

**UNITED STATES OF AMERICA  
BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION**

**Duke Energy Morro Bay, LLC )      Docket No. ER98-2681-000**

**EMERGENCY MOTION OF THE CALIFORNIA INDEPENDENT  
SYSTEM OPERATOR CORPORATION FOR TERMINATION  
OF MARKET-BASED RATE AUTHORITY, TO INSTITUTE  
FURTHER PROCEEDINGS, AND MOTION TO CONSOLIDATE**

By this filing, and companion filings in Docket Nos. ER98-2680, ER98-2682, ER99-1785, and ER99-2774, and 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: (1) to terminate its grant of market-based rate authority to Duke Energy Moss Landing, LLC; Duke Energy Morro Bay, LLC; Duke Energy Oakland, LLC; Duke Energy South Bay, LLC; and Duke Energy Trading and Marketing, LLC (collectively "Duke") for the sale of Energy and Ancillary Services<sup>1</sup> 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 Duke's resources and the

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<sup>1</sup> Capitalized terms, not otherwise defined, are used with the meanings given in the Master Definitions Supplement, Appendix A to the ISO Tariff.

market revenues actually received; and (3) to institute a proceeding to determine whether, prior to May 1, 2000, Duke exercised market power and, if answered in the affirmative, to order additional refunds with appropriate interest. Further, the ISO moves that the Commission consolidate Docket Nos. ER98-2680, ER98-2681, ER98-2682, ER99-1785, and ER99-2774.

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 Duke's 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 28, 2001.<sup>2</sup>

## **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 to conclude with confidence that the potential for the exercise of market power either does not exist or has adequately been mitigated.

In granting Generators and power marketers market-based rate authority, the Commission has recognized 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

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<sup>2</sup> This motion and such attachments as are available electronically are being served

efficiency as expected or *if [the company] gains market power.*” *Public Service of Indiana, Inc.*, 51 FERC ¶ 61,367 at 62,226 (emphasis added) (1990). The Commission has before it unequivocal evidence that Duke has exercised market power in California, and that the overall efficiency of the California electricity market has not improved. The Commission must fulfill its promise to take the action mandated by the evidence without hesitation. To do otherwise would be to fail to fulfill the Commission’s primary responsibility – to protect consumers.

Undoubtedly Duke will argue, and the Commission itself may be preliminarily inclined to conclude, that the proposal announced by the Commission on April 26<sup>th</sup><sup>3</sup> provides adequate price mitigation going-forward. That is not correct. The adequacy of that mitigation plan is very much the subject of ongoing challenge,<sup>4</sup> 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, including Duke. The ISO has submitted compelling evidence that the exercise of

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electronically on counsel for Duke.

<sup>3</sup> *San Diego Gas & Electric Company, et al., v. Sellers of Energy and Ancillary Services into the Markets Operated by the California Independent System Operator and the California Power Exchange, et al.*, 95 FERC ¶ 61,115 (2001) (“April 26<sup>th</sup> Order”).

<sup>4</sup> Indeed, as discussed below, ten of the nation’s most prominent economists have recently written the President and Congress expressing their opinion that the Commission’s mitigation will be ineffective. See Attachment A, Letter of Roger Bohn, *et al.*, to The Honorable

market power is more pervasive than the Commission has acknowledged, and has demonstrated both that the Commission must impose a mitigation plan that is effective in all hours and in all markets and that the measures prescribed in the April 26<sup>th</sup> Order fail on their face to satisfy this requirement. 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 that monopoly power is being exercised and unjust and unreasonable wholesale charges imposed, and having recognized the significance of "megawatt laundering," the Commission may not sanction a continuation of market-based

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George W. Bush, *et al.*, dated May 25, 2001.

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 be ineffective. Thus, unless the Commission immediately adopts a fully protective mitigation plan that includes an interim measure to prevent “megawatt laundering,” the Commission must revoke the authority of Duke to sell at market-based rates.

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. COMMUNICATIONS**

Please address communications concerning this filing to the following persons:

Charles F. Robinson  
Vice President and General Counsel  
Roger E. Smith, Senior Regulatory Counsel  
The California Independent System  
Operator Corporation  
151 Blue Ravine Road  
Folsom, CA 95630  
Tel: 916-351-4400

Fax: 916-351-2350

Edward Berlin  
J. Phillip Jordan  
Michael E. Ward  
Julia Moore  
Swidler Berlin Shereff Friedman, LLP  
3000 K St., NW, Suite 300  
Washington, DC 20007  
Tel: 202-424-7588  
Fax: 202-424-7645

### **III. EMERGENCY MOTION**

#### **A. Summary**

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 before the Commission in other dockets (and attached to this filing)<sup>5</sup> that Duke has profited systematically from the exercise of market power to the significant harm of California's electric consumers and economy, and that such unlawful exercise of market power began at least as early as May, 2000 and possibly before, the ISO submits that the Commission must –

- terminate the authority of Duke 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 Duke 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;

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<sup>5</sup> In order to avoid unnecessary duplication, and in light of the ISO's Motion to Consolidate, the ISO is filing the attachments in Docket No.ER98-2680. If the Commission denies the Motion to Consolidate, the ISO requests that the Commission incorporate the attachments by reference in this and each of the Duke dockets for which the attachments are not being provided.

- require the submission by Duke 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 Duke's submission of cost support, issues remain as to the propriety of the filed cost-based rates;
- direct that Duke 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 Duke 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 of the actions described above may be amenable to immediate resolution. One critical element, however -- the termination of market-based rate authority -- is properly the subject of quick action and we most respectfully request that the Commission take that action unless the Commission immediately acts to address price mitigation comprehensively and on a regional basis. Because of the uncontroverted evidence that Duke 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 28<sup>th</sup> on its request that the Commission terminate Duke's 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 Duke. 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.

It is neither proper nor permissible, however, for the Commission to postpone action until the next three-year update is presented, in view of the mounting evidence of market power abuse *and the Commission's own findings to that effect*. The Commission has before it in other dockets voluminous evidence,



which is being provided in connection with this filing,<sup>6</sup> substantiating the blatant exercise of market power by Duke, the exaction by Duke of unjust and unreasonable prices, and the extreme prejudice to the public interest occasioned by that abusive conduct. Moreover, the Commission itself has found that California's electricity markets are "dysfunctional" and that market power has been exercised. Presented with such evidence, and in light of such findings, 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 now is necessary to prevent the confiscation by Duke of consumer welfare (assuming the failure immediately to make effective an adequate mitigation plan, including measures to prevent "megawatt laundering"), Duke 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 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

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<sup>6</sup> See note 2, *supra*.

and decisively the Commission responds to pressing evidence of extreme 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.

Indeed, ten of the nation's most prominent economists<sup>7</sup> have recently expressed this precise concern. In a letter to the President and Congress, which is included as Attachment A, these economists explained the lack of a competitive market in California, their findings that the Commission's mitigation plan will be ineffective and unable to control prices, and their belief that the Commission must take further action, such as the institution of cost-based rates, if it is to fulfill its responsibilities under the Federal Power Act. They concluded:

Designing a well-performing competitive electricity market is an extremely complex evolutionary process. The public must have confidence that the federal government will work cooperatively with the states to establish appropriate restructuring, market-design, and market-monitoring programs so that when market-performance problems emerge FERC will act quickly and effectively to mitigate them. The Federal Power Act gives FERC both the responsibility and the tools to act when wholesale markets produce unjust and reasonable rates for sustained periods of time. *FERC's failure to act now will have consequences for the State of California and will setback, potentially fatally, the diffusion of competitive electricity markets across the country.*

(Emphasis added.)

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<sup>7</sup> Roger Bohn, Severin Borenstein, James Bushnell, Peter Cramton, Alfred Kahn, Paul Joskow, Alvin K. Klevorick, Robert Porter, Carl Shapiro, and Frank Wolak.

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 28<sup>th</sup>, the Commission terminate the authority of Duke 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 to preclude the out-of-state "laundering" or 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.

## **B. Background**

On February 11, 1998, three subsidiaries of Reliant (Alta Power Generation (now Reliant Energy Coolwater) Ocean Vista Generation (now Reliant Energy Mandalay), Oeste Power Generation (now Reliant Energy Ellwood), and Mountain Vista Power Generation (now Reliant Energy Etiwanda)) submitted market-based rate applications for Energy sales from Generating Units at the three plants. On February 11, 1998, the Commission granted the market-based rate authority with respect to these Units. *Ocean Vista Power*

*Generation, L.L.C., et al.*, 82 FERC ¶ 61,114 (1998). Similar applications for market-based rate authority were filed by AES Huntington Beach, L.L.C., AES Redondo Beach, L.L.C., and AES Alamitos, L.L.C., (together, “AES”) on March 13, 1998;<sup>8</sup> El Segundo Power, L.L.C., on December 23, 1997;<sup>9</sup> Long Beach Generation, L.L.C., on February 9, 1998;<sup>10</sup> Ormond Beach Power Generation, L.L.C., (now Reliant Energy Ormond Beach), on May 1, 1998;<sup>11</sup> Duke Energy Moss Landing, L.L.C., Duke Energy Morro Bay, L.L.C., and Duke Energy Oakland, L.L.C., on April 24, 1998;<sup>12</sup> Cabrillo Power I, L.L.C., and Cabrillo Power II, L.L.C., on December 31, 1998;<sup>13</sup> Duke Energy South Bay, L.L.C., on February 10, 1999;<sup>14</sup> and Southern Energy Delta, Southern Energy Potrero, and Southern Energy California (now Mirant Delta, Potrero, and California, respectively) on February 17, 1999.<sup>15</sup> Certain energy marketers previously had been granted market-based rate authority.<sup>16</sup>

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<sup>8</sup> These applications were approved by the Commission on April 30, 1998. *AES Huntington Beach, et al.*, 83 FERC ¶ 61,100 (1998).

<sup>9</sup> This application was approved by the Commission on February 12, 1998. *El Segundo Power, LLC*, 82 FERC ¶ 61,126 (1998).

<sup>10</sup> This application was approved by the Commission, with regard to energy sales, on March 26, 1998. *Long Beach Generation, LLC*, 82 FERC ¶ 61,295 (1998).

<sup>11</sup> This application was approved by the Commission on June 24, 1998. *Ormond Beach Power Generation, LLC*, 83 FERC ¶ 61,306 (1998).

<sup>12</sup> These applications were approved by the Commission on June 25, 1998. *Duke Energy Moss Landing, LLC, et al.*, 83 FERC ¶ 61,317 (1998).

<sup>13</sup> These applications were approved by the Commission on February 24, 1999. *Cabrillo Power I, LLC, et al.*, 86 FERC ¶ 61,180 (1999).

<sup>14</sup> This application was approved by the Commission on March 31, 1999. *Rockingham Power, LLC, et al.* 86 FERC ¶ 61,337 (1999).

<sup>15</sup> These applications were approved by the Commission by Letter Order on March 31, 1999.

<sup>16</sup> These marketers included NP Energy, LLC (now Duke Energy Trading and Marketing, LLC), whose application was approved on October 2, 1996; Electric Clearinghouse, Inc. (now Dynegy Power Marketing, Inc.), whose application was approved on April 7, 1994; Destec Power Services, Inc. (now Dynegy Power Services, Inc.), whose application was approved on January 20, 1995; and NorAm Energy Services, Inc. (now Reliant Energy Services, Inc.) whose application was approved on July 25, 1994.

In May 1998, AES sought market-based rate authority for the sale of Ancillary Services from its Units. The ISO argued to the Commission that the Commission's traditional analysis of market-power was inadequate in light of the hourly nature of the ISO's markets, and that a time-differentiated analysis was required. Rather than recommending rejection of 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 re-examination was necessary.<sup>17</sup>

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. In response to this emergency, and the ISO's request, the Commission authorized the ISO to impose price caps on Ancillary Services.<sup>18</sup> The Commission explained that although it ultimately sought to eliminate reliance on price caps, some mechanism was necessary to constrain prices until market design flaws were corrected.<sup>19</sup> Relying on similar reasoning,

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<sup>17</sup> *AES Redondo Beach, L.L.C., et al.*, 83 FERC ¶ 61,358 (1998). 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).

<sup>18</sup> *AES Redondo Beach, LLC, et al.*, 84 FERC ¶ 61,046 (1998).

<sup>19</sup> *AES Redondo Beach, et al.*, 85 FERC ¶ 61,123 (1998)

the Commission, in an order dated January 27, 1999, granted approval to the ISO to adopt a purchase price cap in its Imbalance Energy market.<sup>20</sup>

In its November 1, 2000 Order Proposing Remedies for California Wholesale Electric Markets,<sup>21</sup> the Commission – although it found that the California markets were dysfunctional – terminated the ISO’s price cap authority. Instead, the Commission proposed a \$150 “soft” cap, which would permit bids over \$150 to clear, but would allow only bids of that amount or lower to set the market clearing price. This “soft cap” proposal was confirmed by the Commission in an order issued on December 15, 2000.<sup>22</sup>

Recently, in the April 26 Order, the Commission adopted a new price mitigation scheme to replace the \$150 “soft” cap. Under the new methodology, which the Commission set to take effect on May 29, 2001, price mitigation is available only in the ISO’s real time markets during periods of reserve deficiency, defined as emergency situations beginning at stage 1 (when reserves are 7.5 percent or less). Under these conditions, the market clearing price will be set at a proxy price, reflecting the highest marginal cost of all of the units dispatched, as calculated by the ISO. Generators can also submit bids greater than this proxy price, and if accepted, will be paid as bid, subject to justification and refund. On May 25, 2001, the Commission issued an order

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<sup>20</sup> *California Independent System Operator Corp.*, 86 FERC ¶ 61,059 (1999).

<sup>21</sup> *San Diego Gas & Electric Co. v. Sellers of Energy and Ancillary Services into Markets Operated by the California Independent System Operator and the California Power Exchange*, 93 FERC ¶ 61,121 (2000) (“November 1<sup>st</sup> Order”).

<sup>22</sup> *San Diego Gas & Electric Co. v. Sellers of Energy and Ancillary Services into Markets Operated by the California Independent System Operator and the California Power Exchange*, 93 FERC ¶ 61,294 (2000) (“December 15 Order”).

clarifying that similarly limited mitigation measures would apply in the ISO's markets for Ancillary Services.<sup>23</sup>

**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).<sup>24</sup> 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

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<sup>23</sup> *San Diego Gas & Electric Co. v. Sellers of Energy and Ancillary Services into Markets Operated by the California Independent System Operator and the California Power Exchange*, 95 FERC ¶ 61,275 (2001).

<sup>24</sup> 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.

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. 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”).<sup>25</sup> 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:

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.

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.

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<sup>25</sup> 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.

734 F.2d at 1493 (citations omitted).<sup>26</sup>

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.

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<sup>26</sup> In its brief to the Court of Appeals in *Farmers Union*, Williams Pipeline Company 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.

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 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 Duke’s 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 Duke, imposed on the seller the obligation to reestablish its eligibility for that authority no less often than every three years.

**D. Uncontroverted Evidence Requires the Conclusion That Duke Has Exercised Market Power in the California Markets**

**1. Recent Events Have Demonstrated the Invalidity of the Commission’s Initial Determination that Duke Lacks the Ability to Exercise Market Power**

The Commission traditionally has analyzed Generation market power by evaluating the 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 Duke discussed above. Events since that time forcefully demonstrate the need for the Commission to recognize that such analysis is inherently flawed in the context of the California market, and the Commission can no longer rely upon any

conclusions based on that analysis.<sup>27</sup>

A predictor of market power, such as the Commission's traditional market power analysis, is only as good as the accuracy of its predictions. The evidence that has been presented to the Commission, and is discussed in the following section, demonstrates 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 even a remotely effective gauge of a Generators' ability to exercise market power in California markets. As Commissioner Massey recently observed:

First, the hub-and-spoke method is an anachronism. This method focuses solely on the market share of the individual seller instead of conditions in the market. It assumes that all sellers that are directly interconnected with the customer, and all sellers directed interconnected with the applicant for market-based rates, can reach the market, and market shares are evaluated on that basis. As a result, little or no account is taken of the important factors that determine the true scope of electricity markets, such as physical limitations on market size including transmission constraints, prices, costs, transmission rates, and the variance of supply and demand over time. Virtually no seller ever fails this screen.

And second, the 20% market share threshold is too simplistic.

*Exelon Generation Company, LLC, et al.*, 95 FERC ¶ 61,309 (2001)

(Commission Massey dissenting, slip op. at 2).

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<sup>27</sup> One significant intervening event is the termination of the ISO's price cap authority. In previous orders, 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 Services, the Commission pointed to the ISO price cap authority. *Williams Energy Services Company*, 84 FERC ¶ 61,072 (1998). The Commission, however, has refused to extend that authority. See,

Reliance on a "generation dominance" standard that does not assess the underlying competitiveness of properly defined electricity markets, simply fails to detect significant opportunities for the exercise of 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 much less than 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, under the definition of market power, must be whether a Generator is able to increase prices significantly over a substantial period of time. Generators in California have done so, and only one conclusion is possible: under current market conditions in California, a Generator's share of total uncommitted capacity is not determinative of that issue. More significant, although not conclusive, 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 (of which 20,000 MW are uncommitted), and the ISO's total requirements are 38,000 MW, a Generator controlling 3,000 MW can set the Market Clearing Price, even if that 3,000 MW represents only 15 percent of uncommitted capacity. A Generator with even less capacity can determine prices by physically withholding a portion of the capacity or, more

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*e.g.*, November 1<sup>st</sup> Order. That fact, in itself, is sufficient to justify revisiting the issue of a need

subtly, by bidding a portion of the capacity at prices well above the clearing price.<sup>28</sup>

It should not be necessary, however, to have a debate about the appropriate “screening” mechanism. Those tools might be proper in the absence of evidence of actual market performance. In that circumstance, academic exercises may represent the only available measures of market power. That is not the case here. With regard to California, we have empirical evidence, and it demonstrates, unassailably, that Duke has exercised market power.

## **2. Empirical Evidence Confirms that the California Markets Have Experienced the Prejudice of the Exercise of Market Power by Generators, Including Duke**

“Without empirical proof” that the market will constrain rates 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 [the company’s] prices in reasonable check” (*Tejas Power Corp.*, 908 F.2d at 1005), the Commission may not, as a matter of law, permit the continuation by Duke of market-based rates.

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for time-differentiated studies.

<sup>28</sup> Suppose that Generator A has only 1500 MW, with a variable cost of \$100/MW. If it bids it all at \$104/MW, and the marginal unit has a bid of \$105/MW, Generator A makes 1500 x \$5, or \$7,500. If it bids it all in at \$107/MW, it might not make anything. Suppose, instead, that Generator A bids 1400 MW at \$104/MW and 100 MW at \$107 (economic withholding). Because Generator A’s output is not available, a different unit will be the marginal unit, at perhaps \$106, and Generator A will have determined the Market Clearing Price. Generator A will get 1400 x \$6 or \$8,400 – over 10% more than it would have had it not withheld.



Evidence previously submitted to the Commission has shown that Generators that have been granted market-based rate authority under the Commission's standards, including Duke, persistently have exercised market power, both before and since the termination of the ISO's price cap authority and the December 15 Order authorizing and directing the investor-owned utilities to devote their resources to native Load.<sup>29</sup> The ISO is including that evidence with this Motion. Following the precise methodology specified by the Commission as appropriate for assessing the presence of market power – an analysis of “price-marginal cost margins” (*Public Service Company of New Mexico*, 25 FERC at 62,042) – the ISO's Department of Market Analysis has confirmed the rampant exercise of market power by Duke and others.

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 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,<sup>30</sup> Dr. Hildebrandt demonstrated that 30 percent of the

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<sup>29</sup> The Commission already implicitly has 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 finding.

<sup>30</sup> 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

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 also was 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 from May to November 2000.<sup>31</sup> 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.

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credits, and even appropriate scarcity rents.

<sup>31</sup> Of the 25,000 hourly bidding profiles studied, less than 2 percent displayed the absence of

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. In Dr. Sheffrin's study, Duke is identified as Generator [redacted]. According to Dr. Sheffrin's analysis, Duke earned approximately [redacted] in monopoly rents between May and November 2000 as a result of the exercise of market power in California.<sup>32</sup>

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. These results represent substantial evidence that Duke and other suppliers successfully inflated market prices in the 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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a clear pattern of withholding.

<sup>32</sup> Because some of the information included in Dr. Sheffrin's report may involve sensitive market information, the ISO requests that the Commission treat the identification of the specific Generators as confidential. The ISO is therefore redacting this information in all copies except one, which the ISO is filing under seal. The ISO also will provide this information to Duke.

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.*

**E. The Commission Must Either Terminate Duke’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 its 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 region-wide 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 Duke’s 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,<sup>33</sup> 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 Duke’s continued authority for market-based rates.

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

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<sup>33</sup> The ISO has pressed its concerns about the Commission’s plan in its Petition for Rehearing of the April 26<sup>th</sup> Order, and will not further detail the deficiencies of the Commission’s mitigation plan here. Even the Commission, however, has recognized that effective mitigation

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;<sup>34</sup> or the diversion of funds from other essential public purposes;<sup>35</sup> or the unprecedented rate increases that have been necessitated;<sup>36</sup> or the bankruptcy of one utility and the financial frailty of another, pushing it, too, to the precipice.<sup>37</sup>

Third, because portions of Duke's sales would continue to be made into ISO markets in which prices are determined through a single-price auction, continuing to allow Duke to submit bids that are disciplined neither by competitive market conditions nor cost-based regulation will have consequences that extend far beyond allowing Duke 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 Duke is later required to disgorge the excessive revenues that it earned.<sup>38</sup>

Refunds can never reverse these wrongs. Nor can refunds restore the

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requires that "laundering" be dealt with.

<sup>34</sup> See, e.g., Attachment F, L. Weston and M. Bustillo, "State's Bond Rating Downgraded to A+", *Los Angeles Times*, April 26, 2001.

<sup>35</sup> See, e.g., Attachment G, M. Bustillo and D. Vrana, "A One-Two Punch at the Budget", *Los Angeles Times*, May 16, 2001.

<sup>36</sup> See, e.g., Attachment H, T. Reiterman and N. Brooks, "\$5.7-Billion Energy Rate Hike is Old", *Los Angeles Times*, May 16, 2001.

<sup>37</sup> 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.

<sup>38</sup> If Duke, through the exercise of market power, sets the market clearing price – as it surely could do at least during unmitigated hours – all sellers into the market at that time will have been overpaid, presenting an impossible settlement dilemma and making refunds illusory.

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 legally is required to terminate Duke's market-based rate authority.

#### **IV. 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 Duke 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 Duke exercised its market-based rate authority.

Finally, it would be highly inappropriate to limit Duke's refund obligation to an October cut-off date. While the Commission established an October 2, 2000 effective date in the November 1 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.<sup>39</sup>

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 an algebraic formula, charges under market-based rates are, like charges under formula rates, affected by factors and

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<sup>39</sup> 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] rates, then can change repeatedly, without notice to the Commission provided those changes are consistent with the formula.”).



circumstances that 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 neither a violation of the filed rate doctrine nor of the rule against retroactive ratemaking 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 the 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 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 a recent Show Cause Order. *AES Southland, Inc., Williams Energy Marketing & Trading Company*, 94 FERC ¶ 61,248 at 61,877 (2001):

. . . 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.

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 Duke – 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 of 2000. We know that at least beginning then, Duke 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 Duke 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 price mitigation regime if market-based rates are to continue.

There is one additional requirement. We cannot be sanguine that Duke did not exercise market power prior to May 2000. Accordingly, the Commission must examine the pre-May, 2000 activities of Duke and direct the refund of any market power gains.

## **V. MOTION TO CONSOLIDATE**

The ISO moves that the Commission consolidate Docket Nos. ER98-2680, ER98-2681, ER98-2682, ER99-1785, and ER99-2774. These dockets concern the market-based rate authority of affiliated companies, each of which participates in California markets. In such situations, the Commission evaluates

the market power of the combined companies. *See, e.g., AES Huntington Beach, et al.*, 83 FERC ¶ 61,100 (1998). As a result, the facts, issues, and legal arguments in these dockets are identical. Accordingly, consolidation is appropriate.

## **VI. CONCLUSION**

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

- by no later than June 28<sup>th</sup>, terminate the authority of Duke 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, 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 Duke 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 Duke 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 § 35.14a; and

- schedule an expedited hearing to determine whether Duke 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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Charles F. Robinson  
Vice President and General Counsel  
Roger E. Smith, Regulatory Counsel  
The California Independent  
System Operator Corporation  
151 Blue Ravine Road  
Folsom, CA 95630  
Tel: 916-351-4400  
Fax: 916-351-2350

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Edward Berlin  
J. Phillip Jordan  
Michael E. Ward  
Julia Moore  
Swidler Berlin Shereff Friedman, LLP  
3000 K St., NW Suite 300  
Washington, D.C. 20007  
Tel: 202-424-7588  
Fax: 202-424-7645

Date: June 7, 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 7<sup>th</sup> day of June, 2001.

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Julia Moore  
(202) 295-8357

June 7, 2001

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

**Re: Duke Energy Morro Bay, LLC  
Docket No. ER98-2681-000**

**Includes Request for Confidential Treatment**

Dear Secretary Boergers:

Enclosed please find an original and fourteen copies of the Emergency Motion of the California Independent System Operator Corporation ("ISO") For Termination of Market-Based Rate Authority, Motion to Institute Further Proceedings, and Motion to Consolidate in the above-captioned matter. The ISO is requesting expedited treatment of this Motion, and an expedited response on the part of Duke Energy Morro Bay, LLC ("Duke"). The ISO has apprised Duke that this Motion has been filed today, and has provided Duke with an electronic copy of this filing.

Pursuant to 18 C.F.R. § 388.112, the ISO requests confidential treatment of information contained on page 27 of this filing, which allows the reader to identify which data contained in Attachment C, a report by Dr. Anjali Sheffrin, pertains to Duke. Consistent with this request, the ISO will not disclose the confidential information to other parties. The ISO reserves the right, in the future, to request that this information no longer be treated as confidential. The original of the ISO's Motion, including page 27, 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.

The Honorable David P. Boergers  
June 7, 2001  
Page 2

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