Environmental Brokerage Services, an average NOX emissions rate of 2 lbs./MWh and variable operations and maintenance costs of $2/MWh. *Id*. 61,863. The ISO believes that the Commission's proxy price: (1) overstates the rates necessary to serve as an incentive to attract new generation; (2) overstates the appropriate NOx costs; and (3) overstates the appropriate gas costs.

a. The March 9 Order Overstates the Rates Necessary to Attract New Generation

The Commission states that the proxy price "should provide an incentive for new suppliers to enter the market with lower priced energy." *Id*. at 61,863. While the courts have recognized that encouragement of new supply is a permissible objective for the Commission to pursue, the rates *must not be more than is needed for the purpose*:

> While as we have indicated the Commission may be empowered to consider some of these factors *it must also, and always, relate its action to the primary aim of the Act to guard the consumer against excessive rates*. If the Commission contemplates increasing rates for the purpose of encouraging exploration and development . . . it must see to it that the increase is in fact needed, and is no more than is needed, for the purpose.

City of Detroit v. FPC, 230 F.2d at 817 (emphasis added). The court affirmed this determination in *Farmers Union*, criticizing the Commission for failing to "even attempt to calibrate the relationship between increased rates and the attraction of new capital." *Farmers Union,* 734 F.3d at 1502-03.

The study by Dr. Hildebrandt discussed above also examined wholesale prices in relation to the cost of investment in new supply. The results indicate

that on an annualized basis wholesale prices since January 2000 have exceeded the cost of new capacity by approximately 400 percent and would allow recovery of an investment in a new supply resource with a useful life of decades in a period of less than two years.[21]

The ISO recognizes the importance of new generation to California. The state is making significant strides in expediting the approvals for new facilities. Nevertheless, the need for new supply does not justify excessive prices well beyond those necessary to fulfill this objective.

b. The March 9 Order Overstates NOx Compliance Costs

The variable NOx costs as used by the Commission in the March 9 Order to calculate its proxy price appear to be far in excess of the actual costs a generator would have incurred during these months. The result is that the proposed screen price is significantly overstated.

First, it is important to recognize that the NOx RECLAIM[22] market affects only thermal power generating units in the SCAQMD.[23] These units account for approximately 20 percent of the power generating capacity in the state.[24] Thus,

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[21] The analysis is based on a typical 500 MW combined cycle unit, since the majority of projects proposed in California and the WSCC during the last three years have been 500 MW gas-fired combined cycle plants.

[22] Regional Clean Air Incentives ("RECLAIM") was adopted by the SCAQMD in October 1993. RECLAIM regulates emissions on a mass basis rather than limiting emission rates and was implemented to provide facilities with added flexibility in meeting emission reduction requirements while lowering the cost of compliance.

[23] The SCAQMD includes Los Angeles and Orange counties and parts of Riverside and San Bernardino counties. The ISO notes that part of this area is outside the ISO Control Area.

[24] See testimony of Michael H. Scheible, Deputy Executive Officer of the California Air Resources Board at 4-6. This testimony was provided as an attachment to the November 22, 2000 comments of the California Public Utilities Commission in Docket No. EL00-95-000.

the March 9 Order is making assumptions not only about the operating characteristics of the hypothetical marginal unit, but also its location. Generators located outside of this region are subject to different environmental rules and regulations.

Second, generators in SCAQMD are given annual baseline amounts of credits and would only need to purchase additional credits if they exceed this allocation. The March 9 Order in effect assumes without any factual basis that this allocation had been completely exhausted throughout all of January.

Third, the March 9 Order fails to recognize that a series of recent events have changed the NOx RECLAIM market. The District has issued a proposed rule that would bifurcate the RECLAIM market between electric generators and non-utility facilities, suspending the RECLAIM rules for power generators over 50 MW.[25] The new rule would freeze the number of Reclaim Transfer Credits ("RTCs") available for generators' use at their original allocation plus any purchases made through January 11, 2001. Any emissions in excess of these available RTCs would be offset by a payment of $7.50/lb. which would be used to obtain NOx emission reductions from mobile, stationary or area sources to mitigate any air pollution effects. Thus, under the proposed rule, generators would be charged a fixed mitigation fee of $7.50/lb. of NOx emissions emitted in excess of their current RTC holdings. Although the proposed rule is not

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[25] The proposed rule would separate existing generation facilities over 50 MW for the 2001 through 2003 compliance years. These generators would not be allowed to rejoin the other RECLAIM participants until the Governing Board concludes that their reentry for the 2004 Compliance year would not result in any negative impact on the remainder of the RECLAIM universe or California's energy security needs.

expected to be adopted by the SCAQMD until May 11, 2001, the SCAQMD Executive Director issued Order #01-03 on February 20, 2001 which placed the provisions of the proposed rule in affect *retroactive* to January 11, 2001.[26] The Executive Director issued the proposed rule in response to an Executive Order issued by the Governor on January 17, 2001 that required that all state agencies work to alleviate the energy crisis in California. While SCAQMD Executive Orders are only effective for a period of 10 days, the Order has been extended and is likely to continue to be extended by the Executive Officer until such time as the new rules are enacted on May 11, 2001.

The new rules are designed to limit the influence of NOx RTC prices on the electricity market while the State of California addresses the State's energy crisis. Given the changes to the RECLAIM market, it was error for the Commission to apply the SCAQMD NOx auction prices reported by Cantor Fitzgerald as a proxy for variable emission costs in California.[27]

Clearly, the current amendments to environmental regulations in the state to address the increased production of thermal power plants leads to variable

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[26] See Attachment C to this rehearing request.

[27] In addition to failing to recognize the new rule applicable only to power generators, the NOx market prices reported by Cantor Fitzgerald in January and February largely reflect purchases by RECLAIM participants to cover year 2000 emissions. The reconciliation period for 2000 emissions expired on March 1, 2001, which explains the sharp increase in RTC market prices that occurred at the end of February. Clearly, the Cantor Fitzgerald estimated market prices did not represent the marginal emission costs of generators who supplied power to California in January and February 2001. To cover NOx emissions emitted in January and February 2001, under the RECLAIM rules, generators may utilize their allotment of either Vintage 2000 Cycle 2 or Vintage 2001 Cycle 1 RTC or, according to the new rules in place, pay a mitigation fee of $7.50/lb. for emissions in excess of their RTC holdings. In addition, under the new rules generator are forbidden from selling their current RTC holding in the market. Therefore, generators of over 50 MW are not foregoing any opportunity costs related to their RTC holdings as they have been effectively removed from the RECLAIM market.

NOx emission costs far less than those reported by Cantor Fitzgerald for the SCAQMD. Any methodology the Commission uses to determine whether power prices in California are just and reasonable should not assume variable NOx emission costs in excess of $7.50/lb. The Commission needs to account for the varying emission requirements that each generator must abide by based on where the generator is sited.

c. The Proxy For the Generator's Gas Procurement Costs in the March 9 Order Is Unsupported

In developing its proxy price, the Commission used a natural gas rate of $12/mmBtu based on the average reported January midpoint prices for "Southern California Gas Company large package" transactions as reported in Financial Times Energy's "Gas Daily" publication. The Commission does not explain how the use of this data results in a reasonable rate.

The ISO notes that the California Public Utilities Commission ("CPUC") recently modified the gas prices used to calculate short-run avoided costs ("SRAC") for qualifying facility contracts. Previously, the CPUC used the published border prices at Topock on the Arizona border for the SRACs for the Southern California Edison Company and San Diego Gas & Electric Company.[28] In its March 27, 2001 decision in Rulemaking 99-11-022, the CPUC noted that a number of factors, including the potential exercise of market power by the El Paso Natural Gas Company raised questions concerning the appropriate of

[28] Gas prices for Pacific Gas and Electric Company's SRAC were based on a 50/50 weighting of published prices for Topock and Malin on the Oregon border.

the Topock indices. Slip op. at 14. The CPUC is conducting a workshop to determine the appropriate gas price. *Id.* at 18.

The Commission recently set the issue of El Paso's potential exercise of market power for hearing in Docket No. RP00-241-000. *Public Utilities Commission of the State of California vs. El Paso Natural Gas Company, et al.*, 94 FERC ¶ 61,338 (2001). If this investigation finds that gas prices were unjust and unreasonable due to the use of market power, the Commission must make corresponding adjustments to the rates charged by wholesale electric suppliers.

Furthermore, the Commission does not support the appropriateness of complete reliance by electric generators on spot gas prices. To the contrary, the remedies in the December 15 Order place great reliance on the need for a balanced supply portfolio of long-term and short-term agreements. The March 9 Order does not explain why generators should not similarly hedge their risks with regard to their fuel purchases.

There is an acute need for an investigation of the generators' gas procurement practices. The problem is that the Commission's December 15 Order creates an incentive for suppliers to utilize their most expensive gas since the higher price will provide a greater cost justification for bids above the $150/MWh breakpoint. This is an important issue that should be addressed in the hearings requested below.

C. The ISO Expects that the Commission Would Work With the Secretary of Energy To Remedy Any Overcharges Imposed by Federal Power Marketers

The ISO recognizes that the Commission does not have the authority to direct Federal entities such as the Bonneville Power Administration ("Bonneville") or the Western Area Power Administration ("WAPA") to make refunds of sales above rate levels the Commission has found to be just and reasonable. Nevertheless, the Commission should not simply ignore the issue.

The Commission should call on sister agencies within the auspices of the Department of Energy to provide it with sufficient data to determine on a basis comparable to that applied to public utilities that the rates for sales have been just and reasonable. If the Commission finds that sales were made at unreasonable prices, this information should be communicated to the respective administrators, the Secretary of Energy, and Congress. Simply stated, Bonneville and WAPA should not be entitled to windfall profits by virtue of their separate status under the Department of Energy umbrella.

D. The Commission Must Ensure that Generators Provide the ISO with Cost Data

In their March 1, 2001, filing, the ISO and the EOB sought access to unit-specific cost data being compiled by the generators. March 1 Motion at 12. The ISO and EOB noted that the goal of the Market Monitoring and Information Protocol of the ISO Tariff is to "adequately inform regulatory agencies, ISO Participants and others of the state of the ISO Markets, especially their competitiveness and efficiency"[29] and to meet this objective DMA must scrutinize

[29] *Id.*, citing MMIP at Section 1.2.1.

market behavior to identify anomalous market behavior defined as a departure "from normal competitive markets that do not require continuing regulation." *Id*. at Section 2.1.1.

In the March 9 Order the Commission failed to act on this request, implying that it would be the subject of a future order. March 9 Order at 61,862 n.3. The unwarranted delay in ordering suppliers to provide this data is inconsistent with the Commission's prior statements recognizing the importance of the ISO's market monitoring functions and the need to compare bids to marginal costs. In its October 1997 Order conditionally authorizing operation of the ISO, the Commission stated that:

> The issues and criteria outlined by the ISO and PX cover the range of market power issues we are concerned about. In particular, *the comparisons of bids to marginal costs*, analyses of unit availability over time and during different market conditions, and detecting the creation of transmission constraints will be important.

Pacific Gas and Electric Co., et al., 81 FERC ¶ 61,122, 61,552 (emphasis added). While the original concern was with the bidding behavior of the three California IOUs, the problems of economic and physical withholding persist with the divestiture of the units to the five primary purchasers.[30]

Accordingly, the ISO renews its request for this vital information. In order to ensure the timely analysis of the relation of bidding practices to actual costs, a quintessential element of market power monitoring, the Commission should

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[30] Economic withholding is bidding substantially above a unit's marginal costs, and physical withholding is not bidding or scheduling available resources in the market.

immediately order that this data be provided to the ISO and appropriate state authorities.

E. The Commission Must Hold Hearings Regarding the Extent of Market Power To Order Appropriate Refunds

In their March 1 filing, the ISO and the EOB requested the Commission to set the justness and reasonableness of the sales submitted in the California markets by public utility sellers in the PX and the ISO markets since December 8, 2000 for hearing (reserving the right to seek a hearing and refunds for prior periods). March 1 Motion at 12-13. The ISO and EOB argued that the strong prima facie showing of the improper exercise of market power from both the Commission's own investigations as well as the DMA Report mandate that a full and fair airing of the matter and that hearing procedures were necessary to allow full discovery of the cost information supporting the bids to be had, and to allow Market Participants to present evidence regarding the existence of market power.[31] As with the request to provide data, the Commission failed to act on this request, implying in footnote 3 of the March 9 Order that it would be the subject of a future order.

Further delay in instituting a hearing is unwarranted. The Commission should take action immediately by initiating expedited hearing procedures with full discovery rights.

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[31] *Id*. The ISO and the EOB also noted that, if the public utility sellers in the California markets have at their disposal evidence that their bids have not been based on the exercise of market power, this, too, could be presented in a hearing context, allowing other Market Participants to understand better that no abuse of market power has taken place. *Id*. at 13.

In general, "the Commission must hold an evidentiary hearing whenever a complainant raises a genuine issue of fact that is material to the justness and reasonableness of a rate and cannot be resolved upon the written record." *Louisiana Public Service Commission*, 184 F.3d at 895. The courts have found that it is an abuse of discretion for the Commission to refuse to hold a hearing when the petitioners has proffered facts that raises serious doubts concerning the mitigation of the utility's market power. *Cajun Electric Power Co-Op, Inc. v. FERC*, 28 F.3d 173, 177 (D.C. Cir. 1994).

Recently, the Commission set for an expedited trial-type hearing the question of whether El Paso Pipeline or its merchant affiliate had market power and, if so, exercised it so as to drive up the price of natural gas at the California border. *Public Utilities Commission of the State of California vs. El Paso Natural Gas Company, et al.*, 94 FERC ¶ 61,338 (2001). In the *El Paso* proceeding, the Commission noted that there were conflicting studies from the intervenors and the pipeline on the issue of whether or not market power was exercised and provided the parties an opportunity to supplement the record. *Id.*, slip op. at 11.

The findings of the DMA study of the December to January period and, indeed, the additional DMA and MSC studies of all other periods demonstrate that market power has been exercised and that consumers have paid unjust and unreasonable rates. Failure to order hearings and to provide an appropriate record for decisions pertaining to the reasonableness of billions of dollars worth of potential overcharges is an abuse of discretion.

F. The Commission Should Order Refunds to the Full Extent of Its Statutory Authority

The refunds ordered in the March 9 Order were constrained by the Commission's unduly limited authority to remedy suppliers' abuse of their authority to male wholesale sales at market-based rates. The ISO recognizes that the Commission's authority to order refunds is limited by the "filed rate doctrine," which prohibits the Commission from ordering retroactive adjustments to amounts collected by a public utility under rates schedules filed with and accepted by the Commission. *See, e.g., Montana-Dakota Utilities Co. v. Northwestern Pub. Serv. Co.*, 341 U.S. 246, 254 (1951); *Towns of Concord, et al. v. FERC*, 955 F.2d 67, 71 n.2 (D.C. Cir. 1992). The Commission has recognized, however, that this prohibition does not apply when, instead of filing a schedule of the specific rates it will charge, the utility files a "formula rate" that permits the rate to fluctuate without prior review.[32] Where the rates collected by a utility for wholesale sales have not been subject to the Federal Power Act's prior filing and review requirements, the Commission is not barred from ordering refunds if it subsequently determines that the rates charged were excessive because they did not reflect the "cost incurred by the utility in the relevant time period." *Connecticut Yankee Atomic Power Co.*, 40 FERC ¶ 63,009, 65,102, *aff'd in relevant part*, 40 FERC ¶ 61,372 (1987).

[32] "When the Commission accepts a formula rate as a filed rate, it grants waiver of the filing and notice requirements of section 205 of the Federal Power Act. . . . [The utility's] rates, then can change repeatedly, without notice to the Commission *provided* those changes are consistent with the formula." *Alabama Power Co. v. FERC*, 993 F.2d 1557, at 1567-68 (D.C. Cir. 1993) (*quoting San Diego Gas & Electric Co.*, 46 FERC ¶61,363 (1989) (emphasis in original)).

The Commission has found previously that the ISO Tariff is a formula rate: "The recovery of RMR costs under the ISO's tariff is through a formula rate. The ISO purchases RMR services under contracts and passes through the costs to Responsible Utilities under the formula rate. The filed rate in this circumstance is the formula." *California Independent System Operator Corporation*. 90 FERC ¶ 61,315, 62,042 (2000). While that proceeding involved the pass through of Reliability Must-Run costs, the ISO also purchases Ancillary Services, Imbalance Energy, and out-of-market Energy and passes costs through to Scheduling Coordinators through other formulas in the ISO Tariff. The charges and payments that flow through the ISO remain subject to Commission review to ensure that they are just and reasonable.

The wholesale sales of suppliers through the ISO's markets also constitute sales pursuant to formula rates. Since utilities collecting market-based rates for these wholesale sales do not file rate schedules at the Commission showing the specific rates they will charge, the normal prohibition on retroactive adjustments of amounts collected under "filed rates" accordingly should not apply. There is accordingly no legal basis for the Commission to limit the period during which, or the extent to which, it will scrutinize wholesale sales of electricity under its market-based rate authority. Whenever market conditions are insufficient to ensure just and reasonable rates, the Commission has the authority and the duty to order refunds to protect consumers. Certainly, the Commission's assumption that sales prior to October 2, 2000 are beyond its reach cannot be sustained.

Indeed, the Commission has recognized its authority to order refunds of market-based charges for wholesale transactions for abuse of authority under formula-based rate schedules. In its Order to Show Cause in Docket No. IN01-3-00 issued on March 14, 2001, the Commission found evidence that certain suppliers had manipulated outages in order to circumvent the mitigation by the ISO's Reliability Must-Run Contracts of locational market power. *AES Southland, Inc. and Williams Energy Marketing and Trading Company*, 94 FERC ¶ 61,248 (2001). The Commission was concerned that the conduct violated the prohibition in Section 2.1.3 of the ISO Tariff against "gaming" "which render[s] the system vulnerable to price manipulation." *Id.* at 61,873. Other practices subject to scrutiny under Section 2 of the MMIP include "withholding of Generation capacity under circumstances in which it would normally be offered in a competitive market" (MMIP 2.1.1.1) and "pricing and bidding patterns that are inconsistent with prevailing supply and demand conditions" such as "prices and bids that appear consistently excessive" (MMIP 2.1.1.4). The misconduct at issue in Docket No. IN01-3-00 took place in April and May 2000. *See AES Southland*, 94 FERC at 61,874-75. Nevertheless, the Commission found that

> remedies for these potential violations would be, first, a refund by Williams and/or AES to the ISO of the revenues Williams received in excess of the amount it would have collected from the ISO had Williams and AES not engaged in the practices discussed in this order and the non-public Appendix. Such a refund would place Williams in the same position it would be in had Williams and AES permitted the ISO to dispatch the RMR units. The second remedy would be a condition on Williams' market-based rate authority.

Id. at 61,877. Accordingly, the Commission has recognized it has the authority to order refunds to remedy conduct occurring prior to May 2000.[33] The data and analyses in the studies by Dr. Hildebrandt and Dr. Sheffrin provided in response to the ISO's March 22, 2001 comments on the Commission Staff's market mitigation proposal in this docket and included as Attachments A and B to this application for rehearing, together with other evidence in the record, demonstrate that market power was exercised in California wholesale markets throughout the period beginning in May 2000. The Commission should accordingly expand the scope of the refund relief it grants to encompass the entire period from May 2000 to the present.

The Commission must also take any appropriate actions necessary to ensure its continuing refund authority. Having determined that prices to consumers have been in violation of statutory mandates, the Commission may not excuse suppliers' continuing exaction of unjust and unreasonable charges by means of a self-imposed sixty-day deadline.[34]

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[33] This is consistent with the Commission statements and requirements regarding the quarterly filing of transaction statements of short term sales under umbrella service agreements. The Commission has stated that these summaries are "necessary to ensure that contracts relating to rates and services are on file as required by Section 205(c) of the Federal Power Act and to allow the Commission to evaluate the reasonableness of the charges and to provide for ongoing monitoring of the marketer's ability to exercise market power." *New Century Services, Inc.*, 86 FERC ¶ 61,307, at 62,066-67 (1999).

[34] In the March 9 Order, the Commission states that in addition to the refund approach being adopted in the order, the Commission is continuing to "review any information brought to our attention with respect to the indicators of potential market power that were identified in our December 15 order." March 9 Order at 61,864 n.11. The Commission does not state how this continuing review related to its prior sixty-day preliminary review period.

IV. CONCLUSION

WHEREFORE, for the above-stated reasons, the ISO respectfully requests that the Commission grant rehearing of its March 9, 2001 Order Directing Sellers To Provide Refunds of Excess Amounts Charged for Certain Electric Energy Sales During January 2001 or, Alternately, To Provide Further Cost or Other Justification for Such Charges, and that the Commission further find, determine and order:

(1) That sellers be ordered to immediately refund all amounts above the rate screen (subject to the provision of additional data) for all hours and not just those hours for which Stage 3 emergencies have been declared;

(2) That the Commission suspend payment of all amounts owing to generators based on bids below the rate screen but above the $150 soft cap for the period from January 1, 2001 forward, until a final resolution of the issues set for hearing;

(3) That the Commission work with its sister agencies to facilitate the achievement of just and reasonable rates for sales from these federal entities.

(4) That the Commission require generators to provide to the ISO and to the EOB their unit-specific cost data (subject to appropriate confidentiality protections);

(5) That the Commission immediately establish hearings to develop the appropriate record to establish unit specific reasonable rates for

this period of market dysfunction; and

(6) That the Commission vacate that part of its December 15 Order providing a 60-day limitation on review of amounts bid into the California markets.

Respectfully submitted,

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