February 9, 2001

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

Re: California Independent System Operator Corporation, Docket No. ER01-889-000

Dear Secretary Boergers:

Enclosed for filing are one original and 14 copies of the Answer of the California Independent System Operator Corporation to Motions to Intervene, Comments, Protests, and Motion to Cease and Desist in the above-referenced proceeding. Two additional copies of the filing are also enclosed. Please stamp the two additional copies with the date and time filed and return them to the messenger.

Thank you for your assistance in this matter.

Respectfully submitted,

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Attorneys for the California
Independent System Operator
Corporation

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

California Independent System Operator Corporation	)	Docket No. ER01-889-000

ANSWER OF THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION TO MOTIONS TO INTERVENE, COMMENTS, PROTESTS, AND MOTION TO CEASE AND DESIST

Pursuant to Rule 213 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.213, the California Independent System Operator Corporation ("ISO")[1] submits its answer to the Motions to Intervene, Comments, Protests, and Motion to Cease and Desist submitted in the above-captioned docket.[2] The ISO does not oppose the intervention of any of the parties that have sought leave to intervene in this proceeding. As explained below, however, the comments and protests of those parties in opposition to proposed Amendment No. 36 are without merit and should be rejected. The ISO

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[1] Capitalized terms not otherwise defined herein have the same meaning set forth in the Master Definitions Supplement, Appendix A to the ISO Tariff.

[2] Some of the Intervenors commenting substantively on proposed Amendment No. 36 do so in portions of their pleadings variously styled as "Comments," "Protest," and other headings, without differentiation. There is no prohibition on the ISO's responding to the comments in these pleadings. The ISO is entitled to respond to these pleadings and requests notwithstanding the label applied to them. *Florida Power & Light Company*, 67 FERC ¶ 61,315 (1994). In the event that any portion of this answer is deemed an answer to protests, the ISO requests waiver of Rule 213 (18 C.F.R. §385.213) to permit it to make this answer. Good cause for this waiver exists here given the importance of this proceeding to the stability of the California electric system and the usefulness of this answer in ensuring the development of a complete record. *See, e.g.*, *Enron Corporation*, 78 FERC ¶ 61,179, at 61,733, 61,741 (1997); *El Paso Electric Company*, 68 FERC ¶ 61,181, at 61,899 & n.57 (1994).

accordingly requests that the Commission accept Amendment No. 36 without condition or substantive modification. The ISO also reiterates its request that the Commission provide guidance regarding a means of addressing, on a going-forward basis, the creditworthiness issues that gave rise to Amendment No. 36.

I. BACKGROUND

In late December and early January it became apparent to the ISO and others that for various reasons the financial well-being of Southern California Edison Company ("Edison") and Pacific Gas and Electric Company ("PG&E") was deteriorating rapidly. A downgrade in the credit rating of those companies, and of the California Power Exchange ("PX"), which depended on Edison and PG&E for the majority of its revenues, was inevitable. Under Section 2.2.3.2 of the ISO Tariff, however, such a downgrade would preclude those entities or Scheduling Coordinators representing them from scheduling transactions with the ISO, forcing their Loads to be served through real-time Imbalance Energy, unless the entity in question first posted an appropriate level of financial security, in accordance with Section 2.2.3.2.[3] As of January 5, 2001, such security for the PX, as Scheduling Coordinator for Edison and PG&E, would have exceeded $2.25 billion, an amount far in excess of the amount that the PX alone, or with the support of both Edison and PG&E, could have provided. The extraordinary shift of Demand to real time that would have resulted from the downgrade, and

[3] Section 2.2.3.2 provides in relevant part that a Scheduling Coordinator, Utility Distribution Company, or Metered Subsystem that does not maintain an Approved Credit Rating "shall be subject to the limitations on trading set out in Section 2.2.7.3" of the ISO Tariff. Under Section 2.2.7.3, the only limitations on trading concern the inability of such entities to have their schedules accepted by the ISO.

the inability of the PX, Edison, and PG&E to post security, would have seriously imperiled the ability of the ISO to meet its statutory responsibility of ensuring the reliability of the electric grid.

Accordingly, in order to protect its ability to reliably serve California electricity consumers, the ISO, on January 4, 2001, filed with the Commission Amendment No. 36 to the ISO Tariff. Amendment No. 36 would modify Section 2.2.3.2 of the ISO Tariff to provide on a day-to-day basis a temporary grace period following a downgrade in the credit rating of certain Scheduling Coordinators, during which period such Scheduling Coordinators could continue to schedule transactions without providing one of the specified forms of security. This grace period would apply to Scheduling Coordinators that are Original Participating Transmission Owners or that schedule on behalf of an Original Participating Transmission Owner.

On January 5, 2001, following the credit downgrades of Edison and PG&E, the ISO posted notice on the ISO Home Page that the scheduling limitations would not apply to Scheduling Coordinators for Original Participating Transmission Owners for the following Trading Day. The ISO has posted such a notice for each subsequent Trading Day to date.

In accordance with the Notice of Filing issued January 9, 2001, a number of interventions were filed on or before January 25, 2001, some of which included comments on or protests of proposed Amendment No. 36, or additional motions.[4]

[4] Timely motions to intervene were filed by the California Electricity Oversight Board ("Oversight Board"); the PX; the Cities of Redding, Santa Clara, and Palo Alto, California and the M-S-R Public Power Agency ("Cities/M-S-R"); the City of Vernon, California ("Vernon"); Dynegy Power Marketing, Inc. ("Dynegy"); El Paso Merchant Energy L.P. ("El Paso"); Mirant California,

II. SUMMARY OF INTERVENORS' POSITIONS

Several Intervenors, including Duke, Dynegy, Reliant, and Williams, take exception to the ISO's proposal to temporarily waive the ISO Tariff's creditworthiness requirements.

Duke asserts that the creditworthiness provisions are an essential feature of the ISO Tariff, and that Duke, like other energy suppliers, entered into significant financial commitments on the basis of the fundamental premise that they would be paid when power is provided. Duke at 4. Williams argues that Amendment No. 36 materially changes the agreement between generators and the ISO, and notes its concurrence with Reliant's assertion that implementing the changes proposed in Amendment No. 36 would represent "a repudiation of the basis upon which participating generators initially agreed to be bound by the [ISO] Tariff . . . ." Williams at 4-5.

Duke and Dynegy argue that energy suppliers cannot be expected to sell power without adequate assurances of payment because that would violate the Commission's obligation to ensure that service is provided under terms that are "just and reasonable." Duke at 2, 6; Dynegy at 4. Duke and Dynegy also argue

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LLC ("Mirant"); Modesto Irrigation District ("MID"); Northern California Power Agency ("NCPA"); PG&E; Sacramento Municipal Utility District ("SMUD"); San Diego Gas & Electric Company ("SDG&E"); Edison; Tucson Electric Power Company ("Tucson"); Turlock Irrigation District ("TID"); and Williams Energy Marketing & Trading Company ("Williams"). A Notice of Intervention was filed by the Public Utilities Commission of the State of California ("CPUC"). A motion to intervene out of time was filed by Puget Sound Energy, Inc. ("Puget"). Along with their motions to intervene, motions to cease and desist were also filed by Duke Energy North America, LLC and Duke Energy Trading and Marketing, LLC ("Duke") and Reliant Energy Services ("Reliant"). The ISO has responded to Reliant's Motion to Intervene, Protest, and Reject Amendment No. 36, and Emergency Motion for Order to Cease and Desist, which was filed in the instant docket on January 8, 2001 ("Reliant Motion"). The ISO will undertake to respond to Duke in the instant answer.

that requiring energy suppliers to sell power under these conditions would be confiscatory, and would raise taking concerns under the Fifth Amendment. Duke at 7-8, Dynegy at 4. Duke emphasizes that Commission precedent has expressly provided for FERC regulated entities to terminate service in cases of non-payment. Duke at 7.

Mirant and Tucson argue that the ISO's categorical waiver of basic credit protections undercuts the stability of the California energy market at a critical time when stability is most necessary, and imposes great risk on market sellers. Mirant at 4-5; Tucson at 2-3. Duke asserts that forcing energy suppliers to make deliveries without adequate assurance of payment will "inevitably end up threatening the reliability of the electrical grid." Duke at 2.

Mirant and Tucson request that the Commission condition acceptance of Amendment No. 36 on the maintenance of balanced credit protections, such as the continued use of the California Department of Water Resources ("DWR") as a purchasing entity, or the substitution of an equally creditworthy party as a direct counterparty or guarantor. Mirant at 6-7; Tucson at 4-5. Mirant also urges the Commission to require that the ISO provide assurances that suppliers will be paid in full for energy deliveries made between January 4, 2001 (the date that the ISO implemented Amendment No. 36) and the date on which additional credit support is provided. Mirant at 7. Williams asserts that the proper solution to the current credit crisis facing the IOUs depends on the CPUC permitting Edison and PG&E to recover their wholesale power costs, and suggests that it may now be appropriate for the Commission to take affirmative steps to force the CPUC to do

so. Williams at 5-6. Williams also urges the Commission to order the ISO to cease and desist from its implementation of Amendment No. 36, arguing that the ISO "cannot be permitted to disregard Tariff provisions on a whim without Commission approval." *Id*. at 7.

SDG&E asserts that the result of the ISO's action in waiving the creditworthiness requirements is to harm consumers in SDG&E's service territory and to drive up prices in ISO markets and for bilateral transactions outside that market. SDG&E at 4. SDG&E contends that because of Amendment No. 36, energy suppliers are reluctant to sell into the ISO's markets, or are seeking a price premium to compensate them for the risks they face, and that SDG&E has also been forced to pay higher prices for bilateral power purchase arrangements. *Id*. at 4-6. Finally, SDG&E argues that if the Commission accepts Amendment No. 36, it should impose conditions to ensure that no market participant is required to bear losses it could not have anticipated at the time it sold into the ISO markets. *Id*. at 6-8.

In its intervention, Dynegy states that it does not oppose the implementation of Amendment No. 36 on a temporary basis until February 7, 2001 (the date on which the Department of Energy order under Section 202(c) of the Federal Power Act ("FPA"), 16 U.S.C. § 824a(c) (1994), compelling certain Generators to sell Energy to the ISO expired). Dynegy at 3. However, Dynegy asserts that it would be unreasonable to require suppliers to sell to PG&E and Edison past this date without further credit assurances or without supplier agreement. *Id*. Dynegy also argues that if the ISO feels the need to extend

waiver of the creditworthiness provisions past February 7, it should be required to make a new filing with "significant generation supplier support." *Id*.

A number of parties convey support for Amendment No. 36 in their interventions, including PG&E, Edison, EOB, and CPUC. PG&E and Edison urge the Commission to accept Amendment No. 36, arguing that it is necessary to allow them to continue to serve their customers. Edison at 2; PG&E at 2-3. PG&E and Edison, along with the CPUC, explain that inability to provide service would have serious consequences for health and public safety in California. Edison at 2; PG&E at 3; CPUC at 2. Edison also argues that Amendment No. 36 should be modified to provide even greater short-term fiscal relief to the California markets by suspending all creditworthiness requirements for the self-provided load of the Original Participating TOs' Scheduling Coordinators. Edison at 2-3. Both PG&E and Edison urge the Commission to reject Reliant's Motion for Order to Cease and Desist, arguing that Reliant has sufficient assets to deal with the risks present in the California markets. PG&E at 3-5; Edison at 4.

While Cities/M-S-R supports the relief sought by the ISO respecting the creditworthiness provisions of the ISO Tariff, it requests that the Commission take appropriate action to ensure that entities making power sales into California are compensated for such sales. Cities/M-S-R at 8. NCPA does not oppose Amendment No. 36 either, but argues that the creditworthiness requirements of the ISO Tariff have a disproportionate impact on small entities because they bear a burden proportionally greater relative to their size. NCPA at 3-4. NCPA asserts that in the new deregulated markets, the ISO's current credit and load

shedding programs are flawed and inequitable, and asks that the Commission ensure that credit and curtailment requirements properly allocate incentives.[5] NCPA at 4.

III. DISCUSSION

The protests, comments, and request of intervenors follow certain general themes. None, however, suggests a reasonable alternative to Amendment No. 36. The ISO hopes, with the Commission's guidance, to work with these parties to develop a means to continue effective and reliable service without unduly increasing the financial risk to Market Participants. Intervenors, however, present no viable arguments for rejection of Amendment No. 36.

A. Even if the IOUs Were Prohibited From Forward Scheduling, Their Customers Would Have to Be Served

Duke, Mirant, Tucson, and Williams contend that Amendment No. 36, and the ISO's "unilateral" implementation thereof, alter the fundamental terms under which Generators agreed to be bound by the ISO Tariff. In various forms, they essentially argue that, absent provision for some reasonable assurance of payment to Generators, the ISO Tariff is not just and reasonable and Participating Generators should not be bound by the Participating Generating Agreements. This is the same argument Reliant raised in the Reliant Motion, and to which the ISO has already responded. See Answer of the California Independent System Operator Corporation to Reliant Motion at 3-5 (Jan. 16,

[5] NCPA explains that the California market should be structured in such a way as to reward those participants that prudently plan ahead to serve their forecasted load, rather than impose upon them the risk of blackouts along with those entities that have not done likewise. NCPA at 4-5.

2001). Dynegy does not object to the implementation of Amendment No. 36 prior to February 7, 2001, but indicates that any amelioration of credit requirements subsequent to that date should only be with the concurrence of Generators.

The ISO reiterates that it understands the concerns of these Generators. The ISO has sought Commission guidance in balancing these concerns with the need to ensure the reliability of the grid in order to provide continued service to California consumers. The ISO must emphasize a fundamental point, however: rejection of Amendment No. 36 would do nothing to improve the Generators' prospects for receiving payment. Absent Amendment No. 36, Edison and PG&E, who serve the majority of Load in the State, would be unable to schedule transactions in the Day-Ahead or Hour-Ahead Markets by using, for example, their own Generation. As a result, their entire Load would appear as unscheduled Demand in real time, with severe consequences both for reliability and economics. Most significantly, the appearance of this additional Demand in real time would impose even greater demands on the ISO's operators, threatening further the ISO's ability to ensure that enough Generation is available to serve the Demand and significantly increasing the likelihood of system failures. From an economic perspective, real-time prices would climb even higher, but there would be no additional influx of payments to meet the increased costs. Generators that supply power to meet the ISO's real-time needs, whether by submitting bids or by responding to emergency Dispatch instructions issued by the ISO, would have no greater assurance of receiving payment.

While awaiting Commission guidance and the culmination of efforts in California to address this situation, the ISO therefore sees no alternative to the temporary suspension of the scheduling prohibition. Despite their protests, Duke, Dynegy, Mirant, and Williams suggest no reasonable alternative means of ensuring service. Reliant's Motion to Cease and Desist, which Williams endorses, had suggested that the Scheduling Coordinators that cannot maintain the necessary credit ratings be required to post financial security. As noted earlier, this proposal was not feasible at the time the Amendment was filed, and the financial options available to these entities have been further reduced since then. On February 2, 2001, the PX, Edison, and PG&E defaulted on amounts owed the ISO totaling hundreds of millions of dollars. It is not realistic to expect these entities now to post security to meet obligations of this magnitude, and it is not reasonable to enforce the prohibition on scheduling contained in Section 2.2.7.3 of the ISO Tariff, which would (1) result in thousands of megawatts of IOU Load being shifted to real time and (2) create the risk of massive rotating blackouts for California consumers. Similarly, the suggestions of Mirant and Tucson – that the Commission require as a condition of accepting Amendment No. 36 that the ISO provide alternative assurance that the Generators will be paid, such as a State guarantee, for Energy delivered – is not feasible. The ISO itself has no independent source of funds. Any assurance of payment would therefore have to come from other Market Participants or from another source. Generators present no justification for shifting these costs to other Market Participants, particularly when Generators retain a cause of action against the

defaulting ISO Debtors. Although the ISO agrees with the underlying premise of these suggestions, and the concern expressed by Cities/M-S-R, that some mechanism must be developed for ensuring that Generators receive reasonable compensation when they provide power, without sacrificing the provision of reliable service to the majority of California's population, the suspension of scheduling limitations is necessary if reliable service is to continue in the interim.

B. The Generators Have Not Been Harmed By Amendment No. 36

Although the concerns of the Generators are very real, a little perspective is appropriate. First, Amendment No. 36 is intended and is still hoped to be of very limited duration. It continues only on a day-to-day basis and sunsets on March 3, 2001. The ISO would have to file a further amendment to continue the suspension of scheduling limitations, and any further filings will be able to take into account the progress being made in California toward addressing all of the intertwined issues raised by the current crisis (such as the State's forward purchases of Energy) and any guidance that is forthcoming from the Commission.

Second, there has been no fundamental undermining of the understandings on which Generators agreed to operate in California markets. The Generators, which are for the most part affiliates of long-established public utilities selling at wholesale, are well versed in the requirements of the FPA. When they began using the ISO Controlled Grid, and when they signed the Participating Generator Agreements ("PGAs"), they were fully aware of the ISO's ability to unilaterally file amendments to the ISO Tariff under Section 205 of the

FPA, and the Commission's ability to waive notice requirements under that section and section 35.11 of the Commission Rules of Practice and Procedures.[6] Although implementation prior to Commission acceptance for filing is not to be taken lightly, the Commission has on a number of occasions allowed it in emergency circumstances. *See, e.g.*, *California Independent System Operator Corp.*, 88 FERC ¶ 61,146 (1999) (waiving prior notice requirements in order to allow the ISO to implement market rules relating to Congestion Management two days after the date of filing); *ISO New England, Inc.*, 88 FERC ¶ 61,304 (1999) (granting petitioner's request for waiver of prior notice requirements in order to permit the petitioner to implement emergency measures as of the day after filing); *ISO New England, Inc.*, et al., 89 FERC ¶ 61,211 (1999) (granting petitioner's request for waiver of prior notice requirements in order to allow revisions to market rules to take effect prior to date of filing). The Generators are free to protest the Amendment, as they have done, or to propose additional changes to the ISO Tariff under Section 206 of the FPA. Both the ISO's rights and the Generators' rights are contemplated by the PGAs.

Third, the Generators have not been denied payment for their Energy. Each retains a cause of action against the defaulting parties. Indeed, if a Generator provides power in a transaction that occurs above the $150 "soft cap" applicable to bids in the California markets, and if the Commission reviews the

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[6] If the Generators believe that Amendment No. 36 has so fundamentally altered their risks that they no longer wish to participate in the ISO's markets or schedule transactions on the ISO Controlled Grid, then their remedy is to file to seek permission to terminate the Participating Generator Agreement. Section 3.2.2 of the PGA provides that in the event that Reliant no longer wishes to participate in the ISO's markets, "it may terminate this Agreement, on giving the ISO ninety (90) days written notice . . . With respect to any notice of termination given pursuant to this

cost support provided for the transaction and approves the bid, the Generator has a right to compensation, with interest, and the ISO is obligated (upon request) to document and certify the unpaid amount. *See* ISO Tariff, §§ 11.12 and 11.20.2. Such certification may be used as prima facie evidence of the amount due to the ISO Creditor by the ISO Debtor in any legal proceeding. Moreover, there are a variety of scenarios under which full payment may be forthcoming. In particular, Williams itself notes the pending action in the United States District Court for the Central District of California in which Edison seeks to require the CPUC to permit pass-through of its wholesale costs.[7] Williams acknowledges that "it appears that such relief will eventually be found in federal court . . . ." Williams at 6.

Fourth, despite the increased risk of nonpayment, the financial health of the Generators is not threatened. According to the January 31, 2001, *Foster Electric Report*, Duke had fourth quarter net income of $284 million, compared to a net loss of $189 million for fourth quarter 1999; Dynegy's fourth quarter earnings were up 135% from the same quarter the previous year; Reliant saw a 65% increase in earnings in 2000; and Mirant's earnings increased 36% during the year. Moreover, the markets do not see the risk in Amendment No. 36 that Generators assert. Since Amendment No. 36 was filed, the price of common stock in The Williams Companies has risen over 20%; in Dynegy, Inc., over 15%; in Mirant Corp., over 10%; in Duke Energy Corp., over 15%; and in Reliant Energy Inc., over 10%.

Section, the ISO must file a timely notice of termination with FERC. . . . This Agreement shall terminate upon acceptance by FERC of such notice of termination."

C. The Argument That Amendment No. 36 Amounts to An Unconstitutional Taking Is Without Merit

Duke's and Dynegy's suggestion that requiring Generators to produce without the assurance of payment provided by the creditworthiness standards may amount to an uncompensated government taking lacks any substance. The current situation lacks the fundamental criteria for a taking. In this context, according to the United States Supreme Court in one of the cases cited by Duke:

> The guiding principle has been that the Constitution protects utilities from being limited to a charge for their property serving the public which is so "unjust" as to be confiscatory. Covington & Lexington Turnpike Road Co. v. Sandford, 164 U.S. 578, 597, 17 S.Ct. 198, 205-206, 41 L.Ed. 560 (1896) (A rate is too low if it is "so unjust as to destroy the value of [the] property for all the purposes for which it was acquired," and in so doing "practically deprive[s] the owner of property without due process of law"); FPC v. Natural Gas Pipeline Co., 315 U.S. 575, 585, 62 S.Ct. 736, 742, 86 L.Ed. 1037 (1942) ("By long standing usage in the field of rate regulation, the 'lowest reasonable rate' is one which is not confiscatory in the constitutional sense"); FPC v. Texaco Inc., 417 U.S. 380, 391-392, 94 S.Ct. 2315, 2392, 41 L.Ed.2d 141 (1974) ("All that is protected against, in a constitutional sense, is that the rates fixed by the Commission be higher than a confiscatory level"). If the rate does not afford sufficient compensation, the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments.

Duquesne Light Co. v. Barasch, 488 U.S. 299, 307-08 (1989). First, in this instance, the Commission has not imposed confiscatory rates. Indeed, the Generators are authorized to sell at market-based rates. The Generators, however, have *chosen* to sell at those rates through the mechanisms provided in using the ISO Tariff, and in doing so have agreed to abide by the ISO Tariff, as it may be amended from time to time. Moreover, it is impossible to assert that subjecting Generators to a *risk* that payment may be delayed, for a limited

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[7] Case No. CV00-12056-RSWL.

period, following a period in which they enjoyed unparalleled profits in the California markets, is "so unjust as to *destroy* the value of [the] property for all the purposes for which it was acquired." *Id.* at 307 (emphasis added).

D. SDG&E's Argument That Amendment No. 36 Has Raised Prices Is Unsupported

SDG&E presents no analysis to support its conclusion that prices have risen because of Amendment No. 36. If anything, Amendment No. 36 should have had an ameliorating effect on prices. Absent Amendment No. 36, the Load served by Edison and PG&E would be forced entirely into the Real Time Markets, where prices are historically higher, particularly during periods of tight supply. The knowledge that significant Load must be served in the Real Time Markets would also exert upward pressure on the forward markets.

SDG&E's second argument – that the Commission impose conditions to ensure that no participant will be required to bear losses it could not have anticipated when it sold into the ISO markets – relies on the untenable premise that Amendment No. 36 could cause such losses. The suspension of scheduling limitations in Amendment No. 36 did not affect, and could not have affected, Edison's or PG&E's financial condition prior to the suspension of scheduling limitations or Edison's and PG&E's default regarding transactions prior to that suspension. The default regarding such transactions would have occurred regardless of Amendment No. 36. Moreover, the ISO provided market notice of the suspension of scheduling limitations prior to the deadline for the submittal of schedules for transactions during the period of the suspension. As a result, Market Participants had full notice of the suspension of scheduling limitations

prior to scheduling any transactions that might be affected by the suspension. Accordingly, Amendment No. 36 cannot occasion losses that could not have been anticipated at the time a Market Participant sold into the ISO's markets.

IV. CONCLUSION

For the foregoing reasons, the ISO requests that the Commission accept proposed ISO Tariff Amendment No. 36 as filed.

Respectfully submitted,

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Dated: February 9, 2001

CERTIFICATE OF SERVICE

I hereby certify that I have served the foregoing document upon all parties on the official service list compiled by the Secretary in the above-captioned proceeding, in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and Procedure (18 C.F.R. § 385.2010).

Dated at Washington, DC this 9th day of February, 2001.

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Michael Kunselman