UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Williams Energy Marketing & Trading Company	))	**Docket No. ER99-1722-004**

EMERGENCY MOTION OF THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION FOR IMMEDIATE SUSPENSION OF MARKET-BASED RATE AUTHORITY, FOR THE INSTITUTION OF REFUND PROCEEDINGS, AND REQUEST FOR SHORTENING OF TIME TO ANSWER

Pursuant to Rule 212 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.212, the California Independent System Operator Corporation ("ISO"), hereby moves the Commission immediately: (1) to terminate its grant of market-based rate authority to Williams Energy Marketing & Trading Company ("Williams") for the sale of Energy and Ancillary Services[1] from generating units in California, unless the Commission, as a condition to the continuation of that authority, imposes a 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; (2) to order refunds, together with interest, back to May 1, 2000, of the difference between cost-based rates determined by specific reference to the Williams resources and the market revenues actually received; and (3) to institute a proceeding to determine whether, prior to May 1, 2000, Williams exercised market power and,

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

if answered in the affirmative, to order additional refunds with appropriate interest.

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 can lawfully be granted only upon a meticulous showing by the applicant that permits the Commission to conclude with confidence that the potential for the exercise of market power either does not exist or has adequately been mitigated.

Williams, in total disregard of its burden, has submitted a recertification filing that is nothing short of contemptuous of the Commission, and of the consumers that the Commission is charged with protecting. There can be but one lawful response – immediate termination of Williams' market-based rate authority.

Undoubtedly Williams will argue, and the Commission itself preliminarily may be 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 acceptability, 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 region-wide 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. But today, 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 "closing the barn door".

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, one that, among other things, prevents "megawatt laundering," which the Commission recognized in the April 26th Order as a currently possible practice that undermines any other mitigation efforts, the Commission has but one option: it must revoke Williams' market-based rate authority. As to the past, the Commission has no alternative to requiring total disgorgement of all monopoly rents.

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. SUMMARY OF FILING

By this filing, the ISO is placing before the Commission an urgent request as to which the ISO is compelled to ask for an expedited response. In light of the overwhelming, uncontradicted evidence in this docket that Williams has systematically profited from the exercise of market power to the significant harm of California's electric consumers and economy, and that such exercise of market power began at least as early as May, 2000 and possibly before, the ISO specifically requests that the Commission immediately –

- terminate the authority of Williams to sell either Energy or Ancillary Services at market-based rates from units located in California from which it is entitled to market the output, and require Williams to file cost-based rates going forward, together with their underlying cost supports, unless the Commission has approved 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;

- require the submission by Williams of rates based on actual costs, for sales of Energy and Ancillary Services from those same units for each month from May 2000 to the present, together with the underlying cost support;

- schedule an expedited hearing to determine the appropriate cost-based rates from those units for the entire period beginning May 2000 if, following Williams' submission of cost support, issues remain as to the propriety of the filed cost-based rates;

- direct that Williams immediately refund all charges collected since May 1, 2000 that are in excess of the cost-based rates that it files and, if a hearing is held on those rates, that any additional amounts adjudged in excess of appropriate cost-based rates be refunded at the conclusion of that proceeding, all refunds to be with interest as provided in 18 C.F.R. 35.19a; and

- schedule an expedited hearing to determine whether Williams exercised market power or in any respect violated its privilege to enjoy market-based rate authority prior to May, 2000, and take

> appropriate action to require refunds, with interest, if the finding is affirmative.

The ISO recognizes that not all portions of its request may be amenable to immediate resolution. However, one critical element -- the *immediate* termination of market-based rate authority -- is properly the subject of quick action and we most respectfully request that it be granted unless the Commission immediately acts to address price mitigation comprehensively and on a regional basis. Because of the uncontroverted evidence that Williams has and continues to exercise market power, because the exercise of market power is having a devastating impact on the public interest, and because the continuation of inadequately mitigated market-based rates would be in direct contravention of the Federal Power Act ("FPA") and uniform judicial and Commission precedent, the ISO requests action by no later than June 15th on its request that the Commission terminate Williams' market-based rate authority or, in the alternative, take region-wide action in the context of a comprehensive price mitigation plan that includes preclusion of "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. However, only where it is possible to conclude with confidence that market mechanisms will accomplish that end 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 and other intervenors already have demonstrated the shameful inadequacy of the Williams' submission. The paucity of that presentation, in light of structural changes within the relevant market (*e.g.*, the demise of the PX and the creation of a third trading zone within California) is reason enough for the Commission to act summarily. The total disregard by Williams of the Commission's findings that the market in California is "dysfunctional" and plagued with the potential for market power abuse represents either an arrogant disregard of Commission policy and, therefore, an affront both to the Commission and to the consumers it is charged with protecting, or an implicit admission by Williams that it has no adequate response. In either event, but one Commission response is consistent with the dictates of the FPA and the responsibilities that it entrusts to the Commission: the immediate revocation of Williams' privilege (for surely, it is not its entitlement) to sell Energy or Ancillary Services at market-based rates.

Yet, it is not only the fatal failures of Williams' filing that compels Commission action. The Commission also has before it in this docket voluminous evidence substantiating the blatant exercise of market power by Williams, the charging by Williams of unjust and unreasonable prices, and the extreme prejudice to the public interest occasioned by that abusive conduct. Presented with such evidence, it is incumbent upon the Commission to fulfill its oft-repeated commitment to reimpose cost-based regulation *without hesitation* when a company displays the ability to exercise 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 stem the illegal confiscation by Williams of consumer welfare, Williams 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 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 enhance consumer welfare by producing efficiencies and spurring innovation not as likely to be stimulated under a tightly regulated structure. But if the end goal is stimulation of a competitive electric industry, 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 extreme market abnormalities. If, in the face of overwhelming evidence of consistent 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 electric industry across the nation can only be stalled, if not derailed.

On a broader social basis, therefore, the need for expedited relief in this case is compelling. In the face of the extreme prejudice being imposed daily on California's distribution utilities and electricity consumers and on the State's economy, relief now is imperative. Leaving aside the total inadequacy of the Commission's refund orders to date (which proceed, as this motion makes clear, on an erroneous standard), 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 Williams to sell 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 adequate to preclude the out-of-state "laundering" of energy sales. The ISO respectfully requests that the Commission act on each of the other requests made by the ISO in this filing on the earliest date that each can be implemented.

III. 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

A. 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*).[2] 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.

[2] 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 (1983), n.160.

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. Federal Power Comm'n*, 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 the pre-1935 Power Act regime was rampant with market power abuse. *See Gulf States Utilities Co. v. Federal Power Comm'n*, 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, prices that cover the producer's costs 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.

B. 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").[3] 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 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

[3] *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.

> 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*.[4]

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

[4] 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.

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."

> 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.

Public Service Company of New Mexico, 25 FERC ¶ 61,469 at 62,053 (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 absolutely 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 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); *Florida Gas Transmission 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*, *Inc*., 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 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 "*will 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 Co-op, 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.

IV. UNCONTROVERTED EVIDENCE REQUIRES THE CONCLUSION THAT WILLIAMS HAS EXERCISED MARKET POWER IN THE PAST AND CAN DO SO IN THE FUTURE

A. The Burden of Establishing the Absence of Market Power Rests With Williams and It Does Not Even Purport to Make the Required Showing.

The abandonment of cost-of-service regulation, under a statute that has as its core objective the protection of consumers, *see Atlantic Refining,* 360 U.S. at 388, is not to be embraced lightly. It is for this reason that the Commission steadfastly has insisted that applicants for market-based rate authority carry the burden of establishing their inability to exercise market power both at the outset and thereafter no less frequently than triennially. *See Entergy*, 58 FERC at 61,754. Williams does not even purport to make the required showing. Indeed, if its filing had been a pleading in federal court, it could well be sanctionable.

When Williams first sought market-based rate authorization for the sale of Ancillary Services in California, the ISO pointed out the inappropriateness of the Commission's screening methodology in light of the time-differentiated characteristic of the California market structure. The Commission dismissed that concern, in part in reliance on the protection afforded by price caps. *Williams Energy Services Co.*, 84 FERC ¶ 61,072 (1998). Those price caps no longer exist and both the Chairman of the Commission and the Administration have made clear their disdain for their re-imposition,[5] making it all the more important that the market power analysis be rigorously structured and applied.[6]

As discussed in its protest in this docket, the ISO still believes that the traditional "hub and spoke" methodology is ineffective in identifying the potential for the exercise of market power in the context of the California markets. Indeed, the actual market performance of Williams itself (discussed below) allows for no

[5] S*ee* Hon. Spencer Abraham, "Our Energies Are in the Right Place," *Washington Post*, April 16, 2001; Testimony of Hon. Curtis Hébert before the Energy and Air Quality Subcomm. of the Energy and Commerce Comm'n, U.S. House of Rep., March 20, 2001.

[6] As noted in Section II B, when the Commission initially embraced market-based rates, it considered the addition of price caps a required component.

other conclusion. It is not even necessary, however, that the Commission reconsider the appropriate methodology, for Williams does not even address the traditional measure. The totality of what Williams offers as justification for the continuation of its market-based rate authority for output from its California capacity entitlements, is as follows (Compliance Filing at 4-5, footnotes omitted):

> WEM&T does not possess generation market power in any relevant market. WEM&T does not directly own any generation, although as indicated above, it is affiliated with entities that own generation. WEM&T has the exclusive right to market and dispatch the output of certain facilities owned by AES located in southern California. However, because the Commission has recently granted WEM&T market-based rate authority to make these sales, which remain subject to Commission review, there are no market power concerns with respect to WEM&T's sales from these facilities.

After the "recently granted WEM&T" authorization -- upon which Williams' Compliance Filing depends *in toto* – there have been significant structural modifications in the California markets. Illustrative but by no means exhaustive examples are the use by the investor-owned utilities of their own generation and entitlements to serve native load, the demise of the PX, and the creation of a third zone for congestion management. At an absolute minimum, it was incumbent upon Williams to address those changes. But its responsibility did not stop there. Since the Commission's 1998 grant of market-based rate authority, the Commission has found that the California electricity markets are "dysfunctional." *San Diego Gas & Electric Company, et al.*, 93 FERC ¶ 61,121 at 61,359. Does Williams really believe that the Commission will tolerate its complete and utter malfeasance? Surely the Commission will not.

B. The California Markets are Plagued With Market Power Abuse*.*

1. Empirical Evidence Confirms That the California Markets

Have Experienced the Prejudice of Market Power.

"Without empirical proof" that the market will constrain prices to levels that are "just and reasonable" (*Farmers Union*, 734 F.2d at 1510), and without "substantial evidence upon the basis of which the Commission could conclude that market forces will keep [Williams'] prices in reasonable check" (*Tejas Power Corp.*, 908 F.2d at 1005), the Commission may not, as a matter of law, permit the continuation of market-based rates. Not only is it apparent that Williams has utterly failed to meet its burden, the "empirical," "substantial evidence" submitted by the ISO (which bears no burden of proof or persuasion) leads to but one conclusion: Williams has flagrantly misused its market-base rate authority. Following the precise methodology specified by the Commission as appropriate for assessing the presence of market power – an analysis of "price-marginal cost margins" (25 FERC at 62,042) – the ISO's Department of Market Analysis has confirmed the rampant exercise of market power by Williams and others.

As Attachment B to its protest in this docket, the ISO submitted 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*. The analysis reaches a number of relevant, and distressing, conclusions.

First, using a "system price cost markup" methodology, which compares energy prices to the variable costs of the marginal unit called upon in each hour to meet demand,[7] 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,

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

moreover, that prices exceeded the competitive market benchmark in all hours, under a variety of system conditions (not just during System Emergencies). 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*.

Second, Dr. Hildebrandt examined wholesale prices in relation to the cost of investment in new supply. The results indicate that on an annualized basis, wholesale prices since January 2000 have exceeded the cost of new capacity by approximately 400 percent and would allow recovery of an investment in new supply in a period of less than two years. While the ISO recognizes and supports the Commission's goal of attracting new supply into California and the other Western states, current prices are well beyond the range of any reasonable incentive. Beyond a certain level, higher prices will not speed the introduction of additional supply, but will simply hurt consumers and the California economy needlessly -- and with national impacts.

As Attachment C to its protest, the ISO submitted an analysis prepared by Dr. Anjali Sheffrin, entitled *Empirical Evidence of Strategic Bidding in California ISO Real Time Market*, which presented the results of an analysis of the bidding behavior in the ISO's real time market of five large in-state non-IOU suppliers and 16 importers. Dr. Sheffrin examined two types of bidding strategies: (1) economic withholding, which is bidding substantially above a unit's marginal costs; and (2) physical withholding, which is not bidding or scheduling available resources in the market. The study found that withholding, especially economic withholding, plagued the market for most hours from May to November 2000,[8]

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[8] Of the 25,000 hourly bidding profiles studied, less than 2% displayed the absence of a clear pattern of withholding.

providing direct evidence that many large suppliers actively engaged in strategic bidding indicative of oligopoly pricing behavior, with a direct and substantial impact on market prices.

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 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. In the Report (appended as Attachment A), Dr. Hildebrandt confirms an earlier indication that "total potential revenues in excess of competitive levels exceed $6.7 billion." *Id*.

While the April 9, 2001 Report post-dated the Williams Compliance Filing, its conclusions parallel those reached in Dr. Hildebrandt's earlier study. Moreover, those studies aside, Williams did not even feel compelled to address the concerns about the exercise of market power discussed by the Commission in its November 1st and December 15th Orders. It bears remembering that in the former, the Commission found that the "electric market structure and market rules for wholesale sales of electric energy in California were seriously flawed and that these structures and rules, in conjunction with an imbalance of supply and demand in California have caused, and continue to have the potential to cause, unjust and unreasonable rates for short-term energy . . . under certain conditions."[9] In its December 15th Order, this finding was reaffirmed.[10]

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[9] 93 FERC at 61,349-50 (2000).

[10] *San Diego Gas & Electric Company, et al.*, 93 FERC ¶ 61,294 at 61,998.

On the record that must guide the Commission's response to the Williams filing, there can be no dispute that the "dysfunctional" California market has, and remains, plagued with the reality of market power abuse, a circumstance that does not permit simple reliance on market-based rates. Moreover, as we next show, the empirical evidence is that Williams itself has been guilty of gross market power abuse.

2. The Record Contains Ample Evidence that Williams Has Been Guilty of Gross Market Power Abuse.

As Attachment A to its protest in this proceeding, the ISO attached detailed analyses of the specific bidding behavior of Williams from May through November 2000 (the "Williams Analysis"). The analysis submitted as Attachment A to the protest reaches the following conclusions:

- Williams, among others, displayed bidding patterns that were consistent with the exercise of market power. The study concluded that Williams bid in excess of the marginal cost of generation through either economic or physical withholding and bid in expectation of increasing the market clearing price ("MCP"). (Williams Analysis at 1).

- Economic and physical withholding were the bidding strategies used by Williams to inflate prices, and these actions had a significant impact in raising MCPs. DMA estimates that Williams economically withheld during 72 percent of the hours in May through November 2000, and engaged in physical withholding in 28 percent of the hours.
- DMA found only 17 hours among the entire 5,137 hours during the period in which Williams did not withhold capacity either economically or physically, thereby exercising market power in nearly every hour from May through November 2000. (Williams Analysis at 2).

- As a result of its exercise of market power, Williams earned extraordinary amounts of excess profit (or monopoly rents) and imposed huge costs on electricity consumers in California. (Williams Analysis at 3).

- Williams clearly exercised significant market power in the California electricity markets from May through November 2000. Furthermore, nothing has changed since November 2000 to reduce the amount of market power held by Williams in the California electric markets. Indeed, additional analysis of Williams' bidding behavior over the following four months indicates an even greater exercise of market power. DMA estimates that during the period from December though March 2001, Williams' sales to the ISO real time market were approximately $116 million in excess of its costs. This analysis covers the period of December 8-31, 2000, when the ISO implemented a soft price cap of $250/MWh and the most recent period of January through March 26, 2001, when, pursuant to the Commission's December 15, 2000 Order, the ISO changed its soft cap to $150/MWh. (Williams Analysis at 7).[11]

The paucity of Williams' filing, in light of its market activities, truly is inexplicable. Does Williams really expect the Commission to turn a blind eye?

Finally, it is noteworthy that Williams recently entered into a settlement agreement resolving a show cause order directed at its alleged exercise of market power during April and May 2001, in violation of its market-based rate authorization. *AES Southland, Inc., Williams Energy Marketing & Trading Company*, 95 FERC ¶ 61,167 (2001). While the secrecy with 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 (*AES Southland, Inc., Williams Energy Marketing & Trading Co.*, 94 FERC ¶ 61,248 (2001)), are troubling and indicative of the need to approach the past activities of Williams (and its future activities if left unrestrained) with a healthy dose of skepticism. At a minimum, they underscore the importance of examining the propriety of the exercise by

[11] Because it contained data that may be confidential under the ISO Tariff, the Report itself was submitted on a confidential basis.

Williams of its market-based rate authority extending back well before May, 2000.

V. THE COMMISSION MUST EITHER TERMINATE WILLIAMS' MARKET-BASED RATE AUTHORITY, OR ACT NOW TO IMPOSE AN ADEQUATE PRICE MITIGATION PLAN, INCLUDING PREVENTION OF "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 measures adequate to address the "laundering" problem that the Commission has acknowledged to exist right now. If the Commission is not willing to take the necessary mitigation action now, it must revoke Williams' market-based rate authority

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* Declaration of Dr. Keith Casey, Attachment B). 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,[12] the Commission's own acknowledgment of the "laundering" issues shows that the mitigation now in place, and the mitigation foreseen in the Commission's April 26 Order, is not sufficient to justify Williams' continued authority for market-based rates.

This is not a situation where mitigation can be deferred with comfort drawn from the retention of refund authority. In the section that follows, we discuss the refunds required as a result of the flagrant past violation by Williams of its market-based rate authority. Here we are concerned with whether, on a going-forward basis, refunds can excuse the failure of adequate mitigation. They cannot.

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

[12] 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 requires that "laundering" be dealt with.

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;[13] or the diversion of funds from other essential public purposes;[14] or the unprecedented rate increases that have been necessitated;[15] or the bankruptcy of one utility and the financial frailty of another, pushing it, too, to the precipice.[16]

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

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[13] *See, e.g.*, Attachment C, L. Weston and M. Bustillo, "State's Bond Rating Downgraded to A+," Los Angeles Times, April 25, 2001.

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

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

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: the Commission must either revoke Williams' market-based rate authority, or condition it on the implementation of a comprehensive price mitigation plan that includes, among other necessary components, measures that effectively address "megawatt laundering."

VI. THE COMMISSION MUST DIRECT THE REFUND OF ALL REVENUES THAT WERE THE PRODUCT OF MONOPOLY POWER

While it is imperative that the Commission act now to stem the continued accumulation of unlawfully-gotten gains, it is no less important that it aggressively mandate the disgorgement of all monopoly rents – extending over the entire period tainted by the exercise of monopoly power. The required relief is clear: the Commission must establish cost-based rates for the entire period during which Williams possessed market power, and direct refunds, with interest, of all charges in excess of cost-based levels. This direction must cover all transactions in which Williams exercised its market-based rate authority.

Finally, it would be highly inappropriate to limit Williams' refund obligation to an October cut-off date. While the Commission established an October 7,

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

2000 effective date in the November 1st Order, it did not rule that it lacked authority to order refunds before that date, 95 FERC at 61,982. To the contrary, in the case of market-based rates, there is no retroactivity bar; rather, the Commission is obliged to extend the reach of refunds back to the last "clean" rate – that is, back to the point in time when the Commission can conclude with confidence that the potential for the exercise of market power did not exist.

The prohibition against retroactive rate adjustments does not apply to refunds of charges under market-based rates for the same reason that it does not apply to refunds of charges made and to revenues collected under a formula rate. Like market-based rates, formula rates permit the fluctuation of charges and revenues without prior Commission review. In such instances, retroactivity is not implicated, because the Commission is not changing a rate but simply assuring that it provides the correct revenues, the result always intended and always contemplated.[17]

In all significant respects, a grant of market-based rate authority is indistinguishable from a traditional formula rate. Although market-based rates do not set charges according to a formula, charges under market-based rates are, like charges under formula rates, affected by factors and circumstances that

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17 *See also Connecticut Yankee Atomic Power Co.*, 40 FERC ¶ 63,009 (1987); *Alamito Company*, 41 FERC ¶ 61,312 (1987), at 61,829 n.6 ("Of course, to the extent that the Commission may determine that Alamito has improperly billed under its formula rate, the Commission can always direct refunds with interest, since, in such an event, the company would have violated the terms of its filed rate. . ."); *Louisiana Public Service Comm'n. v. Entergy Services, Inc.*, 67 FERC ¶ 61,338 (1994) at 62,197 ("It is well established that the Commission has the discretion to order retroactive refunds whenever it determines that amounts have been improperly passed through a formula rate.") *Cf. Alabama Power Co. v. FERC*, 993 F.2d 1557 (D.C. Cir. 1993) ("When the Commission accepts a formula rate as a filed rate, it grants waiver of the filing and notice requirements of section 205 of the Federal Power Act . . . [The utility's]

are not included in the rate itself. In the case of market-based rates, the determinative factor is the competitive market price. Recipients of the privilege of market-based rates have the freedom to "adjust" their allowed charges and revenues and thereby to reap the benefits of a workably competitive market. They can do so without any filing requirement or the imposition of any lag. Further, similar to formula rates, the amount recovered under market-based rates is not necessarily tied to the costs actually incurred. For example, in a workably competitive market that operates under a single market clearing price payment scheme, while each participant is expected to bid its own marginal costs, it reaps the full benefit of its efficiencies. If, however, the price charged does not reflect the price that a seller would receive in an appropriately competitive market situation, the charge is not consistent with the authorized market-based rate. It is not a violation of the filed rate doctrine or retroactive ratemaking doctrines for the Commission to order refunds of those amounts collected in excess of the amounts that would have been charged under competitive market conditions, because the seller's collection of such excess amounts is inconsistent with the market-based rate itself.

The underlying premise that justifies the privilege of market-based rates is availability of a workably competitive market that will determine the price charged. *See New York Independent System Operator Corp., et al.*, 88 FERC ¶ 61,228 (1999) (granting the New York ISO authority to enact Temporary

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rates, then can change repeatedly, without notice to the Commission provided those changes are consistent with the formula.").

Extraordinary Procedures, including the adjustment of clearing prices in order to correct outcomes differing from those that would occur under workably competitive market conditions); *New England Power Pool, et al.*, 87 FERC ¶ 61,055 (1999) (granting similar authority to the New England ISO).

Because revenue collections occur under formula rates without the necessity of the rigorous filing typically required under FPA § 205, the Commission has an especially heavy obligation to police, for example pursuant to FPA § 309, rigid adherence to the formula. The Commission already has recognized as much, and has recognized as well the absence of a retroactivity bar, in the *Williams* Show Cause Order (94 FERC at 61,877):

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

Williams, too, acknowledged in its Compliance Filing that the sales it makes pursuant to its market-based rate authority "remain subject to Commission review." Compliance Filing at 5. While continuing exposure to refunds is insufficient to ensure that market power is not exercised (for the reasons discussed above), it is a minimum necessary condition.

The relief required here is straightforward: the Commission is obliged to place Williams – and California's consumers – precisely where they each would have been had market power not been exercised. We know, from the analyses undertaken by DMA, that the "formula" broke down at least as early as May

2000. We know that at least beginning then, Williams began reaping monopoly rents in direct contravention of the essential predicate of its formula -- that it would collect no more than the revenues associated with a market that is workably competitive and free of market power abuse. Accordingly, as of that date (and possibly earlier), all ill-gotten gains must be disgorged.

In a different circumstance, there might be a debate as to what revenues the "formula" should have produced had the market been workably competitive. But that is not a pertinent debate. Due to the dysfunctional nature of California's electricity markets throughout that period, there is no way of reconstructing "what should have been." There is, in short, no occasion for the exercise of discretion. What is mandated instead is that the Commission calculate, on a resource-specific basis, the just and reasonable cost-based rates to which Williams would have been entitled were it operating under a fully regulated paradigm, from May 2000, until the revocation of market-based rates or implementation of an adequate prior mitigation regime if market-based rates are to continue.

There is one additional requirement. We cannot be sanguine that Williams did not exercise market power prior to May 2000. Indeed, in view of the Show Cause Order, we must at least be concerned that it did. Accordingly, the Commission must examine as well the pre-May, 2000 activities of Williams and direct the refund of any market power gains.

VII. CONCLUSION

For the foregoing reasons, the ISO requests that the Commission:

- by no later than June 15th, terminate the authority of Williams to sell either Energy or Ancillary Services at market-based rates from units located in California as to which it has the entitlement to outputs, and require Williams to file cost-based rates going forward together with the underlying cost support, unless by such date the Commission has imposed an adequate region-wide price mitigation plan that, among other things, precludes the prejudicial consequences of “megawatt laundering”;

- require the immediate submission by Williams of rates based on actual costs for sales of Energy and Ancillary Services from such units from May 2000 to the present, together with the underlying cost support;

- schedule an expedited hearing to determine the appropriate cost-based rates for each month from May 2000 to the present if, following the submission of cost support, issues remain as to the propriety of the filed cost-based rates;

- direct that Williams refund all charges collected from May 2000 to the date on which its market-based rate authority is terminated or the Commission has in place an adequate price mitigation plan including preclusion of “megawatt laundering,” that are in excess of the rates justified by its cost-based filing and, if a hearing is held on those rates, direct that any additional amounts adjudged in excess of appropriate cost-based rates be refunded at the conclusion of that proceeding, all refunds to be with interest as provided in 18 CFR 35.19a; and

- schedule an expedited hearing to determine whether Williams exercised market power or in any respect violated its privilege to enjoy market-based rate authority prior to May, 2000, and, if there is an affirmative finding, order refunds with interest.

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 No. ER99-1722-004 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, 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: ***Williams Marketing & Trading Company***
Docket No. ER99-1722-004

Dear Secretary Boergers:

Enclosed please find an original and fourteen copies of the Emergency Motion of the California Independent System Operator Corporation for Immediate Suspension of Market-Based Rate Authority, for the Institution of Refund Proceedings, and Request for Shortened Time to Answer in the above-captioned matter. The ISO requests that the Commission shorten the time to answer this Motion to no more than 7 days.

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
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Counsel for the California Independent System Operator Corporation