UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

AES Huntington Beach, L.L.C.) Docket No. ER98-2184-006

MOTION TO INTERVENE, PROTEST AND MOTION FOR IMMEDIATE SUSPENSION OF MARKET-BASED RATE AUTHORITY OF THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION

Pursuant to Rules 211, 212, and 214 of the Commission's Rules of Practice and Procedure, 18 C.F.R. §§ 385.211, 212, and 214, and the Commission's May 11, 2001, Notice, the California Independent System Operator Corporation ("ISO"),[1] hereby moves to intervene and protest in the above-entitled proceeding. This proceeding, and the companion proceedings AES Alamitos, L.L.C., Docket No. ER98-2185 and AES Redondo Beach, L.L.C., Docket No. ER98-2186, concern the filings by the three affiliates (collectively, "AES") complying with the Commission's requirement that AES provide a triennial update of the market power analysis supporting its market-based rate for sales of Energy and Ancillary Services in California. As discussed below, AES's market power must be analyzed in conjunction with capacity owned by it and its affiliates that is currently under contract to Williams Energy Marketing and Trading Company ("Williams"). The ISO submits that such an analysis justifies termination of AES's market-based rate authority.

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

Further, the California Independent System Operator Corporation ("ISO"), hereby moves the Commission immediately to suspend AES's grant of market-based rate authority, unless the Commission has, before acting on this request, authorized a price mitigation plan that fully protects against the exercise of market power in California, including provisions to preclude the out-of-state "laundering" of energy sales.

Because the continued exercise of inadequately mitigated market-based rate authority places California consumers and the State's economy (if not that of the surrounding region and, indeed, the nation) at extreme peril, the ISO must ask that the Commission shorten Williams' response time to no more than 7 days, and that the Commission act on this emergency motion within 14 days thereafter, or by no later than June 15, 2001.

I. INTRODUCTION

Market-based rate authority is not an entitlement. Rather, it is a privilege that lawfully can be granted only upon a meticulous showing by the applicant that permits the Commission confidently to conclude that the potential for the exercise of market power either does not exist or has adequately been mitigated.

As will be show below, AES's update of its market-power analysis entirely fails to establish that AES lacks market power under current market conditions in California. Accordingly, there can be but one lawful response – immediate termination of its market-based rate authority.

Undoubtedly AES will argue, and the Commission itself may be preliminarily inclined to conclude, that the proposal announced by the Commission on April 26th provides adequate price mitigation going-forward. That is not correct. The adequacy of that mitigation plan is very much the subject of ongoing challenge, and to presume now its finality, well before the required review process is completed, would amount to an abdication of statutory responsibilities. Moreover, the Commission itself has acknowledged the inadequacy of the plan in at least one respect – the failure to address so-called "megawatt laundering".

We know that market power has been exercised. The Commission has made that finding with respect to sellers in California's electricity markets. The ISO has submitted compelling evidence that the exercise of market power is more pervasive than the Commission has acknowledged, and has contended that the Commission must impose a mitigation plan that is effective in all hours and in all markets. Absent such a plan, market-based rates can neither be justified nor tolerated. Although the Commission has not agreed with the ISO's position on the extent of the exercise of market power, there is one deficiency with the Commission's mitigation plan on which there is agreement, and that deficiency alone, unless corrected, is sufficient to preclude continued market-based rate authority. We know that California will continue to be a net importer from elsewhere in the region and that "megawatt laundering" has been identified as a significant problem that must be addressed if price mitigation is to be at all effective in California. The Commission has acknowledged as much, has initiated a comprehensive investigation, and has proposed a region-wide mitigation regime comparable to that which would be applicable in California. The Commission has, in short, recognized that it must consider “closing the barn door” lest price mitigation in California prove illusory. Today, however, that door remains open, inviting the passage through it of egregious monopoly rents.

The Commission’s current course is unlawful. Having found the exercise of monopoly power, and having recognized the significance of “megawatt laundering,” the Commission may not sanction a continuation of market-based rate authority without either “closing the barn door” or being in a position to be able to conclude with confidence that “megawatt laundering” is not a serious issue.

It is simply insufficient to do no more than institute an investigation. If the issue is of sufficient credibility to warrant investigation – as “megawatt laundering” surely is – the Commission may not sanction continuation of market-based rates with the knowledge that the price mitigation it has required may well not be effective. Thus, unless the Commission immediately adopts a fully protective mitigation plan that includes an interim measure to prevent “megawatt laundering,” the Commission has but one option: it must revoke Williams’ market-based rate authority.

Because the summer peak season already has begun, the Commission must act on this request *immediately*. Any delay, with the enormous, unrectifiable consequences associated with it, would constitute nothing less than relief denied.

II. MOTION TO INTERVENE

The ISO is a non-profit public benefit corporation organized and existing under the laws of the State of California, and authorized to do business therein. The ISO operates a grid comprising the transmission systems of Pacific Gas and Electric Company, Southern California Edison Company, San Diego Gas and Electric Company, and the City of Vernon, California. The ISO is responsible for maintaining the reliability of electric transmission scheduled into and through the ISO Control Area. To support reliability, the ISO is also responsible for procurement of Ancillary Services, to the extent that they are not self-provided, at least cost.

In the above-entitled docket, AES seeks to extend its market-based rate authorization for sales in California of Energy and Ancillary Services. The ISO currently operates the principal markets for Ancillary Services and Imbalance Energy in California. The ISO has a direct and substantial interest in this proceeding because of the ISO's responsibility for maintaining the reliability of the ISO Control Area in accordance with Western Systems Coordinating Council and North American Electric Reliability Council standards. For these reasons, the ISO's participation is in the public interest. 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.

III. COMMUNICATIONS

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IV. PROTEST AND EMERGENCY MOTION

A. INTRODUCTION AND SUMMARY

By this filing, the ISO is placing before the Commission an urgent request to which the ISO is compelled to ask for an expedited response. In light of the current conditions in California markets and of the evidence that AES has the ability to exercise market power, the ISO specifically requests that the Commission immediately terminate the authority of AES to sell capacity, Energy, or Ancillary Services at market-based rates, unless the Commission in the alternative approves a price mitigation plan that fully protects California consumers from market power abuses, including provisions to preclude the out-of-state "laundering" of energy sales. Because of the uncontroverted evidence that the exercise of market power is having a devastating impact on the public interest, and because the continuation of market-based rates would be in direct contravention of the Federal Power Act and of uniform judicial and Commission precedent, the ISO requests that the Commission action by no later than June

15th on its request to terminate AES's market-based rate authority or, in the alternative, take action in the context of a comprehensive price mitigation plan to preclude "megawatt laundering."

The ISO is mindful of the exceptional nature of its request. The ISO also anticipates that it likely will be met with the contention that action is being urged before all the facts are in and fully analyzed. The ISO submits, however, that any such contention would be based on a fundamental misunderstanding of the underlying law and of the burden that it places on Williams. Market-based rates are not an entitlement. They can be an appropriate means to the end mandated by the Federal Power Act: the establishment of charges that are just and reasonable. Only where it is possible to conclude with confidence that market mechanisms will accomplish that end, however, is it permissible to have them supplant traditional cost-of-service review. It undoubtedly is for this very reason that the Commission steadfastly has imposed the burden on applicants for market-based rates to establish at the outset their inability to exercise market power and to repeat satisfaction of that burden no less frequently than every three years. Williams has fallen far short of meeting that burden.

The ISO recognizes that AES currently does not sell Energy and Ancillary Services into California markets; rather, Williams, as discussed below, has contracted with AES to market and dispatch the Energy produced by its units. That contract, however, is itself a product of AES's market-based rate authority and can be amended or terminated by the parties pursuant to that authority. Moreover, the Commission's recent show cause order in *AES Southland, Inc. and Williams Energy Marketing and Trading Company,* 94 FERC ¶ 61,248 (2001), raises serious issues regarding collaboration between AES, which continues to maintain and operate the units, and Williams. Accordingly, an analysis of AES's market power must include the capacity being marketed by

Williams. The studies discussed below demonstrate the Williams has profited from the exercise of market power through the capacity. Indeed, AES's own studies show that, under the Commission's traditional Generation market-power analysis, capacity will exceed the Commission's benchmark requiring further examination of market power.

While revocation of market-based rate authority (assuming an adequate mitigation plan, including measures to prevent "megawatt laundering," is not adopted) now is necessary to prevent the confiscation by AES of consumer welfare, AES itself would suffer no undue prejudice. All that it is entitled to is cost-based rates (*i.e.*, compensatory rates that provide for a return of, and a fair return on, investment).

The ISO does not make this filing, or this request for immediate relief, out of hostility to market-based rates or to the embrace of a competitive paradigm. To the contrary, the ISO shares the view that a truly competitive market can and should increase consumer welfare by producing both efficiencies and innovation not as likely to be stimulated under a tightly regulated structure. Yet if the end goal is stimulation of a competitive electric economy, it must be kept in mind that receptivity to that fundamental change will be influenced by how expeditiously and decisively the Commission responds to pressing evidence of market abnormalities. If, in the face of overwhelming evidence of market power abuse, the Commission sits silently by or responds with anything less than the required aggressiveness (for example, by leaving market-based rate authority in place and relying on inherently ineffective after-the-fact refund authority), the evolution to a competitive market economy can only be stalled, if not derailed.

On a broader social basis, therefore, the need for expedited relief in this case would be compelling. In the face of the extreme prejudice being imposed daily on California consumers and on the State's economy, relief now is imperative. The potential for after-the-fact refunds is little comfort to the elderly consumer who, because of outrageously high prices, was forced in the interim to forego air conditioning notwithstanding serious health implications, or to the small business that was forced to close its doors.

The ISO therefore respectfully requests that, by no later than June 15th, the Commission terminate the authority of AES to sell capacity, Energy, or Ancillary Services at market-based rates from California generating units, unless the Commission has by that date authorized implementation of a price mitigation plan that fully protects against the exercise of market power in California, including provisions to preclude the out-of-state "laundering" or energy sales.

B. Background

In March 1998, three subsidiaries AES submitted market-based rate applications for Energy sales for Generating Units at the three plants. The filing was supported by a Generation market dominance analysis, prepared by J. Stephen Henderson, that evaluated the Units' share of uncommitted capacity in the relevant geographic market. On April 30, 1998, the Commission granted the market-based rate authority with respect to these Units. *AES Huntington Beach, et al.*, 83 FERC ¶ 61,100 (1998).

In May 1998, AES sought market-based rate authority for the sale of Ancillary Services from these Units, relying upon another analysis by J. Stephen Henderson that evaluated the Units' share of total uncommitted Ancillary Services capacity. The ISO argued to the Commission that such an analysis was inadequate in light of the hourly nature of the ISO's markets, and that a time-differentiated analysis was appropriate. Rather than recommending rejection of the market-based rate authority, the ISO suggested that the Commission grant the authority subject to a rate cap. On June 10, 1998, the Commission granted the requested authority, finding a time-differentiated study unnecessary and a rate cap undesirable. The Commission promised to revisit the need for a time-differentiated analysis if the ISO's market monitoring indicated that such a reexamination was necessary. *AES Redondo Beach, L.L.C., et al.*, 83 FERC ¶ 61,358 (1998).[2]

Soon after Generators began to exercise their newly granted market-based rate authority, the ISO experienced dramatic spikes in the prices for replacement reserves. Between July 9, 1998, and July 13, 1998, prices for Replacement Reserves of $5,000/MW and even $9,999/MW resulted in millions of dollars in customer costs, even though other sellers, such as the investor-owned utilities, were still limited to cost-based rates. In response to this emergency, the ISO filed for authorization to impose price caps.

In late May, 1998, Williams filed notice of a change of facts regarding its existing market-based rate authority, seeking to extend that authority to the sales of Energy and Ancillary Services for the AES Units, from which Williams had obtained the right to market and dispatch the Energy and capacity. In light of the price spikes that had followed the Commission's previous grants of market-

[2] The Commission also concluded that Replacement Reserves were not Ancillary Services, and that entities with market-based rate authority for Energy could therefore sell Replacement Reserves at market rates. Subsequently, the Commission granted market-based rate authority to additional applicants. *El Segundo Power, LLC et al.*, 84 FERC ¶ 61,011 (1998); *Ocean Vista Power Generation, LLC et al.*, 84 FERC ¶ 61,013 (1998).

based rate authority for Ancillary Services, the ISO protested, requesting that the Commission require a time-differentiated market analysis or, in the alternative, allow the ISO to impose a price cap.

Subsequent to the ISO's protest, the Commission authorized the ISO to impose price caps on Ancillary Services. *AES Redondo Beach, LLC, et al.*, 84 FERC ¶ 61,046 (1998). On July 24, 1998, the Commission granted Williams' requested market-based rate authority. It rejected the ISO's request for a time-differentiated study, noting that the ISO had been granted its alternative requested relief – price cap authority. *Williams Energy Services Company*, 84 FERC ¶ 61,072 (1998).

The current proceeding concerns AES's update of its market power analysis in support of its continued market-based rate authority. AES again relies upon an analysis by J. Stephen Henderson. In his analysis of uncommitted capacity, Mr. Henderson does not include the units under contract as available to AES.

C. THE FEDERAL POWER ACT MANDATES THE ESTABLISHMENT OF RATES THAT ARE JUST AND REASONABLE; MARKET-BASED RATES MAY BE AUTHORIZED ONLY WHERE THE RESULTING CHARGES ARE LIKELY TO SATISFY THAT STATUTORY IMPERATIVE

1. The Statutory Standard.

Presumably, there is no dispute about the applicable statutory standard: rates for wholesale power must be "just and reasonable." 16 U.S.C. §§ 824d, 824e. *See Federal Power Comm'n v. Hope Natural Gas. Co.*, 320 U.S. 591, 610 (1944); *Atlantic Refining Co. v. Public Utility Comm'n of the State of New York, 360 U.S. 378 (1959*).[1] To be sure, the Commission enjoys considerable flexibility in selecting the means to that end, *Hope*, 320 U.S. at 602, but whatever path the Commission elects, the journey must come to rest with the establishment of rates that are within the zone of what is just and reasonable, *see, e.g., Alabama Electric Cooperative v. FERC*, 684 F.2d 20, 27 (D.C. Cir. 1982). While rates cannot be so low as to be confiscatory, *see Federal Power Comm'n v. Texaco, Inc.*, 417 U.S. 380, 391-92 (1974), the primary purpose of the standard is to protect consumers against excessive rates, *see Hope,* 320 U.S. at 610-612; *Pennsylvania Water & Power Co. v. FPC*, 343 U.S. 414, 418 (1952); *Sierra Pacific*, 350 U.S. at 355; *Atlantic Refining*, 360 U.S. at 388. Rates that fall outside that zone of reasonableness are *illegal* and, confronted with such rates, the Commission is obliged, *sua sponte* if necessary, to take corrective action.

To understand what is meant by rates that are just and reasonable, it is necessary to understand why Federal Power Act rate regulation was provided in the first place. It was precisely because of a market breakdown. It was because

[1] Although these seminal decisions concerned the Natural Gas Act, the Federal Power Act is interpreted in parallel to the Natural Gas Act. *See, e.g., Federal Power Comm'n v. Sierra Pacific Power Co.*, 351 U.S. 946, 353 (1956); *Federal Power Comm'n v. Conway*, 426 U.S. 271, 280 (1976); *Public Service Company of New Mexico*, 25 FERC ¶ 61,469 (1984), n.160.

the pre-1935 Power Act regime was rampant with market power abuse. *See Gulf States Utilities Co. v. FPC*, 411 U.S. 747, 758 (1973); *see also Hope*, 320 U.S. at 610. It was because of the universal recognition that rates that were the product of the exercise of market power were injurious to consumers and to the economy – it was because such rates were neither just nor reasonable. *Id.* Rates that have embedded within them the ill-gotten fruits of market power – *i.e.*, monopoly rents – are *per se* outside of the permissible zone.

Regulation, therefore, was intended to emulate the results that could be expected in a free, workably competitive marketplace – namely, rates that cover the producer's costs (including a fair return commensurate with the underlying risk) while providing consumers with essential services at the lowest possible cost. *See Hope*, 320 U.S. at 603. It was necessary for regulation to step in precisely because the market had failed, precisely because prices were inflated with the prejudice of abusive market practices. Now to sanction market prices that are the product of the abusive exercise of market power – that are inflated with monopoly rents – would be a complete abdication of the very purpose of Commission regulation. It would amount to nothing less than a sanctioning of illegality.

2. The Courts and the Commission Have Recognized the Limitations that Must Govern the Authorization of Market-Based Rates.

Among the rate methodologies that the Commission can allow is the use of market-based rates. *See Elizabethtown Gas Company v. FERC*, 10 F.3d 866, 871 (D.C. Cir. 1993). What the Commission *cannot* do, however, is abdicate its responsibility to ensure that just and reasonable rates in fact obtain. The Commission cannot defer to the market in the face of indications that the prevailing market structure cannot be relied upon to fulfill that statutory requirement. *See Texaco,* 417 U.S. at 397. The seminal judicial discussion, to date, of the interplay between just and reasonable and market-based rates is that of the District of Columbia Circuit in *Farmers Union Cent. Exchange v. FERC*, 734 F.2d 1486 (1984). There, the Commission had presumed that if it simply established ceiling prices, albeit at very high levels, "market prices could be relied upon to keep prices at reasonable levels throughout the oil pipeline industry." 734 F.2d at 1510. The Court's response was very much to the point:

> . . . Without empirical proof that it would, this regulatory scheme, however, runs counter to the basic assumption of statutory regulation, that "Congress rejected the identity between the 'true' and the 'actual' market price." *FPC v. Texaco*, 417 U.S. at 399, 94 S.Ct. At 2327. In fact, FERC's "'regulation' by such novel 'standards' is worse than an exemption simpliciter. Such an approach retains the false illusion that a government agency is keeping watch over rates, pursuant to the statute's mandate, when it is in fact doing no such thing." *Texaco v. FPC*, 474 F.2d at 422.

Id. *See*, *also*, *Tejas Power Corp. v. FERC*, 908 F.2d 998, 1005 (D.C. Cir., 1990) (where the Commission's acceptance of a settlement was overturned in the absence of "substantial evidence upon the basis of which the Commission could conclude that market forces will keep Texas Eastern's prices in reasonable check").[2] It is of more than passing interest that in *Farmers Union*, the Commission had found the oil pipeline industry "competitive" as evidenced by "the significant decline in the price of pipeline transportation from 1931-1969 . . ." (734 F.2d at 1494) – a pricing pattern that stands in marked contrast to the trend in wholesale electric prices in California over the past three years. It is

[2] *See also Air Transport Assoc. v. DOT*, 119 F.3d 38 (D.C. Cir. 1997) where the statute required the Secretary to establish guidelines pursuant to which airports receiving federal assistance would establish "reasonable" fees. The Court struck down the Secretary's deference to market forces, where there was insufficient evidence of adequate competitive forces to keep fees in check, even though the Secretary had found that the public airports at issue had no incentive to profit maximize.

also significant that in justifying a somewhat lenient construction of "just and reasonable" the Commission, as the Court acknowledged, drew a distinction between the rigor required in the regulation of electric utilities as contrasted with oil pipelines:

> [C]onsidering numerous differences in the reasons for the establishment of a regulatory scheme over "public utilities," such as electric companies, as opposed to "transportation companies," such as oil pipelines, FERC determined that:
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> > the authors of the Hepburn Act's oil pipeline provisions did not use the words "just and reasonable" in the sense in which public utility lawyers have used them since the 1940's.
> >
> > We think that what was meant was not "public utility reasonableness," but ordinary commercial "reasonableness." To be specific, we discern no intent to limit these carriers' rates to barebones cost. What we perceive is an effort to restrain gross overreaching and unconscionable gouging.
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> Thus, on the basis of this historical survey, FERC interpreted the statutory mandate that oil pipeline rates be "just and reasonable" to require only the most lighthanded regulation, with no necessary connection between revenue recoveries and the cost of service.

734 F.2d at 1493 (citations omitted). Here, of course, we are concerned with the regulatory requirements applicable to Williams, the regulated electric utility, not to the Williams' oil pipeline affiliate that was at issue in *Farmers Union*.[3]

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[3] In its brief to the Court of Appeals in *Farmers Union*, Williams urged that a more lenient construction is appropriate in the case of oil pipeline rates than would be permissible for public utilities:

> . . . The Commission having found oil pipelines not to be public utilities, the arguments for cost-based rates, such as those commonly ordered for utilities, rest on a foundation of sand. As the Supreme Court has recognized, a particularized adherence to a scalded "cost of services" approach has proved impractical in the past.

Brief of Williams Pipeline Company as Intervenor-Respondent at 22-23.

The discussion in *Elizabethtown Gas Company*, 10 F.3d at 871, sets forth the demanding prerequisites for market-based rates. There, the Court sustained the Commission because the record evidence confirmed that:

> . . . Transco will not be able to raise its price above the competitive level without losing substantial business to rival sellers. *Id*. Such market discipline provides strong reason to believe that Transco will be able to charge only a price that is "just and reasonable" within the meaning of §4 of the NGA.

The Commission's holdings are to the same effect. In its very first, quite tentative "experimental" flirtation with market-based rates, albeit one that included an upper bound on what could be charged, the Commission observed:

> In considering the proposed upper bound, we frankly acknowledge that there is a real tension between the needs of the experiment, on the one hand, and our duty to protect consumers from overcharges on the other. An ideal experiment would put *no* upper bound on price. Thus, if our hypothesis that competitive market forces will restrain prices were wrong, we would be able to observe utilities with market power exercising that power by consistently charging prices above cost. While such results would be very valuable from an experimental point of view, they would be damaging, at least in the short-run, to the consumers we are bound to protect. The courts have given us great freedom to move away from cost-based regulation where there is an important policy objective to be served by doing so, but that freedom is not unlimited.

25 FERC ¶ 61,469 at 62,042 (1983). Notwithstanding that the rate experiment was to be of limited duration (no more than two years), and that prices would be constrained within an established zone (which the Commission characterized as "an absolute necessary ingredient in the experiment, and is neither so wide as to likely cause substantial injury to consumers, nor so narrow as to prevent market power from manifesting itself, should it exist," *id*. at 62,060), the Commission imposed a two-prong monitoring regime, one part of which "will focus on market

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Here we are dealing with Williams the "public utility," and it is imperative that its actions not be permitted to place consumers "on a foundation of quick-sand."

performance through the use of price-marginal cost margins and price dispersion measures." *Id*. at 62,042. As will be discussed presently, this is the very methodology upon which are based the analyses by the ISO's Department of Market Analysis ("DMA") that establish Williams' consistent exercise of market power.

Thereafter, the Commission authorized market-based rates where the seller lacked or had adequately mitigated market power and the price charged was subject to a cap based on the seller's costs, *see, e.g., Pacific Gas & Electric Co.*, 42 FERC ¶ 61,406 (1988); *Pacific Gas & Electric Co.* 44 FERC ¶ 61,061, or on the buyer's avoided cost, *see, e.g., Orange and Rockland Utilities, supra; Ocean State Power*, 44 FERC ¶ 61,261 (1988); *Citizens Power and Light Corp.*, 48 FERC ¶ 61,210 (1989); *Chicago Energy Exchange of Chicago*, 51 FERC ¶ 61,054 (1990). To establish the absence of market power, it was held that a seller would have to establish that it was unable "to increase prices by restricting supply or by denying the customer access to alternative sellers." 44 FERC ¶ 61,261 at 61,979.

In *Public Service of Indiana, Inc.*, 51 FERC ¶ 61,367 (1990), where permissible market rates were again capped by the buyers' avoided cost, the Commission nonetheless stressed its obligation continually to monitor market performance, emphasizing that it "*would not hesitate to reimpose cost-of-service regulation* if competition among generating utilities fails to improve overall efficiency as expected or *if [the company] gains market power*." *Id.* at 62,226 (emphasis added).

Finally, in *Entergy Services, Inc.,* 58 FERC ¶ 61,234 (1992), *rev'd on other grounds sub nom., Cajun Elec. Power Coop., Inc. v. FERC*, 28 F.3d 173 (D.C. Cir. 1994), in granting market-based rate authority, the Commission not only noted that non-traditional rates must be within the "zone of reasonableness," but also that, under *Farmers Union*, a departure from cost-based rates required that "the regulatory scheme act[ ] as monitor to determine whether competition will drive prices to a zone of reasonableness *or to check rates if it does not*." *Id.* at 61,752 (emphasis added). To facilitate that essential market monitoring, the Commission there, as it has in every grant of market-based rate authority since, including *Williams*, imposed on the seller the obligation to reestablish its eligibility for that authority no less often than every three years. It is pursuant to the latter requirement that Williams filed the pending, ill-titled "update" of its market-power analysis. How the Commission responds, in the face of the overwhelming evidence of market power abuse discussed below, will send a powerful signal to industry and consumers alike.

D. UNCONTROVERTED EVIDENCE REQUIRES THE CONCLUSION THAT AES HAS MARKET POWER IN THE CALIFORNIIA MARKETS

1. An Analysis of AES's Market Power Must Include the Capacity Under Contract to Williams

Although the operational capacity owned by AES is currently under contract to Williams, that capacity remains fundamental to an analysis of AES's market power. The contract between AES and Williams, entered pursuant to AES's market-based rate authority, is "a contract providing for the sale for resale of electricity in interstate commerce." *AES Huntington Beach, L.L.C., et al.*, 87 FERC ¶ 61,221 at 61,877 (1999). "The fact that Williams also intends to resell the electricity in interstate commerce does not change the jurisdictional nature of the first sale." *Id.* Inasmuch as AES is making sales from the capacity, it would be illogical to exclude that capacity in evaluating AES's ability to affect the prices at which it sells electricity, which is, of course, the real test of market power.

Moreover, including such capacity in an analysis of AES's market power is necessary on a practical level. If Williams' market-based rate authority is terminated, as the ISO believes it must be (and has requested in another filing made today in Docket No. ER98-1722), Williams' rates will be determined by its cost – *i.e.*, the cost under the contract with AES. The AES-Williams contract, however, which is on file in this docket, may be amended by the parties, and would thus allow AES and Williams to circumvent a decision that Williams can use the capacity owned by AES to exercise market-power. Indeed, if AES does not intend revise contracts or otherwise sell energy or capacity from the Alamitos and Redondo Beach facilities until the Williams contracts terminate in 2013, one must question the purpose served by continued market-based rate authority for AES Alamitos, L.L.C., and AES Redondo Beach, L.L.C.

Finally, one cannot ignore the potential for collaboration between AES and Williams. In its unprecedented Show Cause Order regarding AES and Williams, the Commission found substantial evidence that the companies had cooperated to exercise locational market power. *AES Southland, Inc., Williams Energy Marketing and Trading Company*, 94 FERC ¶ 61,248 (2001)). Although the Commission accepted a settlement in the proceeding, under which Williams agreed to refund $8 million to the ISO, *AES Southland, Inc., Williams Energy Marketing and Trading Company*, 95 FERC ¶ 61,167 (2001) at 61,357, the evidence cited in the initial order raises serious questions about whether the relationship of the companies is sufficiently arm's length to prevent cooperative market power abuse. The settlement itself includes an admission that an employee of Williams suggested that Williams would not object if AES prolonged an outage that was financially beneficially to Williams. *Id.* at 61,342. While the secrecy in which the Commission shrouded the settlement places all who would wish to comment on it at a decided (and we believe inappropriate) disadvantage, the preliminary conclusions described in the Show Cause Order are troubling and indicative of the need to approach the past activities of AES (and its future activities if left unrestrained) with a healthy dose of skepticism. Such concerns preclude an analysis of AES's market power that ignores its ownership of the facilities under contract.

2. Williams' Market Behavior Demonstrates that the Capacity of the AES Units is Sufficient for the Exercise of Market Power

Although the Commission has traditionally analyzed Generation market power by evaluating portion of the capacity in a given market that is controlled by a seller, as in the original grant of market-based rate authority to AES in 1998, events since that time forcefully demonstrate the need for the Commission to require time-differentiated, in depth, market-power analysis as a condition precedent for sellers' continued market-based rate authority for either Energy or Ancillary Services in California markets.

One significant intervening event is the termination of the ISO's price cap authority. As described above, in denying the ISO's request that the Commission require a time-differentiated market power analysis in support of its market-based rates for Ancillary Service, the Commission pointed to the ISO price cap authority. The Commission, however, has refused to extend that authority. *San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Services into Markets Operated by the California Independent System Operator and the California Power Exchange, et al.*, 93 FERC ¶ 61,121 (2000). That fact, in itself, is sufficient to justify revisiting the issue of a need for time-differentiated studies.

Even more important, however, is a recognition that the Commission's traditional benchmark for the ability to exercise market power – 20 percent of uncommitted generating capacity, *see, e.g., Louisiana Energy and Power Authority v. FERC*, 141 F.3d 364 (D.C. Cir. 1998) – has proven not an effective gauge of a Generators' ability to exercise market power in California markets. Reliance on a "generation dominance" standard that does not assess the underlying competitiveness of properly defined electricity markets, simply fails to detect significant opportunities to exercise market power. A market share threshold, such as 20 percent, can represent very low market power in an hour with a great amount of surplus Generation; when, however, the level of Demand has risen to approach available Generation, a supplier with a 20 percent market share can be pivotal in setting the price because its supply is needed to meet system load and reserve requirements.

The determinative relevant issue must be whether a Generator controls sufficient generating capacity in the relevant markets to increase prices significantly over a substantial period of time. Under current market conditions in California, a Generator's share of total uncommitted capacity is not determinative of that issue. More significant is a comparison of the Generator's available generating capacity with the difference between the ISO's total requirements (Demand plus reserves) and the total resources available to the ISO in particular time periods. For example, in an hour when there are 40,000 MW of total available capacity, and the ISO's total requirements are 38,000 MW, a Generator controlling 3,000 MW can affect prices by withholding capacity, even if that 3,000 MW represents only 15 percent of uncommitted capacity. The Generator can effect that result by physically withholding the capacity or, more subtly, by bidding the capacity at prices well above the clearing price.

The ISO's Department of Market Analysis ("DMA") has identified compelling evidence of the exercise of such market power by Williams, and therefor of the ability of AES to exercise market power when the Williams contracts terminate, in a significant number of hours. Attachment A to this filing is an analysis of Williams' market behavior prepared by the ISO's DMA and previously provided to the Commission on April 2, 2001 in Docket No. ER99-1722-004. This analysis contains information that may be confidential under the ISO Tariff. The ISO therefore requests that the Commission treat this analysis as confidential and not release it except to Williams. The analysis shows that Williams has engaged in and profited from the exercise of market power since at least May 2000. DMA calculated that Williams earned nearly $8 million in excess profits between May 2000 and November 2000, exclusive of excess profits in the California Power Exchange markets. Indeed, the DMA was not able to identify any hours during the period from May 2000 through November 2000 in which Williams did not engage in physical or economic withholding. The DMA also determined that, subsequent to the termination of the ISO's price cap authority, Williams exercise of market power was even more profitable. The DMA estimates Williams' real-time market revenues for the months of December 2000 through March 2001 were almost twice (173%) its estimated operating costs, resulting in excess profits of approximately $114 million.

3. Empirical Evidence Confirms that the California Markets Have Experienced the Prejudice of the Exercise of Market Power by Generators, Including Williams.

Evidence previously submitted to the Commission has shown that there have been a significant number of hours in which Generators that have been granted market-based rate authority under the Commission's standards, even prior to the termination of the ISO's price cap authority and the December 15th Order authorizing and directing the investor-owned utilities to devote their resources to native Load, have exercised market power.[4] The ISO is including that evidence with this Protest and Motion. Attachment B is a study prepared by Dr. Eric Hildebrandt, entitled *Further Analyses of the Exercise and Cost Impacts of Market Power in California's Wholesale Energy Market* that has been provided to the Commission in Docket No. EL01-10. The analysis reaches a number of

[4] The Commission has already implicitly found the exercise of market power by Generators in hours of peak imbalances between resources and Demand. *See San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Services into Markets Operated by the California Independent System Operator Corporation and the California Power Exchange, et al.*, 94 FERC ¶ 61,245 (2001). The ISO's evidence, however, goes well beyond that evidence.

relevant, and distressing, conclusions.

First, using a "system price cost markup" methodology which compares energy prices to the variable cost of the marginal unit in the market in each hour to meet demand,[5] Dr. Hildebrandt demonstrated that 30 percent of the wholesale energy prices over the last year can be attributed to the exercise of market power (*i.e.*, that wholesale energy costs were about 30 percent higher than they would have been in the absence of market power). His analyses show, moreover, that prices exceed the competitive market benchmark in all hours under a variety of system conditions. The data demonstrate that over the March 2000 through February 2001 period, the gap between actual wholesale prices and the proper competitive level (which takes into account spikes in natural gas prices) *continued to grow.*

Provided as Attachment C is an analysis completed by Dr. Anjali Sheffrin, entitled *Empirical Evidence of Strategic Bidding in California ISO Real Time Market,* that examines the bidding behavior in the ISO's Real Time Market of five large in-state non-IOU suppliers and 16 importers and was also submitted to the Commission in Docket No. EL01-10. Dr. Sheffrin examined two types of bidding strategies exhibited by suppliers: (1) economic withholding – bidding substantially above their units marginal costs and (2) physical withholding – not bidding or scheduling available resources in the market. The study found that withholding, especially economic withholding, plagued the market for most hours

[5] As such, this methodology represents the price that would have occurred under workably competitive conditions. It attempts to account for variations in gas prices, costs of emission credits, and even appropriate scarcity rents.

from May to November 2000.[6] The study provides direct evidence that many large suppliers actively have engaged in strategic bidding efforts that are consistent with oligopoly pricing behavior, with a direct and substantial impact on market prices.

Dr. Sheffrin's study concludes that, from the period of May to November 2000, as a direct consequence of the exercise of market power, large suppliers earned excess profits of more than $500 million over competitive price benchmarks in the ISO's real time energy market. The overall impact (i.e., including smaller suppliers) of the exercise of market power on the ISO's Real Time Market during the same period is estimated at $1.19 billion. This study represents substantial evidence that individual suppliers successfully inflated market prices in the California ISO Real Time Market. This represents, however, only 10 percent of the total market costs incurred. To gain a more complete understanding of the prejudice that has been imposed on California ratepayers and on the California economy, it would be necessary to apply this methodology to transactions in the PX markets.

Most recently, in response to a request of the Commission Staff, the ISO filed an additional report prepared by Dr. Hildebrandt, entitled *Impacts of Market Power in California's Wholesale Energy Market: More Detailed Analysis Based on Individual Seller Schedules and Transactions in the ISO and PX Markets* (hereafter, "April 9, 2001 Report") This report analyzed and documented "the

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[6] Of the 25,000 hourly biding profiles studied, less than 2 percent displayed the absence of a clear pattern of withholding.

degree to which wholesale prices in California wholesale energy markets have exceeded competitive price levels over the period May 2000 through February 2001." April 9, 2001 Report at 1. The Report is appended as Attachment D. Dr. Hildebrandt confirms in this report the finding of an earlier report, that "total potential revenues in excess of competitive levels exceed $6.7 billion." *Id.*

4. Even Under a Traditional Market Power Analysis, AES's Update Must Be Rejected

Even if the Commission does not share the ISO's belief that the ISO's studies demonstrate the that the capacity owned by AES is sufficient for the exercise of market power, it must at least find that Generation market share levels above the traditional "safe harbor" levels demonstrates a need for further investigation Under the analysis submitted with the Henderson affidavit, when the Williams capacity is included, owns 27.4 percent of the uncommitted capacity in the hub-and-spoke analysis and 36.6 percent of uncommitted capacity in the Southern California market. Both are well above the Commission's 20 percent benchmark, and should preclude continued market-based rate authority pending further investigation.

E. THE COMMISSION MUST EITHER TERMINATE AES'S MARKET-BASED RATE AUTHORITY, OR ACT NOW TO PREVENT "MEGAWATT LAUNDERING"

On this highly disturbing record, the Commission's hands, under established law, quite frankly are tied. The Commission cannot defer to the "market" to set just and reasonable rates unless it can find, based on "substantial empirical evidence," that the market will produce such rates -- otherwise, the Commission simply abdicates it's statutory responsibility. Being confident that the market will yield just and reasonable rates is precisely what the Commission now is *not* able to do, at least not without the imposition of an adequately protective mitigation plan, including the comprehensive price mitigation already identified as potentially necessary to address a "laundering" problem that unavoidably is inherent with any California-only proposal. If the Commission is not willing to take the necessary action now, it must revoke AES' market-based rate authority. If the Commission is prepared to deal with the endemic problem (and it should be), it must obviate the possibility of "megawatt laundering."

If any portion of an unavoidably interdependent market is left unmitigated, it is to that portion of the market that supplies will gravitate. That is simply logic, requiring no exhaustive empirical analysis. (*See* Attachment E, the Declaration of Dr. Keith Casey). California is and will remain for some extended period a net importer. The Commission itself has acknowledged that "megawatt laundering" is an issue that threatens to undermine price mitigation entirely. Leaving aside all other questions of what might constitute an adequate mitigation plan,[7] the Commission's own acknowledgement of the "laundering" issue shows that the mitigation now in place, and the mitigation foreseen in the Commission's April 26 order, is not sufficient to justify AES' continued authority for market-based rates.

This is not a situation where action can be deferred with comfort drawn from the retention of refund authority. Refunds cannot excuse the continuation

[7] The ISO has pressed its concerns about the Commission's plan in its Petition for Rehearing of the April 26th Order, and will not further detail the deficiencies of the Commission's mitigation plan here. Even the Commission, however, has recognized that effective mitigation

of market-based rate authority in the absence of adequate mitigation.

First, as a matter of law, markets can supplant cost-based regulation *only* where it is possible confidently to conclude that prices will not be elevated through the exercise of market power. Even under cost-based regulation, the potential availability of refunds was never intended as an excuse for dereliction in the timely performance of cost-based review.

Second, the enormous past prejudice already suffered by the State of California and by its consumers from prices that are the product of market power abuse makes it especially incumbent on the Commission to cut off the bleeding now, rather than assume that transfusions later administrated can rectify the harm. They cannot. Presumably, it is not necessary that we recount in detail the unprecedented costs that have been imposed on the State as it has had to step-in to make purchases that the investor-owned utilities no longer could afford; or the downgrade in the State's credit rating that is directly attributable to these necessary purchasing activities;[8] or the diversion of funds from other essential public purposes;[9] or the unprecedented rate increases that have been necessitated;[10] or the bankruptcy of one utility and the financial frailty of another,

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requires that "laundering" be dealt with.

[8] *See, e.g.*, Attachment F, L. Weston and M. Bustillo, "State's Bond Rating Downgraded to A+", *Los Angeles Times*, April 26, 2001.

[9] *See, e.g.*, Attachment G, M. Bustillo and D. Vrana, "A One-Two Punch at the Budget", *Los Angeles Times*, May 16, 2001.

[10] *See, e.g.*, Attachment H, T. Reiterman and N. Brooks, "$5.7-Billion Energy Rate Hike is Old", Los Angeles Times, May 16, 2001.

pushing it, too, to the precipice.[11]

Third, because portions of Williams' sales would continue to be made into ISO markets in which prices are determined through a single-price auction, failure by the Commission to prevent Williams from being in a position to submit bids that are disciplined neither by competitive market conditions nor cost-based regulations will have consequences that extend far beyond allowing Williams to earn excessive revenues. Such bids will establish elevated market clearing prices that would burden all purchasers in those markets and that cannot be undone even if Williams is later required to disgorge the excessive revenues that it earned.

Refunds can never reverse these wrongs. Nor can refunds restore the health of the elderly who, because of high prices, must forego what for them are essential services, or restore businesses that have had to close their doors, stranding workers and their families.

There is but one way to prevent continuation of this intolerable prejudice to the very consumers whom it is the Commission's statutory responsibility to protect. A tourniquet must be applied now: unless the Commission forthwith implements a comprehensive price mitigation plan that includes, among other necessary components, measures that effectively address "megawatt laundering," it is legally required to terminate AES's market-based rate authority.

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[11] *See, e.g.*, Attachment I, T. Reiterman, D. Morain, and M. Landesberg, "PG&E Declares Bankruptcy; State's Crisis Plans Collapse", *Los Angeles Times*, April 7, 2001.

V. CONCLUSION

WHEREFORE, the ISO respectfully requests that the Commission immediately terminate AES's market-based wholesale rate authority for sales of Energy and Ancillary Services in California pending AES submission of a fully supported analysis demonstrating that it lacks market power. In the alternative, the Commission should set the matter for hearing and immediately limit AES to cost-based wholesale rates in the interim.

Respectfully submitted,

__________________________	______________________________
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Date: May 25, 2001

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 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 25th day of May, 2001.

____

Julia Moore
(202) 295-8357

May 25, 2001

The Honorable David P. Boergers
Secretary
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, DC 20426

Re: *AES Huntington Beach, LLC*
Docket No. ER98-2184-006

Dear Secretary Boergers:

Enclosed please find an original and fourteen copies of the Motion to Intervene, Protest, and Motion for Immediate Suspension of Market-Based rate Authority of the California Independent System Operator Corporation ("ISO") in the above-captioned matter.

Pursuant to 18 C.F.R. § 388.112, the ISO requests confidential treatment of Attachment A of this filing. This attachment is an analysis of Williams Energy Marketing & Trading Company's market behavior prepared by the ISO's Department of Market Analysis and previously was submitted to the Commission pursuant to a request for confidential treatment in Docket No. ER99-1722-004 on April 2, 2001. The analysis contains information that may be confidential under the ISO Tariff. Consistent with this request, the ISO will not disclose the information in Attachment A to other parties. The ISO will make the information available to AES Redondo Beach, LLC, subject to a protective order in this proceeding. The ISO reserves the right, in the future, to request that this information no longer be treated as privileged and confidential. The original of the ISO's Attachment A has been provided under seal, and all confidential information has been redacted from the fourteen copies of the ISO's filing. Please contact the undersigned with any inquiries concerning this request for confidential treatment.

Also enclosed are two extra copies of the filing to be time/date stamped and returned to us by the messenger. Thank you for your assistance.

Respectfully submitted,

Julia Moore
(202) 295-8357

Counsel for the California Independent System Operator Corporation