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AMERICAN ARBITRATION ASSOCIATION

DALLAS OFFICE

RELIANT ENERGY POWER GENERATION, INC. a Delaware Corporation; RELIANT ENERGY ETIWANDA, LLC, a Delaware Limited Liability Company; RELIANT ENERGY MANDALAY, LLC, a Delaware Limited Liability Company; and RELIANT ENERGY SERVICES, INC., a Delaware Corporation, Claimant, v. CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION, a California Nonprofit Public Benefit Corporation, and DOES 1-500, Respondent.	CASE NO. 71 198 00295 99 **RESPONSE OF CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION TO CLAIMANT'S CLAIM FOR DAMAGES, DECLARATORY AND INJUNCTIVE RELIEF**

GENERAL DENIAL

1. The California Independent System Operator Corporation (the "ISO"), the respondent, generally denies the material allegations supporting the Claim for Damages, Declaratory and Injunctive Relief of Reliant Energy Power Generation, Inc. *et al.*, (collectively "Reliant"), the claimant. Additionally, the ISO submits the following general response.

INTRODUCTION

2. The ISO is responsible for the operation, maintenance, and reliability of the major portion of the transmission grid in California. In order to ensure the reliability of the grid, the ISO purchases certain electric capacity, known as Ancillary Services capacity, from the owners of generating units, including Reliant, for the benefit of other market participants who purchase that capacity through the ISO's market. While the ISO purchases most Ancillary Services capacity through an auction market, pursuant to the terms of the ISO's tariff, as filed with the Federal Energy Regulatory Commission ("FERC"), it may also call upon certain generating units that have been designated as Reliability Must Run units to provide Ancillary Services capacity. Owners of such generating units, including Reliant, file rate schedules or agreements with FERC, setting forth the rates and other terms for their sales of Ancillary Service capacity to the ISO outside of the ISO's auction market. In both cases, the costs the ISO incurs to purchase Ancillary Services capacity are paid by other market participants and ultimately by the electric consumers they serve.

3. This dispute concerns Reliant's claim that, when its generating units are called upon to supply Ancillary Service capacity pursuant to one of Reliant's applicable Reliability Must Run rate schedules, Reliant is entitled to receive both (a) the market price determined in the ISO's Ancillary Service auction; and (b) the price specified in Reliant's Reliability Must Run rate schedule, which includes a component to compensate Reliant for its fixed costs.

4. As explained below, Reliant's claims are unfounded. Reliant is not entitled to be paid twice when it supplies the ISO with Ancillary Services capacity pursuant to one of its Reliability Must Run rate schedules, once through the payments specified in the rate schedule and again at the price the ISO pays to suppliers of capacity selected in its auction market. Reliant's Reliability Must Run rate schedules do not entitle it to the combination of payments that it seeks

and the ISO's tariff specifically rules out any requirement that the ISO pay twice for Ancillary Service capacity obtained under a Reliability Must Run rate schedule or agreement. Reliant's claim that the ISO must pay the market clearing price for any Ancillary Service capacity that Reliant has bid into the auction if it subsequently calls upon a Reliant generating unit to provide the capacity under a Reliability Must Run rate schedule is likewise contrary to the terms of those rate schedules and of the ISO's tariff. The ISO's tariff recognizes that the ISO may have to procure additional Ancillary Service capacity after its auction market closes and Reliant's Reliability Must Run rate schedules obligate it to supply that capacity, upon the ISO's demand, at predetermined prices. Reliant cannot establish a right to different or additional payments.

BACKGROUND

5. The ISO is a California non-profit public benefit corporation. The ISO is an electricity transmission provider and was created as part of California's recent restructuring of California's electricity industry.

6. As part of the California restructuring, the ISO has assumed operational control of the transmission systems of Pacific Gas and Electric Company ("PG&E"), San Diego Gas & Electric Company ("SDG&E"), and Southern California Edison ("Edison") – the State's investor-owned utilities. These facilities constitute the "ISO Controlled Grid." Under section 201 of the Federal Power Act, 16 U.S.C. § 824, the ISO's provision of transmission services is subject to the jurisdiction of, and regulated by, FERC. The ISO Tariff, which includes the ISO Protocols and which the ISO has filed with FERC pursuant to section 205 of the Federal Power Act, 16 U.S.C. § 824d, provides the rates, terms and conditions of the ISO's services.

7. Claimants Reliant Energy Etiwanda LLC and Reliant Energy Mandalay LLC (the "Reliant Energy entities") own and operate generating facilities originally owned and operated by Edison.[1] These facilities were acquired from Edison in April 1998 also as a result of the California restructuring. The Federal Power Act subjects the sale of energy from these facilities at wholesale

[1] The facilities were originally acquired by Houston Energy Power Generation, Inc. and transferred to two newly created Houston subsidiaries, Mountain Vista Power Generation LLC and Ocean Vista Power Generation Vista. Subsequently, Houston was renamed Reliant Energy Power Generation, Inc. as parent of the renamed owners, Reliant Energy Etiwanda, LLC and Reliant Energy Mandalay, LLC, respectively.

to the jurisdiction and regulation of FERC.

8. In order to ensure the reliability of the ISO Controlled Grid, the ISO must at all times have generating capacity available that it can hold in reserve and call upon on short notice for the production of energy to address energy imbalances. This capacity is known as Ancillary Services capacity.

9. Under the ISO Tariff, transmission transactions are arranged by "Scheduling Coordinators," who have signed Scheduling Coordinator Agreements with the ISO on behalf of generators and others that wish to use the ISO Controlled Grid. In order to schedule transmission on the ISO Controlled Grid, Scheduling Coordinators must supply or pay the ISO to supply an amount of Ancillary Services capacity proportional to the magnitude of the demand served by their transactions.

10. The ISO seeks to procure Ancillary Services capacity on behalf of Scheduling Coordinators through a competitive auction in the market. Through the ISO's settlement process, the ISO pays the Scheduling Coordinators for the generators that provide the capacity and correspondingly bills the costs pro rata to the Scheduling Coordinators that have scheduled transmission service and have not provided their own Ancillary Services capacity.

11. In addition, because adequate Ancillary Services capacity may not always be available through the competitive market, or because additional Ancillary Services capacity needs to become known after close of the competitive market, the ISO Tariff authorizes the ISO to call upon certain generating units in the state that have been designated, for reasons independent of the need for Ancillary Services capacity, as Reliability Must-Run Units ("RMR units").

12. An RMR unit is one that the ISO has determined must be operating during certain time periods to maintain local reliability on the ISO Controlled Grid, independently of the ongoing need for Ancillary services capacity. The ISO may call upon these RMR units to provide energy to accommodate local reliability needs through use of a dispatch notice. The RMR unit owners invoice the ISO for the RMR services according to the applicable RMR rates on file with FERC. The ISO then recovers these costs from the utility in whose services area the RMR unit is located.

13. The units owned by the Reliant Energy entities have been designated RMR units since before they were acquired by the Reliant Energy entities. The rates, terms and conditions of the Reliant Energy entities' provision of energy to support the reliability of the ISO Controlled Grid is governed by rate schedules (the "RMR Rate Schedules") filed with FERC pursuant to section 205 of the Federal Power Act, 16 U.S.C. § 824d. Although these rate schedules are denominated "Reliability Must Run Agreements," they are not contracts because the ISO has never signed or otherwise agreed to the stated terms and conditions. They are simply rate schedules, which were originally filed with FERC in unexecuted form by Edison, and later assumed by the Reliant Energy entities. Under FERC's rules, the RMR Rate Schedules were, during the period relevant to this dispute, in effect on an interim basis, subject to further order of FERC. Effective June 1, 1999, they were superseded by newly filed rate schedules that conform to a Pro Forma RMR Agreement filed as a settlement in RMR-related FERC proceedings and accepted by FERC on May 28, 1999.

14. The RMR Rate Schedules provide that when the Reliant RMR units are dispatched to provide energy, they receive a payment that provides for recovery of variable costs, a payment that provides for recovery of start up costs, and a "Reliability Payment." The Reliability Payment provides for recovery of fixed costs in accordance with the magnitude of the ISO's demands upon the units, and thus compensates the Reliant Energy entities for the capacity that has been committed to RMR service.

15. Under the ISO's billing and settlement procedures, because of software limitations, the ISO pays the market price to all Scheduling Coordinators for providers of Ancillary Services, regardless of whether the services are provided through the market or through a dispatch notice issued to the RMR unit. Because this would result in RMR unit owners receiving double payment for Ancillary Services capacity, the ISO Tariff directs that these market payments be deducted from the RMR payments to RMR unit owners and, correspondingly, the ISO tariff requires these deductions from the invoices that the ISO submits to the utilities responsible for the costs incurred by the ISO for the RMR services.

16. The Reliant Energy entities are providers of Ancillary Services, both as RMR units and in the competitive markets, through their affiliated Scheduling Coordinator, Reliant Energy Services, Inc. ("Reliant Services").

17. The rates, terms and conditions of the Reliant Energy entities' sale of Ancillary Services as RMR units are governed by the RMR Rate Schedules.

18. Under Schedule E of the RMR Rate Schedules, the Reliant Energy entities, through Reliant Services, receive one of two forms of payment when called upon to provide Ancillary Services capacity as an RMR unit. If the Reliant Energy entity has already been scheduled to provide Ancillary Services capacity or energy, and the ISO issues a dispatch notice inconsistent with the commitment, the ISO pays an opportunity cost payment for such capacity or energy. Otherwise, the Reliant Energy entity receives the variable costs payment, start-up payment, and Reliability payment described above, according to the amount of energy, if any, that the Reliant Energy entity provides from the capacity. The RMR Rate Schedules provide no other compensation for Ancillary Services capacity.

19. Throughout the process described above, the ISO serves the role of a neutral intermediary. The ISO operates, maintains and ensures the reliability of the transmission facilities that are necessary for the purchase and sale of electricity, in part by ensuring the availability of sufficient Ancillary Services capacity. The ISO is responsible for allocating the costs associated with those functions to the responsible parties through their Scheduling Coordinators. The ISO Tariff governs how the ISO conducts these practices. The ISO thus has no financial stake in this dispute; the dispute solely concerns the allocation of costs between the owners of RMR units and other users of the ISO Controlled Grid.

NATURE OF THE DISPUTE

20. In this dispute, Reliant appears to claim entitlement to two sets of payments for Ancillary Services capacity provided by Reliant Energy entities pursuant to RMR dispatch notices issued by the ISO, in addition to the payments specified in the RMR Rate Schedules. Under the ISO Tariff and the RMR Rate Schedules, which are determinative of Reliant's entitlement to payments, Reliant is not entitled to either.

21. One set of claimed payments, which Reliant calls Course of Conduct Payments, represents market payments for Ancillary Services previously made by the ISO to the Reliant Energy entities through Reliant Services when Reliant's RMR units had not been selected in the Ancillary Services market, but were called upon to provide those services under the RMR Rate Schedules. As describe above, such market payments are made during the ISO's settlement process regardless of whether a unit was selected in the Ancillary Services auction or called as an RMR unit. The ISO Tariff provides that such payments shall be deducted from payments due to RMR owners. The Reliant Energy entities have been able to retain these additional payments by neglecting to make appropriate deductions on the invoices that they routinely submit to the ISO for compensation as an RMR unit. The Reliant Energy entities failed to make this deduction from April 1998 to September 1998. The ISO has subsequently sought to recoup these amounts from the Reliant Energy entities by withholding them from subsequent payments to Reliant. Reliant alleges that the "Course of Conduct Payments" equal approximately $1 million.

22. After September 1998, and subsequent to the ISO's determination that the Reliant Energy entities had failed to deduct these payments, the ISO has withheld those market payments from the RMR payments to Reliant Energy entities. These amounts, which Reliant contends are due it, are included in Reliant's "Past Service Payments" claim.

23. Also included in Reliant's "Past Service Payments" is compensation to which Reliant claims entitlement because the ISO called upon the Reliant Energy Entities' RMR units for RMR service rather than accepting a market bid. In these instances, Reliant Services bid the Reliant Energy entity's RMR unit into the Ancillary Services market, but the bid was not accepted because the ISO was able to fulfill its projected need for Ancillary Services capacity with less expensive bids. After the close of the Ancillary Services market, the ISO concluded that additional Ancillary Services were needed, and called upon the Reliant Energy entity's unit for RMR services. Reliant contends that the ISO deliberately underestimated its Ancillary Services needs in to order to call upon the Reliant Energy entities units as RMR units. The ISO denies this contention.

24. Reliant asserts that the total "Past Services Payments" amount to approximately $7 million.

25. With regard to both sets of claimed payments, this dispute must be determined according to the terms of the RMR Rate Schedules and the ISO Tariff. According to the filed rate doctrine, as enunciated by the United States Supreme Court and implemented by FERC, under the Federal Power Act a seller of electric capacity and energy can charge no rate different from the rate on file with the FERC. In this case, the governing provisions are the RMR Rate Schedules and the ISO Tariff.

26. When providing RMR services, the Reliant Energy entities are operating under the rates set forth in the RMR Rate Schedules.

27. When engaged in the sale of Ancillary Services through the market, the Reliant Energy entities are operating under their market-based rate tariffs for Ancillary Services capacity, which are on file with FERC. The tariffs allow sale of Ancillary Services at rates agreed upon by the buyer and seller. If the Reliant Energy entities elect to sell Ancillary Services in the ISO's auction market through Reliant Services, they are agreeing to the terms and conditions governing that market, as set forth in the ISO Tariff.

28. Reliant Services is not entitled to any market payments for Ancillary Services capacity provided by the Reliant Energy entities as RMR services because such payments would constitute double compensation for capacity from the RMR unit – once under the RMR Rates Schedules, in which the Ancillary Services payment, though based on the amount of energy delivered, includes compensation for capacity through the Reliability Payment, and again from the Ancillary Services market. The double compensation would be at the expense of other market participants.

29. Of independent significance, under the filed rate doctrine, Reliant is not entitled to any market payments for Ancillary Services capacity provided as RMR services because there is no rate schedule of tariff that entitles any Reliant entity to such payments.

30. The RMR Rate Schedules do not entitle any Reliant entity to such payments. The RMR Rate Schedules explicitly set forth the payment due for Ancillary Services. Unless the RMR unit has previously been selected in the Ancillary Services auction, the Tariff provides for payment based solely on the amount of energy, if any, delivered. The RMR Rate Schedules do not provide

for market payments for Ancillary Services unless the unit has been selected in the Ancillary Services auction.

31. The ISO Tariff does not entitle Reliant Services to such payments. The ISO Tariff explicitly provides that the market payments made to Scheduling Coordinators for RMR units will be deducted from the RMR payments.

32. To the extent that Reliant contends that rate schedules associated with the RMR Agreement and the ISO Tariff do not require the giving of appropriate credits, an issue exists as to whether, as so construed, these documents are unjust and unreasonable. If this is an issue, then it falls within the exclusive jurisdiction of FERC and is outside the scope of any arbitration under Section 13.1.1.2 of the ISO Tariff. Therefore, the ISO reserves the right to make such a claim before FERC at some future time.

33. Reliant Services is not entitled to payment for Ancillary Services bids that were rejected in the market, even though the ISO subsequently called upon the Reliant Energy entities' units bids to provide Ancillary Services capacity under the RMR Rate Schedules, because there are no rate schedule or tariff provisions that required the ISO to accept those bids.

34. The auction for Ancillary Service capacity is conducted in advance of real time operations. Although the ISO makes every reasonable effort to fulfill its projected Ancillary Services needs through the auction market prior to calling upon RMR units, there is no provision in the RMR Rate Schedules or in the ISO Tariff that requires the ISO to do so.

35. Under the ISO Tariff, the initial determination of Ancillary Services needs is in the ISO's discretion. In making that determination, the ISO must balance projected reliability needs with the potential cost of an excessive procurement of Ancillary Services.

36. During the initial phase of its operation, the ISO concluded that the preferable method of determining projected Ancillary Services needs was to rely upon the amount of transmission scheduled by Scheduling Coordinators, such as Reliant Services. Under the terms of the ISO Tariff, therefore, the ISO only procured through the auction market sufficient Ancillary Services to full the scheduled needs. When, subsequent to the close of the market, it became apparent that Scheduling Coordinators had understated their schedules, and delivering energy in

excess of those schedules, the ISO was required to turn to RMR units to provide additional Ancillary Services. This practice was entirely consistent with the ISO Tariff provisions governing the procurement of Ancillary Services, which provisions were on file with FERC, available on the ISO's webpage, fully known to Scheduling Coordinators, including Reliant Services, and accepted by Scheduling Coordinators that elected to submit bids to that market.

37. When, within months of its initial operation, the ISO determined that Scheduling Coordinators had developed a practice of underestimating their schedules in order to avoid assessment of Ancillary Services costs, the ISO–consistent with its desire to rely upon the market whenever possible–used its discretion to revise its practice and begin procuring Ancillary Service based upon its own load forecast. This was intended to increase the extent to which the ISO relied on market bids to meet its Ancillary Service needs. The ISO provided Market Participants with notice of this change in policy.

38. The ISO is aware that other parties besides Reliant–including PG&E and SDG&E–have raised contentions that may entitle them to the same monies or credits to which Reliant also claims entitlement. As discussed above, the ISO simply serves the role of an intermediary and stakeholder. Thus, if other parties' contentions culminate in arbitration, then it should be joined with this arbitration so as to leave the ISO whole.

FIRST CAUSE OF ACTION

(Breach of Written Contract)

39. The ISO denies that it has breached any Written Contract with the Reliant Energy entities. This ISO has not entered into any contract with the Reliant Energy entities for the provision of RMR services.

40. The ISO denies that it has violated any applicable tariffs or rate schedules. As described above, all of the payments that the ISO has made to or withheld from Reliant Services have been consistent with and required by applicable tariffs or rate schedules.

SECOND CAUSE OF ACTION

(Breach of Implied Covenant of Good Faith and Fair Dealing)

41. The ISO denies that it has wrongfully deprived Reliant of benefits of a contractual

agreement entered into between claimants and that the ISO in breach of the covenant of good faith and fair dealing implied by law.

42. The ISO has not entered into a contractual agreement with the Reliant Energy entities that entitles them to the benefits claimed.

43. The Reliant Energy entities are not entitled to the benefits claimed under any tariff or rate schedules filed with FERC.

THIRD CAUSE OF ACTION

(Misrepresentation)

44. The ISO denies that it made any false or misleading statements to Reliant that the ISO had reason to believe were not true.

45. The ISO denies that Reliant could have relied to its detriment on any representations of the ISO concerning payment for Ancillary Services.

FOURTH CAUSE OF ACTION

(Declaratory Relief)

46. The ISO denies that there is a ripe controversy regarding "Future Services Payments." Effective June 1, 1999, payment for future RMR services is governed by a Pro Forma RMR Agreement. Pursuant to a stipulation entered into by the ISO and Reliant, among others, the issue of whether, and the extent to which, owners of RMR units must credit back market payments received for Ancillary Services is currently unresolved and pending before FERC. Until that issue is settled by FERC, there is no applicable tariff language under which to determine the parties respective rights and obligations.

FIFTH CAUSE OF ACTION

(Unfair Business Practices)

47. The ISO denies that it has engaged in unfair business practices in its dealing with Reliant.

48. Specifically, the ISO denies that it has withheld payments for services provided. Reliant Services has received all payments to which it is due under the relevant rate schedules and tariffs.

49. The ISO's requirement that the Reliant Energy entities provide credits for payments received from Reliant services is supported by the relevant rate schedules and tariffs.

50. The ISO denies that it is obligated under any contractual agreement, rate schedule, or tariff, to pay disputed amounts to Reliant pending the resolution of an underlying dispute.

Respondents therefore request a decision against claimants as follows:

1. Declaring that claimants are not entitled to the Course of Conduct Payments, Past Services Payments or any other payments not currently being made that are set forth in claimants' statement of claim;

2. For costs of the arbitration incurred herein; and

3. For such and further relief, as is just and proper.

Date July _30, 1999

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