UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Duke Energy Moss Landing LLC) Docket No. ER98-2668-000

MOTION TO INTERVENE, PROTEST, CONSOLIDATE ,
AND REJECT FILING OR, ALTERNATIVELY,
MOTION FOR SUMMARY DISPOSITION OF THE
CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION

To the Commission:

Pursuant to Rules 211 and 214 of the Commission's Rules of Practice and Procedure, 18 C.F.R. §§ 385.211 and 385.214, the California Independent System Operator Corporation (ISO), hereby moves to intervene in and protest the above-captioned filing by Duke Energy Moss Landing LLC (Duke) in connection with the Reliability Must Run Unit (RMR) located in and serving the South San Francisco Bay area at Moss Landing. In addition, the ISO hereby moves for the following Commission action:

(1) that the Commission consolidate this docket with the related Notice of Termination for the Moss Landing and Oakland units filed by Pacific Gas and Electric Company (PG&E), Docket No. ER98-2785-000;[1] and Duke's filing in connection with the Oakland Must Run unit, Docket No. ER98-2669;

(2) that the Commission reject Duke's initial rate filing and PG&E's related Notice of Termination because they fail, as a matter of law, to meet the limited conditions under which PG&E may terminate its RMR Agreement without ISO consent or, in the alternative, deny Duke's requested effective date and set all

[1] Interventions and protests in the PG&E Notice of Termination filing are due on May 20, 1998. The ISO will file a motion to intervene and protest in that docket, which will include this pleading as an attachment.

matters for hearing, with the effectiveness of Duke's filings and PG&E's termination to be contingent on a final Commission order; and

(3) that the Commission determine on summary disposition that, as a matter of law and public policy, purchasers of divested electric generating facilities that cannot qualify for market-based rates shall not be entitled to recover acquisition premiums in cost-based rates.

The ISO respectfully submits that prompt and decisive Commission action is needed in this proceeding for several reasons. First, prompt action is needed to avoid a flood of similar proceedings by the purchasers of the other RMR units that have been and will be divested by the California public utilities. This could potentially drown both the ISO and the Commission in new rate filings. Second, there is a significant risk to the reliable operation of the ISO control area. The ISO has determined that its ability to maintain the same reliability of service will be seriously impaired if it is compelled to purchase energy under RMR contracts with significantly varying terms and conditions. Accordingly, the ISO urges the Commission to reject Duke's efforts to force the ISO to operate under conditions inconsistent with the maintenance of reliable service.

Third, the Duke filing contains certain terms and conditions that will expose the ISO to substantial financial liability in connection with the operation of the RMR unit. If FERC accepts the Duke Energy filing and the PG&E filing, then the ISO will be in immediate violation of the Reimbursement Agreement in Article VII Negative Covenants of the ISO Section 7.9 Must Run Agreement Units and the ISO will be in default of the Reimbursement Agreement in Article VIII Defaults and Remedies Section 8.1c Events of Default. The banks will restrict access to the proceeds of the bond issuance, impose large increase penalties, force early retirement of disbursed funds in 1999 and require that

funds not disbursed be used to collateralize the Letter of Credit and to redeem issued bonds.[2] Any of these results will substantially increase the ISO's costs of operating the ISO Controlled Grid, which must be passed on to users.

Fourth, if the Commission fails to reject the acquisition adjustment, other buyers will expect the same treatment, thereby substantially increasing the costs to maintain reliable electric service.

Finally, by accepting the Duke filing, the Commission will be undermining a keystone to the California ISO structure—the requirement for use of *pro forma* agreements for the myriad of contractual relationships that are required when reliability operations are driven by a market engine.

I. SERVICE

The names and addresses of the persons to whom communications concerning this filing are to be addressed are as follows:

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2 PG&E's proposed RMR agreement contains some the same objectionable financial terms and conditions as the Duke proposal, but those concerns are not objectionable to the ISO Lenders so long as PG&E is selling RMR services to the ISO as well as buying those services because the ISO has the right of set off against PG&E.

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II. DESCRIPTION OF THE PARTY

The ISO is a non-profit public benefit corporation organized and existing under the laws of the State of California, in which it is authorized to do business. On March 31, 1998, the ISO took control of and currently operates the transmission systems of Pacific Gas and Electric Company (PG&E), San Diego Gas and Electric Company (SDG&E) and Southern California Edison Company (SCE). The ISO is responsible for maintaining the reliability of electric transmission scheduled into, out of and through the ISO Control Area. The activities of the ISO are subject to the jurisdiction of the Commission.

III. MOTION TO INTERVENE

On April 28, 1998, Duke tendered for filing under Section 205 a Rate Schedule to establish terms and conditions of the Reliability Must Run Services that Duke intends to provide to the ISO through its Moss Landing generating unit. Duke requests authorization for a new Reliability Must Run Agreement (RMR Agreement) with initial rates to be accepted by the Commission effective June 23, 1998.

As a party to the RMR Agreements and the purchaser of the energy and ancillary services offered in these agreements, the ISO has a direct and substantial interest in this proceeding. Moreover, the ISO's interests cannot be adequately represented by any other party. Accordingly, the ISO respectfully requests that it be permitted to intervene herein with full rights of a party.

IV. SUMMARY OF ARGUMENT

At present, the California restructuring presents the only example of an independent system operator charged with reliability operations but dependent on a market engine to obtain the tools to maintain reliability. As such, it is particularly dependent on having a multitude of contractual arrangements (*e.g.* the ISO currently has over 140 jurisdictional contracts on file with the Commission). To be able to administer those contracts efficiently and fairly, a fundamental precept of the ISO design has and continues to be the use of *pro forma* agreements for each of the necessary relationships. This is particularly so for the purchase of RMR services, which are a significant component of overall cost of transmission[3] and which the ISO must evaluate and competitively select at least annually.

Reliability Must Run service is, in effect, a substitute transmission service. Likewise, the ability of the ISO to call on RMR units for supply of ancillary services not provided by the market is also a transmission service. As a result, RMR arrangements are *sui generis* when compared to typical wholesale sales arrangements and the Commission's pronouncements in this matter will have broad ramifications not only in California, but elsewhere when the grid operator does not own or directly control generation. The ISO understands that divestiture of the generation is in the public interest and the ISO does not want to delay the divestiture of these units. However, the ISO urges the Commission to reject Duke's filing for the serious operational and financial reasons described below. This action does not leave PG&E and Duke without

[3] For example, the ISO estimates that it will collect approximately $680 million for ancillary services markets, real-time energy, congestion and wheeling charges, of which $150 million will represent the grid management charge. In contrast, the estimated invoices for RMR services, which are passed on to customers in the distribution rate, are between $1 and $2 billion annually.

an opportunity to effectuate the divestiture. The Commission should inform PG&E and Duke that they can arrange an assignment of PG&E's filed rate, or Duke can file a rate with substantially the same terms and conditions. Duke could then file a change in those rates, and ask that it be implemented prospectively after establishing that the changed terms are shown to be just and reasonable.

Here the Commission's refund and suspension authority will not protect the ISO (and consumers). As discussed below, the ISO will incur operational and financial harm if Duke's unilateral filing is accepted subject to refund. In analogous situations, the Commission has rejected rates from entities that have not shown that there are adequate safeguards to protect captive customers. *KNI Interstate Gas Transmission Co.*, 68 FERC ¶ 61,401, at 62,585-86 (1994) (rejecting filing where KNI had not shown that it lacked significant market power and had not proposed safeguards to adequately protect captive customers).

Duke's filing lacks a proper foundation. Duke may only initiate service from Moss Landing if PG&E is first permitted to terminate service from Moss Landing. PG&E's notice of termination and Duke's rate filing are so inextricably linked that the Commission must consider them as a single application and consolidate them for consideration. The Commission's action in the consolidated proceeding must be to summarily reject PG&E's notice of termination and defer any action on Duke's filing until the condition precedent—a valid termination by PG&E—is accomplished. The notice of termination is inconsistent with the terms of PG&E's filed rate for Moss Landing. That rate provides that PG&E may transfer the facility only to a purchaser willing to provide service under substantially the same terms and conditions. As detailed in this pleading, the Duke terms and conditions are materially different from those in the

PG&E filed rate. The material differences will seriously impair the ISO's ability to provide reliable electric transmission service. Moreover, the terms will impose substantial additional financial costs on the ISO to the detriment of all California ratepayers relying on ISO service for delivery of their electric energy. These facts are so self-evident that the Commission should reject PG&E's filing as a matter of law, as the ISO will request in its protest to PG&E's Notice of Termination. This preclusion of conveyance and termination will prevent Duke from acquiring the Moss Landing facility. Thus, its filing of the proposed rate schedule, which is the subject of the instant proceeding, is without foundation. Should the Commission not grant summary disposition on the question of whether PG&E's termination pre-condition has been satisfied, (*i.e.,* the filing by a successor of a rate with substantially the same terms and conditions) then the Commission should suspend PG&E's termination notice for a full five months and set for expedited hearing the question of whether PG&E's requested termination is just and reasonable under the circumstances.

V. MOTION TO CONSOLIDATE - THIS DOCKET NO. ER98-2668-000, DUKE'S FILING ON OAKLAND, DOCKET NO. ER98-2669-000, AND THE RELATED PG&E NOTICE OF TERMINATION ARE INEXTRICABLY INTERTWINED AND THEREFORE SHOULD BE CONSOLIDATED

Under the Commission's Rules of Practice and Procedure 18 C.F.R. § 35.15, PG&E must file a Notice of Termination with the Commission in order for Duke's RMR Agreement to become effective and for Duke to assume ownership and control of the sold generating facilities. PG&E submitted its Notice of Termination on April 30, 1998 in Docket No. ER98-2785-000 for both the Moss Landing and Oakland must run units. The ISO respectfully requests that PG&E's Notice of Termination and Duke's filing be consolidated.

The fundamental issue in each of these dockets is whether PG&E has met the conditions under which it is allowed to convey RMR units to a new purchaser. As a current supplier of must run service from the Moss Landing unit, PG&E can terminate its service to the ISO if it sells the must run facility to a purchaser who executes a contract with ISO or files a rate schedule with FERC to provide the ISO the right to purchase energy and ancillary services *under substantially the same terms* and specified cost-based rates. As discussed further below, the terms and conditions in Duke's filing are not substantially similar to the terms and conditions in PG&E's agreement. PG&E should not be allowed to terminate service to the ISO until it complies with its current agreement with the ISO. Likewise, Duke should not be allowed to file a must run agreement for service to the ISO that was not properly conveyed to it.

Because PG&E's ability to terminate its must run service to the ISO and, consequently, Duke's authority to file the successor must run agreement are fundamentally intertwined, the dockets should be consolidated.

VI. MOTION TO REJECT FILING AND PROTEST

On October 31, 1997, PG&E filed fourteen RMR agreements to provide services to the ISO, including the provision of energy and ancillary services from the Moss Landing unit. The services that PG&E provides to the ISO help to ensure that the ISO can operate the ISO Controlled Grid is a reliable manner. In July 1997, the ISO Governing Board designated Moss Landing and Oakland as must run units. In late 1997, PG&E and Duke entered into an agreement by which PG&E agreed to sell three of its generating units to Duke. As such, Duke was well aware prior to purchasing the facilities

that Moss Landing and Oakland were must run units. On April 24, 1998, Duke filed its RMR agreement and rate schedule for the Moss Landing unit in this proceeding.[4]

However, Duke's proposed RMR Agreement is not substantially similar to the ISO's RMR agreement with PG&E. Thus, as discussed below, the ISO is requesting that the Commission reject Duke's filing. The ISO will also request that the Commission deny PG&E's request to terminate service to the ISO. In the alternative, should the Commission not grant the ISO's request to reject the filing, the Commission should order the maximum suspension of five months. This suspension will coincide with the suspension and expedited hearing on PG&E's Notice of Termination. In addition, the ISO moves for summary judgment on Duke's request for approval of an acquisition adjustment and requests the Commission deny Duke's request for a waiver of the Section 35.13 filing requirements.

The ISO cannot operate the ISO Controlled Grid in a reliable manner with 117 separate must run agreements with the 117 separate must run units. There must be some uniformity in the terms and conditions of those agreements. PG&E's RMR agreement specifically provides that the contract can be transferred only if the terms and conditions are "substantially similar." Duke's proposed terms and conditions are not substantially similar to the PG&E agreement. If the Commission accepts for filing Duke's proposal with its disparate terms and conditions, it will be sending the message that all m-Must run unit owners can file any terms and conditions and tie up the ISO's resources with needless litigation and at the same time jeopardize the reliability of the California transmission system. The Commission should therefore either reject Duke's filing as a matter of public policy or, the Commission should reject the Duke filing because Duke

[4] On April 24, 1998, Duke filed the RMR agreement for the Oakland unit.

has not complied with the transfer provisions in PG&E's contract. At 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.

The Commission has often suspended notices of termination for a full five months and ordered expedited hearings. *See Potomac Elec. Power Co.*, 43 FERC ¶ 61,189 (1988) (termination would reduce liability of service); *Ohio Power Co*., 8 FERC ¶ 61,210 (1979) (termination would make emergency service uncertain); *Montana-Dakota Utils. Co*., 44 FERC ¶ 61,327 (1988) (termination would have serious adverse affect on party's operations); and *Otter Tail Power Co*., 55 FPC 3817 (1976) (termination would have serious impact on electric service within the region).

Also, before service under a filed rate can be terminated, the termination must be shown to be in the public interest. *Pennsylvania Water & Power Co. v. FPC*, 343 U.S. 414 (1952). The Commission has found that where a notice of termination would have impacts contrary to the public interest, it would not approve such terminations unless and/or until satisfactory alternative service is provided. In *Florida Power & Light Co.*, 8 FERC ¶ 61,121 (1979), the Commission rejected restrictive service availability proposals and two notices of termination that were based on those proposals. In those proposals, Florida sought to exclude from its new partial requirements service those customers that had sufficient generating capacity to meet their loads. The Commission found that the proposals, and, consequently, the terminations, would eliminate the only practical source of baseload power to competing utilities within the markets dominated by the company and, therefore, were anticompetitive. Similarly here, by permitting PG&E's notice of

termination 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. The Commission should forestall this result by suspending PG&E's Notice of Termination and deferring action on Duke's filing until a final Commission determination is made in PG&E's termination proceeding.

A. PG&E Has Failed To Meet The Conditions Under Which Moss Landing May Be Conveyed.

1. Duke Has Failed To File An Agreement That Is Substantially Similar, As Required By PG&E's RMR Agreement

a. On Its Face, The Structure Of The Agreement Is So Fundamentally Different In Form That It Cannot As A Matter Of Law Be Found To Meet The Condition Precedent To A Sale

As the purchaser of RMR services from 117 separate units—services the ISO requires to maintain the reliability of the system—the ISO requires a uniform *pro forma* RMR agreement to ensure equity and ease in administration and consistency in cost determination. The word "uniform" does not imply that each RMR unit must have identical costs, identical performance characteristics and identical service limits. Given the large portfolio of RMR units under the ISO's control—117 hydro, geothermal, steam turbine and gas turbine units ranging in size from less than 1 MW to over 700 MW—the contracts cannot be literally the same. The RMR contract schedules, where the costs, performance characteristics and service limits of the units are listed, are sufficiently detailed to allow for differences among units. However, uniformity in the RMR context does mean that the costs, performance characteristics, service limits and obligations of both the RMR Owner and the ISO in all the contracts must be determined—and administered—in the same way.

According to PG&E's RMR Agreement "A", section 2.2(a)(iii):

> This Agreement may be terminated by Owner, if it sells the Facility to a purchaser who, if ISO requires the Units to continue to be available, 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 (including terms specifying cost based rates, subject to the provisions of Section 5.7 of the Master Must Run Agreement). Such termination may not take effect prior to the effective date of all necessary regulatory approvals, including acceptance by FERC of the contract between ISO and the purchaser of the rate schedule filed by the purchaser.

The ISO will not execute or support a rate schedule filed with FERC by a new owner that does not include substantially the same terms and conditions as the contract being replaced. Having substantially the same terms for all RMR Agreements is very important for the ISO to operate Reliability Must Run services efficiently and effectively. That condition of uniformity was included specifically to avoid forcing the ISO to litigate terms and conditions each time a unit owner chooses to file a completely new agreement—in particular when an agreement is so different it cannot be redlined against the predecessor and requires 12 pages just to summarize the differences (*see* Attachment A).

"Rate filings consistent with contractual obligations are valid; rate filings inconsistent with contractual obligations are invalid." *Richmond Power & Light v. FPC*, 481 F.2d 490, 493 (D.C. Cir.), *cert. denied*, 414 U.S. 1068 (1973). In a similar vein, the Commission has found that the "rejection" of a filing " may be used by an agency 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).[5]

Here, the contract filed by Duke is a nullity and, therefore, the rate filing should be summarily rejected. The contract filed by Duke is contrary to the contractual obligations of the parties because the contract is not "substantially similar" to the contract between PG&E and the ISO. That contract provides that PG&E may not terminate the must run contract at issue, unless the must run contract filed by the purchasers is substantially similar to the contract between the ISO and PG&E. *See* PG&E's RMR Agreement "A" section 2.2 (a)(ii). As is shown in Attachment 1, there are numerous substantive differences that show that Duke's proposed contract is not substantially similar to PG&E's and, therefore, is contrary to contractual obligations and invalid. *See also Ohio Edison Co.*, 43 FERC ¶ 61,316, at 61,882-83 (1988) (summarily rejecting a rate filing because it was contrary to a previous settlement agreement and, thus, a nullity);[6] *Union Elec. Co.*, 51 FERC ¶ 61,083, at 61,185-86 (1990) (rejecting a change to

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[5] The PG&E must run agreement that is on file with the Commission is the agreement that governs the service between PG&E and the ISO. That agreement was filed by PG&E. Although 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. This situation is not unlike a *Mobile-Sierra* filing. The Supreme Court has held that if a public utility, subsequent to entering into a contact, unilaterally files with the Commission under section 205(d) of the Federal Power Act, a new tariff inconsistent with its contractual obligations, the newly filed tariff is a nullity and does not abrogate or supersede the contract. *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332, 338 (1956); *FPC v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956) (expressly adopting *Mobile*'s reasoning). The D.C. Circuit has found that the rule of *Mobile-Sierra* is "refreshingly simple"—"[t]he contract between the parties governs the legality of the filing." *Richmond Power & Light v. FPC*, 481 F.2d 490, 493 (D.C. Cir. 1973).

[6] In *Ohio Edison*, the Commission summarily rejected the rate filing even though it had to interpret an ambiguity in the settlement agreement through the use of extrinsic evidence.

a tariff that would restrict service based on retroactive criteria as clearly not reasonable because customers must have the opportunity to consider the consequences of changes and make rational planning and operating decisions of their own).

This issues has already been argued and briefed by the parties to the RMR proceedings. The Chief ALJ has likewise recognized the need for uniform terms, *over the objections of the utility sellers.* The Chief ALJ specifically found that "[t]he simultaneous existence of different sets of terms of [sic] conditions by various owners can lead to confusion, uncertainty, and inefficiency." *Southern California Edison Co.,* 82 FERC ¶ 63,011, at 65,024 (1998) (citing the Commission's rejection of different open access tariffs). Several parties supported the Commission Trial Staff's motion to sever the terms and conditions, such as the Public Utilities Commission of California, Cogeneration Association of California, the California Independent Energy Producers and—Duke.[7]

b. Without The *Pro Forma* Agreement, Reliability Is At Risk

The ISO's RMR structure was carefully crafted to recognize the need for uniformity of these agreements. The conditions under which an RMR Agreement may be assigned (only with ISO consent) or a unit conveyed and a new agreement filed (only on similar terms with the new owner and with the additional protection that any initial rate must be found just and reasonable before it is allowed to go into effect) are policy choices made by the California market participants and known by Duke when it committed to the purchase. Moreover, these are reasonable conditions that are fundamental to the ISO being able to operate reliably.

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[7]Parties opposing the creation of a separate terms and conditions proceeding included Houston Industries, PG&E, SCE, SDG&E, SMUD, Southern Cities and Segundo.

Allowing each RMR contract to specify different communications protocols, timing and structure of Dispatch Notices, the conditions under which the ISO may call upon the units or the conditions under which the units would be required to furnish service, would wreak havoc with ISO operations.[8] ISO dispatchers would have to treat each RMR facility differently and either develop photographic memories of each separate RMR contract or be forced to consult each Unit's contract before every RMR transaction—an impossible task when trying to dispatch units in real time.

c. Without The *Pro Forma* Agreement, Costs Will Increase

In addition to the risk to reliability, there are significant risks to the ISO's ability to minimize the cost of RMR services through its annual selection of RMR units. For example, the ISO's goal is to reduce and ultimately eliminate the need to call on units under the RMR contracts to manage system reliability. To do so, the ISO will have to be able to assess both the effectiveness and the cost of alternatives to RMR contracts, such as new transmission or new generation resources. The ISO requires the RMR contracts to be structured uniformly so the cost-effectiveness of RMR generation can be properly compared—both against other RMR units, and against other generation and transmission alternatives.

Likewise, to minimize the cost of reliability to each transmission owner's ultimate customers, the ISO will need to dispatch RMR units as efficiently as possible. If the

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[8] Consistent with the Chief ALJ's views, the ISO also favors a uniform approach to calculating rates. As such, the ISO supports a formula rate for must run service. As the Commission is aware, formula rates consist of inputs which then vary on a yearly basis as the various cost inputs change. The ISO does not want to go through the time and expense of litigating must run rates every time the inputs change, or new owners come on board. Such an approach is consistent with Commission precedent. *See, e.g., Middle South Services, Inc.*, 16 FERC ¶ 61,101, at 61.219 (1981).

service limits, performance characteristics and costs of RMR units are not specified according to uniform criteria, it will be difficult for the ISO to compare the effective costs of RMR units, and therefore difficult to dispatch them in the most economic fashion.

Moreover, if RMR units are not compensated the same way for providing the same service, the potential for disputes is enormous. The ISO would have to calculate all RMR charges manually, which opens the door to errors. Otherwise, the ISO would have to develop and maintain complicated software to associate the right compensation methodology with each unit. Non-uniform contracts could logically lead to non-uniform invoices for RMR services, which would greatly complicate the efforts of the ISO Settlements staff trying to validate RMR Owners' invoices with the ISO's dispatch records.

d. The Substantive Terms Of The Agreement Are So Fundamentally Different That The Agreement Cannot As A Matter Of Law Be Found To Meet The Condition Precedent To A Sale

The substantive terms of the Duke filing are fundamentally different from the terms and conditions in the PG&E agreement, and are, therefore, in violation of the assignment clause in the PG&E agreement. As such, Duke's filing should be rejected. For example,

- Duke seeks a Letter of Credit from the ISO. The ISO is prohibited from issuing this Letter of Credit by the Reimbursement Agreement in Article VII Negative Covenants of the ISO Section 7.2 Limitations on Additional Debt. Any breach of this covenant would be an event of default in the Reimbursement Agreement in Article VIII Defaults and Remedies Section 8.1c Events of Default.

- Duke retains the right to suspend service for non-payment. There is no such right in the other RMR Agreements and, in fact, this alone creates a major reliability issue given PG&E's refusal to agree to pay under dispute.

- Duke has changed the way "Owner's Deemed Costs" are calculated for the B contract.

- The definition of *force majeure* would excuse Duke from mechanical breakdowns. We believe that equipment failure belongs in the forced outage rate calculation.

- Duke's termination provision would not bind a new owner to file a contract under substantially the same terms.

- Duke would be able to move to the "B" contract 90 days from ISO operation, without notice. Currently an owner must give 90 days notice. This allows Duke to weigh market risks right up to a conversion.

- Duke provides a right to roll *back* to "A" at the start of a new year. Our contract would limit conversion to once a year and require rollover on whatever version the unit is on at the end of the previous year. Duke also provides for more frequent changing from B to A and *vice versa* and with 30 days notice, not 90.

- Duke has added an *obligation* on the ISO's part to issue dispatch notices, rather than the permissive language in PG&E's version. This creates a materially different liability for the ISO.

- Duke has materially altered the schedules governing what happens if the ISO needs to issue a dispatch notice above the various limits and has included *monthly* service limits. Given the uncertain nature of the RMR need in the initial years, any further limitation could have significant cost and reliability implications. Duke also adds a new limit for "maximum hourly generation."

- Duke added a 2% margin for error for reliability testing.

- Duke has significantly limited the ability of the ISO to deny capital expenditures. Since the ISO is obligated to pay an exit fee for unrecovered capital expenditures, this could substantially bias any evaluation of alternatives to Duke's RMR units.

- Duke has lowered its obligation to "reasonable efforts" from "best efforts" in a number of places. This allows Duke to consider economics in deciding whether to comply with the ISO's directive.

- Duke seeks coverage under the ISO's errors and omissions insurance policy.

- Duke has limited the period in which the ISO can audit Duke's books.

- Duke has significantly altered the indemnification provisions.

Other provisions of Duke's RMR Agreement that are substantially different from PG&E's RMR Agreement are set forth in Attachment 1.

If the Commission accepts this filing, it will set precedent for future RMR owners who may want to file their own versions of the RMR Agreement. *The ISO cannot*

operate with a multitude of different RMR Agreements while litigating with parties before the Commission to determine what version of a contract ultimately should be utilized to operate the ISO's Reliability Must Run obligation. Public policy supports a *pro forma* RMR Agreement with uniform conditions and agreements for all owners. These public policy concerns and the balance against current RMR owners are being addressed in the current RMR settlement negotiations. That proceeding should determine the terms and conditions for any owner buying RMR units.

e. The ISO Faces Substantial Additional Costs And Risks Associated With Its Financing If The Commission Accepts Duke's Filing

The ISO's ability to obtain financing has been dependent on its ability to mitigate the risk that it would owe RMR unit owners amounts due for RMR service but be unable to collect those amounts from the applicable transmission provider. When the ISO first sought financing, no bank was willing to lend to the ISO unless the ISO's obligation to RMR unit owners was "non-recourse"—payable solely out of amounts collected from the relevant transmission provider. So long as the transmission provider also is the RMR unit owner, the ISO has the equivalent of a non-recourse obligation since there is an express right of set-off of amounts due to the unit owner with amounts due from the affiliated transmission owner.

The RMR unit owners purchasing the SCE plants, SCE and SDG&E have agreed to and signed equivalent non-recourse liability in a "Principles of Agreement." Tariff and contract language is being drafted to accomplish that agreement in principle.[9] PG&E's

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[9] ISO Settlement and Billing Protocol Annex 1, Settlement and Billing of Reliability, Must-Run Charges and Payments.

January 29, 1998 filing included similar language, but PG&E withdrew that provision in an *"errata"* notice filed March 6, 1998.

Before any PG&E units were sold and on the strength of the SCE and SDG&E agreements in principle and an expectation that an agreement with PG&E could be reached, the ISO, in consultation with its lenders, arranged for the sale of $301,400,000 in tax-exempt variable rate demand bonds issued by the California Economic Development Financing Authority and backed by a letter of credit issued by Bank of America National Trust and Savings Association (BofA). The first issuance of $101,600,000 was sold May 5, 1998. The second issuance of $199,800,000 is scheduled for May 15, 1998. Because BofA provides the credit support, the ISO's representations, warranties, and continuing covenants are principally to BofA through the Reimbursement Agreement. The Reimbursement Agreement provides THE FOLLOWING IN Article VII Negative Covenants of the ISO Section 7.9 Must Run Agreement Units:

> SECTION 7.9 Must-Run Agreement Units. The ISO shall not designate a unit as a Reliability Must-Run Unit as provided in Section 5.2.3 of the Tariff unless (i) the Owner of such unit has agreed that it has no recourse to the ISO in respect of any Reliability Must-Run Charge in the event the ISO has not received the Reliability Must-Run Charge from the applicable PTO (a "Pay When Paid RMR") and (ii) the applicable PTO has agreed that it will pay to the ISO all Reliability Must-Run Charges invoiced to the PTO in respect of such Reliability Must-Run Unit without setoff; provided, however, that such agreement may allow such PTO to make such payment under protest and to obtain a refund, with interest, of any invoiced amount determined not to have been due and payable, which refund (with interest) shall be netted against future payments form such Owner.

Duke's contract would result in a breach of the above covenant and trigger an event of default. The Reimbursement Agreement provides that a violation of Section 7.9 is an event of default under Article VII, Section 8.1.c.. As such, it is materially different from

the PG&E agreement in its effect on the ISO as thus fails to meet the condition for sale of an RMR unit.

BofA has advised the ISO that if PG&E refuses to agree to principles of agreement substantially similar to those agreed to by SDG&E, SCE and the SCE unit purchasers, and FERC accepts Duke's filing and permits it to become effective, BofA will:

- impose substantial restrictions on the use of the proceeds of the second issuance;[10]
- create a term loan for the $69,245,000 of disbursements for working capital and completion of infrastructure at a substantially increased interest rate that is payable over one year in 1999, rather than ten years;
- require that the funds not disbursed would be used to provide collateral for the Letter of credit and to redeem the outstanding bonds

These lending restrictions exist because the potential liability of the ISO for RMR payments is very large relative to its overall operation budget. For example, the total for must-run services during a peak season month alone could total $152.7 million, an amount equal to the ISO's annual operating budget. The must-run agreements are estimated at costing more than $1.5 billion for 1998. The ISO estimates the potential financial impact of these restrictions to be between $2 and almost $4 million in increased interest costs. In addition, the ISO will be required increase the Grid Management Charge by approximately $0.4872 for 1999 to repay the one-year term loan.

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[10] Before the ISO issues its second issuance the BofA has required the ISO to execute an amendment to the Reimbursement Agreement providing sever limitations on the use of bond proceeds until "such time . . . as . . .the Banks have received from the ISO and Pacific Gas and Electric Company ("PG&E") a fully executed agreement in form and substance satisfactory to the Issuing Agent, the Agent and the Banks regarding the sale by PG&E of its Reliability Must-Run Units." Reimbursement Agreement, Amendment 1, Section 6.13.

This potential cost increase can be wholly avoided if PG&E retains ownership of the units. All but about $800,000 in increased borrowing costs can be avoided if PG&E agrees to the "Principles of Agreement" already agreed to by SDG&E, SCE and the SCE owners. The ISO respectfully submits that any filing putting the ISO is such a materially adverse financial situation is facially inadequate to meet the conditions of PG&E's RMR Agreement on sale of the unit.

This potential cost increase can be wholly avoided if PG&E retains ownership of the units. All but about $800,000 in increased borrowing costs can be avoided if PG&E agrees to the principles of agreement already agreed to by SDG&E, SCE and the SCE owners. The ISO respectfully submits that any filing putting the ISO is such a materially adverse financial situation is facially inadequate to meet the conditions of PG&E's RMR Agreement on sale of the unit.

B. The Duke Agreement Should Be Rejected And Not Accepted Even With A Refund Condition.

A purchaser that does not agree with an initial rate should not be unilaterally forced to take service under it. As the above discussion indicates, the Commission, for both legal and policy reasons, should reject this filing. As to Duke's contention that the filing is an initial rate, at a minimum, an initial rate contemplates arms length bargaining between the parties. *Middle South Energy*, 23 FERC 61,277, at 61,572 (1983), *order on remand,* 31 FERC ¶ 61,304, at 61,627, *reh'g denied*, 32 FERC ¶ 61,223, at 61,510 (1985). Here, the ISO attempted to negotiate with Duke prior to its filing. However, Duke unilaterally terminated those negotiations and made this filing. The Commission should not allow such an approach. The Commission should protect the ISO, a captive customer in the receipt of must run service, by rejecting the filing.

More importantly, the Commission should also not just accept the filing, suspend it and make the filing subject to refund. The Commission's refund and suspension authority will not protect the ISO in these circumstances. The ISO has documented the harm, both operationally and financially, that will occur if Duke's unilateral filing is accepted subject to refund. The ISO simply cannot operate the transmission grid in a reliable fashion if unilateral filings are accepted and allowed to be in effect for a substantial period of time before those filings are found just and reasonable.

The Commission has taken steps in other situations when its refund and suspension authority will not protect captive customers. This is that situation. For example, if a transmission provider seeks market-based rates, the Commission will not grant market-based rate authority until the market power of that transmission provider is mitigated by offering comparable open access transmission. The Commission will not allow transmission providers to exercise market power while the lengthy hearing process unfolds. *Kansas City Power & Light Co.*, 67 FERC ¶ 61,183 (1994); *Kentucky Utils. Co.*, 71 FERC ¶ 61,250 (1995). So too, the Commission will not accept modifications to the Commission's open access tariff unless the transmission provider proves that the modified terms and conditions are equal to superior to the Commission's open access tariff. *Northern States Power Co.*, 83 FERC ¶ 61,098 (1998), *citing New York State Elec. & Gas Co*., 78 FERC ¶ 61,114 at 61,434-35 (1997), *reh'g denied*, 82 FERC ¶ 61,209 (1998). The Commission will not let parties use the Commission's practice of acceptance, suspension and a hearing process that often can be lengthy, to frustrate open access transmission.

The case of *KN Interstate Gas Transmission Co. (KNI)* clearly states why. 68 FERC ¶ 61,401 (1994). There an interstate pipeline made a Section 4 rate filing, the

companion to the Section 205 filing Duke made here, seeking authority to charge market based rates. KNI wanted the Commission to accept and suspend the filing so that it could charge market based rates pending the outcome of the hearing. The Commission said no. The Commission stated:

> In the instant case, KNI has not shown that it lacks significant market power. It is clear that certain customers are connected solely to the Buffalo Wallow System. These customers have no good alternatives, and the Commission concludes that KNI has not proposed safeguards that will adequately protect these captive customers.

The Commission added:

> In this instance where the proposal lacks adequate safeguards to protect captive customers, the Commission cannot fulfill its duty to protect those captive customers if it accepts and suspends the proposed tariff sheets. The maximum suspension period of five months is unlikely to be adequate time for the Commission to analyze possible revisions to KNI's proposal to ensure that adequate protective measures could be crafted that would ensure just and reasonable rates for these customers. Therefore as discussed in greater detail, the Commission finds that it *must* reject the proposed tariff sheets.[11]

The circumstances surrounding the ISO are the same. It is a captive customer for must run services. Duke must provide such services to the ISO if the grid is to operate in a safe and reliable fashion. There are no alternatives. Yet, Duke has made a unilateral filing with terms substantially different from the terms in the ISO's contract with PG&E. Duke's filing, if accepted, would not allow the ISO to operate efficiently and could affect the ISO's obligation to provide reliable transmission service. Duke has proposed nothing to mitigate market power. Moreover, the Chief ALJ's goal of standard terms and conditions for must run service may not be completed during the five month suspension

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[11] *KNI*, 68 FERC ¶ 61,401, at 62,587-88 (1994) (emphasis added). *See also Natural Gas Pipeline Co. of America*, 41 FERC ¶ 61,358 (1987) (order rejecting gas inventory charge filing finding that if filing is accepted without reviewing the terms, Commission could not put parties in same place as if proposal had never been filed).

period. Therefore, the Commission should reject the Duke filing and require PG&E to perform must run under the currently effective tariffs, pending the successful completion of negotiations on standard terms and conditions for must run service. By only taking this approach will the Commission protect the ISO, a captive customer for must run services.

C. Substantial Public Interest Issues Warrant the Commission's Scrutiny and Use of Conditioning Authority Under Section 203 of the Federal Power Act.

Important public interest considerations dictate that the Commission should require PG&E and its successor in interest, Duke to file under Section 203 of the FPA for authority to transfer jurisdictional assets and demonstrate that, on balance, the proposed transfer is consistent with the public interest. The Commission has well established authority to treat the proposed transfer as subject to the requirements of Section 203. The sales from the Moss Landing facility are clearly being sold into a commingled supply of electrons, some of which are delivered in sales for resale in interstate commerce. Since 1942, both the records and other accounts related to such transactions, as well as the generation facilities from which the sales are made, have been characterized as jurisdictional facilities. *Hartford Elec. Light Co. v. FPC,* 131 F.2d 953, (2d Cir. 1942), *cert. denied*, 319 U.S. 741 (1943). The Commission has repeatedly relied on this precedent to determine when to assert jurisdiction over sales for resale in interstate commerce. *See Enron Power Marketing, Inc.,* 65 FERC ¶ 61,305 (1993) and *Louis Dreyfus Elec. Power, Inc.,* 62 FERC ¶ 61,234 (1993). The Commission has also relied on the *Hartford* decision to justify consideration of whether a merger or other transfer of jurisdictional facilities is consistent with the public interest. *See San Diego Gas and*

Elec. Co. v. Alamito Co., 38 FERC ¶ 61,241 (1987) and *Enova Corp. and Pacific Enterprises,* 79 FERC ¶ 61,107 (1997).

Recently, the Commission approved a sale of generation and related transmission assets from New England Power Company and others to U.S.Gen. New England, Inc. *New England Power Co.,* 82 FERC ¶ 61,979 (1988). In that order, the Commission carefully reviewed the effects that the transfer, part of the overall restructuring of the New England electric industry, would have on the public interest, including the effects on competitors rates, regulation and other issues. No less is required by the transaction at issue in this proceeding. As a key component of California restructuring with a significant potential effect on future electric operations, this transaction requires a full public interest scrutiny.

There are compelling public interest reasons why the Commission should assert its Section 203 jurisdiction and not approve an unconditioned transfer of facilities from PG&E to Duke. First, these facilities are critically situated and by definition have market power under certain operating conditions since the ISO has no alternative but to call on these facilities during those conditions to ensure the reliable operation of the transmission system. Thus, the public interest requires that operational terms and conditions be attached to the transfer to limit the exercise of that market power to electric consumers. Secondly, these generation facilities operate to support and substitute for transmission service. As the reliable operation of the transmission system is necessary for the provision of electric service and the development of competitive energy markets, the Commission must also act to ensure that the owners of these facilities reasonably coordinate their operations with the operation of standard transmission facilities. The whole thrust of recent regulatory efforts by the Commission has been to require that the

owners of facilities needed for transmission service make those facilities available for use by others on reasonable terms and conditions. If Duke will not agree to terms that are needed to provide the reasonable coordination and uniformity needed by the ISO, then the Commission should exercise its Section 203 authority over the transfer of jurisdictional facilities to impose such conditions as a condition of transfer. At the very least, the Commission should require that Duke be required to operate under the existing terms and conditions filed by PG&E until Duke has established that its non-conforming terms and conditions are consistent with the public interest.

VII. MOTION FOR SUMMARY DISPOSITION

A. As A Matter Of Law And Public Policy, Acquisition Premiums Are Not Just And Reasonable In These Circumstances And Should Be Summarily Rejected.

As discussed above, the ISO has shown that Duke's filing should be rejected because it does not meet the conditions under which PG&E and Duke can agree to convey an RMR unit without ISO consent. If, however, the Commission does not reject Duke's filing, the ISO alternatively requests that the Commission deny Duke an effective date and set all matters for hearing. In conjunction with the alternative relief, the ISO also requests that the Commission determine on summary disposition that Duke's proposed acquisition adjustment of $182 million is not just and reasonable in these circumstances.

While recognizing that its must run services are to be provided to the ISO at cost-based rates, Duke proposes to increase the original cost basis for purposes of calculating

the must run rates of the Moss Landing unit from $198 to $380 million,[12] an increase of $182 million.[13] Duke asserts that this "adjustment" is justified by off-setting benefits to consumers, and even attempts to quantify these benefits. However, Duke fails to identify one improvement in service or other benefit to customers that *will result from its purchase of the facility*.

Thus, the ISO hereby moves for summary disposition of Duke's proposed rate recovery of acquisition adjustment. Pursuant to Rule 217 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.217, "[i]f the decisional authority determines that there is no issue of fact material to the decision of a proceeding or part of a proceeding, the decisional authority may summarily dispose of all or part of the proceeding." The Commission requires that two conditions be met before it will summarily dispose of an issue under Rule 217: (i) the proponent of the issue must have had an opportunity to present its arguments and facts, and these arguments and facts must be viewed in a light most favorable to that party, and (ii) the Commission must find that a hearing on the issue is unnecessary and would not affect the outcome of the case. *Pacific Gas & Elec. Co. v. FERC*, 746 F.2d 1383, 1386 (9th Cir. 1984), *citing Coastal States*

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[12] This results, in part, in a substantial increase in the cost of must run service.

	PG&E Rate	Duke Proposed Rate
Schedule A Reliability Rate		
Unit 6	$15.83/MWh	$18.669/MWh
Unit 7	$12.58/MWh	$14.629/MWh
Schedules B & C Availability		
Rates – Unit 6	$6,151.12/hour	$7,253.69/hour
Unit 7	$6,231.64/hour	$7,243.85/hour

[13] Through its crediting mechanisms, Duke has attempted to ensure that the ISO will not carry the full cost of the acquisition premium to the extent that Duke makes market sales, but will only bear an allocable portion thereof.

Mktg. v. Texas-New Mexico Pipeline Co., 5 FERC ¶ 61,164 (1983), and *Citizens for Allegan County, Inc. v. FPC*, 414 F.2d 1125, 1128-29 (D.C. Cir. 1969). In contrast to the Commission's rejection of a filing because the filing "patently is either deficient in form or a substantive nullity," summary disposition is appropriate when there is no factual dispute for the Commission to determine, but only questions of law or administrative policy. *Municipal Light Boards v. FPC,* 450 F.2d 1341, 1345-46 (D.C. Cir. 1971), *cert. denied,* 405 U.S. 989 (1972).

The Commission will therefore grant summary disposition when the pleadings reveal no dispute of facts or there is no need to review the underlying facts in order to assist it in making a policy determination. The Commission has granted summary disposition in a variety of circumstances where the filing contains provisions that are contrary to Commission precedent. *Gulf States Utils. Co.,* 28 FERC ¶ 61,391 (1984) (Commission ordered summary disposition rejecting nuclear facility pollution control CWIP included in rate filing on the ground that Commission precedent established that only limited facilities would qualify for such treatment); *Utah Power & Light Co*., 23 FERC ¶ 61,287 (1983) (summary dispositions ordered where applicant improperly synchronized interest expense in income tax calculation and included non-qualifying CWIP in rate base); *Virginia Elec. & Power Co.,* 23 FERC ¶ 61,289 (1983) (summary disposition granted with respect to inclusion in its rate base of cancellation costs associated with cancelled nuclear plant); and *South Carolina Elec. & Gas Co.,* 23 FERC ¶ 61,436 (1983) (summary disposition granted for improper exclusion of accumulated deferred investment tax credits from rate base).

The ISO has met the criteria for summary disposition of Duke's proposed acquisition adjustment. The ISO has clearly demonstrated that, even when viewed in a

light most favorable to Duke, the acquisition adjustment proposal presents no issues of fact which would require a hearing. In addition, the ISO has demonstrated that Duke's proposal is contrary to Commission policy and precedent regarding acquisition adjustments. The ISO has shown that the facilities purchased by Duke will provide the same must run service to the same customers as PG&E would have provided had the facilities not been sold and there will therefore be no new public use. Moreover, Duke will have the opportunity to recover its above-book purchase costs by participating in the competitive California market. Duke's attempt to recover its acquisition adjustment from captive customers through reliability must run service is either "gravy" or an attempt to subsidize its operations in the competitive market. Finally, even assuming, that the payment of above-book cost will reduce stranded cost in the short run, the Commission must remember that Duke's proposed recovery of the acquisition adjustment will offset these savings. It will also extend the recovery period over which the stranded costs are recovered from ratepayers to 20 years instead of the four-year period provided by A.B. 1890. This extended recovery means that some measure of stranded costs will continue to be reflected in market prices for the next twenty years. Thus, even in a light most favorable to Duke, its proposal is contrary to the public interest and should be summarily dismissed.

Duke's quantification of purported benefits obscures the main issue before this Commission—whether Duke's purchase of Moss Landing provides any new value or a new service to customers receiving must run service. Without divestiture, PG&E would have provided the must run services at an original cost-based rate. Now, without any change in the service provided or in the customers served, Duke wants to be reimbursed

for must run service at its cost of acquisition. Duke's request has no foundation in Commission precedent or policy, and should be summarily rejected.

1. Duke Has Not Identified Any Tangible, Specific Dollar Benefits Resulting From The Acquisition.

In all but the most rare of cases, this Commission has refused to allow rate recovery of amounts paid for facilities in excess of the net original cost. As was explained by the Federal Power Commission in *United Gas Pipeline Co.,* 25 FPC 26 (1961), *rev'd on other grounds sub nom. Wilmut Gas and Oil Co. v. FPC,* 299 F.2d 111 (D.C. Cir. 1962), any other approach would violate the basic principles of original cost ratemaking and allow regulated utilities to artificially inflate their cost of service simply by transferring facilities:

> Under the "prudent investment" standard, the consumers of a public utility service compensate investors in the public utility for building the plants, but where a plant has been built and put into public service and where such plant is sold later the investors in the buying company are simply taking over the former company's claims to a return of and on the capital originally devoted to the public service. *Were it otherwise, all that need be done to raise rates and obtain greater income would be to have one company buy utility properties from another at a higher price than original cost and in this very simple way, increase the size of the rate base and increase the cost of service to consumers.*

United Gas Pipeline Co., 25 FPC at 64 (emphasis added). *See also, Minnesota Power & Light Co*., 43 FERC ¶ 61,104 (1988); *Commonwealth Edison Co.*, 51 FPC 2179 (1974).

Given these concerns, the Commission has adopted a strict standard against the inclusion of acquisition premia in rate base. The only exception to the rule is when the utility seeking such an adjustment can show that "specific dollar benefits resulted directly from the sale." *Mid-Louisiana Gas Co.,* 7 FERC ¶ 61,316, at 61,682 (1979), *aff'd sub nom. Transcontinental Gas Pipe Line Corp. v. FERC,* 652 F.2d 179 (D.C. Dir. 1981). These dollar benefits must be the "tangible direct results of a sale that are quantifiable in

monetary terms" and must accrue to all customers. *Id.* at 61,684. Moreover, the utility seeking the adjustment has the burden of showing that the excess amounts paid resulted in a rate reduction or service improvements, or otherwise directly benefited consumers. *United Gas Pipeline Co.,* 25 FPC at 56.

Not surprisingly, the Commission has allowed ratepayers to be charged for excess amounts paid in acquiring new facilities or systems in only a few instances. *See, e.g., Longhorn Pipeline Partners,* 73 FERC ¶ 61,355 (1995), discussed in section 2, *infra.* Evidence of a subsequent rate reduction is insufficient to meet the test for rate recovery, unless the utility affirmatively establishes a clear nexus between that rate reduction and the need to acquire the facilities at higher than book cost. *United Gas Pipeline Co.,* 25 FPC 26. Likewise, in *Mid-Louisiana Gas Co.,* the Commission rejected a pipeline's claim that the purchase of cushion gas at less than fair market value conferred a tangible benefit on consumers, noting there was no change in the customer's position as a result of the transfer:

> Practically speaking, customers at Hester storage field are not any better off following the sale than before the sale. Unless the sale itself causes a tangible benefit, no specific dollar benefit exists. Indeed, even if we view the sale theoretically as a bargain to Transco, no evidence is offered as to why the benefit of the bargain should not be passed through to Transco's customers.

7 FERC at 61,685; s*ee also Commonwealth Edison Co.*, 51 FPC 2179 (1974) (Commission refused to allow above the line amortization for an acquisition premium where the same customers would be served by the same facilities, regardless of potential savings due to decreases in operating costs).

As was the case in *Mid-Louisiana Gas,* Duke cannot show that the transfer of the facilities already committed to public use will result in any tangible, quantifiable benefit for the customers who have already paid for the facilities at their original cost. Duke

cannot point to a single way in which California customers receiving must run service are better off. Absent the transfer of facilities, California consumers would have been able to obtain must run services from PG&E at a net original cost-based rate. Now, Duke is proposing to provide those same services, from the same facilities and to the same customers, but at an adjusted cost-based rate, inflated with costs above depreciated net book value.

While Duke suggests that the ISO should have to acquire its must run service at rates that reflect the competitive value of generation, *see* April 24, 1998 Transmittal Letter at 14, Duke does not propose to subject itself to a true, market-based price for its must run services. Instead, Duke asks that it receive all of the protection against loss that is inherent in a cost-based regulatory structure, while adjusting its rate base upwards based on its own assessment of the value of its acquired generation. As is discussed in greater detail in section VIII.A., *infra*, Duke's bid price was based on the knowledge that part of its energy sales from the acquired units must be provided as must run service; that such services must be provided at cost-based rates. *See Pacific Gas & Elec. Co.,* 81 FERC ¶ 61,122, at 61,537 (1997). If it bid more than the book value for the units, it was because it believed it could earn enough from its market-based sales (now and in the future) to justify the cost. Duke does not need or deserve the current subsidy it is seeking in order to recoup their expected earnings from the units purchased.

Duke attempts to distract the Commission's attention from the fundamental fact that they are injecting elements of market-based pricing into rates that the Commission has determined must be cost-based; *see Pacific Gas & Electric, supra,* by invoking the mantra of off-setting benefits. However, Duke's purported "quantification" is confusing at best, and cannot begin to meet the Commission's strong presumption against an

acquisition adjustment. Among other things, Duke's quantification (1) fails to explain how it has created any new stranded cost "benefits", that were not already part of PG&E's total stranded cost calculation; and (2) fails to provide adequate support for the specific quantifications of benefits.[14] Duke has failed to meet its burden of showing that the collection of an acquisition adjustment is justified by tangible, quantifiable benefit to consumers.

2. Duke's Provision Of Must Run Service Does Not Constitute A New Public Use.

Given the inherent dangers in deviating from an original cost basis, the Commission has been receptive to including an acquisition premium in rate base only where the acquired asset is being dedicated or converted to a new public use. For example, in *Longhorn Partners Pipeline,* 73 FERC ¶ 61,355, at 62,112 (1995), the

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[14] Assuming *arguendo* that California consumers benefit in any tangible way, the Duke's quantification of such benefits is excessive and unsupported, even if one relies on Duke's calculation of Net Book Value and market values for the individual plants. For instance, the CPUC determined that PG&E's Transition Cost Balancing Account (TCBA) would be reduced by $60 million as a result of the sale of the three plants, but Duke claims that the TCBA will be reduced by $129 million. Cicchetti at 19, lns. 11-18. The discrepancy appears to result from the CPUC's reduction of the credit to the TCBA by $41 million to account for taxes (as well as from the CPUC's noted Net Book Value of the three plants—$390.2 million). Interim Opinion, Exh. ___ (PSH-2) at 6. Duke fails to explain why its calculation of the TCBA credit does not reflect taxes and why the Net Book Value that it uses is less than PG&E's calculation of the Net Book Value.

It is also unclear why Duke argues that the $43 million in stranded costs related to Oakland and Morro Bay is "effectively, never placed in the balancing account." Cicchetti at 19, lns. 22-23. Duke first states that California consumers receive a benefit from the $182 million in "stranded benefits" associated with Moss Landing, reduced by the $43 million in stranded costs associated with Oakland and Morro Bay and transaction costs ($10 million), because overall stranded benefits ($129 million) reduce the level of the TCBA and, consequently, the Competition Transition Charge. Then Duke argues that California consumers receive an additional benefit of $43 million because the stranded costs associated with Morro Bay and Oakland are never placed in the balancing account. This second argument is illusory because it reflects the impact of the stranded costs associated with Moss Bay and Oakland a second time, which is unsupported.

Commission indicated that it would allow a pipeline to include a premium above net original cost in acquiring a crude oil pipeline. Following the acquisition, the pipeline planned to switch the flow of the pipeline and make other improvements necessary to accommodate transport of refined petroleum products. In granting the acquisition adjustment, the Commission explicitly found that the service to be provided was "substantially different" from that provided by the previous owner, and that the pipeline would serve a new and distinct market. Likewise, in *Cities Services Gas Co.*, 4 FERC ¶ 61,269 (1978), the Commission indicated it would allow recovery of the cost to acquire an oil pipeline for later conversion to gas services, noting that the gas customers would not have to pay twice for the cost of depreciation. *See also KN Interstate Gas Transmission Co.*, 79 FERC ¶ 61,268, at 62,153 (1997).

There could not be a greater contrast between the new use required under *Longhorn* and *Cities Services* and the simple transfer of facilities in the case at hand. Duke's own description of operations at Moss Landing demonstrates the lack of any change in service provided or customers served.

Duke witness Cicchetti argues that a "new use" exists because reliability is a new product or service created by restructuring in California, and because the ISO is a new buyer also created by that restructuring. Cicchetti Direct at 27. However, as Dr. Cicchetti admits, prior to restructuring, the plant was operated by a vertically integrated utility that sold bundled electric energy—which necessarily included a reliability component. *Id.* at 26-27. The simple fact is that the Moss Landing facility was needed to provide reliable service in the San Francisco Bay area prior to restructuring.

Far from creating a new product called "reliability", California's restructuring efforts have been geared to maintaining the kind of reliability the system had previously

enjoyed in a vertically integrated market. In short, reliability is not a new service. Rather, it is an old service, as old as the beginnings of the electric grid. Surely, Duke is not asking the Commission to accept the notion that as a result of the California restructuring, captive customers such as the ISO and ultimately California consumers, will be forced to pay premium prices for receipt of reliable energy service.

Moreover, to the extent that any new product or service has been created, that product derives from the unbundling of rates and the separation of transmission control from generation, *not from the divestiture of a subset of PG&E's generation.* PG&E is currently providing the unbundled, must run services to the ISO that Duke describes as a new public use. Following Duke's purchase of Moss Landing, it will continue to operate the unit just as PG&E has been operating it, *i.e.*, providing must run services as needed and selling any remaining power at market-based rates if authorized. Duke will offer on an unbundled basis the exact same electric services that is currently being provided by PG&E, and Duke has failed to show that it will provide a new public use following the transfer. The request for recovery of an acquisition adjustment must accordingly be rejected.

VIII. DUKE'S PROPOSAL WOULD EXTRACT MARKET-BASED PROFITS FOR NON-COMPETITIVE SERVICES.

Duke suggests at various points in its filing that the ISO should be required to pay for generation at a rate that reflects its competitive value, just like any other participant in the restructured electric market in California. *See* Duke's April 24, 1998 Transmittal Letter at 14. However, Duke itself has not asked for a true market-based price,[15] nor

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[15] In essence, Duke is asking to enjoy the protections of a cost-based rate, including a guaranteed return of and return on prudently invested capital, but wants the measure of that investment to be judged by an asset's market value at the time of its acquisition. *See* discussion in section VII.A.1., *supra.*

could it support one under the circumstances. Instead, these essential must run services are not sufficiently subject to competitive market forces to allow abandonment of cost-based, regulated rates.

This Commission has determined that absent a specific competitive market showing, essential ancillary services, including those needed to support reliability of the transmission system, must be cost-based. *See, e.g., Ocean Vista Power Generation, L.L.C.,* 82 FERC ¶ 61,114, at 61,407 (1998). Moreover, the Commission has specifically determined that ownership and control of units which must be run for reliability purposes are subject to locational market power. *Pacific Gas & Elec. Co.,* 81 FERC ¶ 61,122, at 61,537 (1997). Duke's reliance on market valuation in setting the rates for must run services ignores the fact that there is no possibility of market discipline in the provision of must run services. Simply put, the ISO requires these units to provide reliable service. There are no competitive alternatives. As such, the Commission must not abandon traditional cost-based regulation in setting rates for must run service.

As is stated in the testimony of Duke witness Mr. Head "[c]ost-based must run services are required by the California ISO for system reliability during the transition to a completely open market." Head Direct at 10. The ISO agrees and accordingly requests that the Commission require Duke to provide such service using the traditional method of calculating a cost-based rate.

A. Duke's Proposal Sends Inappropriate Price Signals to Future Purchasers of Generating Assets.

Duke also asserts that the Commission must allow rate recovery of its acquisition premium in order to send appropriate price signals to future buyers of generating assets. To the contrary, approving Duke's proposal would increase the future cost for necessary must run services far above the actual value of those services. Many of the 119 units

have been sold. If Duke prevails here, the other buyers will expect to receive an acquisition adjustment. This will give future bidders in California and elsewhere every incentive to bid up the price far above the true market value, thereby increasing of must run services.

Duke never claims that it formulated its bid for the Moss Landing unit with the expectation that it could sell *all* the energy produced from the unit at market-based rates. Denial of an acquisition adjustment for sales under the RMR contract will in no way restrict the revenue that Duke can collect during the time it sells energy from Moss Landing at market, *i.e.*, where the unit is not called for RMR service. Instead, prospective purchasers in the PG&E divestiture were aware of the must run restrictions placed on certain generating units and of the Commission's traditional view of an acquisition adjustment, and should have adjusted their bids accordingly. More importantly, it is inconceivable to the ISO that Duke purchased these units solely in the hope they could provide must run service to captive customers at a premium price. Rather, Duke's witness Avera states that Duke's acquisition of the three fossil units provided a "strategic entry into the California market." Avera Direct at 20. In short, the acquisition adjustment Duke seeks is simply "gravy," now that they have secured their foothold in the competitive California energy market.

B. Duke's Own Market Valuation Cannot Serve as the Measure of a Valid Acquisition Adjustment.

Regardless of whether Duke can show that its acquisition of the Moss Landing units provided any tangible benefits to California customers, Duke should be precluded from adjusting the unit's net original cost to reflect its own valuation of the unit, rather than a specific purchase price. Duke has not identified a single Commission decision in which a utility was permitted to assign a value to regulated facilities in order to derive its

proposed acquisition premium, while assigning lesser values to any non-regulated facilities purchased as part of a package. Given that any such apportionment of value is subject to manipulation, the ISO suggests that any such acquisition adjustment should be rejected out of hand.

In coming up with a relative value for each of the three units purchased from PG&E, it is interesting to note that the unregulated unit (Morro Bay) was valued at about 27% less than book cost, while the other two regulated units, the costs being paid by captive customers of reliability must run services, were valued at about 86% more than their total book cost.[16] *See* April 24, 1998 Transmittal Letter at 9. Duke's assertion that the fair market value of all three units acquired is equal to the $501 million purchase price has some validity. However, it does not necessarily follow that the regulated, must run units contribute virtually all of the value of those facilities above book cost. In a case like this, where the acquisition premium cannot be readily ascertained without resort to economic estimates, the Commission should not invite additional controversy and should simply reject the acquisition adjustment *in toto*.

IX. FURTHER PROTEST - DUKE'S REQUEST FOR WAIVER OF SECTION 35.13 FILING REQUESTS SHOULD BE REJECTED.

If the Commission accepts Duke's filing, it should reject Duke's request for waiver of the Section 35.13 filing requirements. 18 C.F.R. § 35.13. Duke claims that, because it has had no cost experience with the Moss Landing facilities, it is unable to provide the required base period data, and requests waiver of the Section 35.13 filing requirements. Transmittal Letter at 17. According to Duke, if the Commission finds that

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[16] While Duke did assess the value of one of its must run units (Oakland) at less than book cost, its downward adjustment was only $2 million, as compared to the $182 million upward adjustment Duke would make for Moss Landing.

its filing constitutes a change in rate, the Commission must also conclude that its rate revision is being made to PG&E's rates. Transmittal Letter at 17.

Duke has offered no valid reason why, the Commission's filing requirements should be waived. The Commission and the other parties need Duke's Section 35.13 data in order to adequately evaluate the reasonableness of its filing. Duke can use PG&E's historical data to develop its own cost projections if it deems such use appropriate. However, if Duke chooses to rely on PG&E's data, it should not be relieved of the burden of showing that its rates are just and reasonable.

Duke also states that "no officer or other official of [Duke] can make the representations regarding historical data which officers of PG&E have proffered." Transmittal Letter at 17. This statement is misleading. Section 35.13 of the Commission's regulations do not require Duke to affirm PG&E's historical data; rather, the regulations set forth the data that Duke itself is required to provide in a change in rate filing. The Commission should therefore deny Duke's request for waiver of the Commission's filing requirements.

X. CONCLUSION

Wherefore, based on the foregoing, the ISO respectfully requests the Commission to permit the ISO to intervene and be treated as a party to this proceeding with all rights appropriate to that status, and request the Commission to duly consider the protest, and grant the ISO's motions for rejection, consolidation and summary disposition filed herein.

Respectfully submitted,

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Date: May 14, 1998

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the forgoing document upon each person designated on the official service list compiled by the Secretary in this Docket No. ER98-2668-000, 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 13th day of May, 1998.

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