UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Calpine Corporation, Citigroup Energy Inc., Dynegy Power Marketing, Inc., J.P. Morgan Ventures Energy Corporation, BE CA, LLC, Mirant Energy Trading, LLC, NRG Energy, Inc., Powerex Corporation, and RRI Energy, Inc., Complainants,	)	
v.	)	**Docket No. EL09-62-000**
California Independent System Operator Corporation, Respondent.	)	

ANSWER OF THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION TO COMPLAINT

Pursuant to Rules 206(f) and 213 of the Commission's Rules of Practice and Procedure[1] and the Notice of Complaint issued in this proceeding on July 2, 2009, the California Independent System Operator Corporation ("ISO") hereby submits its answer ("Answer") to the complaint ("Complaint") filed in this proceeding by the above-listed entities (collectively, "California Sellers").[2] For the reasons explained below, the Commission should deny the Complaint. Alternatively, the Commission should establish settlement procedures in this proceeding as the issues presented involve allocating risk to Market Participants in the event of a payment default of an ISO invoice. Issues such as this, which

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[1] 18 C.F.R. §§ 385.206(f), 385.213.

[2] The ISO is also sometimes referred to as the CAISO. Capitalized terms not otherwise defined herein have the meanings set forth in the Master Definitions Supplement, Appendix A to the CAISO Tariff.

concern fairness and balancing of equities, are better suited to negotiated resolution in a settlement context rather than a litigated result.

I. Introduction and Summary

Ever since the ISO began operations, its tariff has included provisions providing that the ISO will allocate financial losses associated with defaults in its markets ("default losses") to net CAISO Creditors only. The Commission has found this ISO "default loss rule" to be just and reasonable, most recently fewer than three years ago in anticipation of the market design under which the ISO currently operates. The California Sellers propose in their Complaint to replace the ISO tariff provisions with a proposed alternative default loss rule, under which default losses would be allocated based on the "absolute value" of all charges and payments made by or to CAISO Creditors and CAISO Debtors for all ISO products and services.

The Commission should deny the California Sellers' Complaint. As discussed in detail below, there is no legal or factual basis to justify implementation of the California Sellers' proposal. The ISO acknowledges that it is the only Commission-jurisdictional Independent System Operator ("ISO") or Regional Transmission Organization ("RTO") that allocates default losses only to net creditors and recognizes that this rule has become a subject of some stakeholder contention.[3] Therefore, the ISO is not opposed to examining

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[3] Besides the ISO, the other ISOs and RTOs are: ISO New England Inc. ("ISO New England"); the New York Independent System Operator, Inc. ("New York ISO"); PJM Interconnection, L.L.C. ("PJM"); the Midwest Independent Transmission System Operator, Inc. ("Midwest ISO"); Southwest Power Pool ("SPP"); and the Electric Reliability Council of Texas ("ERCOT"). *See also infra* note 17.

whether the rule should be revised. However, the California Sellers have failed to meet either element of their burden of proof under Section 206 of the Federal Power Act ("FPA"), whereby a complainant bears the burden of proving with substantial evidence, not merely unsubstantiated allegations and speculation, both that the existing tariff provisions are unjust and unreasonable and that the complainants' own proposal is just and reasonable.

First, the California Sellers do not show that the ISO's current default loss rule is unjust and unreasonable. The Commission's repeated affirmations that the ISO's current rule is just and reasonable are entirely consistent with the wide range of terms and conditions which the Commission has found to be just and reasonable under the FPA. Over the years, the Commission has approved a variety of different default loss rules for the various ISOs and RTOs. The orders that the California Sellers cite regarding the default loss rules of the New York ISO and PJM do not establish that the ISO is required to use the same default loss rule as those entities. The California Sellers also fail to demonstrate that a change in circumstances, such as the recent turmoil in the United States financial markets, has rendered the ISO's current rule unjust and unreasonable. Further, although the California Sellers contend that the current rule creates unjust and unreasonable disincentives for sellers to participate in the ISO markets and imposes unjust and unreasonable financial burdens on suppliers, they do not offer sufficient evidence to support this contention or to demonstrate that any hypothetical disincentive renders the existing rule unjust and unreasonable.

In addition, the California Sellers fail to demonstrate that their proposed alternative rule is just and reasonable. Their alternative rule would establish a default allocation metric based on a wide variety of charges and payments administered by the ISO, including charges and payments that are not included in the current ISO default allocation methodology. The ISO does not believe the costs subject to default allocation should be expanded to include, for example, Reliability Must-Run ("RMR") costs, which are currently allocated to Responsible Utilities pursuant to RMR Contracts. Moreover, contrary to the claims of the California Sellers, the alternative rule does not closely conform to the default loss rules that all of the other ISOs and RTOs employ. Although it is true that the California ISO is the only ISO or RTO that ultimately allocates defaults only to net creditors, there are in fact considerable variations among the default loss rules employed by other ISOs and RTOs. For example, many ISOs and RTOs provide for some netting or offsetting of charges in their default allocation rules, and some (but not all) ISOs and RTOs do not allocate default losses to transactions occurring pursuant to bilateral contracts and self-schedules. Accordingly, there is no uniform approach to default allocation and, certainly, no recognized best practice as suggested by the California Sellers. For these reasons, the Commission should reject the California Sellers' specific proposed alternative rule.

Although the California Sellers fail to satisfy their burden of proof under Section 206 of the FPA, the ISO is not opposed to examining whether the current rule should be revised. Because such a change would affect a wide range of

ISO Market Participants, the ISO believes some significant level of Market Participant involvement would be crucial for Commission consideration of an alternative approach and the Commission should not accept the California Sellers' proposal without consideration of other Market Participants' interests. Even if the ISO were amenable to an "absolute value" approach, there are considerable variations in how such an approach is implemented by other ISOs and RTOs, so consideration of a default loss role based in part on the model of the rules of other ISOs and RTOs would benefit from discussions with interested parties. To that end, the ISO supports engaging in discussions with the California Sellers and other interested parties through a settlement process established by the Commission in this proceeding, in order to determine if all interested parties can agree on a mutually acceptable approach to revising the ISO's default loss rule. Throughout the settlement process, the ISO would evaluate all alternative rules based on the need to preserve the ISO's core market and reliability functions.

II. Service and Communications

All service of pleadings and documents and all communications regarding this proceeding should be addressed to the following:

Sidney M. Davies
Assistant General Counsel
California Independent System
Operator Corporation
151 Blue Ravine Road
Folsom, CA 95630
Tel: (916) 351-4400
Fax: (916) 608-7296

sdavies@caiso.com

Sean A. Atkins
Bradley R. Miliauskas
Alston & Bird LLP
The Atlantic Building
950 F Street, NW
Washington, DC 20004
Tel: (202) 756-3300
Fax: (202) 654-4875

sean.atkins@alston.com
bradley.miliauskas@alston.com

III. Answer

A. A Complainant Bears the Burden of Proof Under Section 206 of the Federal Power Act.

Under Section 206 of the FPA, a party challenging an existing rate, term, or condition of a public utility on file with the Commission bears the burden of proof. As the United States Supreme Court has stated, any party that "would upset the rate order under the [Federal Power] Act carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable."[4]

The party challenging an existing rate under Section 206 cannot meet its burden of proof by showing that another rate is just and reasonable, or even by showing that another rate is more just and reasonable than the existing rate.[5] Rather, the challenging party must satisfy both prongs of a two-pronged or dual

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4 *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944).

5 *Wis. Pub. Power, Inc. v. FERC*, 493 F.3d 239, 265-67 (D.C. Cir. 2007)

burden of proof. First, the party "must furnish the Commission with a satisfactory evidentiary record that demonstrates how and why the existing rate is unjust and unreasonable."[6] Should the party fail to meet this first burden, the Commission will deny the party's challenge to the existing rate for that reason alone.[7] Second, even if it meets its first burden, "then, and only then, may [the] challenging party submit an alternative rate or revision to the filed rate proffered as just and reasonable, and must provide evidence as to the justness and reasonableness of the new rate."[8] In order to satisfy its dual burden of proof, the party must provide evidence that consists of more than mere unsubstantiated, speculative allegations.[9]

As explained below, the California Sellers fail to satisfy either prong of their burden of proof under Section 206.

B. The California Sellers Fail to Show that the ISO's Previously Approved Default Loss Rule Is Unjust and Unreasonable.

The Commission approved the ISO's use of its current default loss rule as just and reasonable over eleven years ago, and reaffirmed that the rule is just and reasonable fewer than three years ago, in anticipation of the new ISO market under which the ISO now operates. Nothing in the Complaint justifies a Commission order overturning its approval of the current rule.

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6 *Cal. Mun. Util. Ass'n v. Cal. Indep. Sys. Operator Corp.*, 126 FERC ¶ 61,315, at P 71 (2009).

7 *Id.* at PP 69, 91.

8 *Id.* at P 71.

9 *Id.* at P 72 (citing Commission precedent).

1. The Commission Has Repeatedly Found the ISO's Long-Standing Default Loss Rule to Be Just and Reasonable.

The California Sellers fail to mention – let alone account for – the Commission's repeated findings over the years that the ISO's current default loss rule is just and reasonable. The Commission first accepted the ISO's default loss allocation tariff provisions as just and reasonable before the ISO began operations in 1998.[10] The rule was included in Section 11.16.1 of the ISO's former tariff until it was moved to Section 11.29.17.1 of the CAISO Tariff that implements the new ISO market now in operation (*i.e.*, the "MRTU Tariff").[11] In September 2006, in the proceeding on the MRTU Tariff, the Commission again found the current default loss rule to be just and reasonable as part of the overall MRTU Tariff.[12] Thus, the Commission reaffirmed the justness and reasonableness of the current rule within the past three years.

The Commission has also acknowledged that the current default loss rule is consistent with the ISO's market structure. In a proceeding in 2003 regarding the proposed addition of new provisions to the same parent section of the former

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10 *See Pac. Gas and Elec. Co.*, 81 FERC ¶ 61,122, at Ordering Paragraph (G) (1997) (accepting without comment the CAISO Tariff provisions not specifically discussed in this Commission order, which included the ISO's default loss rule) ("October 1997 Tariff Order").

11 The MRTU Tariff and the new ISO market went into effect on March 31, 2009, for the Day-Ahead Market for the April 1, 2009, Trading Day. MRTU stands for Market Redesign and Technology Upgrade.

12 *See Cal. Indep. Sys. Operator Corp.*, 116 FERC ¶ 61,274, at P 35 (2006) ("Our review of the proposed MRTU Tariff sections that are not contested and not specifically discussed herein indicates that they are just and reasonable and are hereby accepted for filing.") ("September 2006 MRTU Tariff Order"). The Commission's acceptance of the ISO's default loss rule as just and reasonable in the October 1997 Tariff Order and the September 2006 MRTU Tariff Order, without discussion of the rule specifically, in no way undermines the justness and reasonableness of the rule. It is common practice for the Commission to accept tariff provisions as just and reasonable without discussing each of them specifically. *See, e.g.*, *id.*; *Midwest Indep. Transmission Sys. Operator, Inc.*, 108 FERC ¶ 61,163, at Ordering Paragraph (B) (2004) (order conditionally accepting provisions of the Midwest ISO's Open Access Transmission and Energy Markets Tariff); *ISO New England, Inc.*, 110 FERC ¶ 61,111, at Ordering Paragraphs (B)-(E) (2005) (order conditionally accepting tariff revisions to establish ISO New England as an RTO).

ISO tariff that contained the default loss rule (Section 11.16), the Commission stated that:

> In its answer, the ISO provides helpful context for its proposal. ISO reminds market participants that under the ISO market structure, individual buyers and sellers are not matched. Rather, each ISO Creditor is a creditor against all ISO Debtors in the ISO Market, and all ISO Debtors are debtors of all ISO Creditors in the market. Therefore, all ISO Creditors have an interest in the bankruptcy of an ISO Debtor. ISO offers that, under the existing Tariff and Protocols, if the ISO is unable, for a particular trade month, to fully pay all ISO creditors due to the insufficiency of payment made by the ISO debtors for that month, the ISO will reduce payments to all ISO creditors *pro rata* in proportion to the net amounts payable to them.[13]

In that same proceeding, the Commission also found, subject to further changes on compliance, that certain tariff provisions concerning late market payments linked in part to the current default loss rule were just and reasonable.[14]

In the Affidavit that accompanies the Complaint, Mr. Stoddard argues that considerations of equity forbid "netting" between load and suppliers in determining the default loss allocation, and argues that the ISO's current practice of employing such netting results in discriminatory payments among suppliers.[15] These arguments are belied by the Commission's approval of the ISO's default loss rule. If netting were inequitable or unduly discriminatory, the Commission would not have accepted the ISO's rule, which employs netting, as just and reasonable.

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13 *Cal. Indep. Sys. Operator Corp.*, 105 FERC ¶ 61,284, at P 22 (2003) ("December 2003 ISO Late Market Payment Order").

14 *Id.* at PP 28-29 (conditionally accepting provisions in Section 11.16.2 of the former ISO tariff regarding payment of defaulted receivables to CAISO Creditors). These tariff provisions are now contained in Section 11.29.17.2 of the MRTU Tariff.

15 Complaint at Attachment 2 (Affidavit of Robert B. Stoddard In Support of California Sellers), at P 15 ("Stoddard Aff.").

2. The Commission's Approval of Different Default Loss Rules for Other ISOs and RTOs Does Not Undermine the Commission's Finding that the ISO's Default Loss Rule Is Just and Reasonable.

The California Sellers argue that other ISOs and RTOs employ default loss rules that are unlike the ISO's rule, and argue that Commission orders on the default loss rules employed by the New York ISO and PJM compel a finding that the ISO's current rule is unjust and unreasonable.[16] Neither the different default loss rules of other ISOs and RTOs nor the Commission's orders accepting such rules compel such a finding or undermine the Commission's previous determination that the ISO's current rule is just and reasonable.

The ISO acknowledges that each of the ISOs and RTOs other than the ISO and ERCOT[17] ultimately allocates default market losses to all of its market participants based on a variation of an "absolute value" approach. However, that fact does not suggest that the ISO's approach to allocating default losses is unjust and unreasonable. It merely shows that ISOs and RTOs are not all required to employ the same approach and that more than one approach is just and reasonable. As courts and the Commission have recognized on numerous occasions, there is no single just and reasonable set of rates, terms, and conditions that a public utility like the ISO must adopt. Rather, the FPA allows

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16 Complaint at 2, 4, 7-10.

17 ERCOT ultimately allocates default market losses to all scheduling entities representing load-serving entities, on a load ratio share basis, using the load ratio share for the calendar month three months prior to the date on which the invoice is issued. ERCOT Protocols, Section 9: Settlement and Billing, at § 9.4.4(5). Although the Commission has limited jurisdiction over ERCOT, the Commission has recognized ERCOT as an ISO. *See N. Am. Elec. Reliability Council*, 119 FERC ¶ 61,060, at P 230 (2007); Notice of Proposed Rulemaking, *Remedying Undue Discrimination Through Open Access Transmission Serv. and Standard Elec. Mkt. Design*, 100 FERC ¶ 61,138, at P 23 (2002).

each public utility to propose a wide range of rates, terms, and conditions that can be found to be just and reasonable.[18]

To the ISO's knowledge, the Commission has never established a requirement that all ISOs and RTOs must use the same default loss rule. To the contrary, there are significant, Commission-approved differences between default loss rules even among the ISOs and RTOs in other parts of the country that utilize a variation of an absolute value approach. For example, as the California Sellers point out, ISO New England is alone in maintaining insurance to cover some portion of default losses and passes on the costs of such insurance *pro rata* to all market participants.[19] Also, PJM is alone in allocating 10 percent of each default loss amount in equal shares to all of its members (other than the defaulting PJM member) regardless of the level of their participation in the PJM markets in a given settlement period.[20] Variations such as these indicate that the Commission does not require a one-size-fits-all approach to default loss allocation.

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18 *See, e.g.*, *FPC v. Conway Corp.*, 426 U.S. 271, 278 (1976) ("[T]here is no single cost-recovering rate, but a zone of reasonableness."); *Wis. v. FPC*, 373 U.S. 294, 309 (1963) ("It has repeatedly been stated that no single method need be followed by the Commission in considering the justness and reasonableness of rates, and we reaffirm that principle today.") (citations omitted); *Louisville Gas & Elec. Co.*, 114 FERC ¶ 61,282, at P 29 (2006) ("[T]he just and reasonable standard under the FPA is not so rigid as to limit rates to a 'best rate' or 'most efficient rate' standard. Rather, a range of alternative approaches often may be just and reasonable."); *Am. Elec. Power Serv. Corp. v. Midwest Indep. Transmission Sys. Operator, Inc.*, 122 FERC ¶ 61,083 at P 113 (2008) ("[T]he fact that there may be other rate designs that fulfill the Commission's requirements . . . is not a basis to find that the existing inter-RTO rate design is unjust and unreasonable. Similarly, the fact that there may be rates other than the existing ones that are also just and reasonable does not mean that we must reject the existing inter-RTO rate design.").

19 Complaint at 4 n.11; Stoddard Aff. at P 7.

20 PJM Amended and Restated Operating Agreement, Third Revised Rate Schedule FERC No. 24, at § 15.2.2(a) (Second Revised Sheet Nos. 51-51A). This allocated amount is not allowed to exceed $10,000 per member per calendar year, cumulative of all defaults. If the amount exceeds $10,000 per member, the excess is reallocated through PJM's "gross activity factor." *Id.*

Further, the Commission has not required all ISOs and RTOs to use a strict absolute value approach to allocating default loss amounts to all market participants in all circumstances. In addition to finding that it is just and reasonable for the ISO ultimately to allocate default losses to net creditors, the Commission authorized ISO New England, the Midwest ISO, and SPP to use a netting approach that is much like the ISO's default loss rule as the initial step of each of their processes for allocating default market losses.[21] The Commission also authorized the Midwest ISO and Southwest Power Pool to allocate default losses for transmission service charges only to creditors. Specifically, in the Midwest ISO, those types of default losses are allocated to all transmission owners and independent transmission companies owed monies for the default period *pro rata* based on the amounts owed to those transmission owners and independent transmission companies.[22] SPP employs a similar allocation methodology for transmission service charges, except that in SPP the allocation is only to the transmission owners (not to independent transmission companies).[23] Therefore, the Commission does not uniformly require ISOs and RTOs to allocate default losses to both debtors and creditors.

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[21] ISO New England, FERC Electric Tariff No. 3, General Terms and Conditions, Section I, Exhibit 1D – ISO New England Billing Policy, at § 3.3(h) (Substitute Original Sheet Nos. 310-11); Midwest ISO, FERC Electric Tariff, Third Revised Volume No. 1, at § 7.8(b) (Second Revised Sheet Nos. 170-71); SPP, FERC Electric Tariff, Fifth Revised Volume No. 1, Attachment L, at § V.C(1) (Original Sheet Nos. 257-58).

[22] Midwest ISO, FERC Electric Tariff, Third Revised Volume No. 1, at § 7.4(b) (Second Revised Sheet No. 163).

[23] SPP, FERC Electric Tariff, Fifth Revised Volume No. 1, Attachment L, at § V.D(1) (Original Sheet Nos. 263-64).

The New York ISO order and the two PJM orders that the California Sellers cite in their Complaint[24] in no way suggest – let alone compel a finding – that the ISO's default loss rule is unjust and unreasonable. The New York ISO order, which the California Sellers note that the Commission relied on in issuing the two PJM orders,[25] was issued three months before the December 2003 ISO Late Market Payment Order, and the New York ISO order and the two PJM orders were issued years prior to the September 2006 MRTU Tariff Order. If the Commission believed that the ISO's default loss rule violates or might violate the principle enunciated in the New York ISO and PJM orders that "those who benefit most from activity within a transmission organization should pay a larger share of the organization's default costs,"[26] the Commission surely would have said so in the December 2003 ISO Late Market Payment Order, the September 2006 MRTU Tariff Order, or both. However, the Commission did not mention that principle or the New York ISO or PJM orders at all in the December 2003 ISO Late Market Payment Order or the September 2006 MRTU Tariff Order. Instead, the Commission accepted the ISO's rule as consistent with the ISO's market structure and just and reasonable.

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24 *See* Complaint at 2, 7-10 (discussing *New York Indep. Sys. Operator, Inc.*, 104 FERC ¶ 61,311 (2003); *PJM Interconnection, L.L.C.*, 108 FERC ¶ 61,116 (2004) ("*PJM I*"); and *PJM Interconnection, L.L.C.*, 109 FERC ¶ 61,186 (2004) ("*PJM II*")).

25 *See* Complaint at 9.

26 *Id.* at 10 (quoting *PJM I* at P 6 and *PJM II* at P 13).

3. The California Sellers Fail to Show That a Change in Circumstances Has Caused the ISO's Default Loss Rule to Become Unjust and Unreasonable or Unduly Discriminatory.

Under court and Commission precedent, a change in circumstances can render unjust and unreasonable a tariff provision previously found to be just and reasonable.[27] That has not occurred with respect to the ISO's default loss rule. Although the California Sellers assert that the financial crisis that has taken place in the United States over the past twelve months has increased default risk,[28] they do not explain how or why this crisis has caused the ISO's default loss rule to become unjust and unreasonable. Indeed, the default loss rule was accepted (again) as just and reasonable in 2006 after substantial default losses were allocated to CAISO Creditors as a result of the 2000-2001 Western energy crisis. If the Western energy crisis did not cause the default loss rule to become unjust and unreasonable or unduly discriminatory, there is no reason to conclude that general turmoil in U.S. financial markets would have such an effect.

The California Sellers also argue that the ISO's default loss rule is inequitable and unduly discriminatory from the perspective of the market activity which is the "key driver" of default risk, which, according to the California Sellers, is the purchase of electricity products with unsecured credit positions.[29] The California Sellers fail to acknowledge, however, that any risk of default losses presented by unsecured credit positions in the ISO has steadily declined over the years and will likely continue to diminish. This change in circumstances indicates

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27 *See, e.g.*, *La. Pub. Serv. Comm'n v. FERC*, 184 F.3d 892, 897 (D.C. Cir. 1999). *Elec. Consumers Res. Council v. FERC*, 747 F.2d 1511 (D.C. Cir. 1984).

28 Complaint at 4, 13.

29 *Id.* at 11.

that the ISO's default loss rule is at least as just and reasonable as it was when the Commission originally approved it in the October 1997 Tariff Order and again found it to be just and reasonable in the September 2006 MRTU Tariff Order.

Prior to the ISO's submittal of revisions to its credit policy in 2006, there was no maximum limit on the amount of unsecured credit that a creditworthy Market Participant could receive.[30] Then the ISO reduced the maximum UCL to $250 million, a dollar level that the Commission approved as being "proof of reduced mutualized default risk."[31] In 2009, the ISO again reduced the maximum UCL, this time to $150 million, which the Commission approved as representing "an appropriate balance between limiting market participants' exposure to default risk, while allowing market participants to participate in MRTU markets without having to post unduly large amounts of financial security."[32] As discussed further below,[33] the Commission accepted those tariff changes without initiating a proceeding under Section 206 of the FPA on the maximum level of the UCL or the ISO's current default loss rule. Therefore, even if the California Sellers are correct that the purchase of electricity products with unsecured credit positions most directly contributes to the risk of default losses, their argument only reinforces the point that changed circumstances do not require a finding that the

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30 See page 5 of the transmittal letter for the ISO's March 7, 2006 tariff amendment in Docket No. ER06-700-000 (explaining that, under the Simplified and Reorganized ("S&R") tariff in effect at that time, Market Participants "that have an Approved Credit Rating (as defined in the S&R Tariff) generally obtain unlimited unsecured credit in the CAISO markets"). The maximum limit on unsecured credit is also known as the maximum Unsecured Credit Limit or maximum UCL.

31 *Cal. Indep. Sys. Operator Corp.*, 115 FERC ¶ 61,170, at P 32 (2006). "The default risk is mutualized if one market participant defaults and it falls upon the remaining market participants to make up the shortfall." *Id.* at P 32 n.14.

32 *Cal. Indep. Sys. Operator Corp.*, 126 FERC ¶ 61,285, at P 33-34 (2009) ("Credit Policy Order").

33 *See infra* Section III.B(6).

ISO's default loss rule is now unjust and unreasonable. If anything, the reduction in the maximum UCL over the years is a change in circumstances which confirms that the default loss rule is at least as just and reasonable now as it was when the Commission found it to be just and reasonable in the October 1997 Tariff Order and September 2006 MRTU Tariff Order.[34]

4. The California Sellers Fail to Show that the ISO's Default Loss Rule Creates Unjust and Unreasonable Disincentives for Sellers to Participate in the ISO Markets.

The California Sellers assert that the ISO's default loss rule "should be presumed" to create disincentives to market participation by sellers that render the ISO's rule unjust and unreasonable.[35] Such a presumption is entirely unwarranted because the California Sellers fail to provide any evidentiary support for it. They merely speculate that sellers "may be driven" to reduce their default risk exposure by taking the actions that the California Sellers list, and "might" therefore take those actions. The California Sellers cannot satisfy their burden of proof under Section 206 of the FPA by relying on these unsubstantiated and speculative allegations.[36]

The California Sellers note that a white paper regarding revisions to the ISO's credit policy, which the ISO posted in September 2008 for stakeholder review, stated that the current default loss rule creates a disincentive for

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34 The California Sellers also fail to recognize that the current $150 million UCL level is the maximum possible, not the UCL that every Market Participant that applies for one in fact receives. The ISO determines each Market Participant's UCL based on a case-by-case application of the calculation steps and the qualitative and quantitative credit strength indicators set forth in the MRTU Tariff. *See* MRTU Tariff, §§ 12.1.1, 12.1.1.1, 12.1.1.1.1, 12.1.1.1.2, 12.1.1.2. Pursuant to this individualized review, the ISO frequently assigns UCLs to Market Participants that are well below the maximum UCL permitted by the MRTU Tariff or are zero. These UCLs below the maximum UCL further reduce any default risk.

35 Complaint at 12; Stoddard Aff. at P 16.

36 *See supra* Section III.A.

suppliers to participate in the ISO markets.[37] In the white paper, the ISO inadvertently attributed to itself a view expressed to the ISO by power suppliers that the current rule purportedly creates the risk of such a disincentive. The fact that it was the view of power suppliers, not the ISO, is made clear in a presentation the ISO gave in the same credit policy stakeholder process in October 2008. In the presentation, the ISO explained that stakeholders were divided as to how default losses should be shared among Market Participants, with suppliers asserting that the current rule created a disincentive to participate in the markets and Participating Transmission Owners taking the opposite view. The ISO did not express its own opinion on the issue, but instead stated that regardless of whether consensus could be achieved, any changes to the current rule could not occur until after implementation of the new ISO market and would likely require additional discussions with stakeholders.[38]

5. The California Sellers Fail to Show that the ISO's Default Loss Rule Imposes Unjust and Unreasonable Financial Burdens on Suppliers.

The California Sellers cite the financial crises that have occurred over the past twelve months and defaults that have occurred in U.S. markets generally and that have affected organized ISO and RTO electricity markets.[39] However, these general references fall far short of meeting the California Sellers' burden of proof to provide substantiated evidence showing that the ISO's rule has become

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37 Complaint at 12 (citing "Proposed Enhancements to California ISO Credit Policy" (white paper dated September 8, 2008) at 26). This white paper is available on the ISO's website at: http://www.caiso.com/203c/203cd7594fbb0.pdf.

38 "Credit Policy Enhancements Straw Proposal" (presentation dated October 27, 2008) at slides 12-14. This presentation is available on the ISO's website at: http://www.caiso.com/2069/2069b5af25fa0.pdf.

39 Complaint at 13-15.

unjust and unreasonable.[40] The California Sellers fail to provide a single example of a default that has put any financial burden – let alone an unjust and unreasonable financial burden – on sellers into the ISO markets during this time period.

The only significant defaults that have occurred in the ISO markets took place over eight years ago, during the 2000-2001 Western energy crisis. There is every reason to believe that the Western energy crisis, and the substantial defaults that accompanied it, were one-time events that will not be repeated. Since 2001, "the Commission has undertaken numerous measures to address market structure flaws and potential market manipulation in California markets and markets nationwide to ensure that there are appropriate market safeguards in place to prevent a repeat of the California 2000-2001 energy crisis."[41] Prominent among these Commission measures was its approval of the new ISO market under which the ISO now operates.[42] The ISO cannot, of course, represent that a default in its markets will never occur again or know what the amount of any future default may be. However, merely raising the possibility that a default might occur, as the California Sellers do, is speculation, not evidence that the ISO's default loss rule puts an unjust and unreasonable burden on suppliers.

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40 *See supra* Section II.A.

41 *CAlifornians for Renewable Energy, Inc. v. Cal. Pub. Util. Comm'n*, 120 FERC ¶ 61,272, at P 34 (2007).

42 *Id.* (""The Commission's approval of the MRTU is just one of many measures the Commission has taken to improve the California energy market since 2001."); *Cal. Indep. Sys. Operator Corp.*, 119 FERC ¶ 61,076 at P 2 (2007) (""As the Commission stated in the September 2006 [MRTU Tariff] Order, our goal throughout the numerous proceedings that culminated in the MRTU proposal has been to avoid a repeat of the California energy crisis of 2000-2001.").

The California Sellers argue that their lack of supporting evidence is unimportant because, regardless of the lack of evidence, the ISO's rule is inconsistent with the Commission's finding in its 2004 *Policy Statement on Electric Creditworthiness* that "the goal of reducing the mutualized default risk is an important one."[43] Their argument is without merit. The methods for reducing mutualized default risk that the Commission encouraged in the Credit Policy Statement were shortened settlement periods, netting of obligations owed by and to individual market participants whenever possible, and other measures unrelated to default loss rules.[44] The Credit Policy Statement said nothing about what default loss rule an ISO or RTO must or should employ, and nothing in the Credit Policy Statement supports a finding that the current ISO default loss rule is no longer just and reasonable. Indeed, the Commission again accepted the current default loss rule as part of the MRTU Tariff two years after the issuance of the Credit Policy Statement

Instead of supporting evidence, the California Sellers provide only theoretical examples prepared by Mr. Stoddard of possible risks purportedly created by the ISO's default loss rule.[45] These examples are speculative and unrealistic and should therefore be disregarded. First, as explained above, there has not been a significant default in the ISO markets in over eight years. Moreover, contrary to the premise of one of the examples, the chance that 100% of any default loss amount would be allocated to a single CAISO Creditor is so

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43 Complaint at 14 (quoting *Policy Statement on Electric Creditworthiness*, 109 FERC ¶ 61,186, at P 19 (2004) ("Credit Policy Statement")).

44 Credit Policy Statement at PP 19-31.

45 Complaint at 13-14; Stoddard Aff. at PP 10-13.

unlikely as to be virtually impossible. In each month there are in fact numerous CAISO Creditors. Under the ISO's current rule, any default loss would be allocated among all of those CAISO Creditors. For these reasons, the Commission should disregard the California Sellers' theoretical examples, and certainly should not treat them as evidence that the ISO's default loss rule is unjust and unreasonable.

6. The California Sellers Make Several Arguments that the Commission Has Already Rejected.

The California Sellers make several arguments in this proceeding that are similar to arguments that one of the California Sellers, Powerex Corporation, made in the proceeding on the ISO's most recent credit policy changes in Docket No. ER09-589. Specifically, in both of these proceedings, the parties argue that:

- Considerations of equity forbid netting between load and suppliers in determining the default loss allocation, and the ISO's practice of netting is unduly discriminatory.[46]

- The ISO's default loss rule is unjust and unreasonable because it is unlike the default loss rules the Commission approved for the New York ISO and PJM.[47]

- The ISO's default loss rule creates disincentives to market participation by sellers.[48]

- Theoretical examples indicate that the ISO's default loss rule creates possible risks.[49]

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46 *Compare* Stoddard. Aff. at P 15 *with* Motion to Intervene and Protest of Powerex Corp., Docket No. ER09-589-000 (Feb. 19, 2009) ("Powerex Protest"), at Attachment A, P 24 ("Powerex Aff.").

47 *Compare* Complaint at 2, 7-10 *with* Powerex Protest at 16.

48 *Compare* Complaint at 11-12 and Stoddard Aff. at P 16 *with* Powerex Protest at 16-17 and Powerex Aff. at P 25.

49 *Compare* Complaint at 13-14 and Stoddard Aff. at PP 10-13 *with* Powerex Protest at 18 and Powerex Aff. at PP 18-21.

In its order in Docket No. ER09-589, the Commission found in relevant part:

> We deny the J.P. Morgan, WPTF, and Powerex protests requesting that the Commission direct the CAISO to alter its currently effective payment default allocation process in this proceeding. We agree with the CAISO that the issue is beyond the scope of this proceeding. The CAISO has proposed no revisions to the payment default allocation process in this proceeding and *the protesting parties have not demonstrated that the existing payment default allocation process accepted by the Commission renders the MRTU tariff unjust, unreasonable or unduly discriminatory*.[50]

The Commission, in finding that the parties failed to demonstrate that the ISO's Commission-approved default loss rule renders the MRTU Tariff unjust, unreasonable, or unduly discriminatory, rejected arguments that included the Powerex arguments listed above. Powerex's arguments have not become any more compelling with age or repetition. The Commission should find them to be without merit in the instant proceeding, as it did in the Docket No. ER09-589 proceeding.

The ISO acknowledges that, in the Credit Policy Order, the Commission also rejected parties' requests that the Commission initiate proceedings under Section 206 of the FPA "without prejudice to the parties' filing of a properly developed complaint."[51] However, a "properly developed complaint" cannot reasonably be understood to mean a complaint that simply repackages, without additional supporting evidence, the substantive arguments that were rejected the first time they were presented to the Commission. Therefore, the Commission's rejection without prejudice should not be interpreted to mean that the California

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50 Credit Policy Order at P 58 (emphasis added).
51 *Id.* at P 59.

Sellers can succeed in their Complaint in the absence of an appropriate demonstration on the merits and can rely instead only on arguments that failed in the Powerex Protest.

C. The California Sellers Fail to Show that Their Proposed Alternative Default Loss Rule Is Just and Reasonable.

The California Sellers propose an alternative default loss rule that they assert would allocate default losses based on the absolute value of each ISO Creditor's and CAISO Debtor's activities "in the CAISO markets."[52] According to the California Sellers, their proposed alternative rule has three primary features:

- "*First*, the alternative rule allocates default losses based on the sum of gross, absolute amounts payable to and payable by each market participant, without netting of activities, even if such netting were effectuated in a single charge type in the CAISO invoicing."[53]

- "*Second*, the scope of the CAISO Markets from which the absolute value of gross activities would be summed extends to all CAISO administered markets and services, including, without limitation, Inter-SC trades of energy and ancillary services, self-scheduling of energy and ancillary services, Reliability-Must-Run Generation, the Transmission Access Charge, and the Grid Management Charge."[54]

- "*Third*, the scope of transactions in those markets from which the absolute level of amounts payable by and to each market participant would be summed extends to purchase transactions that include, without limitation, export energy, load energy, FROM SC Inter-SC trades, and capacity products, and to sale transactions that include, without limitation, import and export energy, load energy, generation energy, TO SC Inter-SC trades, CRR and capacity products."[55]

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52 Complaint at 15 and Attachment 1. This alternative default loss rule is contained in new proposed Section 11.29.17.1.1 of the MRTU Tariff. The California Sellers also propose what they call "conforming changes" to Sections 11.29.13.10, 11.29.17.1, and 11.29.17.2 of the MRTU Tariff. Complaint at 15 n.61 and Attachment 1, pages 2-3.

53 Complaint at 15-16.

54 *Id.* at 16.

55 *Id.*

The California Sellers also assert that their proposed alternative rule "closely conforms to the cost sharing rules for default losses in Eastern ISO/RTO markets" and is "[c]onsistent with how the New York ISO, Midwest ISO, and PJM allocate defaults."[56]

As explained below, the California Sellers fail to show that the features of their proposed alternative default loss rule are just and reasonable or that those features conform to the default loss rules employed by the other ISOs and RTOs. Therefore, even in the highly unlikely event that the Commission were to find that the first prong of the Section 206 burden was satisfied (*i.e.*, that the ISO's current default allocation is not just and reasonable), the Commission should reject the specific alternative rule that the California Sellers propose.

1. The Proposed Alternative Rule Covers Products and Services that Are Outside the Scope of the ISO Markets.

Pursuant to new proposed Section 11.29.17.1.1, the California Sellers' alternative rule would allocate the absolute values of the amounts payable to and from CAISO Creditors and Debtors "for all products and services transacted in the CAISO Markets."[57] The California Sellers state that their proposed alternative rule covers a broad range of products and services that are purportedly "in the CAISO markets."[58] Specifically, the California Sellers assert that these products and services include, "without limitation," Inter-SC Trades of Energy and Ancillary Services from Scheduling Coordinators and to Scheduling Coordinators, self-scheduling of Energy and Ancillary Services, RMR Generation,

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56 *Id.* at 17 and Attachment 1, page 1.
57 Complaint at Attachment 1, page 2.
58 Complaint at 15.

the transmission Access Charge, the Grid Management Charge ("GMC"), Congestion Revenue Rights ("CRRs"), and capacity products.[59]

Although the tariff language proposed by the California Sellers suggests allocation based on the absolute value of products and services in the "CAISO Markets," their Complaint proposes an allocation based on at least some charges and payments that are outside the scope of this term as it is defined in the MRTU Tariff and outside the scope of the default losses that would currently be allocated pursuant to Section 11.29.17 of the MRTU Tariff. The CAISO Markets are defined in the MRTU Tariff as "[a]ny of the markets administered by the CAISO under the CAISO Tariff, including, without limitation, the DAM [Day-Ahead Market], HASP [Hour-Ahead Scheduling Process], RTM [Real-Time Market], transmission, and Congestion Revenue Rights."[60] Although the definition uses the phrase "without limitation," that does not mean the definition is infinitely elastic. For example, payments under RMR Contracts – which would be covered by the California Sellers' proposed alternative rule – are made using separate invoices and are not payments in the CAISO Markets, and default losses for any RMR contractual obligation would not be allocated to the CAISO Creditors pursuant to Section 11.29.17. Consequently, the risk of defaults on RMR Contract payments is not borne by the market.[61] The ISO does not believe the costs subject to any alternative default loss rule should be expanded to include RMR Contract payments or any other costs that are not covered by the

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59 *Id.* at 16 and Attachment 1, page 1.

60 MRTU Tariff, Appendix A (definition of "CAISO Markets").

61 *See* MRTU Tariff, § 11.13.7.

ISO's current default loss rule.[62] For these reasons, the Commission should find that it would be unjust and unreasonable to impose the California Sellers' proposed alternative rule on the ISO.

2. The Proposed Alternative Rule Does Not Conform to the Default Loss Rules Employed by the Other ISOs and RTOs.

The California Sellers suggest that their proposed alternative rule closely conforms to the default loss rules of all the other ISOs and RTOs.[63] This is simply not the case. There is no uniform set of detailed default allocation rules used by other ISOs and RTOs. For example, as explained above,[64] although most other ISOs and RTOs allocate default losses more broadly to market participants (*i.e.*, not solely to net creditors), some (but not all) ISOs and RTOs provide for some netting or offsetting of charges in their default allocation rules. Further, the California Sellers propose to allocate, to all ISO Market Participants, default losses for all self-schedules and all transactions reflecting bilateral transactions cleared through the CAISO Markets. That proposal differs from the practices of some (but not all) of the other Commission-jurisdictional ISOs and RTOs. PJM, the New York ISO, and the Midwest ISO for the most part net

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62 The ISO notes that its tariff provisions have long established a priority, in the event of a default, to recover all amounts owed for the GMC and then FERC Annual Charges over all other payments. *See* MRTU Tariff, § 11.29.9.6.1. Although the ISO is willing to consider alternatives to the current default loss rule in settlement discussions, as discussed below, the ISO expects that these priorities will remain in place under any successor default loss rule and does not read the Complaint as proposing to alter these priorities.

63 Complaint at 2-3, 17 and Attachment 1, page 1; Stoddard Aff. at P 18.

64 *See supra* Section III.B(2).

market participants' self-schedules and bilateral transactions from the default loss allocation.[65]

The ISO takes no position at this time on what the detailed default allocation rules should be under any proposed alternative to the ISO's current default loss rule. As explained below, the ISO believes that issue and others should be discussed in settlement proceedings established by the Commission among the parties that bear the risk. Only after all interested parties have engaged in such discussions would the ISO be in a position to endorse a particular alternative proposal to be submitted for Commission approval. The ISO would need to ensure that any proposed alternative it endorses does not contain features that have a significant adverse effect on market participation, market incentives, market liquidity, or the reliable operation of the CAISO Controlled Grid. For example, the ISO has concerns that exempting self-schedules and/or Inter-SC Trades from the allocation of default losses could encourage Market Participants to submit self-schedules rather than economic bids, which could adversely affect the ability of the ISO to manage the grid reliably and efficiently. This example is illustrative of the type of issue of concern to the ISO that would need to be analyzed as part of the settlement discussions.

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65 The PJM Operating Agreement expressly excludes bilateral contracts from the monthly bills issued to PJM members and therefore for the most part excludes such contracts from the default loss allocation. *See* PJM Amended and Restated Operating Agreement, Third Revised Rate Schedule FERC No. 24, Schedule 1, at §§ 1.7.10(a)(ii), -(iv) (Sixth Revised Sheet No. 80 and Substitute Original Sheet No. 80A). Note, however, that all PJM members are allocated 10 percent of all default losses, regardless of whether such losses were incurred pursuant to self-schedules or bilateral transactions. *See supra* Section III.B(2). The ISO received confirmation from the New York ISO and the Midwest ISO that they exempt self-schedules and bilateral transactions from the default loss allocation, with the caveat that the New York ISO does not exclude wholesale transmission services charges ("WTSC") from that allocation. The ISO believes that ISO New England does include self-schedules and bilateral contracts in the default loss allocation. The ISO has not determined whether SPP includes self-schedules and bilateral contracts in its allocation.

The equities of any particular approach, however, should be advanced by the real parties in interest, which are all the ISO's Market Participants – not simply one segment of the Market Participants.

D. The ISO Is Willing to Engage in Settlement Discussions in Order to Reach a Mutually Acceptable Solution Regarding the Default Loss Rule.

The ISO acknowledges that, based on the filing of the Complaint and other filings and statements that stakeholders have made (as discussed below), the ISO's default loss rule has become a subject of concern to a number of Market Participants. As such, the ISO is prepared to discuss whether the default loss rule should be revised in an appropriate forum. To that end, the ISO proposes to engage in discussions with the California Sellers and other interested parties through a Commission settlement process to see if the interested parties can agree on a mutually acceptable approach to revising the default loss rule.

The ISO's proposal to discuss the default loss rule with interested parties is consistent with guidance the Commission provided in the Credit Policy Order. Several parties in the proceeding that led to that order, including some of the California Sellers, argued that the Commission should direct the ISO to change its default loss rule. The Commission rejected these arguments and declined to establish procedures regarding the default loss rule pursuant to Section 206 of the FPA. The Commission also noted that the parties have the option of filing a complaint and encouraged the ISO to resolve the issue expeditiously through a stakeholder process.[66]

The ISO took part in initial discussions with individual stakeholders on the default loss allocation issue and planned to conduct a stakeholder meeting in late May 2009. However, the initial discussions revealed enough contention among stakeholders to make the ISO conclude that any proposal it might develop through the standard stakeholder process likely would be the subject of significant litigation at the Commission (whether or not the ISO filed a tariff amendment). Therefore, the ISO cancelled the stakeholder meeting and its related plans to produce a new white paper on default loss allocation. The ISO took these actions with the knowledge, based on earlier discussion with some of the California Sellers, that a complaint likely would be filed with the Commission.

In the interests of getting direct Commission staff involvement on this issue under the auspices of a Commission proceeding, the ISO believes that a Commission settlement process is likely to be a more productive route to the ultimate resolution of the default loss allocation issue. Because the ISO believes that a Commission settlement process would be more fruitful than a standard stakeholder process, the ISO disagrees with the California Sellers' assertion that Commission-sponsored alternative dispute resolution or settlement procedures before a Commission Administration Law Judge would likely be unproductive.[67]

Contrary to the implication of the California Sellers that the Complaint presents a binary decision on which default loss rule to use, even if the ISO and

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66 Credit Policy Order at PP 58-59. The Commission's findings in the Credit Policy Order are discussed further in Section III.B(6), above.

67 Complaint at 18.

parties were to agree to move to an "absolute value"-based default loss rule, numerous critical details in implementing such a new rule would first have to be resolved. As discussed above, these details include the issue of what charges and payments are within the scope of the default allocation metric and whether Inter-SC Trades and/or self-schedules should be exempt from default loss exposure. Other details include the timing after the initial settlement month for implementing the ultimate loss allocation methodology. In other ISOs and RTOs, this can vary from the month following the default loss,[68] to 180 days after the default loss,[69] to the date that the relevant ISO or RTO determines the loss is unrecoverable.[70]

Each of these elements of the default loss rule will have significant impacts on affected parties. The ISO believes these issues should be discussed as part of any settlement proceedings the Commission may order in this proceeding. Although the ISO does not take a position at this time regarding what the specific features of any alternative default loss rule should be, the ISO would evaluate all alternative rules based on the need to preserve its core market and reliability functions. The ISO must ensure that any proposed alternative does not contain incentives or other features that would have a significant adverse effect on market participation, market liquidity, or reliable operation of the CAISO Controlled Grid.

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68 New York ISO, FERC Electric Tariff, Original Volume No. 1, Attachment U, at § 3.0 (Third Revised Sheet No. 707A). However, the New York ISO may instead recover default loss amounts over several months if, in its discretion, the New York ISO determines that such a method of recovery is a prudent course of action. *Id.*

69 ERCOT Protocols, Section 9: Settlement and Billing, at § 9.4.4(5).

70 SPP, FERC Electric Tariff, Fifth Revised Volume No. 1, Attachment L, at § V.C(1) (Original Sheet Nos. 257-58).

IV. Conclusion

For the foregoing reasons, the Commission should deny the Complaint submitted in this proceeding and should establish settlement procedures regarding the ISO's default loss rule.

Respectfully submitted,

/s/ Sean A. Atkins

Sean A. Atkins
Bradley R. Miliauskas
Alston & Bird LLP
The Atlantic Building
950 F Street, NW
Washington, DC 20004
Tel: (202) 756-3300
Fax: (202) 654-4875

Counsel for the
California Independent System
Operator Corporation

Nancy Saracino
General Counsel
Sidney M. Davies
Assistant General Counsel
California Independent System
Operator Corporation
151 Blue Ravine Road
Folsom, CA 95630
Tel: (916) 351-4400
Fax: (916) 608-7296

Dated: July 20, 2009

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing documents upon each party listed on the official service list for the above-referenced proceeding, in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and Procedure (18 C.F.R. § 385.2010).

Dated at Washington, D.C. on this 20th day of July, 2009.

/s/ Bradley R. Miliauskas
Bradley R. Miliauskas