1 UNITED STATES OF AMERICA

2 FEDERAL ENERGY REGULATORY COMMISSION

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4 IN THE MATTER OF :

5 SAN DIEGO GAS & ELECTRIC :

6 COMPANY, :

7 Complainant, :

8 v. : Docket No. EL00-95-000

9 SELLERS OF ENERGY AND :

10 ANCILLARY SERVICES INTO :

11 MARKETS OPERATED BY THE :

12 CALIFORNIA INDEPENDENT SYSTEM :

13 OPERATOR AND THE CALIFORNIA :

14 POWER EXCHANGE, :

15 Respondents. :

16 :

17 INVESTIGATION OF PRACTICES OF : Docket No. EL00-98-000

18 THE CALIFORNIA INDEPENDENT :

19 SYSTEM OPERATOR AND THE :

20 CALIFORNIA POWER EXCHANGE :

21 :

22 PUBLIC MEETING IN SAN DIEGO, : Docket No. ER00-107-000

23 CALIFORNIA :

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1 CALIFORNIA POWER EXCHANGE : Docket No. ER00-3461-000

CORPORATION :

CALIFORNIA INDEPENDENT SYSTEM : Docket No. ER00-3673-000

OPERATOR CORPORATION :

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Washington, D.C.

Thursday, November 9, 2000

The California Market Issues Technical Conference was convened, pursuant to notice, in the Commissioners Hearing Room, at 9:06 a.m.

COMMISSIONERS PRESENT:

CHAIRMAN JAMES J. HOECKER

COMMISSIONER WILLIAM L. MASSEY

COMMISSIONER LINDA BREATHITT

COMMISSIONER CURT HEBERT, JR.

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Senior Staff Attorney

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Executive Vice President

Enron Corporation

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THE FEDERAL ENERGY REGULATORY COMMISSION

CALIFORNIA MARKET ISSUES CONFERENCE

November 9, 2000

(9:00 a.m.)

CHAIRMAN HOECKER: Good morning, ladies and gentlemen. We will go on the record now.

I would like to welcome all the participants in today's conference to the FERC. We are very pleased to have such a strong interest and participation in this.

I believe that this Commission in no way underestimates the importance of this conference and this proceeding to the State of California, to the citizens of San Diego in particular, and to the officials of state government there, but I also think we recognize the importance of this proceeding for the future of electricity competition generally in the country.

And so we are prepared today to listen very closely to what you have to say. We are going to ask you to tell us frankly what you think we should do, and what you think of our Proposed Order. And that is primarily what we will engage in.

We are having a second, short hearing in San Diego next week since I will be out there for other business, and that is designed primarily to gather

comment from those who are unable to be here for this

conference.

But I am also looking forward to the comments that will be submitted for the record in this proceeding by November 22nd, I believe.

Now today, we have got a lot of people who want to express themselves. We are going to hold you fairly to strict time limits of five-minute presentations, and we would like you to be able to wrap up as close to that time as possible.

And you will be asked questions from the Commissioners and Staff at the table, and we will try and keep this from extending into the evening. So forgive me if we are a little arbitrary in terms of the amount of time we will give you, but I think that is necessary.

If I forget to call on you to say who you are for the record, please feel free to make that clear. Your written statements that accompany your oral presentations will be picked up by Staff and submitted to the record and please make sure that you have them handy.

Again, let me thank you for coming, and I look forward to a very productive session today.

Do my colleagues have any comments?

Linda?

COMMISSIONER BREATHITT: I have a very brief

1 opening statement or comment, and I want it to be

brief because I would like for my time to be hearing from you.

So I would like to welcome you to the FERC. I appreciate all of you coming participants and panelists alike, members in the audience, to participate in what I am calling the second phase of FERC's hearing proceeding into the matters affecting bulk power markets and wholesale energy prices in California.

Last week, as all of you know, we issued our proposed road map of specific remedies that we believe will repair the flaws inherent in California's electricity markets, and today we are here to discuss that order.

The approach we are taking in this proceeding is somewhat unusual in that we are, at this point, proposing remedies. FERC does not normally do that unless it is an NOI or a NOPR. We issue orders and that is it.

But we issued one that was a proposal, and I believe that this approach was necessary in order for us to expedite our resolution of the serious problems that are plaguing the electricity markets in California and adversely affecting consumers.

We are taking this expedited yet measured approach so that we can be assured that we are implementing

the remedies that will ultimately correct these problems and

not just react to them.

The electric market abnormalities that became ever so apparent in California this summer took many by surprise, including me.

It was disheartening and disappointing, to say the least, to see electricity consumers in that state being confronted with unusually high prices and the uncertainty and confusion that followed. Clearly, this is not the intended destination on the road of restructuring and competition.

I learned several valuable lessons from the events of this summer, but perhaps the most important lesson I learned is that we cannot allow the experiences in California to cause us to retreat from our worthy goal of achieving competitive wholesale electricity markets. We have all worked too hard for too many years simply now to reverse or even slow the transition to competition.

So thank you for coming today to assist me and my colleagues in implementing short-term and long-term solutions to the problems that have been identified in California, so that we could stay the course to fair, open, and competitive bulk power markets.

And I look forward to a fruitful and worthwhile

discussion.

Thank you, Mr. Chairman.

CHAIRMAN HOECKER: Thank you.

Commissioner Massey?

COMMISSIONER MASSEY: Mr. Chairman, I am here to listen and inquire. I have no statement.

CHAIRMAN HOECKER: Commissioner Hebert?

COMMISSIONER HEBERT: No, thank you.

CHAIRMAN HOECKER: All right.

Thank you very much. Why don't we begin today's session with Terry Winter, President and CEO of the Cal ISO with his statement.

Terry?

MR. WINTER: Thank you, Chairman Hoecker and Commissioners. I certainly want to thank you for having us here today and the commitment that you have made to the people of California in taking upon yourself this issue.

I cannot help but reflect back on five years ago when we were sitting in this very room and I at that time, being with San Diego Gas & Electric, we had just filed, much to the chagrin of our brothers to the north, contesting the different whether we have FTRs, whether we have nodal versus zonal, and all the issues that were before us then.

I think we have learned a tremendous lot since

that time frame as we move forward. I think the one thing

that probably, if I could do, more than anything else, is that I would suggest people in this room at this point come together to cooperate and solve the problem that is facing us.

The things that I have learned, there were three things that really struck out. First, I had tremendous concern that the operators were faced with a brand new market, that every five minutes you were going to tell us to send the generators in a different direction and every hour, we would swap out 100 generators and put in 500 others. And we found that to be a very challenging task.

But the operators at the ISO clearly understood their task, and have been able for the last two-and-a-half, almost three years now operated the system in a reliable manner.

Second, I have learned to respect the innovation that is in marketplaces. I cannot tell you the motivation that different rules have had on the market, and how quickly people adapt.

And the third thing I had learned is that no matter what you do, there are going to be unanticipated consequences of those actions, and the markets drastically change.

So the one strength that they have is they have

innovation. The next item that causes great concern is that

you don't always get what you thought you were going to get when you design the market, so I think we have to be very careful.

I am certainly of the belief that markets are the way to go. I think they have clearly demonstrated that innovation and the generation will be provided, but I think that we have to recognize a few things.

One of those is very clearly California is not all by itself. We are in a more regional market. Our solutions are going to have to be more regional. That is why I have promoted and pushed for a more regional RTO concept, and I think that will help us greatly, not only in California, but in the west, solving some of the problems that we have seen.

I think we have to balance the incentives between suppliers and the customers. Clearly, we cannot have the price fights that we have seen this summer, and we have to do something about them. We have to have effective market mitigation and your order talks to that a great deal.

But last and not least, the infrastructure investment has to be encouraged. We have got to have more generation, we have got to have more transmission lines to allow the supply to move around, take advantage of the

seasonal difference between the northwest and the southwest

and make it a larger region.

And last but not least, we have to offer the demand side programs that we have talked about.

These are not impossible tasks. Often people throw up their arms and want to go back. I believe very clearly that your Order recognizes the importance of forward contracts. As an operator, I like certainty before I move into the market and the day-ahead, and also certainty when I am in the last five minutes. I think this is a good way of providing that.

It is essential that we not restrict reliability. It is extremely important to everyone that we have a supply of power that people can count on.

On the other hand, it is clearly got to have market mitigation for those who would demonstrate market power. I will commit that the ISO and its employees are here to help try and develop these programs, so that we have a workable competitive market, and I think if people work together, we can achieve those goals.

It requires everyone to pull the same direction, and I think that is where we have to go, and I did that with 23 seconds left, so I can throw the pass to Mr. Florio, who will now start the clock again.

CHAIRMAN HOECKER: Thank you.

Mike Florio from TURN.

MR. FLORIO: Thank you very much for inviting me here today. I was not here five years ago. In fact, it is my first time in this building, so I very much appreciate the invitation.

Representing the small consumers in California, I think there is a lot to like in the Order that you put out on November 1st, but we do have some serious concerns.

Prices today in California are still at a level almost twice the energy component in the frozen rates. That means that the utility under collections are continuing to pile up. PG&E filed in Federal Court yesterday seeking an injunction ordering the PUC to pass those costs through to ratepayers.

So, as a consumer representative, I am very concerned that these dollars are not dollars that are just sitting in an account somewhere; they are going to be on people's bills in California very soon if something is not done.

I was the author of the ill-fated Load Differentiated Price Cap that died in footnote number 34, and I do want to urge you to consider, in any cap that you put in place, whether it makes sense for the cap to be the same at 4:00 o'clock on an August afternoon as it is at 4:00 in the morning on a winter night.

1 I think it does not make sense to have it be the

same because conditions are extremely different. The proposal that I put forward is not a cost-based cap; it is a proposal that takes the actual market prices for 1999 at various load levels and multiplies those by the percentage increase in natural gas prices which, for most of this year's two-to-three times what they were in 1999.

So it is not a cost-based cap, but it is a cap that recognizes that system load and input prices have a hugh impact on the price, and I would like for you to give that serious consideration.

We also see a lot of merit in the settlement proposal that ISO Management put forward to have a long-term contract requirement on both buyers and sellers. That may be a way to give us a little bit of a timeout to get things straightened out in the market.

A lot of the other states that have divested generation have had contracts back to the utility for a period of years. We were not bright enough to do that, but if we can approximate that approach, I think it may give us some breathing room to get the other issues sorted out.

The underscheduling issue is obviously a critical one. We are supportive of having some kind of incentive to move people out of real time, but we are very concerned

that, as set out in the Order, it is potentially a very high

penalty and it only falls on the load.

And if the load is facing paying twice the price in real time, that is going to give the sellers a lot more leverage prior to real time to extract higher prices.

What I would suggest is something that ISO Management has already looked at; a real time trading charge that would apply equally to buyers and sellers that show up in real time. That would encourage both sides to stay out of the real time market but it would not tip the scales one way or the other in favor of buyers and sellers.

We are very concerned that a high real time penalty that is only on the load is going to have the effect of raising prices prior to real time.

The other issue that I want to just quickly mention is governance. We agree that it is time to replace the Stakeholder Board with an independent board.

The great concern I have is that, as laid out in the Order, there is no roll for the State of California in the selection.

I do not think that is going to be acceptable from the State's standpoint, and we are potentially headed for a legal stalemate going into appellate courts or whatever, and it is going to leave the ISO in a terrible position trying to function if there is a state/federal

battle.

And I think there are compromises. I think the state is ready to get rid of the Stakeholder Board as well. It is just a matter of deciding on a selection process that everyone can be comfortable with.

I think there are compromises out there, and I urge everyone involved to try to find those compromises rather than ending up in court.

CHAIRMAN HOECKER: Thank you.

Let's go to Jim Macias from Calpine Corporation.

MR. MACIAS: Thank you, Mr. Chairman.

I strongly support -- Calpine strongly supports the FERC direction and the initiatives to bring remedies to the California market.

What I especially like is a comprehensive approach, addressing a number of corrections in the market. If summer 2000 has shown us anything, it is that simple rifle shot approaches to the market does not work.

There are three areas of your proposal Order that I would like to comment on.

The first one involves things that we see going on around the rest of the country that are not happening in California. Calpine is working very hard to bring badly-needed new capacity to the market across the country, not just help for reliability, but to bring badly-needed

competitive price pressures to the market.

As we speak, we have got 24 projects under construction around the country, five of which are in and around California.

Over the next five years, we are going to average bringing new capacity, a new plant on line on line one every month across this market.

With all these plants, they are all merchant plants so essentially we have no customer base for those plants. That means we are very long on supply and very short on customers.

Utilities across the country have the opposite position, especially those that are divesting or selling their generation and entering into price freezes as more and more states are doing. They are very short on supply, very long on customer commitments.

There is a natural attraction there for these two parties to come together and agree on product and prices over a term period to bring stability and financial certainty to both parties.

And when that happens, you do not see the wholesale market, the volatility in the market stop. By its very nature, it is going to be very, very volatile, the changing loads, changing overnight weather patterns, changing can really move loads, plants and lines tripping

1 off-line.

But what you have is that it is a very, very small amount of load that is subject to that high volatility. That is why other parts of the country can tolerate no price caps or even thousand dollar price caps because the magnitude, the dollar, total dollar amount is very low.

In California, as you pointed out, that is not happening. We have huge volumes of load riding on that very volatile market, so even any volatility has huge financial impacts.

That part of the market has to be fixed.

The other two areas I would like to comment on.

We are building the South Point Power Plant in Arizona that is just across the Colorado River from California. We are expediting construction to have that unit on line in time for next summer.

But because it is located in both federal and municipal public power areas, we do not have transmission access and cannot get to the California ISO.

We cannot bid that energy into the day-ahead market. We cannot even enter into bilateral contracts with the California IOUs.

We have to continue and accelerate this regional RTO program and find a way to get public power into these

organizations, and we cannot have this kind of swiss cheese

operations that we have in California, or 550 megawatts will not be able to help drive prices down.

The third area is transmission interconnections. We have negotiated dozens of interconnections with utilities around the country.

We have dozens of others underway right now. And other than environmental permitting, that is the biggest obstacle to bringing new plants on line.

Every transmission owner has interconnection policies that are consistent with the FERC Order. But there are huge differences and inconsistencies and it is a horror story in the actual implementation.

For example, every one has a first-come/first served policy for transmission capacity. But not only is every utility different but even within the transmission owner, there are differences in how it applies.

Sometimes it is when you call them up and say you are interested in transmission services; sometimes it is when you send them a letter; sometimes it is when you send the check; sometimes it is when you actually commit to interconnection service.

We can live with it if it is a difference between transmission owners, but it even varies dramatically within the transmission owners.

1 The queuing process is a mess. We find ourselves

with plant under construction behind projects in the queue that don't even have permits yet, and being forced to sign interconnection agreements committing to massive transmission upgrades.

If we don't sign it, we will have a plant that will not have a wire connection to the grid, so we are forced to commit, even though there are other issues.

So we strongly support having RTOs and especially the California ISO having stronger interconnection procedures that everybody understands where you don't have to guess and have it be consistently applied on transmission owners, developers and also play a strong role in transmission planning.

And I barely made it.

Thank you.

(Laughter.)

CHAIRMAN HOECKER: This is great so far. Everyone's been on time.

Bill Reed from Sempra Corporation.

MR. REED: Thank you, Chairman Hoecker and Commissioners.

San Diego Gas & Electric really appreciates the energy and determination you are putting into this issue.

We appreciate the fact that you came to San Diego

and saw the situation.

Commissioner Breathitt, you said that you were disheartened by what happened.

I have to tell you that I think some in San Diego, most in San Diego are going to be very disheartened by the Commission's conclusion on refunds. Certainly that is an area that we hope you will continue to look at. It is something that I think in our November 22nd comments, we will have more to say about.

But I would hope that at a minimum, this Commission would say that it is not going to rest on the issue of potential market power abuses.

I do not think there is any statute of limitations on market power abuses. And I do not think you should use October 2nd, or any other date as a cutoff for looking at that issue and making sure that San Diego consumers have not been burdened as a result of market power abuses.

In the limited time I have, I want to get into some of the areas of the Order that I hope you will strengthen.

Chairman Hoecker, you said it is a strong Order. I hope you make is stronger. There may be some reluctance in this Commission to be overly prescriptive, and I understand you have got other jurisdictions that you hope

will come to you with ideas.

But in California, you have had two-and-a-half years of experience. You know what does not work in California. You know what is working elsewhere.

And I think you need, in this Order, to take some stands and to get some things adopted. And I want to give you a couple examples along those lines.

I think we need to get at the underlying market structure, economic dispatch, including security constrained redispatch works. You have seen that elsewhere.

Allowing the ISO to use all of the bids to achieve the lowest cost dispatch, simultaneously balancing the system. This clears the market, relieves congestion. It should be mandatory. You should make that part of this Order that California implement that.

On the other hand, imposing rules that prevent the ISO from pursuing lowest cost, particularly in the face of excessive prices, is unacceptable, but that is what is in California today, a minimum shift approach, not an economic dispatch approach.

You need to get rid of that feature of the California program. You need to institute features that are working market in PJM and other eastern ISOs, and you need to do that now, not 90 days from now, wait for some board to be elected and 60 days after that hope that

board will institute something; you need to make that

change.

You need to have integrated short-forward markets, where the ISO integrates transmission ancillary service and energy. Integrating these markets and their pricing produces internally-consistent prices. It eliminates opportunities for gaming. It avoids infeasible schedules, and it allows the ISO to solve congestion efficiently.

All of these effects increase market efficiency and lower the total cost to California consumers.

Again, you know how to do this, you have got it in other ISOs. You ought to tell California to implement it, not wait 150 days to see what California proposes.

Locational marginal pricing works. California's zonal approach has worked badly from the beginning, and it will only become more complicated and unworkable as the ISO creates ever more zones.

Allegedly this was done in California to be more simple. It has turned out to be exceedingly complex. It presents the wrong price signals, it is masking market power, it is facilitating gaming.

You have got locational marginal pricing regimes in the other ISOs. You know they work. You ought to mandate that for California.

1 I want to also mention, as Michael Florio did,

the ideas of the penalty on load-serving entities for showing up in the real time market.

First of all, I think your five percent standard, while it may be a standard for an average for a year, on any given day, it is totally arbitrary.

Weather events on any given day can affect a load-serving forecast by more than five percent. I do not think it is appropriate to put that arbitrary number in there.

And secondly, I have to echo the thought that just putting this on the load serving entity simply gives generators in the day-ahead and hour-ahead market, market power. It tells them that they can charge another $100 because that is what the load-serving entity is going to pay in order to avoid the penalty.

It is not a balanced approach. You, at a minimum, would have to put this penalty on both parties that show up in real time.

But I think if you get at the underlying market structure issues, you will not need this penalty at all.

That having been said, I guess I would ask you simply, you know what works in other jurisdictions, you know what has worked badly in California for some time.

Please, let's go directly to what works. I am

1 sensitive to the concern that this might be off-putting to

other jurisdictions that have yet to come to you, but you have given California two-and-a-half years. And you can give the new California Board time to come back to you with modifications and experiments. This is not a prescription for all time but is a prescription that is needed now to get the market working now.

SECRETARY BOERGERS: Mr. Reed, could you complete your remarks.

MR. REED: Thank you.

CHAIRMAN HOECKER: And last, Steve Kean from Enron.

MR. KEAN: Thank you.

Thank you for letting me be here, and I also want to add my thanks to the thanks you have heard from others for the Commission stepping up and taking bold action to address the problems in this market.

As politically charged as this environment has become, that could not have been easy. You and your Staff are to be congratulated, and I urge you to continue.

It is clear not only in California but across the country that without active intervention from this Commission to open markets, we are destined to lurch from one crisis to the next, from one place to the next.

Only a steely and unwavering commitment to

1 opening markets by this Commission and its Staff is going to

pull us out of the wreckage created by the half-baked and compromised proposals that we have seen emerge so far across the country.

Clearly, voluntary programs are ones that are requiring permission or agreement from incumbent firms are not going to work. No monopoly voluntarily surrenders its power. You have to take it away.

To have a reliable and competitive electricity market, you have to assert your authority. And, as recent events have shown, I think this Commission and its Staff remains the best hope we have for achieving a competitive and reliable electricity market.

I want to highlight a couple of the things particularly that you did that I think will be very helpful in California.

First, in fixing the politicized and unworkable governance structure of the entities in California, the ISO and PX, I think you took a big step forward.

Secondly, in eliminating the PX monopoly over certain purchases and sales and allowing people to contract on a forward basis, again you took a big step forward.

But there is more to be done, and I want to highlight a couple of things in particular.

1 The price cap levels, and also the continuing

threat of refunds, undermine much of the good work that was done in the rest of the Order, and will absolutely run counter to the best interests of the customers in California.

Let me explain why. Wholesale price caps did add reliability in two ways; one is that they discourage new peaking generation from coming in to take care of supply problems that appear on a short-term basis.

We had offered generation and firm sales, over 300 megawatts, that we had to withdraw as a result of price caps and the uncertainties surrounding them in California.

Much of that, over 300 megawatts of that, would have been available for next summer. That is a real and tangible impact. And when you are talking about facilities that get paid for only by running a relatively few number of hours during the course of the year, the price caps that have been proposed are simply not workable, and customers will be harmed.

Now conservation and demand-side management is the flip side of that same coin. When prices rose in California, we found ourselves scrambling to make conservation and demand side management investments. Price caps caused the cancellation of many of those

1 projects. And it is fairly straightforward.

When we go to a customer, what we are selling our customers, our end-use customers in California, is a lower bill. That is a function of not only a lower rate, but also managing demand, shifting load from peak times, conserving energy where possible.

Those things require information technology investments, capital investments, equipment upgrades; those things cost money. The financing of the support for those kinds of investments comes from looking at prices and seeing what we can save by saving a megawatt as opposed to building a megawatt.

And we have between 100 and 200 megawatts of proposed demand-side response investments that we were going to make that have had to be withdrawn as a consequence of price caps in the state.

Let me make sure that you understand my perspective here. Enron, other than some WIN facilities in the state, we are not a generator in California. We have no particular interest in high prices.

Our interest is in a market that works. We sign up customers, we sign up producers, we are protecting them from price volatility. We need a market that works, a market that we can transact in. That is our interest in this proceeding.

1 It is not a matter of should prices be at this

level or be at that level. It is what is going to work here.

You also have another alternative to price caps in the wholesale markets. Many customers and many suppliers, including Enron, have begun to explore taking residential customers, the customers that we are most concerned about and who are most vulnerable to these price swings, and protecting them by having competitive providers provide a supply or a block of supplies in order to serve those requirements.

That can be done in the absence of wholesale price caps, it can be done at a level substantially below the caps that you are proposing, and it solves the problem.

There are economically workable and even politically attractive solutions to the problems of high prices for the most vulnerable customers in California. But you are not going to get at those solutions by imposing price caps and hanging the threat of refunds over everyone's head.

A second item -- and I will be very brief -- second item is a big part of the problem could be solved by having more information available from the ISO, information concerning transmission, loading by line, where the

constraints are, how congestion management is precisely

handled, ancillary services information, and for competitively sensitive information, even some after-the-fact access to information about bids and the like, can all go a long way to helping us, as market participants, route around the problems in the market, and help solve some of the problems we saw in California last summer.

Again, I want to thank you, and I look forward to your questions.

CHAIRMAN HOECKER: Thank you.

Let me remind Staff that they are invited to raise their hands and ask questions, but will start with Commissioner Breathitt.

COMMISSIONER BREATHITT: Thank you.

I have some comments but questions too, and if you do not feel like you have a chance to fully formulate your response, that is what the three-week period is for commentary is.

Terry, I am assuming from your remarks that, unless I did not hear it all in five minutes, that you seem to be pretty much okay with the Order. Is that? You did not give me any constructive criticism.

MR. WINTER: I have been very careful about who I criticize lately.

(Laughter.)

COMMISSIONER BREATHITT: I understand that, but

we need constructive criticism for this Order.

MR. WINTER: In general, I am very supportive of it. I do have some concerns, mainly around the $150 price cap, soft price cap, and those concerns are again unintended consequences.

I'm not sure with the ways around the $150 price cap, I could have some real implementation concerns, and what I mean by that is, if you stop and think all the software that we have developed to keep track of the literally, as it turns out now, billions of dollars moving across the system and who gets it and who doesn't, and which price gets sent to each individual, I've now got a situation where I'm going to be accepting prices over $150 and then those are going to be subject to review later at some other time.

And then I've got to go back and undo all the bills that I sent out and decided in these 51 charge types, how I rearrange those to refund back.

So I think the approach is right.

I would look for hopefully a little more simplistic way to handle the future problems, so that's a concern that I have in implementation.

Other than that, I think we are headed in the right direction, and I know it was difficult for FERC to

1 come in and put some price caps there, but we do have to get

those instances where we have market power being demonstrated, clearly under control and control the volatility in the market.

COMMISSIONER BREATHITT: So your concern speaks more to administrative back office billing settlement type?

MR. WINTER: Yes.

COMMISSIONER BREATHITT: Okay. I wanted to ask you, James or Jim?

MR. MACIAS: Jim.

COMMISSIONER BREATHITT: You talked a lot about your merchant plant development in the U.S. You mentioned you've got a plant a month coming on.

You did a great job of laying out what you saw the problems with interconnections were and I reached over to Commissioner Massey and I said, that must be music to your ears, because he's really helped the Commission think through the interconnection issue.

But you said that you didn't want what your company is doing in other parts of the U.S. to keep you from doing that in California.

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What is stopping you from solving what you clearly outlined were the problems with supply and demand?

MR. MACIAS: Yes, we --

COMMISSIONER BREATHITT: What is stopping you in California?

MR. MACIAS: First of all, nothing is stopping us in California. Despite all these issues, we are still proceeding as fast as we can, as aggressively as we can to bring new development into the state, around the state, across the country.

Some people are criticizing us that we are going to bring too much capacity into the market and flood the market. That is what deregulation is all about. We welcome that kind of competition. We are building plants that can compete in that kind of an environment, and that is where we are going to get to. It is just a question of when we get there.

We are committed to California. We are a California company. We are going to continue to build and develop and work through these issues. We just appreciate the help of -- trying to make it easier for new developers to come in and help build overcapacity into the market.

COMMISSIONER BREATHITT: The soft cap is not deterring your construction?

MR. MACIAS: Well, I mean, not of our basic load

plants, but it did influence us canceling our bids that we had won with the peaking capacity. I do not consider it to be a soft cap. To me, I read it as a hard cap. I may interpret it wrong, but I see it as its market price is below $150. Above $150, you have to be able to defend the cost. And with these peaking units, the cost is above $150, and I think we can defend the costs that would be required to make these even marginally economic.

But in my former life I have been there on cost-based rates. I have gone through regulated pricing and the process you have to go through in both the state and federal level. Very time consuming. It distracts management. It is a big process, and I am not going to lead Calpine into that same market. So we will stay out of it. There is other opportunities for us to use our turbines.

So it does have an impact I think on the peaking kind of capacity the ISO is trying to enter. It has no influence to us at all on our core base load plants and development.

COMMISSIONER BREATHITT: Steve, you talked a little bit along those lines about a plant that your company withdrew. And I actually found that press release on the Internet just hours after we issued our Order that you were withdrawing. And I wondered how quickly you could reach

that conclusion and if you could talk a little bit more

about why.

MR. KEAN: Well, the price caps, whether they were the ones that the Commission proposed or the ones that were in place in California, or the threat of additional ones was creating enough uncertainty that we did not feel comfortable proceeding with those projects. We did not stand by to make the decision, waiting to see what the Commission's Order was going to be.

But I think Jim has it right. I mean, we have a base load facility in California that we continue to build, as well as in some neighboring states, a facility in Nevada, for example. We continue to work on those, because we can we believe, at least still so far, can make those economically work in the market.

But our California facility is not going to come on until '03. Building the combined cycle facility takes a bit longer. The peaking facilities, which could have been on as soon as the summer of next year to meet a vital need in the state, are the ones that become uneconomic under the price caps either as the Commission had or as the ISO had them before.

COMMISSIONER BREATHITT: Billy, you talked about the penalty. Utilities have had decades of experience in planning for your load. The Commission in its Order is

giving back to load-serving entities the ability to plan

your load on a more forward-looking basis.

So you talked about weather being a problem and you talked about a couple of other factors being a problem that could cause you to bump over the 5 percent. But can you say more about the penalty? You just said you did not like the 5 percent. You did not say that you could live with another number or that you wanted it to go away.

MR. REED: Well, frankly, I do not think the Commission has such penalties in the tariffs of the other ISO markets. I do not think it is found them necessary. And I think getting at the underlying structural problems in the market are the cure to this so-called "underscheduling". I have never agreed that there is such a thing as underscheduling.

There is price-sensitive scheduling, and when generation will not meet the load price in the earlier markets, people go to the later markets, and they have gone to the later markets because that was the lowest price available to them.

I think we have structural issues that need to be addressed, and I do not think the so-called underscheduling issue is going to be an issue if we get those things right.

And let me back up one step and say that we will put more of our load under long-term contracts. But I do

not think that you can identify a hard number and say that

is what should go under long-term contracts. I think that number moves around as market circumstances move.

For instance, anytime you buy forward, you create an opportunity, a potential opportunity cost of missing a downside turn in the market. You have to balance the mitigation of the upside risk with the loss of the downside potential. And I think that is going to leave some amount of load always in the short-term markets. And weather and other factors can cause that to show up in the final market.

So I am not in favor of any penalty at all. If there is going to be a penalty, I think you have to avoid only putting it on the load, because that simply gives the generator a higher price to charge in the early market.

COMMISSIONER BREATHITT: I am not gong to ask any time to be taken now with responding to whether it should be on the generator also. But if you want to respond in your comments, that could be helpful.

Bill was suggesting that if we kept one that it would need to be on the load-serving entity and the generator.

I think I have just got one final question. Bill, you also talked about the Commission's refund authority. Are you going to say more about that in written comments?

MR. REED: Yes we will.

COMMISSIONER BREATHITT: Okay. And Mr. Florio, you talked about the -- I thought of one more -- you talked about the Oversight Board, the Commission addressing the elimination of the Stakeholder Board in our Order and that there was potential for -- that we needed to work that out -- and there was the potential for a legal problem there. What are you meaning?

MR. FLORIO: Well, in order to change the Board we have to change the bylaws. The bylaws -- changes to the Board selection process of the bylaws have to be approved by the Oversight Board. And they are not going to approve bylaws that say they have no role in selecting the new Board. So we are going to be back in the same mess we were in before SB-96 where the state says one thing, the FERC says another thing, and we all sit and wait for the D.C. Circuit to figure it out. And in the meantime, the ISO is in limbo.

And what I am suggesting is I think Senator Pease's office and the Chairman's office got together once before and came up with a compromise that everybody could live with, and that is what I am encouraging we do again. Rather than fighting, let's roll up our sleeves and find a solution.

COMMISSIONER BREATHITT: Mr. Chairman, thank you.

CHAIRMAN HOECKER: Thank you. Commissioner

Massey?

COMMISSIONER MASSEY: Thank you. I am intrigued by the comments of Mr. Reed and Mr. Florio about the long-term market structure issues here, and it sounds to me as if you want this Commission to move aggressively to make this market look more like, for example, the PJM market. Am I correct in that assumption?

MR. REED: Yes.

MR. FLORIO: Yes.

COMMISSIONER MASSEY: Well, that was a softball question.

(Laughter.)

COMMISSIONER MASSEY: In case anyone missed it.

VOICE: You did not get a majority, though.

(Laughter.)

COMMISSIONER MASSEY: You know, when you are cross-examining you know who to ask questions to and who not to.

(Laughter.)

COMMISSIONER MASSEY: Let me ask you, do you believe that the failure of the California market to look more like, say, the PJM market, is responsible for some of the high prices that we saw?

MR. FLORIO: Yes.

COMMISSIONER MASSEY: Well, in what respect?

MR. REED: I believe that the underlying structure has created -- first of all, it is -- it starts out as inefficient. The market separation. The fact that the ISO is not allowed to create an economic dispatch but must employ a minimum shift dispatch is an uneconomic move right from the beginning.

But I also think that the structures that have evolved in an attempt to allegedly simplify the California market have in fact created numerous opportunities for gaming, have created other inefficiencies. And I think that the prices that are in California reflect these inefficiencies and opportunities for gaming in the California market.

MR. FLORIO: I think if you have had a chance to look at the Hogan and Harvey paper that Southern Energy submitted a few days ago I have a little problem with some of the spin they have put on it, but the underlying idea that I see there is that because of the iterative, sequential nature of the market, it really has created a whole series of opportunity costs for sellers that kind of feed on each other.

So even when there is a market clearing price auction, it kind of works like an as-bid market, because everybody's bidding in market number one based on what they

1 think they can get in market number two or market number

three.

So I think actually the structure does raise prices in ways that are very complex to untangle. But I think they could explain it a lot better than I can, and there is a very detailed paper on that subject that you could take a look at.

COMMISSIONER MASSEY: Mr. Kean, what do you think about this question?

MR. KEAN: Well I do not think that it is really getting at the underlying problem. The problem has not been really so much, certainly recently, the interface between the ISO and the PX. The problem has been a real lack of forward contracting in the market.

That is the problem to get at, and I think that is the problem that the Commission has begun to get at.

Another big problem is just the delay in bringing new generation on. Those are the real underlying problems.

Now having been through a little bit of the process earlier on in California, I am a little hesitant to say, let's go build another machine. In California, setting up the ISO and the PX in the first place cost about $500--between $400 million and $500 million. And I just do not see setting a bunch of programmers loose again on the

1 market in order to try to come up with the absolute perfect

dispatch and force everybody into that dispatch model really gets at the underlying problem.

You also have--I mean, the Northeast markets have been no bed of roses either. I do not think we are even allowed in the New York ISO, for example. You have got transmission price uncertainty that is produced by the LMP model.

It is really -- I mean, I understand that there is a lot of, on a theoretical level, there are a lot of people, a lot of very smart academics and a lot of other people who feel very strongly that this is exactly the right way to go.

I just think on a practical level, it is not getting at the real problems we are seeing in California, and we have got to focus on those first. Let's get that resolved. Let's get that fixed before moving on.

COMMISSIONER MASSEY: Well, let me ask you: Clearly it is a primary thrust of the Commission's Order to kickstart the overcontracting market. Does the Order move far enough in doing so by eliminating the buy/sell, by encouraging forward contracting and so forth? Shouldn't we have gone further?

Any panelist, I would like your comments.

MR. REED: Let me take a first try at this.

COMMISSIONER MASSEY: Yes.

MR. REED: I do not think going further if you are thinking about minimums, forcing utilities to buy a certain amount or forcing generators to commit a certain amount, I do not think that going further in that regard would be very helpful.

The circumstances are just, they are too--the the purchasing decisions are too much dependent upon the circumstances as they appear.

I think you did a great thing by just, you know, ending the slavish reliance on the spot market and pushing people into the forward market. I think one of the things--and this may not be so much for this Commission as it is for regulators in California--one of the things that is going to have to be gotten at to give your Order real force and effect is to make sure that when rational forward-contracting decisions are being made by utilities that they are allowed to pass those costs through and that they have some certainty in that regard.

Otherwise, they are not going to use the level of contracting authority that they have already be given to go into forward markets. And so those are the things that really need to be focused on to get the effect of your Order further.

COMMISSIONER MASSEY: Mr. Macias?

MR. MACIAS: Yes. I agree that your Order pushes

the market in the right direction, but a lot has to be done at the state level. We have tried and tried and tried to get term agreements with IOUs in California. And in hindsight we are real glad they did not agree -- they did not take the price offers we had.

(Laughter.)

MR. MACIAS: But to be honest with you, utility management is really managing their shareholder risks and not managing ratepayer risks. And as long as that regulatory structure is there, they are going to keep doing what Bill mentioned. They are going to be concerned that if they enter into this contract, what if real prices on delivery actually drop below and they have exposures for disallowance?

As long as they have that concern and uncertainty, they will not enter into term agreements no matter how good they are. We are trying to sell below freeze prices, below market prices to help stabilize and help and still earn an attractive return, and we can't get anywhere.

COMMISSIONER MASSEY: Our Order made an interesting point, which is the forward contract price in PJM for this summer was substantially higher than the spot market price. Mr. Florio?

MR. FLORIO: I think you do need to do a little

bit more, and I think the kickstart along the lines that ISO management suggested following on Frank Wallach's proposal of, say, a two-year contract that, you know, a substantial amount of generation and load is required to enter into.

Now of course that may put you in the position of refereeing what the price is going to be on that contract. But I think the kickstart would really help.

The other thing is, frankly, we have got some work we have to do in California. A big problem that the investor-owned utilities are facing is now we are all saying to them, you know, go long, go long. But they have no assurance of a customer base. The post-transition role of the utilities in retail procurement has not been resolved. And so how can you enter into a five-year contract with one-month customers? And that is a serious problem that I am not sure you can solve, but we need to collectively address that.

We have begun to float the idea of making a core/non-core distinction as California has in its natural gas market so that the utilities' role is defined as putting together a portfolio of supply for its small core customers, and the larger customers that, you know, want to do their own risk management can do that in the market and probably would not want the utilities hedging on their behalf.

1 But that is one way. It is not the only way of

getting at this, but I think we do have work to be done. And, you know, there are a lot of different ideas floating around about how procurement should be done. Some people want to get the utilities out of it entirely.

We have got to make those decisions and move ahead. And by sitting in limbo, it makes it impossible for the utilities to do the work that many of us want them to do.

COMMISSIONER MASSEY: Mr. Macias -- one final question, Mr. Chairman. Mr. Macias, I did appreciate your comments on interconnection. I agree with everything you said. We have directed the ISO to adopt standardized interconnection procedures across the ISO. Now I know you have -- your view is we ought to move more aggressively nationwide, and I agree with you on that.

But in terms of what the ISO does with respect to interconnection in California, have we done enough?

MR. MACIAS: Yes. I think you have given a good direction. If the ISO picks up that ball and establishes interconnection procedures so that everybody understands, it comes up with a cost allocation method, even if it is not perfect, as long as it is stable and people understand what you have to do, yes.

COMMISSIONER MASSEY: Thank you. Thank you, Mr.

1 Chairman.

CHAIRMAN HOECKER: Thank you. Commissioner Hebert?

COMMISSIONER HEBERT: Thank you, Mr. Chairman. Mr. Winter, let me start off asking you -- there is a basket of remedial measures that you are going to have to deal with. Tell me how that affects your January 16th RTO filing.

MR. WINTER: Well, clearly, as you look at the resources in a corporation and you have to give it direction, we would certainly like better not to have to be dealing with a lot of basket of things. But it is also a different group.

I think my concern more in the RTO -- I mean, we can put together an organization that we can file with you saying here is what we would like to do. But where it has hurt us the most is from the standpoints of other states who we might ask to join in our proposals have been very reluctant with the situation in California to get near that.

So as far as our filing, I do not think that it impacts that. We have that on a separate track, although part of your filing does ask us to resolve congestion management, identify how we would do those programs, I think we are ready to do that and make those decisions. So we would be presenting that to you. It would not have in the

congestion management area Board approval, because your

instructions asked us to have the new Board approve it. But as far as the plans, we could file those.

COMMISSIONER HEBERT: I believe you and Mr. Florio both have mentioned potential constitutional problems, bylaw problems in trying to deal with the restructuring of the Board itself. Could you both maybe elaborate a little bit on that, and if that is doable, if it is not doable?

MR. WINTER: Well, first off, I very carefully did not mention it.

(Laughter.)

MR. WINTER: Because I quite honestly have had --

COMMISSIONER HEBERT: Maybe I was just hoping you would.

(Laughter.)

MR. WINTER: I have had several attorneys looking at that very question, and to this date, I am getting a very mixed bag of answers on what the rights of the states are versus the rights of the federal folks. And I guess all I could say from it is if people do not work together and they decide they want to fight about it, there appears to be lots of avenues that they can go down. Beyond that, I really could not comment.

COMMISSIONER HEBERT: Well, then I guess the

1 follow-up question still would come back to you, Mr. Florio.

MR. WINTER: He is an attorney, by the way. I am not.

(Laughter.)

COMMISSIONER HEBERT: I love attorneys, being one, so I will not comment on that. But I love some non-attorneys, too. Then do you think this is going to invite litigation? I guess that is my real question.

MR. WINTER: I think if people feel very strongly, which they tend to, yes, I think it will probably invite some litigation.

COMMISSIONER HEBERT: Yes. I think it would be fair to say there are some strong feelings in California. Mr. Florio, thank you. Mr. Winter, thank you. I know these are tough questions, tough times.

MR. FLORIO: I think there is definitely a potential for a conflict. There was a conflict a couple of years ago that left the ISO in kind of a trying to serve two masters situation.

But I think it is also important to realize that I do not think there is a conflict over the desirability of an independent Board. California has not formally said that yet, but I know a lot of policymakers are thinking about it. And you might very well have seen legislation to that effect if this Commission had not gotten there first.

1 I think the question is what is the selection

process? And I think there are creative ways of addressing that. As long as there is a will to come up with something, I think reasonable people can sit down and do that. But, you know, if the agreement does not happen, the hundred lawyers when they get done in Florida can come to California.

(Laughter.)

VOICE: We cannot wait that long.

(Laughter.)

COMMISSIONER HEBERT: So your thought is that there would be litigation here as well? I do not want to put words in your mouth. That is why I am asking you the question.

MR. FLORIO: I think there would be litigation ultimately. I think initially it is going to put the ISO in a very difficult position being ordered to do certain things by this Commission that would put them in violation of state law. And the first problem would be how does the ISO react to its two masters telling it two different things? And presumably whichever way it moves, it will prompt litigation on one side or the other if a compromise is not reached. And I think it can be.

COMMISSIONER HEBERT: I am not going to name names anymore, so -- all right, Mr. Winter, if you want to

follow up on that.

MR. WINTER: Yes. This is really taking a risk, but, you know, what the heck. I get dissected in front of groups every day anymore.

But I really think the roll we are on is to follow the FERC Order, which is go get us a slate of new Board members and present them. And what I would like people to do is give us at least that 60 days to get that slate put together, look at the quality of people that wee can attract to the Board of the ISO, and then make the decision whether we have done an adequate job of presenting to them a Board that will take into account all of the different interests, at the same time be the fiduciary responsible person to the ISO, and at the same time being independent.

And I think that is a huge task, but people seem to want to rush to take action before they have even seen what the Board is going to look like, and I guess I would just request that they give us time to put together a Board. And hopefully I believe I know all the different people's desires and wishes and I do not think there are any people that could ever fill that role. You know, the human being has not been created that would do that.

But we might have a very good Board that everybody could get behind.

COMMISSIONER HEBERT: I would argue there was one

created, but we will not get into that today.

(Laughter.)

COMMISSIONER HEBERT: I heard several people say that in fact the soft cap is a hard cap. Anyone disagree with that? If so, tell me why.

MR. FLORIO: I do not really see that it is a hard cap. I mean, there is certainly some deterrent there that if you want to go above that you have to file some paper with this Commission, and that is a hurdle. But I think from our standpoint, we are more concerned that once the first person does it and then the second person does it by, you know, a week later, everybody's over the cap and it will not mean anything anymore.

I am not convinced that it is a hard cap. It may depend on how this Commission reacts to people going above it. But if it is just filing your papers and going ahead, I do not think it will take too long and it will be meaningless.

MR. REED: I do not view it as a hard cap either. I think it makes some sense for FERC to have an inquiry into someone who is charging $200 a megawatt hour on an off-peak period to know what the possible justification for that is.

And, you know, I am not sure how the $150 soft cap works fully. That is something we are still looking at

1 and exploring. But I certainly understood it to give the

opportunity for any generator to come in and say my costs are higher than this, and therefore I should be allowed to bid in a higher price.

COMMISSIONER HEBERT: Well, that leads to an interesting question. I am going to come back to you on that. Since Mr. Reed mentioned that, it leads to an interesting question is, is the fact that the price gets above the cap -- you make it sound like it is always the fault of the supplier. Is it always that side of the bid, or is it ever the side of the bid where in fact the buyer, to maybe protect themself for the next-day market moves it up above what the current bid may have been, which may have in fact been below the cap itself?

MR. REED: I will answer that in two ways. First, in terms of the prices getting that high. If competition is disciplining the prices. This market was intended to have, to incent marginal cost bids with the generator with the highest marginal price that gets selected then setting the market clearing price.

In fact, the prices that we are seeing do not seem to bear much relation to anybody's marginal generating cost. And that was the sense in which I said I am surprised to see prices at these times at these levels.

The second thing is, I think you raised an issue

1 about the demand side. One of the major problems that I do

not think this Order address and I do not know that it can is that the demand side is not as responsive as it should be. We need more demand-side response. I do not think we have a competitive market until we have demand playing along with supply.

You suggested there may be some inelasticity on the load side where they are going to go and say jeez, I need a higher price. I need to be willing to accept a higher price. Because in fact we do not have the tools to create a demand response and get a lower result.

COMMISSIONER HEBERT: But in fact, Mr. Reed, if you are a true believer in demand side, I do think that is one issue that this entire Commission -- I will not put words in anybody's mouth, but I think we are all sympathetic in trying to get something which would move us towards a direction where we do have some demand-side issues that work.

But in fact, if you are a firm believer in demand side, which means that you let price certainly affect whether or not someone turns a dial up or off, whether they turn the light on or off, wouldn't you in fact argue that caps would inhibit demand side? And if not, I want to be a part of that conversation.

MR. REED: Yes. And let me again back up and say

that San Diego Gas and Electric, Sempra, has never supported

price caps except as interim measures where the underlying market structure is not working effectively.

And every time that we have come to you or to the ISO and we have said we need price caps, it is because we do not think the underlying market is producing reasonable prices.

We want those price caps to be interim. We want them to be temporary, and we want long term for there not to be any price caps.

COMMISSIONER HEBERT: Well, then you would have to agree with me, would you not, that we are not going to get working demand-side measures until we raise the price cap?

That is what you implied, and I want to hear you say it.

MR. REED: Well, you know, at the prices we are seeing today, I think there ought to be demand response. I do not think the demand side is enabled as it needs to be to give that response.

COMMISSIONER HEBERT: You are not going to answer the question, but I am going to ask it to you one more time in a better way.

(Laughter.)

COMMISSIONER HEBERT: You are making me be a

1 better lawyer. If price caps were not currently there

and/or are not currently there in the future, would you not agree that demand side would work better?

MR. REED: Yes. The demand side would work better. And the prices that would cause it to work better would be unconscionable.

COMMISSIONER HEBERT: Therefore demand side?

MR. REED: Well, you know, we got a huge demand-side response in San Diego this summer. We got hundreds of megawatts of reduction in demand side. I do not think that demand-side response was as good as it could have been if the market had been better enabled. And I think the demand response came in result to very unfortunate prices, to prices that should not have been produced by a competitive market.

COMMISSIONER BREATHITT: Commissioner Hebert, can I ask a clarifying question?

COMMISSIONER HEBERT: Absolutely.

COMMISSIONER BREATHITT: Which class of customer or classes was your demand response from?

MR. REED: It was all across the board.

COMMISSIONER BREATHITT: All three?

MR. REED: Yes.

COMMISSIONER BREATHITT: Thank you, Commissioner. Any one, proportionately, any one greater than the other?

Or if you do not know, that is fine, too.

MR. REED: No, I do not actually know. I know anecdotally of examples from all customers, from residential customers up to large customers. I know anecdotally of responses. I do not have a quantification.

MR. FLORIO: Some of that response is people closing their businesses because they cannot make ends meet anymore. And I guess that is what bothers me about this is in order to save the customers, we are going to kill them first. And I do not think certainly politically and even economically that you could say, well, if we just charge people enough then they will stop using.

COMMISSIONER HEBERT: Yes. Wait, Mr. Florio. I do not want you to misunderstand me. I do not -- and I know you are not meaning to imply that I would ever want to kill economically customers. It is certainly not what I want to do. I pay bills myself.

What I am wanting everyone to understand is, let's not cloud the issue. Let's talk about supply. Let's talk about infrastructure. And let's understand in the meantime that we do not have a structure that is going to allow us to have demand-side measures that are going to work. That is the point I am trying to make. So let's talk about the issues that we need to be talking about.

I am certainly not wanting to penalize anyone and

1 certainly would agree that their prices have been somewhat

disturbing.

MR. FLORIO: I think there are ways that you could still get the response. You could have people bidding demand into the market and, you know, getting paid to curtail under the soft cap. That would be permissible I think. And somebody could say, you know, I will shut down at a price of, you know, $500 a megawatt hour or whatever. And I presume that would be permissible. So, you know, I think there are ways that it can happen even with at least a soft cap.

COMMISSIONER HEBERT: Certainly I know two other people want to make a comment. I think New England has done some of that. I wrote an article not long ago on how the airlines have certainly done that, are willing to buy back seats. So it is certainly something that we have experimented with that works, and I think we should look at it.

Mr. Winter had one, and I will come back to Mr. Kean. Then I have got I think one more question.

MR. WINTER: Yes. The issue of whether the $150 is a soft or a hard cap, one of the clarifying things we are going to be filing on is I believe that in there you gave as opportunity costs or market price outside the ISO as one justification for the price being over $150.

1 Let me just give you a hypothetical. There is a

large utility in the Northwest that has a considerable amount of hydro. They are very concerned that they are not going to have enough power this winter. And so they have an option. They have looked at the natural gas prices that they anticipate may come into the California market. They look at our emissions, and they can see that if they rely on that market along in December or January that they can pay very high prices for power out of California at a time when they do not have sufficient supply.

So at three o'clock in the morning, they look to our market and say, I am not going to run water. I am going to hold it today in the river so that I can have it in January and December. That action can force the price in California to go rather dramatically high at that particular hour. Does that mean that the generator should be restricted in California at $150 when in fact the Northwest would be willing to pay more than that in a more regional market?

And so then if we try to hold the price to $150, is that a justifiable reason for allowing them to go above it? So that is what I mean when Commissioner Breathitt mentioned back room. It goes a little farther than back room. It comes down to what is going to be the justification and how do I determine that?

COMMISSIONER HEBERT: I would agree. A perfect

example of a price cap inhibiting supply coming in.

Textbook. Mr. Kean?

MR. KEAN: I just wanted to say, I think there is a solution, as I mentioned, for retail customers. You can identify the customers who you want to protect, and you can supply those from the competitive marketplace and you can do that at a rate that will go below even the retail caps that have been put in place in California.

Those are the things that need to happen instead of having a debate about, you know, are customers harmed by or helped by the wholesale price cap? On the cap itself, it undoubtedly -- it undoubtedly has an effect on generation investment decisions and on demand-side management decisions. People have to decide if they are going to put their money into these things.

A soft cap may work itself out over time to prove to be very soft. But in the meantime, people have to decide if they are going to put a turbine on the ground in the state or not. And that is a decision that the longer we delay, see how the price cap turns out or how exactly it is enforced or administered, the more problematic it becomes in terms of getting generation and a demand-side response in California in a timely fashion.

So it absolutely has an impact on generation and

1 demand-side investments, and it is making matters worse as

opposed to better in the state.

COMMISSIONER HEBERT: Thank you. Would any of you be opposed to the state of California through the governor's office or the legislature anyone taking some type of action that would in fact give some rate protection to certain classes of persons? Have you explored that? If so, what are they?

MR. KEAN: I think it depends on how you do it. If it is just a pronouncement, which I think we have had already, that, you know, this is now the new price for this class of customers, that is likely to be a mistake. It will affect the utilities certainly who are -- it already has affected the utilities who are caught by that.

If instead, though, what you do is you say let's have competitive suppliers step up to serve these blocks of load, get the utility out of the no-win situation that they are in today, I think what you would find is that their prices can be offered on a long-term basis in a level that is attractive, and you do not have to just by fiat impose a price cap.

And I think that is a better way to do it. You accomplish the purpose of protecting small customers, and you do not bankrupt the utility in the middle.

MR. MACIAS: I strongly agree. The retail loads

that the utilities, for example have, have huge purchasing

power that they could be leveraging to drive down prices, and you do not enter into long-term contracts with the forward price is high. You wait til it is low and lock in suppliers to those prices.

Instead we have -- the analogy was not mine. I have heard others describe it. It is like people traveling on Thanksgiving weekend, and everybody knows it is going to be very, very busy and crowded. No one purchases their tickets way in advance. No one even makes reservations, and you have a huge supply of people showing up at the counter demanding a seat because they need to get to their destination.

When you know it is going to be congested, you know it is going to be crowded, you purchase it as much in advance as possible and get the best price you can. If we do not solve that problem, I do not care what we do, we are just spinning our wheels.

COMMISSIONER HEBERT: Anyone disagree with that?

MR. FLORIO: I do not disagree. I think if we have the utilities in the role of doing that, we have to make sure we have the incentives right for them to do a good job, but I think that is the right direction to move in.

COMMISSIONER HEBERT: I did not know if you had anything, Mr. Reed. I do have one follow-up for you, and

then I will close.

MR. REED: I really agree with what Mike just said. That, you know, every customer in California today does have some price protection from the state-mandated way, either legislation affecting prices i San Diego or the great freezes from prior legislation affecting PG&E and Edison. I think Michael correctly pointed out the issue is how do we accomplish those objectives and the tools to accomplish them or what is needed.

COMMISSIONER HEBERT: Mr. Reed, what has your company done to date to affect you ability to play the forward market?

MR. REED: We have been granted authority by the California Commission to enter into bilateral contracts. We have held our -- we have issued our fees. We have gotten responses in and we have signed some contracts.

We are certainly not done, but we are underway.

COMMISSIONER HEBERT: That is all I have. Thanks, Mr. Chairman.

CHAIRMAN HOECKER: So you are going to be more aggressive in the coming year?

MR. REED: Yes.

CHAIRMAN HOECKER: In the forward market. Let me just try to recap something here. My impression is that, you know, the focus on the $150 benchmark, which I frankly

do not view as a hard cap, is one of a variety of measures

we have chosen to try and mitigate the stress in the real-time markets.

Moving transactions into the forward market seems to me to be the most important remedy that we have put forth in this Order and one that ultimately could make these price mitigation measures like price caps, whether they are viewed as hard or soft or whatever, more or less superfluous.

Have we done everything we can do to make the forward market more active and more responsible -- more responsive to the needs of California?

MR. REED: No. And what you need to do is aggressively address the shot-term markets and the reform of the short-term markets. Because I think it is unrealistic to expect that those of us who are going to be seeking contracts in the forward markets will get the prices we should, will get reasonable prices, if the underlying short-term markets provide suppliers an opportunity to get unreasonable prices.

So, you know, I am concerned to the extent that forward contracting has been presented several times as a panacea, as a solution. I do not think it is. I think it is a very important part of the mix. But absent the underlying market reform, it is not a solution.

CHAIRMAN HOECKER: Other views on that? Mr.

1 Florio?

MR. FLORIO: It is a little scary to agree with Bill so much because we spend most of our time back in California shooting at each other. But I agree with him completely. You know, we do not want to be in a situation of, you know, trying to buy fire insurance when the house is already burning. And I think fixing the short-term market, I think people are going to price long term in relation to their expectations of what the short term will be. And if we can get those kinds of fixes in place, I think that the long term will be much better positioned to take care of itself.

MR. MACIAS: Well, I agree. I think if we did this we may be sitting and waiting forever until the conditions are perceived to be right. If you do more forward selling, it will force the efficiencies and the improvements in the spot market. It is which comes first.

Again, load has tremendous purchasing power that can drive. I think they -- I do not want to tell them how to do that, but they can really drive prices down in the market if you get the smart buying like happens in every other commodity in markets where retailers are trying to look out for their customers, because if they do not protect them from these volatile wholesale prices, they will lose their customers. That happens in every other market. And

1 as long as we argue around the rolls and people are

concerned they are going to do too well or too bad, we are never going to get there.

We offered prices back in April of this year at $45 a megawatt hour in the forward market that was authorized by the PUC in the PX forward market. And parties in this room said these prices are too high. We are going to wait til they go down. We offered them it at $50, and we are still hearing, prices are too high. We are going to wait til they improve and come down.

So I think you can do the other first at the same time you are correcting trying to improve the spot market. But as long as you have such tremendous loads showing up on the spot market and you have this feeding frenzy, you are always going to have that kind of volatility in the California market.

The weather springs, especially in the summer, can swing dramatically. And in answer to your question, I do not think 5 percent is enough, because a load can swing overnight over 5 percent in the state. I think 8 percent might be a better one. You will always have that uncertainty and that volatility in the California and the Western U.S. markets. You will have conditions like Terry described. You cannot manage that volatility. What you do do is protect yourself against the volatility. That happens

in every other commodity market.

So my message is, quit trying to manage that volatility, but manage the protection of it.

CHAIRMAN HOECKER: Terry?

MR. WINTER: Yes. As I reflect on this, I do not think forward prices that the generators are asking for are going to be that hard to judge. I mean, I am not in the generation business anymore. I used to be a little bit. And I have done many programs sitting down and saying here's what I need to return on my investment over the next five years. Here is what natural gas assumptions I am going to make, and here is what I ought to get back, and here is the profit I made from that.

I think that is an easy thing to look at, and if Jim is right and the load gets in and wants to make these contracts and the prices start coming back at $250 because that is where they think a cap may be at some future time, then clearly we are going to have to take some action because that is not a reasonable return on these long-term plans.

People talk about PJM. Why is PJM stable? Well, a couple of things. They have what I had in 1999, which was a nice cool summer, so they did not get stressed. The other thing is, they have about 88 to 95 percent of their units are on fixed contracts based upon the costs that the

1 utilities developed over the last 20 years, and they did not

get rid of those. They did not restart the clock and ask people to buy units and put them in the marketplace with that risk and take the risk of forward contracting.

So I do see it as a big problem. Yes, the spot market congestion, locational market prices, all these things have to be dealt with. But to me, the really fundamental issue is we have got to get more supply so the competition occurs. I do not believe any market is going to work well if you do not put restraints on it and there is not enough supply to meet demand. Prices are going to go high. I think that is what markets say.

And so, you know, we are just going to have to work through that and get the supply. So, you know, I am a strong believer in encouraging more supply and let them get competitive. In the meantime, I do think we have to put constraints on them so this period of short supply, we do not let that price get completely out of control, and limit the impact so that when it does get out of control, it is a very few megawatts.

CHAIRMAN HOECKER: Somebody brought up the idea of real-time trading charges that would apply to both buyers and sellers. Is that part of the improvement in the short-term market you are talking about?

MR. FLORIO: I would say that is more in the

1 category of bandaids that we need immediately to get out of

the short-term problem.

I agree with Bill Reed that if you get the rest of these issues right about structuring the market, underscheduling will probably go away. But in the immediate where Terry is dealing with trying to buy 6,000 megawatts the hour before it is going to be consumed, I think a real-time trading charge that is balanced on both sides is a way of addressing that effectively.

CHAIRMAN HOECKER: Instead of the penalty that we have --

MR. FLORIO: Right. I think the penalty is very, very high for one thing. And I think if you put it on one side and not the other, you are putting a big thumb on the scale in terms of what it is going to do to the forward markets. By putting a charge on one and not on the other, you are going to affect prices in a way that I do not think is going to be helpful.

CHAIRMAN HOECKER: What does everyone else think of that? Is that kind of a charge just too regulatory for some of you?

MR. REED: Somewhat too regulatory. There will always be real-time trading. There will always be balances. So there needs to be some tolerance for that, and I am concerned that the 5 percent that is in your Order now is a

1 quite arbitrary number to put in there. I would look for a

much broader band. There is always going to be some reason for an imbalance to occur.

CHAIRMAN HOECKER: Other thoughts on that?

(No response.)

CHAIRMAN HOECKER: Let me go back just for a second and revisit this issue of the state's role in selecting someone for the new Board.

I think, Mike, you brought this up. And looking at what the RTO is intended to do, which is to manage the grid and to ensure nondiscrimination. Remember what this is essentially kind of a hypertechnical job. And I always have this struggle, and it was brought to light with the operation of the Stakeholder Board, as to what role representative democracy has in this kind of an operation.

I mean, can someone explain to me exactly why we should not simply go out and try to find the best technical experts to run this operation or to oversee it and why somehow or another this has to be an interest group populous kind of governing mechanism. I am a little bit at a loss as to why that ought to be.

And number two, I am at a loss as to, if the state does have a role, how does it exercise that role? And how do we prevent getting back into a stakeholder arrangement such as the one we are proposing to eliminate

now? Anybody?

MR. FLORIO: I think we still have here an industry that is affected with the public interest, and I think the state's concern is that consumer interests be taken into account and not become so technocratic that there is sort of a loss of that connection to the ultimate customer.

That does not mean it has to be political. But I think --

CHAIRMAN HOECKER: Does that imply that somehow this agency is not capable of protecting consumers?

MR. FLORIO: No. But I think the ISO is on the front line. I mean, you folks have a limited amount of time and attention to devote to California, and the RTO or the ISO is on the ground and seeing things at a finer level of detail than -- they are just going to be more hands-on.

I do not think it means that it has to be stakeholder. I think there is a growing consensus to move away from that. I mean, the kinds of ideas I had in mind were something like, well, you hire the consultant, they come back with the list, and the EOB picks three off the list and you or your staff or your designee picks three off the list.

Or you could have the consultant come up with the list, the EOB come up with the list and let the existing

1 Board pick three from each list. I mean, there are ways

this can be done, and I just think that if it just becomes a mandate from this Commission that, you know, California get out of the way, we are going to drive this, there is going to be resistance. And I think there is a better way. I think there can be.

I mean, you worked something out a couple of years ago. I think it can be done again.

CHAIRMAN HOECKER: I agree with that.

MR. MACIAS: I think it is just very important that up front develop the criteria of what you are looking for on this Board, how do you define someone independent? You mentioned people with strong technical. I think you want to have that component on the Board, but you also want people that can manage a company of this size and the money of this size, and manage to the mission is the objective of the ISO, which includes consumer interest and protection, and get the selection criteria right up front.

CHAIRMAN HOECKER: Steve?

MR. KEAN: I think to get at the underlying problem here, you have to take a really close look at what the role of the organization is. What you really need in an ISO is an air traffic controller. We do not elect those. We do not have them appointed by political figures. Their job is to make sure that the planes land and do not run into

each other and provide information.

If you define the role properly, then you do not need to have the organization even be as controversial as it is today. When it gets into the business of saying, okay, I am the one who is going to be responsible for buying supply in the market. I am the one who is going to run the market, the more you -- I am the one who is going to be responsible for determining what the price caps are going to be in wholesale markets. The more you put those kind of burdens on Terry's organization, then the more political it is going to become and the more difficult it is going to be to make objective, sound technical decisions, which is what they should be doing.

We need an air traffic controller. We do not need the all powerful regulator. And that will make it easier to pick people to do the job.

CHAIRMAN HOECKER: Interesting. Well, I appreciate your views on this. Does the staff have any questions that they want to put forth? We are going to -- we are getting a little bit behind here.

Let me ask one last question, and it is something that you brought up, Bill. It is about enabling the demand side. And I am assuming that that has to do as much with retail access and the powers of the CPUC as it does with us. But how do we enable this market to begin to take shape in

1 the ways that you are envisioning it? And does the RTO have

any role potentially in creating a demand-side market?

MR. REED: I think most of the structures need to be state authorized. The demand-side management programs, the utility tariffs that would allow customers to bid megawatts, if you will, real-time metering, those kinds of things I think are mostly at the state level.

I think the ISO certainly has tried to get demand-side programs in, and I think it should continue along those lines. But really, the demand-side pieces are more state oriented I think.

MR. FLORIO: I think there is one thing that you could do, and that is to let the ISO know that it is okay to treat generation and load a little bit differently in terms of things like technical standards and metering and --

What I hear from people on the demand side is, you know, the ISO is being unreasonable. They are putting all these requirements on us. They want us to look like a generator. Now --

VOICE: Well, the generators think they are unreasonable, too.

MR. FLORIO: Yes. And, I mean, I am not trying to criticize the ISO. They are doing what they feel like they need to do to maintain effective oversight of the grid. But I think there is also a feeling that, well, we cannot be

1 flexible toward the load because then we will be

discriminating against the supply. And I do not think that is necessarily true. It is just we have a prototype of dealing with a central station generator, and that prototype can be broadened to take into account other kinds of resources and be a little user friendly.

And I think the ISO is moving in that direction as it starts to deal with loads and gets a better understanding of what their technical requirements are.

CHAIRMAN HOECKER: Thank you. I want to thank this panel for an excellent discussion. We are going to move right away to our next panel. Thank you again.

(Recess.)

COMMISSIONER HEBERT: Let's begin our second panel. I know we all have more to talk about than we could possibly get in today, but two things I would like to mention.

The first is that, to the extent this panel or subsequent panels want us to comment on anything that came up the first time around, in the first panel, they are certainly welcome to do that.

The second is, my fellow Commissioners and I would like to at least reserve our ability to submit written questions to you that you can -- responses so that you can include in your general comments on the 22nd.

1 This morning we have a second distinguished

panel. Let me begin with Jan Smutny-Jones, the Executive Director of the Independent Energy Producers and Chairman of the Board of the Cal ISO.

MR. SMUTNY-JONES: Thank you, Mr. Chairman. I am here today -- Jan Smutny-Jones -- I am here today on behalf of the Independent Energy Producers. As you indicated, I also chair the ISO Board. I am not speaking on their behalf, but I will certainly entertain any questions that the Commission may have of me on that.

I am primarily here today to advocate vote caps for the state of Florida. I think that would move us all forward.

(Laughter.)

MR. SMUTNY-JONES: Our position basically is San Diego did not need to happen, and it certainly does not need to happen again, either in San Diego or anywhere else in California.

There are three critical components that were the result -- well, you saw what happened in San Diego and California this summer. One, which is basically the lack of adequate generation. California has not kept up with -- actually, not only California but the rest of the West -- with its generation needs over the last decade.

The second is the lack of use of the forward

1 markets. I am trying to figure out a more positive way to

say that. But the only way -- and I am going to repeat this -- the only way to stabilize prices in California is to rely more on forward markets. You did not have that in San Diego this summer. I do not believe they even availed themselves of the forward markets that the PFs had forward.

So we need to get that as a critical component here. It is not a panacea. But if you look, as someone indicated, PJM, which is the only connection that I can think of here where PJM is relevant at all, is that 85 to 90 percent of their market actually is a forward market. There are deals out there. They have been offered all summer long. They will continue to be out there. And I do not believe this argument that, you know, you do not buy fire insurance because your house is on fire makes a lot of sense.

There are deals out there right now that are significantly below the price cap that the ISO had in place at $250, and they are significantly below the $150 soft cap that the FERC is proposing.

Quickly. What can FERC do? The last component there I think is really one within the state jurisdiction. But this concept of a more robust retail market is key. Not all ratepayers pay higher energy prices in San Diego this summer. Some of them actually were hedged.

1 What FERC can do is we need a high level of

regulatory certainty. I think you heard from a previous speaker that the constant tinkering with caps has caused some slippage in the much-needed peaker market in California.

But importantly for this Commission is you need to figure out what you mean by "market power". I do not think we are all talking about the same thing when the word "market power" is being used, and I think that requires the Commission to spend some time on.

We do believe that the FERC got it right with respect to what is going on in market fundamentals throughout the West, that no individual market participant or class of market participants was causing that problem. And we do support the fact that FERC is not arguing for re-regulation.

We do believe that there are elements of the Order that require clarification. We believe the equitable solutions language invites litigation and creates additional uncertainty, and I am sure you will know more about that by the next panel.

And we also have some concerns with respect to the soft cap. And I think you heard some of that earlier today. I think most in the generation community believe the soft cap is in fact a hard cap. It does affect different

1 types of resources differently. If you have a low heat rate

unit, you view it one way. If you have a high heat rate unit, you view it the other. And if you are a power marketer, you may view it with a third pair of eyes.

So there seems to be some difficulties generally with that approach, although we do understand what you are trying to get at here. I would recommend highly that if you are going to move down any price cap approach that you conduct a very specific technical conference around that issue, because I think you may be hearing from the wrong people here in terms of technically speaking what needs to be done.

We basically believe that the market reforms that are out there are necessary with respect to we believe the mandatory buy/sell will help, but only if there is significant forward marketing going on out there. We believe there are opportunities out there. A large number of the generators today sell into the forward markets a significant amount of the generation. The only problem is, the load is not buying it. It is not currently purchasing that in California.

It is very critical to move on these problems as quickly as possible. Time is of the essence. We have about seven months until next summer, and we continue to see the WSCC reserves fall short. So we need to basically be able

1 to act in a way that we are prepared for next summer. I

think that the opportunities are there. And I will happily entertain any questions when that would be appropriate.

CHAIRMAN HOECKER: Thank you. Now Dede Hapner from PG&E.

MS. HAPNER: Thank you. FIrst of all, as the first panel stated, we are very appreciative of the time and the seriousness with which this Commission addressed the concerns of California, and we are very pleased with the initial FERC action presented on November 1st.

However, if FERC was trying to present some short, medium and long-term solutions to the problem, the short-term solutions were woefully inadequate.

While FERC moved very quickly with its investigation, the lack of completeness by its own admission means that there are still a lot of unanswered questions.

I would like to use the self-described incompleteness in the staff report as well as the questions that you raised, Commissioner Massey, in your comments to focus my remarks.

First of all, you asked if the reliance on the forward contracts and the penalties for failure to schedule forward were enough. No, they are not. You cannot restrict the load without restricting generation. That is basically fettering a market that is supposed to be an unfettered

1 market of buyers and sellers.

There either has to be a situation where neither party is penalized and both parties incentivized, or both parties need to be penalized for their actions. I believe that Mr. Florio used the term "thumb on the scale", and that is exactly what we are concerned about.

Secondly, we think that there has to be an incentive, and that can be done in a variety of ways, and we will certainly explore that in our comments, for generators to offer rates that are just and reasonable. That is the deal they signed up for by accepting the tariffs that you all approved, and that is the relationship that we all have to enter into.

You also asked the question about the soft cap. Did you use the right assumptions? Is the cap too low, too high? Again, I think we were very intrigued by that idea. I think it is very creative. But we are concerned that the $150 cap basically sets the cap for everyone at the price of the most expensive megawatts in California -- the last 1,000 megawatts, primarily in Southern California.

We also think that the heat rate that was used as the driving assumption of 16,000 and over was too high. If you look at the CEC reports in California, excuse me, the California Energy Commission, as well as much of the megawatts that have been scheduled into the market, they

tend to have heat rates closer to 10 to 12 thousand, and so

their fuel costs tend to be in the range of $50 to $84.

With respect to the emissions, which it is very valid. We think the proper way to deal with that would be to isolate those charges and use them as some sort of a neutrality or uplift charge. Clearly we need those megawatts, and clearly generators are paying more for the offsets. But to again charge 37 or 40 thousand megawatts for the offsets that a thousand megawatts require does not seem quite right.

Lastly, you raised the question about refunds and whether or not there are other equitable solutions. Quite simply, we think until there is further investigation, it is a bit premature to answer that question, and we do not think that any option, including retroactive refunds, should be rejected at this point.

For example, we now have summer data, and the summer data according to the Market Surveillance Committee of the ISO, shows that prices were 40 percent over competitive rates. If you look at prices today in the ISO territory versus the rest of the country, they are still extremely out of whack.

Lastly, you left us a bit exposed. By putting these tools in place and pulling back the capping authority that he ISO and the PFs had, we are not in a position to

1 respond to anything that might be an acute problem. We have

to come back to the FERC. We have to make the case for further investigation, and we think that is your responsibility. And again, thank you. I look forward to your questions.

CHAIRMAN HOECKER: Thank you. Keith McCrea from the California Manufacturers & Technology Association.

MR. McCREA: Thank you, Mr. Chairman. CMTA is a trade association with over 800 members operating in the manufacturing and high technology sectors. Most of those companies consume large amounts of electric power in their operations.

In terms of any single party participating in this proceeding, probably CMTA represents the largest segment of the California economy. We were very active in the electric restructuring effort back in '95 and '96, both at the PUC, the legislature and before this Commission. And we supported the creation of the ISO and the PX.

Under the statutory framework adopted in California, most large customers would not receive any significant benefits from restructuring until after the transition costs were fully recovered or once the rate freeze were over. So we were really looking at a back-end benefit, assuming of course that energy prices remain stable over that period of time.

1 That obviously has not happened, and now we are

really faced with the risk of very high prices once the rate freezes expire. And like other consumers, we are very concerned about what those high prices would -- what type of impact they would have on our operations.

However, notwithstanding this threat and notwithstanding the episodes of this summer, we still believe that in the long run, a fully developed competitive electric market in California will best serve all consumers. And for that reason, we also are in agreement generally with the Commission's Order in this proceeding. We think you have struck a pretty good balance in terms of remaining committed to a competitive market and at the same time trying to impose some additional semblance of order in the California market.

In particular, we support your proposal to eliminate the mandatory buy/sell requirement with respect to the California utilities, and we also support the changes you are proposing to the ISO and PX governance.

With regard to the buy/sell issue, this was a requirement that the PUC imposed back in its policy decision in 1995. We opposed it at that point in time. We thought it was a bad idea. Other parties did as well. The utilities supported it. As recently as April and May of this year, the PUC rethought that issue and came out with a

1 decision that would have liberalized greatly the buy/sell

requirement and would have allowed forward contracting. But unfortunately, that decision was effectively overturned in the legislature a few weeks later.

And I cite this as an example simply of how political and how controversial the ISO and PX issues have become in California. And it is really largely for that reason that we support the proposal to abolish the Stakeholder Boards.

We have -- large customers have representatives on the Board. We think that the Board members have worked very hard. They are very conscientious and for the most part very well intentioned. But it is simply they have been subject too much to outside pressures in terms of their deliberative process, and we also think that the efficiency is not quite what we hoped it would be. I would say that maybe the Stakeholder Boards have pretty much established the limits or the productive limits of the collaborative process, and now it is time to move on.

(Laughter.)

MR. McCREA: So we think it is very important that the Commission basically stick with what you proposed with respect to establishing independent boards. The consultants should come up with a list of candidates who are truly independent and allow those candidates to be seated

and move forward on that front.

One issue with respect to the $150 price threshold. We have -- we understand the use of that with respect to the potential use of converting from the single-price auction to an as-bid auction. We are concerned that even if the $150 is the correct number now, it is almost guaranteed that it will be incorrect down the road a year or so. And at least for the purposes of converting from that single price to as-bid auction, we think consideration simply should be given to going with an as-bid auction period.

We are not asking or suggesting that this should be done precipitously, but we think the issue should be put on the table and the Commission should receive the input from the ISO and PX on that and proceed with that in due course. So generally speaking, we think the Commission's on the right tack here, and we are hopeful that this will lead to really an enhancement of competition in the California market and benefits for all the consumers. Thank you.

CHAIRMAN HOECKER: Thank you. William Hobbs with Williams Energy Marketing & Trading.

MR. HOBBS: Thank you. I am Bill Hobbs. I am representing -- I am President of Williams Energy Marketing & Trading. First I want to thank the Commission for taking on what we feel is a very tough and emotional issue in

California.

SECRETARY BOERGERS: I think you have to turn your mike on.

MR. HOBBS: Okay. I am sorry. For taking on what is a very tough and emotional issue in California. And we believe that your analysis of what occurred this summer is fair and equitable.

We also, looking at the November Order, agree on several points. FIrst, encouraging participation in forward markets has been discussed quite frequently this morning, and we believe it is an excellent step in the right direction.

We also believe allowing market participants to pursue alternative markets outside of the ISO and the PX is a good step. And we believe finding for no retroactive refunds is an excellent step and that it would only confuse and create more uncertainty in the marketplace. But to ensure a successful transition to a workably competitive market based on market solutions and economic incentives, I want to offer some more suggestions.

First, price caps. Williams is not an advocate of price caps in any form. However, if the soft caps must exist, I think it is important that the Commission clarify that the caps are truly temporary in nature.

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Williams also endorses the suggestion that caps should be escalated during this temporary period of time.

And we think it's also important that the Commission further identify what is meant by "marginal" and "opportunity" costs.

We also believe the Commission must address the uncertainty that's been created through the subject-to-refund language.

Market participants are making decisions in a very dynamic environment, and the way it's current structured, we may not know what the real price we bought or sold at for years to come.

And why we think this is important is that we believe this uncertainty will drive liquidity in the forward markets which is exactly what FERC is trying to avoid.

So we offer the following suggestions:

First, we think it's important to build fences around the type of transactions that will be subject to review. We also suggest that all transactions below the soft price cap are closed and not subject to refund.

For transactions greater than the price cap, we believe a two-year window is too long a period of time of uncertainty. We suggest instead that the market's surveillance unit of the ISO provide FERC, within 30 days at

the close of a month, any transactions that were deemed

completed in a non-competitive market environment.

And that all other transactions are deemed closed and not subject to refund.

Looking at the purchases forward market, Williams does agree with the line market participants to deal directly with each other. But for a workably competitive market to truly develop, it is important that market participants have the freedom and the courage to deal in markets that range from one month up to 20 years.

For example, this past summer, Williams forward-sold, prior to the summer, a large percentage of our intermediate generation from our existing facilities at prices that were significantly below those seen in the short-term markets this summer.

Looking at the Board reformation, we have one simple comment. We hope, and we think it is critical that this Board is independent and acts independently.

And in closing, I just want to again, reaffirm something that Terry Winter said earlier. I think it is so important that all of us surrounding this issue find a way to work together, and that's easier said that done, but it is absolutely essential to bringing this issue to a close.

And in that regard, Williams is committed to continuing to work with the FERC, market participants, and

1 state officials, in the continuing development of what we

believe will be a competitive and reliable electric environment.

Thank you.

CHAIRMAN HOECKER: Thank you.

Jim Pope from TANK.

MR. POPE: Thank you.

I'm the Chairman of TANK and a majority owner in that 500 kV facility running from the Oregon/California border to Central California.

I'm also the Director of Silicon Valley Power, a municipal utility whose load is about 450 megawatts. Eighty-five percent of our load and revenue comes from large technical customers, like Intel, Applied Materials, Exodus, and Sun Microsystems, and most recently, Transmedia, the current IPO that was out the day-before-yesterday.

I want to thank, as everyone has, the Commission for taking the right steps to help us get beyond the blame of this predicament that California is in. I believe California is in an emergency situation right now, and time is of the essence, as Mr. Jones has commented.

The power markets in California and the west are dysfunctional as has been observed. We must solve these power shortages first, and then we can actually have a market that works for our customers.

1 I'm going to cover three points.

The first is: We need to get the markets right. Currently, the California ISO has developed somewhat as an island in the ocean of the WSCC. Imports and exports are hindered by unworkable rules and protocols. And the lack of adequate generation in transmission capacity to serve load is complicating this.

In a little over two years, the ISO has offered 31 tariff amendments. The result of this is a moving target. It creates confusion, uncertainty, and inconsistent market rules which has rendered the California market unattractive.

One rule that I want to point out is the ten-minute settlement rule. By establishing this rule, it is not used anywhere else in the west, BPA and others are not using this transaction on this basis.

And viewing the expenses incurred and the technical difficulty by the schedule coordinators in the state and others have experienced, it's no wonder that the bulk market rules have created some problems.

Rather than bulkanize the market, as a result of some ISO rules, the Commission should focus on ways of expanding the markets. The best opportunity for the Commission to improve development of the electric markets in the west is through the California RTO filing and other

1 regional RTO filings.

Restructuring cannot succeed if we don't get the market right. Eliminating these barriers and providing the adequate capacity, particularly transmission capacity and incentives for that transmission expansion, will help us get the right price signals to the market.

The second point is new resources. We need transmission capacity as well as generation capacity in the west. I would hate to have us have a lot of new generation, as Mr. Macias talked about, and not have the ability to get it to market because of lack of transmission capacity and congestion.

I believe the Commission can address this first by new transmission and generation should not adversely impact the transfer capability or create congestion, and second, transmission owners should receive firm transmission physical rights. I believe this is going to be much more critical as investor-owned utilities are in the forward markets.

Transmission may be the only viable solution in congested areas, like the Bay Area and Silicon Valley Power where they're experiencing aggressive load growth.

Third, cost and cost accountability. As we proceed in the restructuring, consumers should not be asked to pay a greater burden of this restructuring. Simply put,

the ISO and institutions around the new market must be held

accountable.

The independent board must be accountable for its actions in the budgets and governing rules must be open for open public meetings, advance notice, so that this is not done, so decisions are not made in a vacuum.

The Commission must take a hard and meaningful look at the ISO cost and impose reasonable means to establish cost accountability. We'd like to see this in your ruling by the end of the year before the new board is seated.

For that, I would like to thank you for the opportunity to speak with you today, and welcome any questions.

CHAIRMAN HOECKER: Thank you very much.

And our last panelist, Lynn Lednicky, I think, I think I got that right, from Dynegy.

MR. LEDNICKY: Thank you for the opportunity to present comments today on behalf of Dynegy.

The events of this summer have exposed three basic problems in the California electricity market. First, California is short generation. Second, California purchases too much of its electricity in the spot market at the highest available prices. Third, California's consumers have been exposed to the full price volatility of that spot

1 market with no real retail supplier options.

Any solution package, whether designed by the FERC, or by California, must address these three basic problems. The Commission's November 1st Order was a needed step in the right direction. FERC correctly focused on market design issues after finding no evidence of market manipulation.

In doing so, it moved toward restoring stability within California's electricity markets. We applaud the FERC for avoiding the fingerpointing that has characterized much of the discussion in California.

Having been at the other end of many of those pointed fingers, we're attaching to my statement, a factual response to some of the rhetoric that has fogged the air in this debate.

While there's much with which we agree in the November 1st Order, I will limit my comments today to a few areas where we think the Order should be changed.

First, the Commission proposes a $150 soft cap after adopting a definition of market power which primarily focuses on a relationship of market prices relative to short-run variable cost. And then using an unstated reasoning process, to relate those market prices to just and reasonable rates.

We think these links are dubious. This focus

1 loses sight of both the reason for the high prices this

summer and the goals of the Commission's Order going forward.

Looking back, the prices experienced this summer in California and in the rest of the West, where the result of the relative lack of generation compared to VAN, and the full cost of producing electricity.

When viewed in this perspective, the resulting rates were just and reasonable. Looking forward, the Commission should be acting to encourage new generation to enter the market. A new, revised, complicated price cap measure is unlikely to achieve this goal.

Second, the November 1st Order makes a distinction between offers above and below $150. There's considerable evidence that many units, which only operate a limited number of hours per year in response to demand in the market, cannot recover their full cost with payments limited to $150.

In the FERC Staff report, the report said market clearing prices that approach the $250 price cap may simply reflect the true cost of the resource and be solely the result of tight supply, not the exercise of market power.

The PX similarly stated, marginal cost during the peak demand periods when all available units are operating could each $500 per megawatt hour.

1 The California Energy Commission, in a report

earlier this year, said that the fixed cost component of a typical peaking unit is on the order $72 per kilowatt year.

Now if such a unit were to operate for 500 hours a year, which is approximately six hours a day, five days a week for four months, the summer peak period, that unit would need to recover over $150 per megawatt hour, or close to $150 per megawatt hour just to recover its fixed cost.

These findings contradict FERC's assumptions underlying the $150 price cap. Continued price caps at the $150 level will not encourage new generation, will do nothing to encourage demand to move into the forward markets, and will not encourage demand response programs.

Finally, we're encouraged to see that the Commission recognizes the importance of opportunity costs as a determinant of offer prices.

How are we concerned? We are concerned that the Commission does not fully understand the nature of opportunity costs or the challenge of calculating and documenting them.

It is my experience that opportunity costs can come in many shapes and sizes, can appear at any time, and may take the form of potentially subjective judgments.

If the Commission chooses to pursue the new soft cap with documentation concept, it is imperative that the

1 Commission fully and accurately define these opportunities

in this proceeding. Contemporaneous documentation will be an incredibly burdensome task.

Will FERC only review bids above $150? What standards will be used? What documentation is required? What period of uncertainty will exist? What grounds might someone else use to protest a FERC judgment?

Rather than applying the $150 soft cap approach, we would advocate the approach suggested by Commissioner Hebert in his concurrence, or an as-bid market.

Documentation combined with potential refund obligations will create unnecessary uncertainty in the market. Markets cannot operate in an efficient manner if uncertainty is the prevailing factor.

Without this clarity, the Commission and market participants will likely be tied up in litigation for years to come. This is not in the interests of California, the market, or any of its participants.

I look forward to entertaining any questions you may have on this or other subjects.

Thank you.

CHAIRMAN HOECKER: Thank you.

Let's begin with Commissioner Massey.

COMMISSIONER MASSEY: I'd like to ask about the so-called single price auction, also know as a second price

1 auction. Now I must say that intuitively for me, that type

of auction, when there is very little risk of non-dispatch, is not likely to produce prices that are just and reasonable.

That is just intuitive with me. But I must also say that virtually every economist that I have ever spoken to about that auction tells me that it is the best way to incent suppliers to bid marginal cost.

So we have a dilemma. It doesn't appear to have worked that way in the California market. So there's a disconnect here.

Some of you have commented on the single price auction. I know that Dynegy's position, that has been well-stated, is that we should move to an as-bid auction.

But most economists believe that prices will go up if we do that.

What is your comment on that, Ms. Hapner?

MS. HAPNER: Well not being an economist, I feel compelled to say that most economists would also assume can opener, if stranded on a desert island.

So all I can say is that we've never supported the second price auction at PG&E. We've also heard the arguments that the auction, a single price auction keeps bids at marginal costs.

Certainly we haven't seen that in California.

1 And whether or not there's exercise of market power, it

doesn't take a lot of collusion or nefarious wishes to converge around a high price, knowing that all the megawatts bid in, whether they are the cheapest megawatts or the most expensive, will get the benefit of that price.

Again I think that calls into question the $150 soft cap. Frankly, I think we are much more likely to see prices converge unconstrained very regularly at $149.99. That seems to be what we've seen ever time there's been a lower cap.

COMMISSIONER MASSEY: Other comments?

MR. LEDNICKY: I think, first of all, economists can be wrong.

Secondly, I think we're approaching the wrong issue here. The problem is that California is purchasing the vast majority of its generation needs in the spot market. If California were to move into the forward markets, which will almost by definition be an as-bid type of market, it will be a negotiated price, then you won't have a situation where everyone is forced into a single market at essentially the last minute.

And just for clarity, I make no distinction between the real time market and the PX day-ahead market. Those are all spot markets in my mind. Those are not forward markets. A forward market is next month, next year,

1 whenever.

When you move people, when you move demand into the forward markets, you will see that people are not under pressure to purchase at that particular instant. People can choose where they want to purchase at the price they want to purchase. They can construct a portfolio. And then you will have a much smaller segment of the demand that's being purchased in the spot market, and you would not be nearly as concerned about the price volatility in the spot market.

A prime example of that would be happened in the midwest two years ago. Prices were at $5,000, $6,000 per megawatt hour. There was concern. There was an investigation. And the bottom line was there were relatively few megawatts that were transacted at that level, but that did provide adequate pricing signals for new generation to move into the area, for demand to say, gee, maybe instead of consuming that electricity, I can do something else with it.

And at the end of the day, the consumers were not adversely impacted because you didn't go around to those midwest states and charge every consumer that price. You had a market design that allowed them to be purchasing through a portfolio.

So the issue, in my mind, is not how do we force

1 the lowest possible price in the spot market. The issue is,

how do we get demand spread across a number of markets so that there's a portfolio that will be much less sensitive to price volatility.

COMMISSIONER MASSEY: I agree with what you said, by the way, with respect to the forward contract market, but there will be a spot market, and the question is how to manage it.

Mr. Smutny-Jones?

MR. SMUTNY-JONES: Yes. I would just say that, you know, for the first couple of years in the Power Exchange, this was somewhat of a non-issue because it was generating prices at about two-and-a-half cents to three cents, whatever, because we were in a surplus mode and gas prices were relatively cheap.

It has now become controversial because the PX is generating significantly higher prices, I think, because of scarcity, largely due to scarcity, and I think a problem that was pointed out, I agree completely with what Lynn had to say. If the relatively small part of the market is actually in those spot markets, it becomes significantly less of a problem.

The third point that I'd like to make is we should not, there are, you know, as-bid markets going on in California now. People are putting power out there and

1 people can purchase that. So I don't want to leave you with

the impression that the only markets that are there is the PX, that there are some regulatory issues that we need to address within terms of perhaps better utilizing some of those other markets.

COMMISSIONER MASSEY: Let me shift gears here.

Mr. Hobbs, you brought up the issue of refunds going back over the summer. Now the Commission found that the market structure this summer did produce prices that were unjust and unreasonable during certain periods.

Now, the question is, you made the point that we should not attempt to go back and provide refunds for that period of time.

There is a question about our legal authority. Our Staff has prepared a memo that comes to the conclusion that we probably don't have that authority.

But let's assume for a minute that we did. If prices were not just and reasonable, why shouldn't this Commission provide refunds?

MR. HOBBS: I think first of all you have to decide if in fact prices were unjust and unreasonable, why is that so. I think the generators tend to get blamed if that was truly the case.

And I think we had discussion in the first panel as to I think you have to look beyond the generators if

1 prices truly in fact became unjust and unreasonable.

And I don't believe, especially in Williams' case, that anything we did created unjust and unreasonable prices. As I mentioned, we have practically foresold a big percentage of our generation at prices significantly below where the summer shook out.

The other thing I think is uncertainty right now is very high, and there was a lot discussion on the morning panel, California needs new generation. California needs demand-side management. Those are givens.

The more uncertainty that's introduced into the marketplace, the less is the likelihood those two things are going to occur. And the perspective refunds create enough uncertainty in that now we kind of are beginning to figure out the rules that we think we may sell at $150 or $175 but two years later find out that's not the case.

That creates a lot of uncertainty, but then, even to be subject to the fact that maybe, at some point down the road, we find out even then there could be more refunds coming, I think is just an unacceptable environment to operate in.

COMMISSIONER MASSEY: Let me move to a new subject, and that is transmission.

Ms. Hapner, do you see the prospect of new transmission being actually built in California that would

1 help import necessary power?

MS. HAPNER: Yes, I do. I think that the ISO planning process--particularly now that we are in our second full year of that--has worked pretty well to encourage transmission that would enable generation coming in. I think that there are a lot of transmission projects underway.

The issues that come up on transmission versus generation have been there and always will be there, but we currently have almost $1 billion committed towards new transmission projects in California.

COMMISSIONER MASSEY: Mr. Smutny-Jones, did you have a comment on that?

MR. SMUTNY-JONES: No, I think Dede did a good job of laying that out. We are taking a hard look at this. Some of the more infamous constraints in the California system, specifically CALIO Path 15 historically has not made a lot of economic sense to upgrade it. That may have changed.

And as I think Dede indicated, the ISO has committed already a significant amount of resources there to wheel. It's basic utilities that will be building these out.

They are controversial, however. Let's not kid ourselves. The two new transmission lines we proposed both

1 have become very controversial from the standpoint of local

land use issues, and they are now at the PUC for actual sighting and it is not an easy task.

COMMISSIONER MASSEY: Let me ask another question, and then I'll stop.

It seems to me that the western interconnection functions generally or would like to function as a single market. And my question is, why shouldn't this Commission be urging the creation of a single western interconnection-wide RTO?

Mr. Lednicky?

MR. LEDNICKY: We would not object to that concept. I mean, obviously the devil's in the details, but the markets are a regional market. They function that way.

It is enormously difficult, as someone said, treat California in the sea of the west, and isolate it and assume that things will behave differently there toward, you know, the general betterment of the market, the greater efficiency, et cetera.

We'd be very supportive of the concept. We'd look very carefully at the details. There are obviously a number of features of the California market that we did not wish to be imposed on the rest of the west, but the concept we would support.

COMMISSIONER MASSEY: I understand.

Does anyone think that, put the details aside,

but does anyone think that this is a bad ideal, a single western interconnection-wide RTO?

(No response.)

COMMISSIONER MASSEY: No. Ms. Hapner, did I see you nodding or shaking your head or?

MS. HAPNER: I certainly don't think it's a bad idea. One of the problems I think that we've seen and one of the areas that I don't think has been addressed as fully as it needs to be addressed in the Staff report, is the out-of-market cost, and the full daisy chain of sellers in and out of the ISO grid.

We do very much have a western market. I think you've heard support from all of us that we can't operate as an island, and so we need price certainty across the whole western United States.

COMMISSIONER MASSEY: Yes?

MR. SMUTNY-JONES: Yes. I've actually spent a fair amount of time on this issue. I think you got, while it's a good idea, and I think it needs to be done, it's just that there are some political realities that become problematic.

First of all, you've got the famous ABC problem throughout the west, which is anything but California, and we have the other states around California have a tendency

1 of viewing that the California is an 800-pound gorilla and

always getting its way and whatever. And there's this push back that if they join some sort of western RSO, the lights will go out in Las Vegas because the board, which will be dominated by California, will keep the lights in Fresno.

If you go to California, I think you'll hear individuals expressing the same kind of concern, that they don't want the lights going out in California to serve Las Vegas.

Now both of those perspectives misses the whole point because that's not what the ISO should be doing or does from an operational perspective.

There probably is an opportunity some time over the next several months to investigate how to encourage something that would be more regional-oriented with the various states throughout the west to see if there is a way of actually creating an independent entity that operates a transmission system.

I think what Mr. Kean said earlier about the fact of the matter is, we're supposed to be air traffic controllers, not rate police. If there's a way of getting back to that where everyone is comfortable that that's what's going on is that we're responsible for operating interstate transmission system and making sure everyone has, you know, fair and adequate access to that transmission

system, maybe we can make some progress on that.

COMMISSIONER MASSEY: Thank you.

CHAIRMAN HOECKER: Commissioner Hebert?

COMMISSIONER HEBERT: Thank you, Mr. Chairman.

I heard some comments by Mr. McCrea and Mr. Pope as to the single price auction. And what we need to do whether to modify it to move forward.

I certainly find it interesting, especially on this panel, that you are the only two members of this panel that are truly representing consumers, which is what this is supposed to be all about.

Not that all of you don't somehow in some phase, governmental or other, or quasi-governmental, do some of that, but as far as pure consumers, I think that's more down your alley.

Can you expand on that a little bit and tell me why that's important to you and what difference you think it will make?

MR. McCREA: Well, I think from our perspective, we were always somewhat skeptical of the single price, or so-called second price auction. And like Commissioner Massey, I think we became convinced, after talking to enough economists, that it really didn't make a big difference.

But I think now that with more experience, this

1 may be one of those economic theories that doesn't work very

well in practice.

And I would hesitate to say there's anything like a consensus in California but with respect to the use of the single-price auction, at least for that very peaky amount of supply, the last increment of supply on peak day, I think there is something of a consensus that the single price auction should not be used for that, that that price should not be the market clearing price for all generators.

So we have concerns about it in terms of the market efficiency. I do think the earlier comments that the problem is probably exacerbated by the heavy reliance upon the spot market and that if there was more forward contracting, this may not be that important of an issue.

MR. POPE: I can respond and kind of carry on from that.

At the City of Santa Clara, we in essence take on the market risk for our customers. We live every day the full obligation to serve. Not the obligation to serve the somewhat modified AB 1890 four years ago.

And by doing that, we stayed away from that market. We used our physical assets to hedge for our customers. We used forward contracts to hedge for our

1 customers. And we used the market or the day of market to

balance our loads every day so that we schedule our load 100 percent.

And I think our customers, through this summer, greatly appreciate the fact that we have rode through this market and have not been hit by this volatility at our bottom line or for future rate problems.

I think the municipal community is largely within that same circumstance within California. A couple utilities got a little short and had to buy in the market more than they would have liked, but in fact we've used our total obligation to serve to help our customers get through that.

I think the customers in Santa Clara really appreciate the fact and are starting to really understand that someone needs to do that for them going forward.

And I think that's got to be learned as we go forward in the market, that somebody is looking out for the customers or the customers have some sort of agent to do that for them.

COMMISSIONER HEBERT: I don't know whether either one of you missed -- this goes back to the two of you again -- have ever heard me talk about how we look at things, or at least how I look at things when I regulate.

And I certainly almost look at it as a triangle

in that you've got your supply, you've got your

infrastructure, and then certainly you've got the price side of it. And you have to be careful about getting one of those sides out of balance.

Certainly I think that has a lot to do with the dilemma in California.

Since you are the two people testifying on this panel that represent consumers, how important is it to you that we set up a system and give guidance that is strict enough and bold enough that in fact gives the three utilities down there a reason to make sure that we have adequate supply?

That in fact gives the governor's office a reason to ensure that things move forward in a sense that provide opportunities for real supply?

And consistent with that, if you don't have that adequate supply and some of these price indications cause problems on the supply side, what fear and what type of repercussions would your customers feel during brown-outs and blackouts?

MR. McCREA: Well, from CMTA's standpoint, we're very concerned about what is done to ensure adequate supplies. We think the Commission has a tough job in striking the right balance, in terms of making sure the incentives are there for new investment and generation, and

1 at the same time, providing some mitigation measure to

protect consumers.

Brown-outs and blackouts are a disaster for most of our members in the high tech industry and in basic manufacturing. Many of our members are participating in interruptible programs and do interrupt under Stage Two emergency situation, but when you're talking about Stage Three, where there's going to be emergency blackouts, that's an extremely serious situation for our plants.

We have, for example, glass manufacturers who have hundreds of tons of molten glass in process at any given point in time, and a blackout that extends for any significant period of time really threatens the viability of that plant forever.

And there are many examples in aerospace and high tech where this same situation can occur, so that is a huge concern for us.

MR. POPE: Thank you.

I believe your triangle of supply, infrastructure, and price is a right model to look at.

I believe in California right now, the customers are riding under five clouds of shortage:

Shortage of energy supply;

Shortage of transmission capacity supply;

1 Shortage of natural gas supply;

Shortage or future shortage of deliverability of natural gas; and

The shortage of the ability to store natural gas through California.

In the next couple of years, we're going to be riding under those five clouds. To that end, I believe if the infrastructure of delivery allows it to get to the adequate supply or surplus, as Dede talked about, there's about $1 billion of transmission capacity in electric site to be expanded, that will help any generation that's built anywhere in the state or on the border to get to the load.

Those have got to be solved very, very quickly, or we'll have another June 14th. We didn't have a supply problem on June 14th; we had a capacity shortage which we needed to curtail and go to blackouts because of voltage stability in the Bay Area. And that was purely a capacity, an infrastructure capacity shortage that caused that.

If the ability to deliver the supply is adequate I believe--and the supply is adequate, the prices will fall in line and will work under an effective market.

With respect to brown-outs, my customers, many of which are Keith's, represented by Keith, an outage or even a power quality event of four, five, six cycles can affect

1 the quality of the chips in the materials that they

manufacture.

So that infrastructure capacity improvement helps the power quality and helps with the quality of the product out the door for our customers.

So I believe that if supply and infrastructure and price are all looked at together, and we get the infrastructure in place quicker, and then the supply has a chance to deliver, all the power plants that Calfine are building will have a chance to find a market, and be successful in the future.

MS. HAPNER: Thank you, Commissioner. I just wanted to respond a bit. While I would hesitate to call the investor-owned utilities "victims," the reality is that we are also consumers in this market. We are consumers of the wholesale price. And we have been as captive to that price as our ratepayers have been captive.

Again, our ratepayers are protected, but that hasn't meant a tremendous burden on Pacific Gas & Electric. We have been paying those high prices and they are currently somewhere around the $3 billion mark. That's certainly a burden that we need to address.

With respect to what that means, it means that we have the same goal as the retail customers. And that is to keep the price as low as possible, and that in fact is

what drives us when we schedule our power into the day-ahead

market.

We do schedule our--pardon me, our load into the day-ahead market. We do schedule all our load, and we schedule it at different prices. And the point is to keep the prices low for everyone.

The IOUs currently, even under the best of circumstances, are neutral in the role of the default provider. There's no opportunity to make money at the end of a good transaction, only to lose money, and after-the-fact reasonableness on these transactions is a pretty important deterrent.

So we're in this together with the retail customers.

COMMISSIONER HEBERT: That leads me to another question then.

I understand the position you're in. I'm certainly sympathetic to it, but I'm not apologetic. And that means this:

There was testimony given in the last panel that talked about how $45 per megawatt power could have and probably was purchased by some.

If you compare that to what was purchased on that day, I doubt that we'll hear any testimony as to how you really took advantage of the people through the forward

1 market that day because of the spot market.

So I am not sure what the balance is there. And I would agree, I would hesitate to call you a victim, although you are certainly in a tough circumstance, but Mr. Reed, on the last panel--which comes to this, and you imply it within your comments so I want to be direct with you and I want you to be direct with me--talked about looking at market power issues and root out not only prospectively but market power considerations and equitable considerations prior to October 2nd.

How do you see that?

MS. HAPNER: Well, I can't answer your second question without answering some of the points you made in your preamble to your question, so if you'll indulge me.

PG&E did take advantage of the tools that we were allowed to take advantage, prior to this summer, through the Power Exchange, and that certainly helped our situation somewhat.

The dilemma when the Power Exchange is the scheduling coordinator for your load and your generation is, you bid in your hedged result--and let's say it's $50--that gets merged with everything else. It might even get sold out of state and come back in.

And so the price you pay is whatever the clearing price was, not whatever you hedged up front.

COMMISSIONER HEBERT: I understand a lot of it

has to do with the rules that you have to follow. I don't have a problem with that. But go ahead.

MS. HAPNER: Thank you.

And that's why, in the Request for Proposal that we put out this summer for long-term contracts based on our new authority from the California Commission, we also asked the Power Exchange and the ISO for separate authority to have a scheduling coordinator position to make sure that the resources that we bought could be matched up with that load, so that we could take advantage of those lower prices.

And again that's still at some peril because the reasonableness of those purchases is still very much in question.

With respect to your question of refunds, I do see this as very difficult. A lot of these transactions have many, many parts to them, and sorting some of this out could be very difficult, and I can't answer on the legal interpretation of your authority with respect to a retroactive solution.

I guess my only response would be then that if there is an attempt to avoid following the tariff, and that created--inadvertently or otherwise--a rate that was unjust and unreasonable, then I think we have to untangle that web

and put the dollars back where they belong.

COMMISSIONER HEBERT: You have been afforded protections in years past by the Federal Power Act. Certainly you're obligated to those and certainly take advantage of those when and where necessary.

Rate certainty is one of those, is it not?

MS. HAPNER: (Nods in the affirmative.)

COMMISSIONER HEBERT: It protects consumers, does it not?

MS. HAPNER: (Nods in the affirmative.)

COMMISSIONER HEBERT: And for the record, she's nodding her head. I don't know if you're picking up on that. She's nodding her head yes.

(Laughter.)

COMMISSIONER HEBERT: I'm curious, since you're a regulated entity and you're willing to look at retroactive refunds, understanding the Federal Power Act like I know you do, understanding the protections that have been afforded you in years past historically under the Federal Power Act, if your testimony would be the same for Pacific Gas Transmission, perhaps?

MS. HAPNER: Well that's a variation on the question that I have been asked before on whether PG&E Corporation would support the same kind of remediations such as price caps in the areas where other parts of our business

1 are operating.

And my response unequivocally would be that if parts of our corporation are acting irresponsibly, or illegally, then whatever rules apply to this situation should apply to all those situations.

COMMISSIONER HEBERT: But you haven't given me any suggestion as to what the rule should be. You've danced around it, but you haven't said what it should be.

MS. HAPNER: Well, what I said--

COMMISSIONER HEBERT: You get your shot here.

MS. HAPNER: What I said in my comments earlier was that in the absence of a full and complete investigation, that no remediation, including refunds, but certainly not limited to refunds should they be appropriate, should be overlooked.

I feel that because of the press of time and with very good reason the press of time, this Commission moved in a Herculean way to address our concerns.

Given that, I think that there's more work to be done and more individual behavior to look at, more market behavior to look at.

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For example, the Staff report was not able to look at prices at the end of the summer and into the fall. All of that needs to be looked at.

And without having all of that data, and some concrete results of that data, I think it's very difficult to tell this Commission how to respond.

COMMISSIONER HEBERT: Last question to whoever wants to answer it.

In my statement under the Order, I issued some responses I thought were important including escalating project. There was even testimony in the last panel that suggested in fact if you were going to have price cap, it's a good idea to have a different cap at different times.

I would like to hear agreement or disagreement as to that and what you think about escalating the price cap to in fact remedy some of the concerns that you've said and other panelists before you have stated as to a problem with getting proper peaking capacity within the State of California to avoid things like we're talking about, brown-outs and blackouts.

MR. HOBBS: Yes. In my opening comments, I address that. Williams definitely supports, if there's going to be a price cap, that that should escalate with time.

1 And again I think price caps in general are still

going to continue to deter new generation as well; not really help the demand side of the equation.

I think people wanted the best in California and put new generation in have to seek movement towards the fact that the price caps are not only going to be temporary, but they are going to be raised as some of the changes that FERC has proposed, like forward markets, come to fruition.

So we're definitely in support of escalating price caps.

MR. LEDNICKY: I would echo those comments and add to that that escalating the price caps will have both a reliability and an economic benefit. The economic benefit is clearly that you're sending the right price signals into the market to incentivize new generation to come in.

And if you solve the problem of getting demand out of the spot market and into the forward markets, the price caps at $150 probably have little impact on the forward markets. You'll be able to buy in the forward markets for most products at less than that price.

So they're not going to be an operative factor there although clearly there's a relationship between the spot market and the current market.

But the economic benefit of that I think is clear. The reliability benefit is equally clear. Why is

there is thing called underscheduling? There is this thing

called underscheduling because the cheapest market that the consumer can find is the cap market, and that creates tremendous reliability problems for the ISO. And it is economically driven.

One of the things Terry said this morning in his opening comments was, one of the things he's learned over the last two-and-a-half years is that when the ISO or the PX puts policies in place, that creates economic incentives, and people will respond to those economic incentives regardless of the intent behind the policy that was there.

So we think that's absolutely a positive step for both economic and reliable reasons.

MR. POPE: I'd like to take the consumer side of this in that my consumers are high tech and power quality and reliability is critical. And any hiccup, whether it be a power quality incident or the lights are out, causes economic hardship to them.

If in fact that the plants need to be put on-line, whatever the market price is, so that they get a reasonable rate of return, so the reliability is maintained, and if those plants are put near a transmission line and the capacity is to get that to wherever the problem is, then in fact, you get the full value of that plant.

And I think it is a combination of the location

1 and having those peaking plants, as well as the ability to

get that energy to where the congestion or the reliability concern is.

And frankly I think my high tech customers would almost pay anything not to have the lights go out going forward. I mean, they don't want to pay 'almost anything,' but the consequence of the lights going off is very, very significant to them. And we work very hard in Santa Clara and as does PG&E, we work with them cooperatively to try to manage that reliability in the transmission grid as well as the sub-transmission grid in Silicon Valley.

MR. McCREA: Let me start off by saying that our members don't want to pay 'almost anything' for electric power.

(Laughter.)

MR. McCREA: Reliability is a big issue, power quality is a big issue for a lot of our members, but the price is also.

The price cap issue is, quite frankly, a dilemma for us. Most large power representatives on the ISO Board consistently have voted against price caps for the very reason that we're concerned that that is simply going to keep the supply storage situation around for a longer period of time and therefore higher prices on average for a longer period of time.

I think the Staff report in this proceeding has

confirmed our fears that price gaps in California this summer resulted in higher average prices over the course of a month and resulted in more exports of power from California.

So obviously price is important for us, but again we have to strike this balance between providing an opportunity for investment, getting the infrastructure on line that we need, at the same time doing something reasonable for consumers.

MR. SMUTNY-JONES: I probably have the dubious distinction of being the first person to approve a price cap in California back in July of '98 or June of '98, when Jeff Trane, who was then our CEO, came forward with a very real problem in one of our ancillary services market. And a price cap looked like a good solution then and I said go ahead and do it, and I'll call a board meeting, and we'll come and beg for permission later on, which is what we did.

We've long since solved that specific problem. And the price caps have continued to morph into other things that have been actually fairly damaging I think to the institution, because we've become fixated on price caps, rather than other market solutions.

So the question is, what are you using the caps to do? Are you trying to address issues of market power?

1 And if so, you may come up with one answer or another. Are

you trying to literally fix the prices in the wholesale market? In other words, do you have it in your head that there's a proper price for power and you shouldn't be paying more than that price? Then you get a different answer.

I think you've got to be careful because you have this unintended consequences issue that I think Keith just referred to. You've reduced the cap from 750 to 250, you would expect prices to come down; in fact, they went up.

And that, by the way, was predicted by one of my utility colleagues. I don't have any idea how they figured that out.

COMMISSIONER HEBERT: It was also in my dissent early on.

MR. SMUTNY-JONES: You were doing the same math.

But the point is, you ended up with an unintended consequence, and then we learned that 250 wasn't enough, and then we went to low differential price caps which Mr. Florio talked about earlier, and all kinds of other suggestions.

So I think you need to step back and try figure out what you're trying to fix and direct it towards that.

I think this forward market issue is critical. I keep coming back to that because to the extent that it's a smaller and smaller and smaller portion that's actually in the spot market, that's highly volatile, the less of an

1 issue it is.

My last recommendation here is, if you're going to go down this path, you need another technical conference, and probably with a different cast of characters than you have up here now to kind of explain what might happen.

You've heard earlier today, I think Mr. Macias indicated, well, his base load units, his new merchant plants with the 7,000 heat rate maybe it doesn't affect, but it did affect perhaps their decision with respect to peakers.

Well, that's kind of important information if you're trying to put together some sort of market power mitigation measure here or whatever else you're trying to do. So I would highly recommend that you take another hard look at that.

I mean, it may be a great idea in the final analysis, but with the kinds of feedback I'm getting from a variety of different generators is the devil's in the details, and we're not exactly sure how this would work.

CHAIRMAN HOECKER: Commissioner Breathitt?

COMMISSIONER BREATHITT: Mr. Smutny-Jones, I'm going to ask you a direct, rather blunt question. You are the current Chairman of the Cal ISO, are you not?

MR. SMUTNY-JONES: Yes.

COMMISSIONER BREATHITT: How did you feel wearing

your hat as the chair of the Cal ISO Board about our portion

of the Order that directed the ISO to eliminate that Board and create a new governance structure?

MR. SMUTNY-JONES: How do I feel on that?

Well, mixed, quite candidly. I think that actually the ISO Board has gotten a fairly bad rap, some of it deserved, some of it not deserved.

I think the ISO Stakeholder Board did a very good job of getting the machine up and running. And shepherding it through the last couple years of actual operation. And I think there's actually eight of my board members, I've been counting them, are here today.

There are a lot of very hardworking people on that Board that have dedicated a considerable amount of their time and resources and heart, I believe, to making ISO work. And we have nothing but a great deal of admiration for the actual management and the staff people who, this summer, notwithstanding the bickering that was going on on a variety issues, that we were able to keep the lights on under some very, very fine circumstances.

However, having said that, I have to concur with Mr. McCrae who observed that perhaps the Stakeholder Board, in its present form, has sort of pushed the envelope in terms of where we can go with consensus management of organizations and whatever.

1 I think it is time, and I have actually thought

this for a while, if the ISO is going to transition into some sort of broader regional entity to revisit the governance issues anyway, I certainly understand why.

I think everyone believes that the Stakeholder Board isn't working for different reasons, but I think most people believe that we should go in a different direction. And I certainly concur with that.

I think Mr. Kean said it best earlier on that part of the problem is is that the ISO Board went from being an institution that was largely responsible for trying to figure out how best to move electrons around, how to create that infrastructure to, quite candidly this summer, we were being pushed into -- to be direct -- a ratemaking mode that somehow our real time market, which was only supposed to be the last three-to-five percent of the market, it had a price cap in it, there was rational behavior of a lot of power being pushed through that, and suddenly we became the focal point of, you know, why are energy costs high in the west.

I think that's a bum rap, but that's what happened. I think moving off of that, creating structures that basically remove that kind of pressure from the institution as a whole, and then moving more towards an independent board, I think in the long run, it'll be a good thing.

COMMISSIONER BREATHITT: Dede, you are

representing one of the three investor-owned utilities in California. And I wanted to ask you if you would react to the section of our Order that speaks about the five percent of an entity's hourly load requirements.

Billy Reed talked about that too. Is that, I"m reading from the order, as the provider of last resort, we propose to establish a penalty charge for deviations in excess of five percent of an entity's hourly load requirements.

And then in a footnote, we say we propose five percent because this is the maximum amount that the ISO intended to balance in the real time market for operating the transmission system.

Can you operate under that?

MS. HAPNER: I would agree that five percent is what we all thought would be the amount that the ISO would have to procure in real time, and clearly that hasn't been the case.

My concern with the requirement on load is that it is asymmetrical, and I think that it is a rational idea to get as much of the load contracted forward as possible.

And 95 percent of that may be the right number. It may move around because of weather, for example, but I

1 don't really think that's the issue.

I think that the dilemma that we all face, and I think you face it most specifically, along with the California Commission, is we've got a group of market participants who are not on equal footing. That's not good or bad, it's just a reality.

We have investor-owned utilities that have a different set of constituents and different regulators to answer to than generators on who are operating in the state or outside of the state, whether they be public or private or marketers.

So I think imposing more rules on the group of market participants that we already have under fairly tight regulation doesn't solve the problem.

COMMISSIONER BREATHITT: So I"m assuming it would be difficult for your company to secure its load and meet that threshold?

MS. HAPNER: I think in an ideal word, Commissioner Breathitt, if we were forward-contracted out, whether that was using our remaining generation assets or by contracting with others, it probably wouldn't be very difficult to meet that threshold.

The problem we are faced with right now is exactly the unintended consequence rule, or Murphy's law that has been brought up before, we're changing the rules in

1 the middle of the game--which is a good thing; we need to do

that; the market is not workably competitive--but we are not all operating on the same time frame.

As you have heard from generators, and we fully agree with this, a deal that might be offered to PG&E or SDG&E or SEE is a perishable deal. They're not going to hold onto that offer for an extended period of time.

They sympathize with our reasonableness concerns but they are operating at the speed of business. The regulators are doing their job. They have to protect consumers. We don't expect them to just throw up their hands and say okay, that looks like a good deal.

We expect there will be criteria and portfolio management standards. But we don't have all this in place just yet. And until we do, I think imposing a penalty on one segment of the market is not appropriate.

COMMISSIONER BREATHITT: Mr. Pope, you mentioned transmission investment too. Other than reasonable returns, can the Commission do anything to incent transmission growth in California? You talked about that.

MR. POPE: I have, for a couple of years, talked to DOE and to a couple of you about the investment return for transmission versus the investment return for generation. And I think in the west, most particularly in California, I can see some sort of accelerated depreciation

1 or some sort of short-term three- or five-years enhanced

return for the transmission investment, so that it gets built and so that the supply infrastructure is adequate to be able to bring the energy to the market.

And I believe that that would quickly get the money moved into that, as it needs to, into California. I'd be willing to talk to you later about other details.

MR. SMUTNY-JONES: If I could add to that, I think that the it's kind of a moving target. The transmission system that was in place when the market opened in California was built for different purposes, and what we're finding at the ISO, putting that add-on for a second, is that we are approving a number of different types of upgrades basically that allow electrons to flow much more smoothly in the kind of market structure we have today.

I don't want to mislead you to believe that some of this is going to be easy. Some of it is easy to do because you're basically upgrading existing facilities and you don't run into the same environmental problems that you do with a new lines.

But we've got two new lines that we did find a need for. One at Rainbow Valley, which is in SDG&E service territory, and the other is Tri-Valley in PG&E's service territory. Both happened to be in fairly well-to-do neighborhoods and have got a whole lot of opposition to

1 them.

And I don't envy President Lynch who basically has to sight these facilities. That's where the California Environmental Quality Act puts the actual sighting because these obviously have been highly--there's a highly motivated opposition to those transmission lines.

So there are going to continue to be those kinds of issues, and I don't frankly know that this Commission can solve it. That's basically a, you know, local state land use issue that they're just going to have to struggle through out there.

COMMISSIONER BREATHITT: Mr. Chairman, I just have one more question.

You mentioned, Jan, that the Commission needs to have a clear definition of market power. I'm going to read you the one that is in the report.

MR. SMUTNY-JONES: Okay.

COMMISSIONER BREATHITT: On Chapter 5, page 18, and it says: "Market power is the ability of a seller to influence market outcomes, especially the market price, for a sustained period."

Would you agree with that?

MR. SMUTNY-JONES: Yes, and that's kind of the classic definition, but I also hear other usage of the word market power.

1 You've heard one I think in the same report, in

the Staff report, there is an analysis out there that raises the question of market power if someone is bidding above their marginal cost. That that somehow is an expression of market power.

I don't think that is, but there is a school of thought that is articulating that.

You also have the school of thought that is sort of caught by the tyranny of two-and-a-half cents. That we opened this market when the prices, again, with a surplus and low gas prices, and the cost of power is two-and-a-half cents, and anything above two-and-a-half cents is obviously an expression of market power.

What I'm saying is, if that's the definition you're using, that's good, and what ought to be done with that definition then is if an individual entity--and I think this is the discussion that was going on earlier--is in fact abusing market power, and it can be demonstrated that that entity is in fact taking action that is allowing them to control prices over an extended period of time, then I think what we need to do is focus attention on that individual, not the situation.

The other way market power has been utilized is any time that the California market hits over 38,000 megawatts, everybody has market power.

1 Well these are all different, all kind of

different concepts. I think the core definition you have there is right on point and it's the one that historically has always been used.

But right now, I can think of three or four ways that the word market power is being utilized and you'll hear it throughout the day, people wanting to propose solutions to the problems that they see as market power that may not be market power at all.

And that's really what I meant by my comment.

MR. LEDNICKY: And I guess if I could just add to that, I think that the important issue for the Commission is to be very clear in your Order as to the definition and the standard that you have for market power, because, as you can probably sense from watching this group over the last couple of years, I think there are certain words that, as Jan is fond to say, makes people's hair catch on fire, and that's one of them, because it means very, very different things. And we have a very difficult time communicating because of that.

So to the extent that you have in mind a very specific thing when you say "market power," it is very helpful to advance the discussion if we are all clear on what that is.

And we can debate perhaps the merits of your

1 best definition versus another, but at least we all know

where we stand.

MR. HOBBS: I would also like to add something. I think in your definition, it said where "sellers can influence." I don't think it made any reference to buyers. Maybe I missed that. But it has been my experience that buyers have the same ability to influence the market as sellers may.

And I also think again, when you look at this summer, when so much of the power is being bought in what we would call spot market, which is not just the hourly but the day-ahead, I think that has been a lot of the cause for the run up in prices. It is not because of necessarily sellers trying to unjustly influence prices.

I think the market conditions cause prices to go up. So I just wanted to make a clarifying point.

COMMISSIONER BREATHITT: Thank you.

MR. POPE: I would like to just -- I'm beating the same drum here. In California, I think Jan commented about how that the transmission system was built for a different kind of market or basically the control areas of the investor-owned utilities, but what that has created now are situational market power opportunities that are just created by the physical makeup of the transmission system.

1 And on your comment about sustained periods of

time, a huge solution to that sustained period of time would be to solve that with additional transmission. And then that sustained period of time goes away.

MS. HAPNER: Just one quick comment.

I think that the definition you read is key. I think what you have to confirm is that your responsibility is to look at the exercise of market power and not just the abuse of market power.

And I hold that very separate from your other actions and the rest of your investigation, which have been focused on whether or not the California market is workably competitive.

And I think the Staff report says very clearly--and most people would agree--that it's not workably competitive and may not be for some time, and that my require a different set of actions.

CHAIRMAN HOECKER: We will have to wrap this up pretty soon, but let me say I look forward to each of your dissertations on the subject of:

What is market power?

When is it exercised?

When is it lawful?

When is it not?

And there are both kinds of market power. And in

this I agree that it gets flung around a bit. I think there

is market power in any market at certain times exercised by sellers and buyers.

It is the abuse of market power and the permanent pre-condition for the exercise of anti-competitive behavior that concerns us. And if you can help us be more specific, I certainly urge you to do so. Otherwise, you're going to be stuck with the definition we come up with. It's pretty much that simple.

Mr. Smutny-Jones, the $150 benchmark that we have got, you say it won't work and you do not like price caps. At the same time, I hear you saying that perhaps some form of price mitigation is needed.

What are the alternatives?

Tell us what we should do?

MR. SMUTNY-JONES: Well, you already have a $250 price cap that's in the market now, and I would leave it there, frankly. But if you--

CHAIRMAN HOECKER: You just got done saying that a price cap is going to result in prices increasing, so you want to increase them from $150 to $250. Is that what you're saying?

MR. SMUTNY-JONES: What I was saying, Mr. Chairman, is I think if you reduce it to--and this is why I was cautioning the Commission, because when we lowered

1 it from $750 to $500, and from $500 to $250, all kinds of

things happened that the Board certainly did not anticipate--and what I'm saying is at $150, I don't know what those consequences actually are.

What I tried to indicate in my presentation is there's a wide variety of opinion about how the $150 price cap would affect investments in the different pieces of this market. And I want to be very clear on what I mean by that.

The entity that is building a new merchant plant at a 7000 Btu heat rate may view that soft cap very, very differently than someone who is operating a plant at a 12,000 heat rate, or trying to build a new peaker with maybe even a higher heat rate than that.

And the power markers may view the $150 cap as a hard cap and they are not willing to take the contingent liability over an extended period of time.

CHAIRMAN HOECKER: And you're heard that this morning.

MR. SMUTNY-JONES: And that was my whole point. I mean, I recognize the fact that what this Commission is struggling with is nobody likes the caps. There is a general concern over what is going on in the wholesale market and you are trying to find a way of basically resolving that issue.

1 And, you know, I'm not trying to be unhelpful

here.

CHAIRMAN HOECKER: Now some people have said that we ought to have a cap that escalates. And I take it that we are not talking about -- or maybe we are talking about -- something like Mr. Florio's load differention system?

Is that what we're talking about?

That that escalates and that takes into account changing conditions.

MR. LEDNICKY: That's certainly not what I was advocating.

(Laughter.)

MR. LEDNICKY: I repeat what I said earlier. I mean, the emphasis ought to be on how do you get demand out of the spot market.

We tend to think of this as a price issue. This is not a price issue, this is a volume issue. We are taking a single price. We have, for whatever reason, decided that the PX market and the ISO market, that is it, and there are prices there, and we multiply that price by all of the volume to determine the end use or end impact to the consumer.

And I think the Commission is dead on track in focusing on trying to find ways to get the demand into the forward markets, eliminating the PX buy/sell requirement.

1 California needs to do some things to eliminate the

regulatory uncertainty that purchasers may have for fear of after-the-fact prudence review.

Those are things that will go greatly toward helping the market.

And I will just add one other thing, because I don't think anybody has really said this yet today: I don't want the Commission to come away with the feeling that, from the supply side of the market, we are trying to hide behind the rules and have those in a way that forces prices up, and that we are hesitant to go into the forward markets.

We are not hesitant to go into the forward markets. Where there has been activity in the forward markets, we have been the ones there making that activity.

And our motivation for doing that is price certainty because I don't know what is going to happen next summer. I don't know what the weather is going to be. I don't know what the demand is going to be. I don't know what the CPUC is going to do. I don't know what you are going to do. And I can avoid all of those problems if I can enter into a forward contract.

Likewise, the demand side can do the same thing. Mr. Pope said exactly the same thing. I love having customers like Mr. Pope because they don't worry about all

1 of the tariffs, they worry about what is the best thing for

their consumers, and from the supply side of the market, we are more than willing.

Dynegy has made a number of offers to all of the IOUs and I think you can talk to the other parties representing the supply side here today, we have done the same thing.

And there are reasons that the demand side market has not entered into some of those contracts. Some of those are structural, some of those are regulatory, some of those are a difference of perception of what the right price is, but I think the Commission would be well-served to focus on those aspects rather than focusing too much on controlling the price in the spot market.

MR. HOBBS: I did want to add, since in my opening comments I referenced escalating caps, but to be clear, we do not believe in price caps. However, if they are going to exist, I felt it was important that the Commission show its intention to ultimately raise and remove those caps.

But I also want to clarify, in the event you do go to an escalating soft cap, as long as you have "subject to refunds" it's our view, as you've heard from many others here, you still have a firm price cap.

CHAIRMAN HOECKER: Well, Mr. Hobbs, you had an

1 idea you floated earlier that certain prices be flagged for

review, and that others be sort of closed out and made non-subject to refund to add certainty to the market, at least at some price level.

How would that work?

MR. HOBBS: Well conceptually what we are trying to say is that we do not believe all transactions should be subject to review. So what we are trying to do is build fences around ones in the even there is a soft cap to determine if in fact prices were transacted in a workably competitive environment.

Our suggestion would be in effect, if the soft cap, whatever the soft cap is, that anything at or below that is closed and not subject to refund.

Anything in addition to that would be through-- and our suggestion would be the market surveillance unit of the ISO--would be flagged within a very short period of time, 30 days after the end of the month, for FERC review.

Then it would be our hope that, instead of a two-year window that FERC would have to look at that transaction, that it could rule very quickly as to whether or not there was in fact a problem or not.

MR. LEDNICKY: I would just add that, while we don't really support the notion of this kind of on-going

1 regulatory intervention--that we have real concerns about

what that does to the market--but if for whatever reason that's the direction that the Commission goes, then as I said in my comments, it's very important for you to be specific on exactly what is to be required, exactly the methodology which you would use to evaluate these things. Whether it is FERC staff or the MSC, somebody is going to be looking at this data and drawing conclusions. Now I can almost guarantee you that litigation will ensue.

So the best defense we have at this point is to be very clear from the beginning exactly what the rules are. Let's have the fight once, and we'll live with it from there. Otherwise, you know the California record with respect to litigation. And I think that will continue.

CHAIRMAN HOECKER: There's a scary thought for you.

(Laughter.)

CHAIRMAN HOECKER: Mr. Lednicky, I was just looking at your written statement, and I appreciate your observation that having been at the other end of a lot of pointed fingers, I know that the folks on the supply side of this debate would rather get on with other subjects, but you are attaching to your statement a factual response to some of the rhetoric that has fogged the air in this debate.

1 I am assuming you are talking about how much the

generators allegedly charged this past summer over and above their costs, issues related to the exercise of market power, what their margins were, and the question that keeps coming up is that when the market has sent these kinds of price signals, it's an incentive for generators, for power suppliers to invest in the market and to build new capacity.

I am assuming some or all of that is going to be in your statement. I haven't read the whole thing, but I would, given the shortness of time, invite you and Mr. Hobbs, I see Mr. Stout out there, and Mr. Macias, anybody who is selling into this market, to take this opportunity to explain to us exactly what the facts are from your perspective in terms of how we got to the kinds of prices we got to.

Until that issue can be fully ventilated, all the short-term market design manipulations this regulatory agency can come up with are not necessarily going to get everyone comfortable with having a fully competitive and open and free market in California and end the potential threat of some form of pre-regulation. And so I think this venue or this proceeding is a good opportunity for you to do exactly what you say you are going to do, and to put your cards on the table in terms of what it costs to serve this

1 market, especially at peak periods.

I think that in the interests of making sure that we are done before sundown, that I will ask you all to--well, let me ask Staff if they have any closing questions they wanted to ask?

MR. GELINAS: I would really like one shot.

CHAIRMAN HOECKER: Okay, John Gelinas.

MR. GELINAS: Lynn, you hit on a lot of points which I think are central to at least some of the thoughts that we had. A shorter degeneration, and entirely too much spot purchases, and moving into the forward bilateral markets. In fact, I think you also advocated getting rid of the single price auction.

With respect to your example on the peaking unit, the 500 hour number you ran past me, there is no question our break point, which is not a cap but I know it requires reporting and so it may have a chilling effect on behavior, but it certainly wasn't in any way derived by assuming someone would make an investment decision and wait for 500 hours of spot market sales to recover that investment.

Why can't the forward and bilateral markets be just as good an avenue for that product as any of the other product we have been talking about?

Why does the break point impact it one bit?

MR. LEDNICKY: Well I think the simplest answer

is that it's a function of the load duration curve. It is

not really a function of the unit that supplies it.

If you look at a load duration curve and 90 percent of the hours, the load is 40,000 megawatts, just to be simple, and the remaining ten percent of the hours then the load will be between 40,000 and 50,000 megawatts.

Then by definition, if you have a system that keeps the lights on, you have to have 50,000 megawatts worth of capacity in that system.

Well, 10,000 megawatts of that capacity will be used less than ten percent of the year, okay. So there is capital cost associated with that. And that--in the market design we have here as opposed to a regulated design--that ten percent of capacity must recover all of its costs, fixed FIN variable, in less than ten percent of the hours of the year, less than 800 hours of the year.

MR. GELINAS: It's not the math. It's if we eliminate the single price auction, Lynn, then you are in bilateral markets for the very product that you are talking about. Why can't you do it right now? I know the characteristics of the product, but why can't you go into a contract with Terry who is looking for 600,000 megawatts on a roller coaster ride in the morning?

MR. LEDNICKY: Okay. You probably can come fairly close to that. I mean you always have some load

1 forecasting error so you'll never be 100 percent perfect and

you'll need a real time market or something to go to, but you could construct a series of contracts that had, you know, some base load to generation in it, some intermediate generation, probably have some auctions associated with it, so that you had commitment for capacity that you used as needed.

So you could go a long way toward doing that. And again, that's a better solution because that's a portfolio. That's a better solution than just hoping that you can buy it all on the spot market when it's hot.

MR. GELINAS: For better or for worse, that is sort of what we're trying to accomplish.

MR. LEDNICKY: And we very much support that.

MR. GELINAS: Okay.

MR. POPE: I think at least the load-serving entity needs to do more of that. I don't believe the ISO needs to do as much. And right now, we're in this crisis. They need to do it. They need to do it to keep the lights on, and being a board member, I support that, but long-term, that should not be where the ISO or the larger RTOs should go.

To that point, we have a bilateral contract with PG&E on our peaker, and we do support them for reliability up the peninsula. So we are in a mini-bilateral market

1 where my peaker supports me or supports --

MR. GELINAS: You're doing that right now.

MR. POPE: I'm doing that right now. I've been doing it with PG&E for the last three years.

MR. GELIAS: Okay.

MR. LEDNICKY: And I would just also add, we have done that in a number of other jurisdictions when we have full service requirements customers, in Texas, for example.

MR. GELINAS: Thanks a lot.

CHAIRMAN HOECKER: There is one question I have been dying to ask, and this is going to be tough, but assuming that the weather in California is normal next summer, and we have an average water year in the Northwest, and California's loads approximate what we had this past summer, what is the prognosis?

And gas prices have come back down below five bucks, but probably not a whole lot more.

MR. LEDNICKY: Well I will take a first stab at that. I think you have to break that question into two parts when you say what is the prognosis.

First of all, you need to look at the fundamentals, okay? The fundamentals are that given a normal weather pattern including hydro, you will see some additional generation come into California, but not a substantial amount.

CHAIRMAN HOECKER: How much are we talking about?

MR. LEDNICKY: Terry may be better able to answer that, but I would guess around 500 megawatts.

MR. POPE: I would say 500 megawatts is going to be base load and if the contracts go out, my guess is you are going to get half of that, half of the 2,000. So you might have 1,000 peaking units available.

I subscribe to the half-as-much/twice-as-long theory, however. That's my economics.

MR. LEDNICKY: I would have given you slightly higher numbers, but no more than 2000 megawatts.

And my next point was that I would expect that demand growth in California will outstrip that. So that from a fundamental perspective, you will not be any different than you were this summer.

And the other thing, remember, this summer, you talk about normal weather, one of the things that is true is that if you look across the West, because it's really the West that you are concerned with, you did not have coincident peaks this year. It's hot in the Northwest, but it was okay in California. It was hot in the Desert Southwest, but you can all of those areas hot at the same time which might happen on a normal basis. You are likely to see the same fundamentals next year as you do this year.

CHAIRMAN HOECKER: Anybody disagree with that?

MR. POPE: I would expand on that.

I see in Santa Clara much of the load density increasing with the business to business E-commerce and the server farm circumstance where we are getting load increases in the chunks of 5 to 15 megawatts per connection.

CHAIRMAN HOECKER: Ms. Hapner?

MS. HAPNER: I guess the caveat is the plants that are older than many of us in this room. And it has cost a lot of money and a lot of heartburn --

CHAIRMAN HOECKER: Another scary thought.

(Laughter.)

MS. HAPNER: -- to try and keep them up and running. And there is only so far you can go with that. And the new load coming on line will not equalize the load that is likely to be down.

CHAIRMAN HOECKER: Well, thank you all very much. We are going to reconvene at 1:15. Sorry that we went long, but we will start the next panel with Governor Davis at 1:15.

(Whereupon, at 12:40 p.m., the hearing was recessed for lunch, to reconvene at 1:15 p.m., this same day.)

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AFTERNOON SESSION

(1:20 p.m.)

CHAIRMAN HOECKER: We are prepared to go back on the record for our afternoon sessions. We have two panels this afternoon. And I know this is an important conference when I look across the table and see as distinguished a panel as we have after lunch.

I want to thank you all for being here. I believe we are going to begin the afternoon session hearing from the Governor of California, Gray Davis, who we have on tape. So if you would roll that tape.

(Begin videotape.)

GOVERNOR DAVIS [By Video]: Good morning, Commissioners. I appreciate the opportunity to address the Commission today by video. I would be there in person, but the President-elect of Mexico, Vincente Fox, is visiting us today, and I need to be with him.

The short statement I will make today will be followed by more extensive comments at the hearings you have scheduled in San Diego on November 14th. However, the gravity of the situation compels me to speak out on behalf of the citizens of our state.

When former California Governor Pete Wilson and the legislature enacted AB1890 in 1996, no one could foresee

1 the circumstances we find ourselves in today.

The marketplace for electricity that was envisioned in 1996 has failed to materialize, and the market structure that was intended to result in lower prices has instead wrought financial hardship on ratepayers. It has also threatened the very financial stability of the utilities that deliver electricity to 10 million customers throughout the state.

Billions of dollars more -- billions -- were spent this summer for merely the same amount of electricity used just one year before. And the newspapers are filled with reports of exorbitant profits reaped by merchant generators and marketeers.

Now they may feel an obligation to collect every dollar possible for their shareholders, but I have an obligation to the citizens of California to protect them from price gouging. My purpose is to assure that we have reliable electricity at affordable prices.

Now I believe that deregulation of electricity can eventually work, but only if the market is competitive and if all parties act responsibly. Unfortunately, neither has happened in California.

Now I am pleased that the Commission agrees with me and several million ratepayers in San Diego that the marketplace in California is dysfunctional and that

wholesale prices are neither just nor reasonable.

However, having made that determination, I am greatly disappointed and perplexed that the Commission did not take the next logical step and order refunds to ratepayers.

We believe the Commission could and should have taken this step and we will include our legal analysis on this point with other written comments we file later this month.

I am also pleased that the Commission agrees that there is a conflict inherent in the Stakeholder Boards that preside over the California Independent Service Operator and the Power Exchange. However, the Commission does not recognize that it is within California's jurisdiction to determine the structure and to reconstitute the structure of these Boards by statute.

I am pleased the Commission has determined that the wholesale price caps imposed last summer were inadequate to rein in wholesale electricity prices, but I am very disappointed that the Commission is proposing untried, experimental market rules that once again can make guinea pigs of California ratepayers.

In so doing, the Commission has stripped California of the protection of any real wholesale price caps, and it has denied the ISO the authority to impose

1 price caps should these experimental market rules fail to

protect the ratepayers next summer.

Commissioners, you found the system is dysfunctional and that the rates are unjust and unreasonable. But you have failed to acknowledge the critical fact that it is the system that created this state of affairs. It is the system that must be changed.

Instead, you are asking us to knuckle under for the next ten years or so, thereby weakening our economy and putting our consumers and businesses at great risk. I cannot allow you to do that.

The past failure to site sufficient generating facilities in California is frequently acknowledged in the Commission's report as a contributing factor to the lack of competition in our electricity marketplace. And it is true that for nearly ten years the previous administrations and their California Public Utilities Commissioners have discouraged the development of new generation. But now we are aggressively reversing that policy.

I sponsored and signed legislation this year which is accelerating the siting of new generation, streamlining the emissions permitting process, and expanding programs to reduce peak demand.

Moreover, the state appropriated $50 million for

1 these efforts this year, and we extended for ten years the

public benefit charges that contributed $500 million a year for renewable energy sources, demand reduction programs and research and development projects.

We believe we are doing all that is possible to increase the supply of electricity and reduce the demand without exposing Californians to public health risks and environmental degradation.

In sum, this is my point:

You will agree with us that California has a problem. You will agree that the marketplace is not competitive. You will agree that rates are not just and reasonable. But you are not willing to do anything about it.

Moreover, what you are prepared to do further reduces California's ability to solve its problems.

Apart from that, I think you are a fine group of people.

(Laughter.)

GOVERNOR DAVIS: I look forward to seeing you on November 14th and the opportunity to address other issues in the Commissioners' report.

Thank you, and have a good day.

(Laughter and applause.)

(End videotape.)

CHAIRMAN HOECKER: Well, we are going to make

sure the "fine group of people" gets in the record.

(Laughter.)

CHAIRMAN HOECKER: Thank you. We will put that in the record, and I very much appreciate the Governor taking his time and effort to focus on this issue and to provide his guidance.

We have with us today President Loretta Lynch of the California Public Utility Commission; Michael Kahn of the Electricity Oversight Board; and Bill Keese from the Energy Commission.

Now it is my understanding that you would rather respond to questions and let the Governor's statement speak for itself. Am I right about that?

(Nods in the affirmative.)

CHAIRMAN HOECKER: And we will do that if that is okay with you.

In that case, I would like to call on Chairwoman Debra Bowen of the California Senate Energy, Utilities, and Communications Committee. Senator?

STATE SEN. BOWEN: Thank you very much, Mr. Chair and members. It is nice to be back in Washington again.

Mr. Chair, you asked a question, the very last question before we broke for lunch, about the prognosis if certain events were to occur, including a continuing lack of

1 supply, continuing dysfunction in the markets, continuing

growth of demand and continuing weather and water patterns that we have seen. And although I had not planned to start this way, I think it is appropriate that I start with what I see as the prognosis in California.

I start with the proposition that markets must deliver results that are deemed just and reasonable, not by the people in this room, but by the citizens who pay those rates.

In this democracy, we determine values via the political process. Not the political process that is going on right here in this room, but the one that occurs at the ballot box every time an election is held. And it is my belief that if the best we can do to reassure the people of California that they will not be subject to unconscionably high prices in the next couple of years is what is contained in this Order, that the people will respond at the ballot box by re-regulating the electric industry in California, if not through the legislature, then directly at the ballot box.

Let me tell you a story of an initiative that appeared on the ballot two days ago in California. It would have raised the threshold for raising fees on particular industries to cover associated costs from a one-half vote -- a majority vote to a two-thirds vote. This initiative was

1 placed on the ballot by the oil, chemical, alcohol and

tobacco interests, which were concerned that fees, for example, to remove lead-based paint would be placed on manufacturers of paint.

There was virtually no money spent in a campaign against this initiative, yet the people of California when they saw who was funding the initiative, voted it down by a large measure. And if we have prices that look in the rest of the state like prices in San Diego looked last summer, I have no doubt that if another Proposition 9 goes on the ballot in California and the people see that the generators whose stockholders have benefitted from this last two years are the ones who are opposing it that the people will vote for it.

We have to take really strong action to deal with what is happening in California if we are to avert a return to regulation via either the legislative process or the ballot box.

I am a believer in markets. I am probably to the right of my caucus in my belief that markets are the most efficient way to deliver an efficient energy market. But that having been said, I don't think that we can stand seeing our economy disrupted, the potential to put the entire state in a recession and possibly to carry the rest of the nation along with it.

1 Your Order finds that markets are not workably

competitive in California, that they are dysfunctional. And yet the solutions really rely, continue to rely on the market to solve the problem. And I think we are going to have to go away from that in the short run if we have any hope of continuing our move towards deregulation.

There are a number of other problems with the Order that I see, and I do want to thank the Commissioners for putting a lot of work into this and attempting to come up with something that I think is helpful. I just don't think it will get us where we need to be.

And as I look at Section 206 of the Federal Power Act, it says that if you find that prices are unjust or unreasonable, you have the responsibility to determine a just and reasonable rate charge classification, rule, regulation, practice or contract.

So my question would be: Is the proposed soft cap mechanism a proposed rate charge classification, rule, regulation or practice? I am not sure what it is. I am not sure what triggers refunds after October 2nd if in fact refunds are due. I am not sure what triggers refunds retroactively.

I am not sure how we reconcile the stated preference for increasing forward contracting with the need to give Californians price signals both about time of use

and about quantity of use and work on the demand-side

market.

I am not certain how we can assure that bilateral contracts are in the best interest of ratepayers. I don't know which Commissioner it was or which--it might have been one of the generators who said it--that the industrial-owned utilities manage for shareholder risk, not for ratepayer risk. And by giving up any kind of authority to review bilateral contracts, we basically cede any ability to look at ratepayer risk issues and ratepayer issues.

I think the jurisdictional issues have been sketched out well. I think it would be very unfortunate were we to get into an argument about whose job it is to reconstitute the ISO and the PX.

I think I would echo Mike Florio's comments. We are all in agreement that the current governing mechanism is not workable and needs to be changed. We don't need to have a legal battle over how we are going to go about doing that. If we can't negotiate that, there is little help I think for us.

But again, to reiterate the point. I think the prognosis, if we don't do a better job of assuring the citizens that we are going to contain costs in the short run while we create workably competitive markets, there will be a return to a regulated structure. I think that would be

1 most unfortunate. I think it would undo a lot of good that

is in the process of being done.

I think it is political reality in a state that just unseated two sitting Republican Congressmen, filled two empty seats with Democrats and picked up seats in both Houses. It is not going to happen in California, and we will have a political revolt on our hands if people view the rates that come in their electric bills every single month as unjust and unreasonable.

Thank you.

CHAIRMAN HOECKER: Thank you very much. I would like to turn now to Senator Steve Peace from California.

STATE SEN. PEACE: Thank you, Mr. Chairman, members of the Commission. I appreciate your taking the time today.

CHAIRMAN HOECKER: You are welcome to take more than five minutes. We've got a little on our hands, so--

STATE SEN. PEACE: I will try to keep as close to that as I can and certainly will be--

CHAIRMAN HOECKER: And by the way, somebody asked me before this session if people can take off their suit jackets, and I welcome everybody to do that if they want to.

Sorry to interrupt. You, too.

STATE SEN. PEACE: As long as I put it on, you know, I might as well keep it. If you had told me that in

1 the first place, I would have worn my bermuda shorts and

thongs.

(Laughter.)

STATE SEN. PEACE: I did note also that Mr. Hebert didn't laugh at the Governor's joke. But that is okay. I don't think he included you in his comment.

(Laughter.)

STATE SEN. PEACE: Let me turn to a couple of documents that I would like to call the Commissioners' attention to, because I think they will prove helpful as you deliberate with respect to making decisions about exactly what the breadth of your authority is and what the options are in front of you.

That first document is your own Order, and to Appendix E it's not--unfortunately, the pages were not numbered in the appendix--but really it is the very last page of that appendix.

This is the discussion with respect to the authority as it relates to retroactive ratemaking, and the last two sentences are:

"Similarly, the filed rate and retroactive ratemaking doctrines which derive from the requirements of Section 205 and 206 would appear to apply equally to cost-based and market-based rates." The key sentence being the next one:

1 "There is no court or Commission precedent that

addresses this question directly, however."

The fundamental issue in front of you is whether the prohibition against retroactive ratemaking in essence--which is a doctrine that developed through the federal courts over a very prolonged period of time and based entirely on the presumption of cost-based filed rates--applies when the Commission at its own volition and without statutory authorization of Congress decides to use market-based rates as a surrogate for ratemaking.

Congress has never repealed, as you know, the obligation for this Commission to find that the wholesale rates are just and reasonable.

In your finding--which I join the Governor in applauding, your very appropriate finding, despite the representative from Dynegy's eloquent efforts to spin it somewhat differently--the overt and direct finding that these rates were unjust and unreasonable, which I think is pretty apparent to everyone, certainly those of us in San Diego, is critically important to all of us, and not just in California but throughout the country.

Because it starts down the road of credibility with respect to FERC exercising its responsibility. We cannot possibly have a competitive market if the wholesale market is not disciplined. It is the core. It is where it

1 all starts.

And as you know--and I would direct you to still another document, and that is former Governor Wilson's letter of July 27th, 1996 to then-Chair Betsy Moeller, imploring this Commission to support the filings. You will note in that letter that the Governor reassures the Commissioners that there will be no change in any legislation because he will veto any legislation that might--this was a letter written before 1890 was passed--and he is assuring the Commissioners that there will be no structural changes in 1890.

And indeed there were not. Except for one thing. The only thing we got, and added to those filings, was the creation of an Oversight Board.

And as you know, you later acted to undo the power of that Oversight Board. You felt it was an incursion into FERC's jurisdiction, and it may very well have been. That may have been an appropriate ruling.

But understand from a practical perspective that that put California at the mercy of a Stakeholder Board, which obviously failed to act.

And we had the original rules which we submitted to FERC in 1890 in which the Governor--it was the only change the Governor agreed to. Our Oversight Board could have stepped in in that. But since the rules were changed,

1 they could not.

So when we look at this issue of restructuring the Board, believe me, you will find enthusiasm. We were always against the Stakeholder Board in the first place. It is why we created the Oversight Board, because we did not trust the Stakeholder Board. So we look forward to working with you in getting it more appropriate.

However, I would take issue with the Chairman's notion that we need a bunch of technocrats. Enron does not have a bunch of technocrats sitting on its Board of Directors. And no responsible, effective operating corporation in this country or anywhere else does. The management may consist of folks with those background and expertise.

But just as both Governors successively--Governor Wilson and Governor Davis--have exercised their responsibilities, I think quite admirably in terms of bringing people in with very extensive backgrounds on boards of directors in these areas to exercise the policy responsibilities associated with a corporate board of directors, that is what I would hope we would steer toward.

Let me go now to really the core issue California faces. It is not only your retroactive authority that you clearly have--and I have absolutely no doubt that

1 the courts will ultimately just as they did in the natural

gas field in the Texaco case should you fail to act retroactively--simply kick it back to you and order you to act retroactively.

Similarly, now that you have made the finding that these rates were unjust and unreasonable, there is no application of Filed Rate Doctrine. And I am proud to say that our Public Utilities Commission will not allow the passthrough of unjust and unreasonable wholesale rates to the retail ratepayer.

If for any reason they should fail to do so, I am similarly confident the legislature will act to order that they not do so. And should for some reason that body fail to do so, as Senator Bowen has already pointed out, I am absolutely confident that the electorate will make such a determination.

It is important to understand the background in which we operate. AB-1890 was passed at a time in which the Republicans controlled the Assembly. There was a Republican Governor. There were five Republican commissioners. Today there are 27 Democratic senators, 13 Republicans, 50 Assembly Democrats, 30 Republicans, a Democratic Governor, a Democrat sitting in every constitutional office in the state but one, and soon to be a three-person majority of Democrats on the PUC.

1 And I tell you that not to make some partisan

point, but I think we can make certain assumptions about what the market philosophies are, and I am sure Mr. Hebert would agree there are certain assumptions one could make about the partisan affiliations and what kind of conduct you can expect.

And more importantly, in an era in which we know how close the country's voting patterns are, this is a state that just was 49 percent to 40 percent for Al Gore, just defeated two Republican Congress Members, one of whom was defeated on this issue.

Brian Bilbray is a close personal friend of mine. I have known him since childhood, and do have a tremendous amount of personal affinity for him, but he lost this election, ironically because his political consultant decided this was going to be a political opportunity for him to attack his opponent, and it ended up turning around and backfiring on him.

The whole last week and a half before the election, as Supervisor Jacob can tell you, consisted of political ads pointing out that Mr. Bilbray had supported the passage of the legislation, and indeed had also received lots of contributions from the power companies which, as you might imagine, I have some empathy, being the object.

(Laughter.)

STATE SEN. PEACE: I have a little trouble

feeling sorry for Dynegy feeling picked on and having the finger pointed at them, but I have some empathy.

make no mistake, the taxpayers, the ratepayers and the citizens are also market participants. And the state only has the authority to deal with the symptoms that are before us. That which is is dysfunctional is 100 percent in your jurisdiction. Every issue you have discussed today and every proposal you have made are associated with tariffs you approved--issues that were never even discussed in the legislature let alone approved of. They were never put before us. They were not in our jurisdiction.

And finally, Mr. Hebert, let me suggest to you that I think you and I probably share more core philosophy than you might guess. But it is not necessary for this Commission to find an acute exercise of market power for it to make a determination that the rates are unjust and unreasonable. And in fact, the representative from Dynegy just made an eloquent argument in attempting to avoid the notion that any market power was being exercised.

For you all to return to cost-based ratemaking, he told you that he already knows that next year we are not going to have adequate supply. How can a responsible regulator charged by federal statute to assure that rates

1 are just and reasonable, having been told by the very

advocates of the market that the market will not be workably functional next summer, do anything other than, at least temporarily return the wholesale market to cost-based.

And I think what you are struggling with here with respect to solutions is that you want these market mechanisms to work. You have invested years in trying to get us to this point. We have economists who have entire reputations at stake from Harvard to the University of California at Berkeley on silly ideas like second price auctions, and their reputations, their academic capital is vested in continuing to convince people that these are good ideas. We just need to make them work.

I would submit to you that the evidence is clearly there, and no matter what changes you make -- put a cap here, do this, squeeze over here -- as Mr. Winter noted at the very beginning of this hearing, these are innovative, smart people whose fiduciary responsibility is to make as much money for their stockholders. They will find a way around the new rules you establish just as they found their way around these rules.

And until you allow this environment to mature and for us to develop, Mr. Hebert, some of those demand-side tools, such as demand-side meters, and the kinds of things that allow the consumer to react so they can be a

1 participant in the supply and demand equation, you have an

inherently dysfunctional market. It will not work. And to say otherwise and to suggest that you can only demand rebates from those in which you find criminal behavior of some sort or invoke overt action is to suggest that if you walked into an arcade with your child and you walked up to one of those exciting machines and started to put in the quarter and found it to be dysfunctional and it suddenly poured the quarters out on the floor, that you as a parent would say, grab those quarters. Pick them up, put them in your pocket and let's run out of here. After all, you did not cheat the machine. You just went to play the game. It was the machine that was broken. So you get to keep the quarters. The machine is broken.

I suspect if you continue your investigation, as you should -- and I do not want you to interpret my remarks to suggest that you should not continue to investigate, to subpoena and to use the power only you have in terms of being able to convene the kinds of environments with the appropriate levels of confidentiality and subpoena power to assure there were not overt illegal acts or to identify where they were -- but you do not need to go there to order rebates and how do you get there, how do you determine what they are.

Mr. Hebert made the point that certainty is

1 critical to markets. The best way to have certainty is to

set rates, of course. But in any market or any competition, the most important, I do not care whether it is a football game or a baseball game, you have to know what the rules are and that the referee or the umpire is willing to enforce the rules.

For you to fail to act retroactively, as I hope you read in my earlier submission, is no different than a soccer goal being scored illegally and the referee blowing the whistle and saying, that is illegal. Do not do that again. But we will let the goal score. What kind of competition does that breed?

Now I have been in business for myself since I was 18 years old. It is just a little company. And we have customers; we have suppliers.

And it is not unusual for us to have a customer come to us in a situation in which they need their service and they need it now, and they don't have time to go to another potential vendor, and so technically--and they need it immediately--so technically, we could charge a billion dollars, because they have to have it. But we don't do that because we want their business in the future.

There is no similar customer-supplier relationship here, and you are the surrogate, and you are the only surrogate to assure that the marketers whose

1 fiduciary responsibility to their stockholders is to make as

much money as they can, to push the envelope of the market to find where the edge of the rules are. They cannot do their job well for their stockholders unless you vigorously enforce the boundaries of the market.

CHAIRMAN HOECKER: Thank you, Senator.

STATE SEN. PEACE: Thank you, Mr. Chairman.

CHAIRMAN HOECKER: Our last presenter is Chairwoman Dianne Jacob from the San Diego County Board of Supervisors. I want to welcome you to the Commission and thank you for your hospitality when we were out in your town.

MS. JACOB: Thank you, Mr. Chairman. And thank you for the opportunity to provide input to you today.

I just wanted to ask one question before I begin with my comments. Since I'm a Republican and we know because of the senator's comments that we now have almost a full Democratic state in California, if I can have equal time.

(Laughter.)

CHAIRMAN HOECKER: Let her rip, Madam Chairwoman.

(Laughter.)

MS. JACOB: Just to lay the background for comments, I think it is important to note that I am one of five Republicans on our San Diego County Board of

1 Supervisors. We support privatization. We support

outsourcing.

In fact, a few years ago we divested. We were the largest jurisdiction to divest a trash system, solid waste system in this nation.

We just recently outsourced our entire telecommunications and technology for the county, and it is the only one all but completely that has been done in the nation. We have set up managed competitions and we are running county government like a business.

Now given all that, we have unanimously voted to support investigating very seriously the feasibility of establishing a municipal utility district.

I sit here today representing over three million people, businesses in the San Diego County area that have been profoundly impacted by the events surrounding the deregulation of the electricity market in California.

I brought my chart with me. It is updated. It is right in front of me so you can see it. But you will see back in June of 1999 the rates per kilowatt hour for the electrical charge was about three cents. They went up to 22 cents. They are down now to about 14 cents or thereabout.

We are still have unjust and unreasonable rates, and I would like to what is occurring in San Diego County as white collar crime and no less. Our citizens were the first

1 consumers in the nation to be exposed to extreme price

volatility and unbridled market conditions that may yet occur in the rest of California and other parts of the nation.

And in your own words, our constituents have been subjected to unjust and unreasonable rates. The successful implementation of your action plan outlined in your proposed Order is crucially important to the residents of San Diego County. We commend you for stepping in to provide guidance and leadership in repairing a clearly dysfunctional and noncompetitive market. And I applaud you for recognizing the unjust and unreasonable rates we are experiencing and the fact that this market is broken. It is extremely dysfunctional.

We believe that in order to be successful, your Commission, Congress, the California Public Utilities Commission, and the California State Legislature will need to work cooperatively to restore some stability in this market.

Given the limited amount of time I do have available at this forum, I will keep my comments as brief and to the point. The county supports your actions to do the following: Number one, to permit investor-owned utilities to purchase resources outside the California Power Exchange and to enter into longer-term contracts to provide

for price stability.

Secondly, to provide for incentives to scheduling coordinators to preschedule at least 95 percent of their electrical needs in the forward markets and for penalties to those who do not.

Number three, to disband and reconstitute both the California PX and the Independent System Operator Governing Board.

The county pledges to provide its support and assistance in the limited jurisdiction that we have over this matter, and specifically the county has taken action to, number one, ensure that county facilities employ appropriate demand-side management and energy conversation measures. We are the fifth largest user in our county of electricity, and we are looking to save at a minimum 10 to 20 percent. That means -- that is equal to bringing on line a small generator or supplying some 2,600 homes. So that is not a small deal.

Number two, to evaluate and develop distributed generation or cogeneration at county facilities where it makes sense to do so. And number three, to balance environmental concerns with supply and resource needs as it relates to siting generation and transmission projects in the county of San Diego. In fact, a couple of years ago the county did approve the siting of a new facility, generation

1 facility in East Mesa, and it is stuck at the state level as

we speak.

There are some areas, however, where the action plan in your Order should be improved. In that regard, the county requests that you amend or adjust your order to do the following:

Number one, to continue or expand your investigation into market power abuse through collaboration with other ongoing investigations such as the California State Attorney General, the PX and the ISO to determine the extent of market power abuse during the summer months. And we believe there has been quite a bit.

I have to say I am disappointed that you did not order refunds. And in that regard, I would like to suggest that you reconsider the scope of your legal authority to order refunds and initiate an investigation to determine what refunds are appropriate and how they should be implemented.

Next, to recognize the significance of the fact that your grant of market-based pricing authority to sellers in California rested upon a determination that competition in the wholesale markets would be adequate to limit prices to just and reasonable rate levels.

Since you have concluded that competition was not effective in limiting prices to just and reasonable levels,

1 there is a record of exceptional circumstances where we

believe you do have the authority to require retroactive refunds.

Next, to support the rollback of rates in San Diego such that no San Diego consumer is treated any worse than the customers of Pacific Gas & Electric Company and Southern California Edison, who have yet to be exposed to these unjust and unreasonable rates.

Next, condition the continued exercise of market-based pricing upon a commitment by sellers to refund revenues found by you to have exceeded just and reasonable levels. Consider whether the $150 soft price cap needs to be applied to the entire Western market, given your findings on this matter.

And last, to consider the development of incentives to encourage suppliers to preschedule their sales of energy.

Given the complexity of the issues and questions as to jurisdiction, it is important that federal and state regulatory agencies and legislative bodies work in collaboration with one another in order to ensure that citizens and businesses in San Diego and California are no longer subject to the market abuses that transpired last summer, and correct market abuses that have unfairly impacted the citizens and businesses in San Diego County.

1 This Commission should not leave San Diego

consumers the victims of a dysfunctional market without an effective remedy for the harms that we have suffered. I urge you to order refunds retroactive to May 1st of 2000. I believe you have the power to do so.

I thank you for your time and attention, and we will provide more detail in our written comments.

CHAIRMAN HOECKER: Thank you very much. Those were excellent comments from everybody. And I have to say that at least speaking for myself, I do not view this as a partisan issue; that the FERC in addressing the future of the bulk power market in this country is going to have to act in a bipartisan manner; and that the minute these issues become overly politicized, at that point, public policy becomes significantly more uncertain, and the investment that is needed to correct the kinds of situations we are talking about becomes less likely rather than more likely.

And I take everybody's comments in that spirit. But I want to make clear that we do not view this as a Republican/Democrat or Independent kind of problem, but a problem for the American energy consuming public.

STATE SEN. PEACE: Mr. Chairman, can I just make sure that we are communicating effectively. Because I think the point Ms. Bowen and I are trying to make here has nothing to do with partisanship.

1 I believe it is easy to not understand how

different the political environment in California is than it is in the rest of the country, (A), and that it was then. This is a very liberal state. Mr. Hebert may argue a Socialist state.

What we are concerned about -- and Ms. Bowen and I, as she indicated, are probably well to the right of our respective caucuses with respect to believing in these markets. Our fear is your fear. And our concern is that if you don't send a clear signal in the form of retroactive action, that the people of this state predisposition is also reflected by the action of a five-member Republican Board of Supervisors with an aggressive history of supporting the private market already acting to form a municipal utility. You will see a ballot initiative on the ballot in 2002 to totally take the entire California market public; to condemn the existing power plants; to have all future construction -- and understand, this is a state that is a potentially huge market player itself. We sit on a $7 billion surplus.

We are not at the mercy of private-sector capital with respect to building power plants. I am not saying that is a good idea. But I am saying is my reading of the body politic in California is that that is what is going to happen.

CHAIRMAN HOECKER: Well, I hear you, and, you

1 know, I think I raised that very issue this morning with the

generators. So I think that is on our minds as well.

Let me turn to Commissioner Hebert for his thoughtful remarks and questions.

COMMISSIONER HEBERT: Thank you, Mr. Chairman. Let me start by saying that having served two terms in the legislature, having been confronted with issues not exactly like you are being confronted with, but certainly issues that are as emotional to the people of the state I represented, I understand your emotion. I am familiar with it. And therefore I do not take offense at your shots at me, because quite frankly, that is your job.

I have done it myself. I haven't always been right, but I've done it myself. And I agree with Chairman Hoecker. Coming from someone quite frankly who went to the state house as one of seven Republicans out of 122, let me tell you, you have never seen a minority.

(Laughter.)

STATE SEN. PEACE: You obviously don't know the history of the Gang of Five.

(Laughter.)

STATE SEN. PEACE: And Mr. Hebert, if you consider that a shot, then politics in your state is certainly a lot easier than it is in mine. That was friendly banter.

(Laughter.)

STATE SEN. PEACE: But I am capable of taking shots if you'd like to start.

(Laughter.)

COMMISSIONER HEBERT: Senator Peace, whenever you are ready to engage, I am here to do whatever.

STATE SEN. PEACE: I know, but perhaps we ought to just communicate through Mr. Leopold.

COMMISSIONER HEBERT: I think I will communicate through the Chair if that's all right. I didn't interrupt you. I would appreciate the same consideration. I didn't get to be a chairman of a Democrat House in the House of Representatives by not reaching across the aisle and by not working with all the people.

I have debated with these three colleagues of mine many a day. That's the way it works. And yes, Democrats and Republicans do disagree. That's the way it works also. But let's explore where we've been so we can try to figure out where we are going. I think that's what is important.

I can remember in 1992 being part of a debate that quite frankly California was the issue. And the debate over lowering costs and competition and choices was the issue.

I can also remember on the panel that I served

1 there was only one individual that agreed with me, and his

name was Herb Tate. He is the chairman in New Jersey of the Commission. And when everyone else was talking about how competition would in fact bring lower prices, Senators, he and I were talking about you don't understand markets. They may bring lower prices. But with certainty, the certainty you are talking about and the certainty I am talking about, they will bring market prices.

They may bring, in fact, more reliable energy for the same price. But they may bring less reliable energy at the same price. They may bring less reliable energy at a lower price. And I think it is all of our vision that hopefully one day it will bring more reliable energy at better prices. I do believe we will see that if we make the right choices.

I didn't draft the Blue Book. I debated against the Blue Book. I didn't set that infrastructure up. THere are people in this room that did. I didn't approve it when it first came through when the ISO came to this level, although I commend the people that were here that did to give the state of California an opportunity to do things on their own, which is something I embrace and I think they made the right call.

Now is it our chance to fix it? I think we are trying to do that. We don't agree. But that's no different

1 in California than it was in New England or New York or

anywhere else, but we are trying to fix it. And I want you to know that everyone at this table cares about the people in California as they do the people in New York and as they do the people in New England and as they do the people in the Midwest.

And our job is not to populistically say things which inflame the people of California, but our job is to set up a marketplace throughout the United States of America the people may be proud of. And I know that's what these people are committed to, and I know that's what I am committed to.

Having said that, let's go over a couple of things. President Lynch, you had said before that the state, the legislature and the Governor was doing some things to streamline some efforts to try to bring some things on line. Can you kind of tell me where you are there and where you are going with it? As much as you can.

MS. LYNCH: Sure. I can certainly talk about where we have been and the vision for the future. Obviously that vision incorporates action on a variety of fronts that haven't yet happened.

Certainly the legislature took quick action in August to stabilize prices in San Diego, and the Governor signed AB265 which did that through 2003. In addition,

1 AB970 shortened the process for siting of power plants in

certain circumstances and also mandated that the Public Utilities Commission begin, in consultation with the Electricity Oversight Board, begin a more expedited process to be looking at transmission and distribution issues, and we are doing that now.

The legislature set a very ambitious goal on the timetables for streamlining and expediting power plants and evaluating and planning for transmission and distribution and other grid functions. That was 180 days from passage. So we are looking at deadlines of this spring collectively as the agencies in California to produce. And then as you probably know, the legislature session from last year ended at the end of September. They are back in session. The new legislature will be back in session the first week of December.

So once the legislature is back in session, I am sure that the administration will be working with the legislature for the future.

I would also note that California I believe made a historic commitment to renewable energy and energy efficiency, including demand-side management programs when the Governor, as part as AB970 signed a bill which -- or signed AB970, which gave us $50 million in general fund monies for energy efficiency.

1 In addition to that, he signed the

reauthorization of our public benefits charge which goes on electric bills now which gives us $500 million a year for renewable resources, for research and development into new energy efficient technologies and for straight energy efficiency programs.

And perhaps the most important component of AB970 was the establishment of the Green Team, which really is an innovative concept bringing together both state and federal entities that deal with energy, deal with the environment, and deal with efficiency so that we are all in the same place now working together on an expedited basis to find new power sources, to develop new energy efficiency programs, and to work together as governmental entities.

And we certainly welcome the participation of the federal government as well as the state government on that Green Team so that it is part of state law. We are working very fast on the Green Team. And to my right, Chairman Kahn is the chairman as well of the Green Team. So we are working in a coordinated fashion to get as much supply on line and to provide as many energy efficiency programs that really work for next summer and then obviously for beyond, because it is not just an issue for next summer for California, it is an issue for the foreseeable future.

COMMISSIONER HEBERT: Thank you. Senator Bowen,

1 you had commented on not only focusing on supply but -- I

mean, focusing on demand, but focusing on supply. You made a comment that we should focus on supply. I am curious to what you are intending to do.

MS. BOWEN: I am not sure which comments you are referring to.

COMMISSIONER HEBERT: Actually I am referring to a comment you made when we came to San Diego, California and had a hearing, and here's the transcript. It is part of my homework.

MS. BOWEN: I actually discussed focusing on the demand side there because I think we focused a great --

COMMISSIONER HEBERT: No. Let me read it to you. It says if we are going to have a workable market, we have to focus on supply and demand and the positions that people can take collectively to control their own destiny.

I know what you are talking about on demand. We have been through this. I want to know what you are talking about when you say focus on supply.

MS. BOWEN: Actually the people generally don't do their own supply, and I think one of the things we have been concerned about in California is that people will take matters in their own hands, go buy a lot of small generation that's extremely dirty, and that while we may solve one problem, we'll create others.

1 So I think the remarks there about what people

could do are focused on the demand side, not on the supply side. Demand is for individuals that do have the ability to control their own destiny.

The cheapest electron people buy is the one they don't use at all, and the next cheapest is the one they use at two in the morning. But not many people in California really understand how that works, except those in San Diego.

COMMISSIONER HEBERT: Well, that's certainly not how I took your comments. Your comments came after a comment by Roderick Wright, who was talking about -- he says I would ultimately, if you look at the construction of plants, California's environmental regulations are not the sole impediment of a block. And then we were talking about supply.

So are you saying now that supply is not an issue or it is an issue?

MS. BOWEN: Well, supply is certainly an issue, but I think you just heard from Commissioner Lynch and Senator Peace describe it as well. We actually streamlined construction of power plants. We have done a great deal of work on the supply side.

My remarks that day though on I think what you just read, we have to have both supply and demand so that people can take their own destiny into their hands. The way

they do that is on the demand side by getting a price signal

that causes them to change their behavior. And that's the part of the market that's missing.

STATE SEN. PEACE: Supply is certainly not an issue today. And if you look at the Power Exchange we have lots of excess capacity in the West right now and the Power Exchange price and the prices throughout the West are ridiculously high, which is why whatever action the Commission takes, it ought to do so regionally, as has been suggested, and it ought to follow its historical pattern of interpreting its powers broadly.

And I just find it odd that a Commission that has really been very aggressive for many, many years in interpreting its authority suddenly when it comes to the issue of retroactivity becomes very timid in interpreting its power.

COMMISSIONER HEBERT: Well, I would suggest -- I certainly don't want to speak for the other two commissioners or the chairman, but I think there's a lot of agreement that the wholesale market is dysfunctional, doesn't work and something has to be done.

I know that's what you are saying and I think we pretty much all agree with that. But what we have been trying to do, certainly the chairman I think has talked about cooperative federalism, and us trying to work together

1 to get things done, being deferential to California now

trying to figure out how to move through the mistakes and correct the process.

STATE SEN. PEACE: Well, I know -- that word, just -- you may reference to being deferential. I want you all to know that we don't feel at all trampled upon with respect to you being more aggressive in the areas where it is your authority. In fact, we don't think you did us any favors. But if in fact it is your view that you approve tariffs that we had no jurisdiction over approving or disapproving -- when I say "we", the legislature -- it was not before us. We couldn't do anything about it one way or the other. If you feel you were deferring to something you didn't really want to do, we are more unhappy about that.

We are not asking you -- these are technical issues in terms of construct of the market that's exclusively within your jurisdiction. What you saw the Governor make reference to is please be aggressive about doing that job, but don't come to us and tell us that part of that job is going to be to keep prices artificially high in order to get us to accommodate the construction of power plants or to compromise our environmental laws in order to build power plants. And now you are doing land use for the state of California and that isn't in your jurisdiction.

COMMISSIONER HEBERT: Herein lies the problem,

that somehow you are blessed with the ability to tell us

what we have the ability to do and what we don't. Jurisdiction falls I think within your heart and not within your mind.

STATE SEN. PEACE: No, it falls within the law. And the Congress of the United States and the law requires this body to assure that wholesale prices are just and reasonable.

You and I might even agree that we don't think that's a good idea, that the market ought to be more open, but the law doesn't allow that, Mr. Commissioner, whether you want it to be that way or not. That's what the law says. And until you can get Congress to change the federal law, this Commission has a legal responsibility to assure that rates are just and reasonable -- a legal responsibility which I am confident the courts will enforce.

COMMISSIONER HEBERT: You are asking me and my colleagues to step in and tell you what to do.

STATE SEN. PEACE: No. I am asking you to follow the law, not your heart.

COMMISSIONER HEBERT: You are asking us to step in.

STATE SEN. PEACE: I can't say "heart" as good as those southern guys, but I will try.

(Laughter.)

COMMISSIONER HEBERT: You just need to slow up a

little.

(Laughter.)

STATE SEN. PEACE: Okay.

(Laughter.)

STATE SEN. PEACE: Then I would stumble over my words.

COMMISSIONER HEBERT: I want you to think about that today.

(Laughter.)

COMMISSIONER HEBERT: I am not going to sit here and debate with you.

STATE SEN. PEACE: Why not? I am enjoying it.

COMMISSIONER HEBERT: Well, I can't debate with you because you won't let me on this side of the table make a comment without being interrupted. But if you were to, what I would say is --

(Laughter.)

COMMISSIONER HEBERT: --you want us to intervene as you see fit. You don't want us to intervene as you disagree with.

Now I am trying to be polite here, because you helped make some decisions that quite frankly have gotten the State of California in trouble.

STATE SEN. PEACE: Such as?

1 VOICE: AB1890.

(Laughter.)

STATE SEN. PEACE: Let's go to a specific --

COMMISSIONER HEBERT: I am not going to sit here and debate it with you. I am telling you that we are going to try to help you move forward. You may not agree with where we are going. My guess is you are not going to agree with where we are going. But this Commission--which it is blatantly clear that I don't always agree with--has every ambition to do that and wants to do that. And I believe we will get it straightened out.

I think if we can focus more on precise measures, what we are doing to try to solve problems, we can shape all this up. I am not going to debate with you. I am finished with my comments. I may have a follow up comment, because this is wasting time and I am not going to do that.

My colleagues will probably have some questions.

COMMISSIONER BREATHITT: I have a dilemma, and I need your comment on my dilemma. Senator Bowen and Senator Peace, you pointed out the very real possibility of a referendum. So herein lies the dilemma to me. If that is very real and in order to make the California market workably competitive -- and I think those were two words that actually came from California pleadings that are now being used in lots of places, "workably competitive" -- the

1 generators, the sellers are telling us that in order for the

market to become workably competitive, and our investigation report says one of the things that can help is to get more supply into the market.

So the dilemma -- and they also maintained that that wouldn't happen with price controls. So it is almost a gamble as to whether or not, you know, the two schools of thought, if you believe that the referendum will happen if the market doesn't become workably competitive and consumers aren't -- don't receive bills that are reasonable, how can all of us who are trying to grapple with this very serious situation determine who's right?

Are we going to have the referendum if the market doesn't become workably competitive and people have invested millions of dollars in California and you turn back the clock to what? Or does the -- and you ask us to look at price controls, to look at refunds, be they retroactive or going forward. And you've asked us to consider market-based rate authority.

So those are three areas that sellers say would cause them to flee the market. And this morning we heard from two sellers who've said they've already made decisions to revoke investment in California. So therein lies, who do you believe?

MR. KAHN: Commissioner, perhaps I can help you

1 on that. The injunction of Commissioner Hebert and the

injunction of everyone in the last six months has been we need more generation.

We have told you that in the past, in the recent -- the Governors have told you just now -- that California was not encouraging generation and was not creating an environment in which it was being promoted. We have also told you that we have changed that dramatically and that we have expended large resources, both in terms of our political capital as well as our economic capital, to change the process.

What we would say to your question is, instead of talking about theory, instead of talking about what is theoretically going to happen if you do something or the other, come on out to California, sit down with us. Our Green Team would be delighted to tell you what we are doing. We know what projects are being scheduled. We know where they're being scheduled. We know what is going to come on line and what is not.

The Energy Commission has an enormous amount of data and information about that. You don't have to rely on the economists and theory about whether or not there will be generation to build. You can come out and see the actual situation.

In the meantime, what the senators are telling

1 you and the Governor is telling you is, be it coupling the

notion of building supply with relief in an area that the Governor and the senators are telling you they desperately need is not necessarily appropriate, especially since it is based on theory. And we can give you real data We can tell you what is really happening. We'd be happy to share that with you. And indeed, we are going to share some of that information with you on the 22nd.

But I think you are absolutely right. And I don't criticize the generators for what they said to you this morning. But I would just suggest to you that they have their own self-interest and they have their own bias and their own predictions of what is best for their positions in the marketplace, whereas we are now on an actual retail basis worrying about getting supply on. And there are plenty of people who are telling us that they're going to build supply or intend to who are not being chased away and don't think it is impossible.

And the PUC is leading an effort to put a little light to the question of what are the actual demands and will we be able to fulfill them.

So rather than, I think the Governor and the senators are telling you, rather than experiment with people in the state of California with respect to a remedy that is keyed to curing a problem that may not be in existence

1 anymore -- we may not have such a terrible supply problem

anymore if we are allowed to finish our work and do it right. And I haven't heard anybody on our side of the table in charge of supply, neither the Energy Commission or the Green Team or the Governor, come to you and say we need you to come in now. Now we might, but we haven't yet.

So we welcome your participation, and we'd be happy to share what we know with you.

COMMISSIONER BREATHITT: Thank you.

STATE SEN. PEACE: And there's a very long line of both private and public sector folk who are perfectly prepared and are waiting to step into the place of some of those like Enron who feel they need to have higher price points in order to risk capital. And we are okay with that. Every entrepreneur will make their own decision about where they want to take their capital.

COMMISSIONER BREATHITT: Can you clarify a comment you made in an exchange with Commission Hebert? You said there was a sufficient supply. Are you talking about in November of 2000?

STATE SEN. PEACE: No. I mean this day right now today.

COMMISSIONER BREATHITT: Okay. You are aren't talking about next summer?

STATE SEN. PEACE: No, not at all. In fact on

the contrary, as I stated earlier, I think the argument was

made by the representative from Dynegy that we know going into the summer there won't be an adequate supply, and it is unrealistic to expect there to be a workably competitive market. And the Commission should, in my view, follow the law.

And I look at the Texaco decision on natural gas. The Supreme Court said very directly that the Commission cannot use the market as a surrogate for its congressional mandate to assure that prices are just and reasonable.

MS. JACOB: If I could make a comment maybe I can help you with this. From the San Diego experiment, we are suffering. Our economy is in jeopardy at this time. There are businesses closing their doors, and there is no business that wants to come to San Diego now because of the high electricity rates. And the 6.5 cent rate cap established by the legislature, at this point in time, unless further action is taken, that's just building up a big balloon payment possibly with interest that we are all going to have pay for at the end of either 2002, 2003.

So if there are no temporary -- and I emphasize "temporary" -- we need some temporary action while there are adjustments to this dysfunctional market to make it a functional market. Because I believe in free enterprise. So if there's no temporary price controls, there's no need

1 for more supplies because there are not going to be any

customers.

So, I mean, it is that bad in San Diego.

COMMISSIONER BREATHITT: What if certain short-term measures that you are advocating do in fact reverse investment decisions? Where does that get any of us?

MS. JACOB: I don't think they will.

MS. BOWEN: I actually think it probably will change some investment decisions, and I would urge you to look at this, much as you might urge what happened in the Nasdaq in March and April and May of this year, which is at a certain point when the Nasdaq looked like it was going up and up and up, people who otherwise would not have been participants in that market became market participants, because they thought they could make a lot of money in short order. When the market came back down, many of those people decided that that was not in their best long-term interest and made other decisions.

And so you probably will have some decisions made on the margin. But we can't focus on the margin, and we can't put ourselves in a situation where if we are required now to secure long-term forward contracts, basically that's like saying to someone in the stock market, well, you know, the Nasdaq's at 4200, but you've got to go out and buy all of your investments for the next 20 years tomorrow. We

1 can't.

COMMISSIONER BREATHITT: I don't think anybody is thinking of forward contracts in what used to be a long-term contract on the natural gas pipelines of 10 and 20-year contracts. I don't think that's what --

MS. BOWEN: Or even two. It makes a lot of assumptions.

STATE SEN. PEACE: Yeah. Look at how the world --

MS. BOWEN: I would ask you to think of yourselves as the Alan Greenspan of this market. You have a tempering obligation to curb the irrational exuberance that some have, with which some of have come into California seeing that very large profits could be made in the short term. And we want stability of supply and markets that function in the long term.

COMMISSIONER BREATHITT: And we do want investment.

MS. BOWEN: We do. But we are getting investment. We hear far more tales of people who are not leaving. Actually building is going on on the ground. Facilities that did not exist will exist before next summer. Additional generation will be available before summer of 2002. So building is happening.

One of the benefits of the price increases is

that some of the renewable contracts start to look better,

and that may serve the state very well in the longer run, even though it is difficult now.

COMMISSIONER BREATHITT: Will some of that evidence be reflected in the written comments?

MS. BOWEN: We can certainly provide it. The Energy Commission has, and I have in my office a map of everything that's being built, that's being constructed.

MR. KEESE: Actually we are talking about two different subjects. The projects we heard were withdrawn today were short-term projects for peaking plants that could be installed by next June 1st.

At the Energy Commission we had -- and I will call it 500 megawatt. Let's just talk about a plant, a power plant. We had two submitted to the siting process in '97. We had three submitted in 1998. The ones in '97 go through our licensing process then go through a construction project. We wont have any on this year yet. But in 2001, we have two expected to come on in July and two in August.

We have a total of about five power plants coming on next year. The following year we have another three that are in our process. We will approve another 10 plants in the next four months at the Energy Commission. They will take about 18 months. We'll have some of those coming on online, perhaps 10, in 2003.

1 Now when do we get out of the problem? As you

heard earlier, we have a fleet of generating that's 30 to 40 years old. It is on the verge of failure. We are going to lose some more of those. The West is growing faster than California is. We are not going to be able to import as much. We have had wet years five years running. It may not be wet this year.

We had -- frankly, I will edit your staff report. This year was cooler than normal. We had our problems when it was warm. But this on average was a cool year in California.

STATE SEN. PEACE: And a bigger threat to dampening that investment enthusiasm is the initiative threat. We lost two years of power plant construction, Commissions, because of Prop 9. The entire industry was deflected in beating off Prop 9. And when there would have been -- and they didn't know whether it was going to pass or fail, so they didn't make application, and we didn't get cued up.

My concern -- I am far more concerned about what the reaction of the private investment community will be in terms of investing in power plants of all types -- peakers and long-term base load plants -- as a consequence of this Commission not recognizing the political reality that we face back home in terms of likely consumer-customer-

1 taxpayer-businessmen response than I am by any what I

believe to be a relatively subtle reaction to an aggressive signal from this Commission that it is going to be a tough, pro-market, pro-competition referee.

MS. LYNCH: And I would just reference back to Chairman Kahn's comments to take a look at the facts. If you are concerned that we are not focused on supply and demand responsiveness issues, please be assured that we are focused like a laser.

And also all the applications that came in in the past few years came in under a price cap system that was imposed by ISO. So we are focused on this issue. We are moving rapidly to address this issue, and the issue is being addressed. The problem that is not being addressed is the wholesale pricings.

COMMISSIONER BREATHITT: Thank you. That concludes my line of questions.

CHAIRMAN HOECKER: Thank you. Commissioner Massey?

CHAIRMAN HOECKER: Do you have one follow-up?

COMMISSIONER HEBERT: Yes. I had just -- if Commissioner Massey will allow it, there's one follow-up to what Chairman Kahn said in trying to communicate what I had said on a question by Commission Breathitt that I tell you to site generation. My communication to you has not been

that. In fact, it has been that you have a choice. You can

site additional generation, or you can depend on imports. I am allowing you to make that decision. It is that great deferential treatment that we are talking about that some of you say you do or you don't want, depending on what in fact we tell you to do. I am just telling you you have a choice.

And when I look at the investigative report that we were provided with, you having all the supply you need is news to me. I think it is probably news to the majority of people in this room.

Now I don't think the issue is whether or not people feel good about the supply on November 9th. I think if you look at Mr. McCrea and Mr. Pope and you ask them what they're concerned about, I think they're concerned about supply in July and August and June and the reliability issue.

And to me, I think the real question is not so much what is coming on this summer or next year, but how many of those are peakers. I think that's the question. How many are peakers? And in the end, I would agree with you Alan Greenspan would be the guy. I don't think you'd like what he'd tell you to do.

(Laughter.)

MR. KAHN: Just a couple of reactions. First of all, the choice between being dependent on others and having

it our own, we think that it is a lot more fun to have it

our own than be dependent on others. I agree with you that's our choice.

On the question, do we have enough now, if we thought we had enough now, we wouldn't be doing what President Lynch was saying and Chairman Keese was saying. What I meant to communicate to you was the message to us we thought from you folks and from others was you've got to get serous about facilitating supply. You have to make the systems you have in place for putting up supply be more user friendly.

And we are focusing as best we can, and maybe we are not very good at it, but we are doing the best we can to talk to the people who are building, the developers, and we are asking them, what about the system don't you like? What has made it difficult? What have the impediments been? And we are trying to smooth those things out. We are creating interagency activities so that you don't have to go to six different doors. You can just come to one place and we'll be able to answer all your questions and we'll work with you.

That's all I meant to communicate to you. That we get it now, and we are -- at least the Governor gets it -- and we have been ordered to fulfill his vision of this, which is to move forward as fast as we can. But we are not

there yet. We are not saying that necessarily.

CHAIRMAN HOECKER: Commissioner Massey?

COMMISSIONER HEBERT: Thank you, Commissioner Massey.

COMMISSIONER MASSEY: Senator Peace and Senator Bowen, I must say that I believe you. I believe that unless this Commission sends a strong signal that we will insist that prices in wholesale markets be just and reasonable. That the citizens of California will choose to re-regulate.

Now the question is -- and you don't think we have met that standard. What do you suggest that we do very specifically?

STATE SEN. PEACE: First act retroactively. If you act retroactively, how would you determine what the rate is and what is -- this is going to end up in a lawsuit no matter. FERC's going to be sued. The question is, who initiates the lawsuit? The generators, the markets, the customers?

I would hope you would act retroactively and allow yourselves to be sued by the generators and the marketers rather than the customers that I believe the law obligates you to protect. And I think that's in everybody's interest to be protecting the evolution of a market.

It would be an incredible irony if the result in California, and then spreading to the West and I suspect

1 throughout the rest of the country, would be that in part of

the equation we have talked about it is sort of ironic to refer to Mr. Pope as a customer.

Louis Pope also is a big seller into this market because he had excess generation capacity, and as you know, so was L.A. Water & Power, so is Bonneville, et cetera. The municipal world, having refused to join the ISO as they committed to do, but then didn't do as out-of-market participants so that they can circumvent caps, exploit the opportunity to market, profiteer. They were like the guy following the pickpocket around the city, and as the pickpocketer ran off to keep from getting caught, he spilled some of it, and they just picked it up as they went along and then they plead innocence.

It would be incredible irony if the people of California reading your inaction as compelling them to distance themselves from the reach of FERC turned over the entire electric system -- and I am not just talking about generation assets -- I mean take the ISO, the Power Exchange, the transmission capacity and the distribution capacity and turned it over to state and/or state/municipal ownership, specifically to get beyond the reach of FERC.

COMMISSIONER MASSEY: I am assuming you have the authority. That it is within the provence of the state to do just that.

STATE SEN. PEACE: Absolutely. You simply

condemn --

COMMISSIONER MASSEY: If you choose to.

STATE SEN. PEACE: Sure.

COMMISSIONER MASSEY: Okay.

STATE SEN. PEACE: And the people could do it by initiative. You condemn the power plant. You don't have to condemn the actual plant. You just condemn the output. Take the distribution system and you are in business.

Now we already have before we get there more than 50 percent of the generation capacity in the Western United States is under public ownership. What happens to your desire to see an RTO and to see the evolution of a private market if you now have -- I don't know what the percentage is. You staff could probably tell you. If all of California's internal capacity became publicly owned, what you left with?

Now I am not advocating that, understand. And I think one of Mr. Hebert's interpretations is that he views it as some passion or notion. It's not that. It is an objective political assessment.

COMMISSIONER MASSEY: Can you tell me what I need to do to avoid that?

STATE SEN. PEACE: Act retroactively.

COMMISSIONER MASSEY: Well, that's number one.

STATE SEN. PEACE: That will compel the parties.

And we will in turn, the file rate doctrine will -- the California utilities need to know, the file doctrine will not apply to unjust and unreasonable rates. PG&E's filing against our Public Utilities Commission attempting to get recovery of these unjust and unreasonable wholesale rates out of California consumers is not going to be sustained.

And once that occurs, we then removed California consumers from that equation. The state should participate and should support the California utilities in their effort to become whole. We don't want them going out of business any more than anybody else. But that becomes a fair fight.

You can compel the settlement conference. You can take the actions that compel all the parties to court. YOu have the authority to provide the appropriate confidentiality allowing these parties to settle this.

If the private market wants the private market to survive, then the people in the private market ought to act like adults and get down and settle this out just like any other businesspeople who want to continue doing business with each other would do if you had unseen, untoward events.

Look, I've been in contracts, in arrangements with distributions of motion pictures where events turned out to be very differently than the contract contemplated, and reasonable parties in the contract don't enforce the

1 letter of contract, they enforce the intent of the contract.

And when the events move beyond the contemplation of the contract, if they want to keep doing business with people, they sit down and settle it out.

You have the power to force these parties to the table, all of them. And that includes those divisions of the PG&Es that profited from this.

MS. BOWEN: A couple of other things.

First, I think many of us today have talked briefly about moving towards regional transmission organizations and how useful that would be. And I think the point has been made that no matter what we do in California at this moment, we are radioactive as a result of the price volatility and cost spikes that we have seen, and so we are not going to move towards -- we will not be able to move towards an RTO until we get past that.

But that does suggest to me that FERC should look at establishing regional wholesale pricing structures, not California. You may choose to use a performance-based structure as a middle ground between a traditional regulated structure and a market-only rate so that you can reward efficiencies and continue generation.

I think that it is critical that our independent system operator have some political responsiveness to the people of California and that it continue to have some

1 jurisdiction to deal directly with prices. Because this

market is going to move very quickly in ways that we can't anticipate, and I think it is very frightening to people to think that we have to come back and file a formal petition at the FERC and then it takes maybe two months before we get the starting date wherein we might have a change in the way the rate structure works.

And certainly you have a bigger pawprint than we do, but we are slightly more nimble at times than you are in our ability to change structure, and I think that's particularly important, given that the $150 soft cap is an untried mechanism, much as the $250 hard cap was.

And I think we ought to be able to have more flexibility to experiment with changing what that soft cap is based on the time of year and the time of day and to set for certain periods when certain conditions are expected, rules that deal with how that works.

I think we also might want to be able to experiment with restricting the real-time market prices to 95 percent of what was bid in the day-ahead market.

That would be the greatest disincentive to people underscheduling. Because if you bid in the day-ahead market or in forward contracts, you could--the best you could do in the real-time market was 95 percent of that, but you might not schedule at all if you weren't called. So it

1 would change the dynamics.

I think there are a lot of things like that that you could look at that we could discuss with generators, because this has to work for generators as well.

And I also think that you can help encourage our ISO to develop rules that make it easier for demand to bid into the market. I know this is a discussion that I have had with a couple of Commissioners.

It is really critical. Because the greatest difficulty we have with this emerging market--and this is a baby market, and it should not be a surprise to anyone that we are having a hard time, even had we not had a situation where our demand is going up at a much higher rate than usual. We are doing something that is unprecedented.

We can't store electricity. We can't just put a bunch up in the attic for when we need it when it is warmer. So we need to be able to rapidly adapt and cycle through the information that we get about what works and what doesn't.

And I think much of the concern about eliminating the ISO's ability to have any kind of jurisdiction over price caps is a reflection of the concern that it will take a very long time to do an iterative process if we need to come back to FERC every time.

I am not saying that something along those lines won't work, but that it is very hard to use an

1 iterative process if we have to all of us come to

Washington to visit you here every time we need to get something done.

MS. JACOB: Commissioner, just a quick comment.

I think the issue here is excessive profits versus reasonable profits. And if you look at the what I consider outrageously excessive profits by generators on the California market--I do have a chart with me if you'd care to see it--they are outrageous.

It is clear if you look at the rate chart that I have submitted, which is just one example in San Diego, but of what is going on in California, you'll see that relationship.

I don't think that there is any requirement of an expectation for excessive profits; only reasonable profits. And I think that is the main issue, and that's the test:

Reasonable profits. Not excessive profits.

That is where we need some controls and some boundaries.

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COMMISSIONER MASSEY: Ms. Lynch, let me ask you this, and Mr. Kahn, how can we resolve this--is there a way to resolve this issue of moving to an independent board for the ISO and PX in a way that would meet your standards with respect to whether we are trampling on state authority?

MS. LYNCH: I think that there definitely is.

As Michael and I wrote in August in a report to the governor, we seriously questioned the current structure of the ISO and the PX Boards as presently concentrated along the lines of your report because we expressed concern about the potential self-interested nature of those boards.

However, the fundamental issue with that is that those entities are non-profit corporations that were created pursuant to state corporation law. So they are state-created entities and their boards are a creature of the state in that manner.

However, just as the federal and state governments have worked cooperatively together in the past, I would hope that we could work cooperatively together in the future by having a conversation before one or the other of the governments acted precipitously.

COMMISSIONER MASSEY: As you know, our ex parte

1 rules make those kinds of conversations extraordinarily

difficult to have.

Did you have a specific suggestion about how we ought to move forward on that issue?

MS. LYNCH: I think then perhaps we should file our suggestions in our formal comments.

STATE SEN. PEACE: However, Mr. Commissioner, I think you could feel very comfortable that you will not only find cooperation in California, you will find enthusiasm, and that is the reason I made the point at the top that there is this significantly different political environment now versus 1996.

The issues you are struggling with are issues that the now-majority in the legislature would have loved to have undone, but in that July 27th, 1996 letter to Chairwoman Moeller, the then-governor made it very clear that the FERC filings that had already been developed and submitted in December of '95 by the PUC and by the same industry participants who are still up here now.

I just can't help but chuckle when I watch Enron and the others, complain about the ISO. I mean, it was Enron's idea to have a separate ISO and a PX. They sold it to the California Manufacturers Association, who in turn sold it to the governor, who in turn drew a line in the sand.

And that is why it is best to get these same

people who drafted these tariffs to now abide by what I would hope was their intentions with those tariffs, which is to produce just and reasonable rates.

COMMISSIONER MASSEY: Thank you.

CHAIRMAN HOECKER: Well, we are all a lot smarter than we were four years ago.

(Laughter.)

CHAIRMAN HOECKER: And I think we can do better.

What I am hearing from this panel is cause for great optimism. I think that we will indeed have a large ration of cooperative federalism in the future. We look forward to working with all of you and with the governor and with the City of San Diego.

I am --

MS. JACOB: County.

CHAIRMAN HOECKER: San Diego County.

MS. JACOB: And cities too.

CHAIRMAN HOECKER: We will work with everybody.

MS. JACOB: Sounds good to me.

(Laughter.)

CHAIRMAN HOECKER: We will take care of -- we do not mind stealing ideas, you know, so we look forward to those, to your comments.

I am especially pleased to hear Senator Bowen's

1 acknowledgment that this is a regional market, that

California does not exist in isolation, that it should not be thinking of its generation and transmission as somehow self-sufficient, and the real question is, how can we work together to ensure that California's borders are commercially porous, that we end up with a truly reasonable market, that California's going to benefit from where the rules are clear and the same for everyone and the ABC, anything but California, that Mr. Smutny-Jones referred to this morning becomes an artifact of history, and that people will want to participate in the California market, and even use the services of the ISO.

How do we get there? What do you want us to do in that regard? Or are we still looking for single-state solutions here?

STATE SEN. BOWEN: Well, I again may be to the right of many of my colleagues on this, but I think we clearly benefit from having a regional transmission organization. The difficulty, however, right now, is that we have deregulated while many of the surrounding states with whom we exchange power have not.

So we have great difficulty in making this workable, yet even with that existing, we benefited during this last year from our interaction with Bonneville Power.

We sold power there at night when our generators

1 could generate more cheaply. That allowed them not to use

water, that they could then use during the day when our rates were high when we had system reliability problems.

That is a benefit to parties in both places. So I look at those kinds of things and wonder how we can encourage that. I am not sure how possible it is so long as we remain the unregulated donut hole in what is otherwise a regulated donut.

STATE SEN. PEACE: And we, California, failed to protect our indigenous generation supply in terms of its availability to Californians because we didn't do things like Texas did.

Our PUC did the exact opposite. Texas protected its utilities and Sylvania protected its utilities and customers. Our PUC ordered, by contrast, our PUC ordered our utilities to divest of the generation capacity.

If they had still owned even half of that generation capacity to be able to use to hedge against the spot market exposure, we probably would not be here having this conversation.

But ironically, that was a mistake made by our PUC in an excess of enthusiasm for the market. They were so convinced, and you hear Mr. Florio's reference of it being odd, agreeing with his PG&E counterparts.

That was part of our problem in California as

well. The consumer groups and our public utilities were so

convinced that the utilities were the bogeymen that they overreached, and they created market power by diminishing the capacity of the three utilities to compete. And they handed over so much generation capacity to the generators, and in turn the marketers, that you ended up having market power exercised as a function of the ability to consolidate control of electrons at a specifically finite period of time.

And that, interestingly enough, when you look back and read the Federal Register of your proceedings over the months, years, and it had your own investigations into the potential for the exercise of market power, not one time in all those proceedings, not once, did this Commission consider the possibility that market power could be exercised other than by virtue of being able to control access to the transmission system.

And we clearly know now that market power can be exercised in other ways.

CHAIRMAN HOECKER: Like I said, we are all smarter now.

The larger question here is trying to differentiate between what you all think your responsibilities are and what ours are. And perhaps there is some overlap.

1 One area that comes up came up this morning, and

it is one that clearly I have some trouble with, is the Stakeholder Board. I think Mr. Florio said that somehow or another to avoid a fight here, that the state has to have a role in determining the constitution of that board or selecting some members or ensuring that it is properly motivated or the retail customers are represented or something.

To the extent you have something on that point, could someone enlarge on that for me? Perhaps Mr. Kahn, as head of the Oversight Board, maybe you could help me with that a little bit as to how we get there and whether you think our proposal in our order is sufficient or not.

MR. KAHN: Well, I think the governor said that he was disappointed with the proposal because it, in a sense, divests the state of what the state thought was its jurisdiction over this issue and that is why the state passed the law that it did, splitting with you the authority to approve the ISO members.

I am not sure how we get from here, given what you have done, to something workable, but I can tell you what the interests are.

I think Senator Bowen correctly said it for us. It is our experience -- now maybe that will change -- but it is our experience that the ISO does things that impact

1 prices, impact distribution of electricity, does things like

when we have shortages, help make decisions that are important to our various municipalities.

And it is our perception, I think it is the senators' view and I think it is the governor's view, that the people of the State of California ought to have a direct link to that group of people who are making decisions that affect price reliability.

And what has essentially happened with the Order that you suggested is that California's link -- and I think Senator Peace is right -- it hasn't been that strong a link anyway since the original plan was amended, but any link whatsoever now has been broken.

And there is an issue of responsiveness as to the two critical issues; price and reliability. And we are just not convinced, and again I think I can speak for all of us in California, the public officials, we are not convinced that the ISO is not going to participate in important decisions with respect to those two issues.

So that is the concern and the interest in responsiveness and if I said it wrong, for Senator Bowen to correct me.

CHAIRMAN HOECKER: I would urge you all to give that issue some thought in terms of specifics. In our proposed Order, we would delegate the ability to select

1 members of the new board to the existing Stakeholder Board,

provided those lists were developed by an independent search firm, and so forth and so on.

Maybe there is a better way to do it. Heck, I do not know, but I am concerned about taking a step back toward a kind of process where people are making judgments not in the interest of economic efficiency and competition but in the interests of what they perceive the public interest of the moment or the political interest of the moment.

STATE SEN. PEACE: Can I comment?

It is interesting, it really is, to watch the generators and marketers who have profited from what you have correctly identified as unjust and unreasonable rates, come here and complain about political influence on the ISO Board or PX Board. If it were not for the seriousness of the impact on our constituents, it would be funny.

These guys have mobilized the most voracious lobbying effort, including the hiring of political consultants to do a nationwide op ed campaign to attempt to isolate and attack any public or private figure who intends to shed any light, including documents that then which they identify certain individuals as particularly important because of their knowledge.

And we do not like the Stakeholder Board and ironically we do not like it because we think they are

1 inordinately influenced by the generators and marketers and

the sellers in the market.

The point the Chairman made is we want to get rid of the Stakeholder Board, but we do not want to hand over to the Stakeholder Board the ability to select their successors in interest.

And at the end of day, our ability to accommodate, feel comfortable accommodating your people that you select will probably be directly related to whether or not you act retroactively.

If this Commission acts retroactively and tells the world, we are going to make sure rates are just and reasonable, I think you are going to find California to be easy as pussycats to get along with.

By contrast, if you do not act retroactively, then we are going to be in court, and we are going to be fighting every single issue we can, just as Dynegy is, just as Enron is, and we are going, the problems potentially raised as a consequence in terms of private capital response in California, we will answer, and we will answer with public capital, and we will build the damn power plants ourselves, if have to, and we sure as heck are not going to charge 14 cents a kilowatt hour for electricity on November 9th.

(Laughter.)

1 CHAIRMAN HOECKER: Mr. Smutny-Jones, in his

written comments this morning, says, let me read this to you, it is kind of interesting:

IEP, the Independent Energy Producers, recognize that FERC has a narrow set of issues that fall within its jurisdiction, and that the larger improvements to the market can and must be made in areas subject to the state's regulation, notwithstanding rhetoric regarding federalization of California's energy market, the lion's share of market design improvements can only come from state level actions to remove impediments to new supply and improve supply procurement strategies.

And I think he was talking about things like hedging and streamlining the sighting process and procurement flexibility for load-serving entities and energy conservation, and a lot of things.

It seems to me that, even outside the scope of the order that we have laid out in terms of improving the mechanisms of the bulk power market, that you all have your work cut out for you, you know, quite independently what what we are doing.

I mean, would you agree with that?

STATE SEN. BOWEN: Yes.

STATE SEN. PEACE: Yes.

CHAIRMAN HOECKER: Okay.

STATE SEN. BOWEN: Can we go back to California

now?

(Laughter.)

CHAIRMAN HOECKER: Well what I would like to say is that I think that all of you, including the governor, are trying to show a very serious and sincere effort to focus on the problems you can control. And clearly if there are things that we can do to assist in that effort, we are committed to doing that.

And going beyond cooperative federalism, you know, we are happy to provide whatever assistance we can. I think it is not just a matter of can't we all just get along; I think Rodney King lives in Californian, doesn't he?

It is really a matter of trying to, within the limits of our ex parte rules and so forth, to look at this market and figure out what can make it tick better.

What what troubles me is, the refund issue aside because I am sure you are going brief that for us, and we are not going to settle that one today, but it seems to me that the crux of your argument, or some people's argument here, is that you agree the market was dysfunctional and it was capable of, it either did or had the potential for producing unjust and unreasonable rates, which, by the way, is the extent of our holding.

1 The competition does not discipline price, or at

least the markets did not produce sufficient competition to discipline price.

So we have to go back to some form, or at least there is a potential for going back to some form of cost-of-service regulation or re-regulation until we have the tools to make this market competitive, and that our Order, at least not in all specifics, does not get us there.

I think Chairwoman Jacob pointed out some things that she agrees with in this Order, and maybe some of the rest of you did as well. But it implies that we have got to take a few steps backwards before we can really engage in market development.

And I am not sure how we get there. I am not sure, number one, why in this environment the last couple of years when prices were actually going down for a while, and with some hiccups, the market was working pretty well, why these competitive tools did not develop.

They developed elsewhere. They developed in Pennsylvania. There were competitive options there. There are not any in California.

STATE SEN. PEACE: Well, I think there is some pretty easy answers to that.

CHAIRMAN HOECKER: Well, you know, the question is not so much, Senator, you know, why didn't it happen, but

really how do we move this process forward.

And I will tell you, I am not doing this just because I am addicted to markets or because I just happened to have spent, you know, a lot of time working on this, but because I am not sure that, as we cross this busy street to get to the other side in a competitive market, that we have the options of going backwards without getting run over, particularly since all this generation's been divested and sold at way above book.

The thing I want to ask you, all of you, is how, in the context of this order, can we begin to develop the tools that are going to get us to a competitive, workably competitive marketplace without saying, let's put the brakes on this, let's put this whole idea in the deep freeze for a few years?

STATE SEN. PEACE: You ask any businessman who does business anywhere in the world and they will tell you that the first criteria for an effective competitive economic market is a stable political environment. Nobody wants to go and invest capital in an instable political environment.

What we are suggesting to you is that if you do not slow down, retrench a little bit in the wholesale environment to allow us to help develop both on the supply side as well as maturing the potential on the retail side

1 and the demand side, that the political environment will

destabilize so quickly that your concerns about going backward will pale in comparison.

Any opportunity in the next 30 years to move forward in a private market will be gone. And I am not advocating that, understand. But Senator Bowen and I have, on more than one occasion, made reference to the fact that we are well to the right of our colleagues. And I do not think you could find literally two -- I do not think there is anybody to the right of us in the Democratic caucus on these market issues.

So--and to Mr. Hebert's admonition with respect to buy/sell--this 1890 was bipartisan. Every action taken thereafter was bipartisan. The rate relief action, which Supervisor Jacob was very instrumental in coming to Sacramento and helping to move was bipartisan.

And the action of California moving away from FERC jurisdiction by using public capital will be bipartisan.

I do not want to go there, but help us not go there.

CHAIRMAN HOECKER: Well I see in front of me some great leaders and leadership, and I know that the public is going to be looking to you for direction, and will be looking to us for some action and I think that is

appropriate.

STATE SEN. PEACE: And the public in California is not going to sit there and watch us sit on a $7 billion plus budget surplus--

STATE SEN. BOWEN: Mr. Chairman, I--

STATE SEN. PEACE: --probably closer to $10 billion, and just let these rates go crazy, because they are not going to distinguish between taxes and rates. And ultimately even CMA is going to be up here demanding that public capital come to the rescue.

STATE SEN. BOWEN: I think the question is really going to be put by what happens in the California markets this summer in Edison and PG&E territory.

So that the salient question for all of us to ask is really the question that you asked before of the end of the last panel:

What is the prognosis if we proceed under this soft cap, knowing that we do not have enough supply in the year 2001, knowing that demand continues to grow, knowing that the states around us continue to use more of their own capacity and therefore will continue to send less power to California, knowing that we are unlikely to get another wet year, and knowing that the rate freeze that we have in place means that our two large investor-owned utilities are under-collecting in the billions of dollars and they are

1 continuing to under collect right now in November.

They are not passing through their costs of buying power today as we sit here in the rates that they have established.

So if we continue on that path, and if this $150 soft cap is not sufficient and if prices that are over that, that are unjust and unreasonable, are not returned with some kind of promptness, everything that we have worked to try to do in California I think will very quickly be deemed to have failed.

And it is really that lens that we have to judge with because we have about two-thirds of the population of the State of California who will be exposed, either this coming summer or, at the very latest, the summer after that, to the same kind of price volatility and costs that San Diego has seen.

I just do not think anyone can contain the political wrath of that many people, all of whom get a utility bill every single month and do not just throw it in a drawer and forget about it when it is two and three times what they are used to seeing.

So that is the lens we have to judge this by. And I look at it as I would look at trying to do diet changes on a patient who just had a heart attack. You do not implement the dietary changes until you stabilize the

1 patient and do major surgery.

And that is what we are asking you to do right now. We are going to have to do -- we are going to have to stop and stabilize the patient and then we can proceed with the kinds of changes in lifestyle--and it really is a lifestyle change for all of us in California; we have to learn the difference between running our driers at 2:00 o'clock in the afternoon and 2:00 o'clock in the morning. We do not have that ability right now, and we do not have the ability to respond, even if we wanted to, in an economic way.

And our large customers do not have it either. We do not have the ability to have our ISO send a computerized signal out to all large commercial buildings saying, we are in a stage three, please turn up all your air conditioner thermostats by four degrees.

If we had that ability, much of the problem that we are discussing right now just would not be a problem.

STATE SEN. PEACE: Given some time, we can have that kind of ability. To the Commissioner, your question earlier about what class of customer did San Diego serve.

And of course San Diego kept the lights on through out the entire state. The breadth and dimension of cross customer classes was breathtaking, but it is an experience emotionally, let alone economically, you could

not go through.

If you went to a shopping mall or shopping center, there were no lights. And that may not seem like a big deal to you, but it looked like Kosovo. We went through, for two consecutive months, where you saw it not just in the fact that business people in El Cajon where the temperature was 115 degrees, were selling pizzas and spaghetti with no air conditioning, you know, with the doors sitting open and no lights on, and that is not a whole of pizza and spaghetti, as you might imagine.

But they also had the benefit that they got this one time cache that was associated with the sale of SDG&E plants. If we had not had that coincidence of that cache moving in, you would have seen a wholesale shutdown of small businesses throughout the county. And a lot of folk are still just there because they did not pay their bill, and they are counting on us to make sure there is no balloon payment in the back end of this.

And I will tell you what is important for I think California is there will not be a balloon payment as long as you stick to your finding that these are unjust and unreasonable rates because they are then not subject to the Filed Rate Doctrine, and we will not allow them to be passed on to the retail level.

And then it becomes a fight between the

1 utilities and the generators, and you all have the power to

preside over that fight, or the courts can preside over that fight.

CHAIRMAN HOECKER: Chairwoman Jacob, let me give you the last word, and then we are going to go to our next panel.

MS. JACOB: Thank you, Mr. Chairman. And you have all been very gracious.

I would only ask, as you deliberate, and no doubt you have an awesome task, that you remember the three million San Diegans that are hanging out to dry right now. We are really the only ones that are paying these kinds of exorbitant electricity rates.

I agree with Senator Bowen in her statement when she said that you need to stabilize the patient before we put in place the long-term cure. There are three million San Diegans that are patients right now. And if you and I use this collectively, if you, as the Federal Energy Regulatory Commissioners, Public Utilities Commission in California, our state legislators, and Congress can work together, we, as a county, will work with you.

But if we collectively cannot fix the problem for the three million San Diegans, how in the world are you going to deal with it when it hits 32 million Californians and when it hits others in other parts of this nation?

1 I thank you very much for your attention. We are

committed to working with you in any way we can to get the immediate relief that we need to get that retroactive refunds that we need and then to work on the long term fixes. And I think we can do it without jeopardizing the supply on the market.

CHAIRMAN HOECKER: Thank you very much, and thank you all for coming.

We will go to our next panel, and we are falling a little behind but --.

(Pause.)

CHAIRMAN HOECKER: Okay, we are going to go back on the record here shortly. Would everyone please take their seats or go outside or --.

Thank you.

That last panel was quite interesting. I look forward to you all is insights as to what the course of this market is or ought to be.

Why do not we start with George Sladoje, CEO of the California Power Exchange.

George?

MR. SLADOJE: Thank you, Mr. Chairman. And thanks to the Commissioners for the opportunity to respond to your November 1st Order. We will share out detailed thoughts with you in our filing on November 22nd.

1 But I want to discuss several big picture items

that we see at the California Power Exchange.

Before I get to those points, though, I have three initial comments.

First of all, I want to congratulate the Commission Staff for its thoughtful analysis and recommendations that it got to in a very short time. We know how extensive the data was and I hope that we were able to be of assistance to them.

Secondly, we do appreciate the Order's vote of confidence that was expressed in the management at the Power Exchange and the ISO. However, I want to emphasize that contrary to the implication in the Order, our management has had a very highly effective working relationship with our Board and we have been able to get things done rather efficiently.

The Board has acted responsibly, constructively, and has remained focused on broad policy issues, and there have been no delays in decisionmaking brought on by a failure to obtain consensus. The Board has clearly been a plus during our formative years and I would have said that even if John Fielder had not been sitting to my right.

Number three, we agree with you that in order to succeed in California, we need a cooperative effort by state and federal officials. And as you move forward, we urge you

1 to remain focused on California objectives as well as your

own.

These continued high power price levels will ultimately cause severe distress to the region's economy, creating hardships for everybody. And we need to address these problems collectively and promptly.

Let me turn to what we would call the big picture issues that I would like to highlight.

First of all, the California Power Exchange is a reliable independent market operator and brings significant value to the market. We were a little bit disappointed that the Staff report, and indeed the comments we have heard so far today, have over-emphasized bilateral long-term contracts that have glossed over the benefits of exchange platforms.

We had some 20 forward contracts available for trading in our marketplace, and they have been here for more than a year. An exchange platform brings a concentration of liquidity, an ease of access to small players, those who are selling ten to 15 megawatts, for instance.

It brings credit enhancement. The price bites in the midwest of two years ago were largely an issue of bad credit decisions made, not necessarily weather-related.

Fourth, it brings price transparency.

Fifth, it enables buyers and sellers to transact

independently and anonymously.

These are benefits you will not get in a bilateral market and I think there needs to be some emphasis on what an exchange platform can bring.

Now there are two specific categories of markets that we have at the Power Exchange. First of all, there is the long-term forward markets that we have had, or the longer-term forward markets. And as we have said on many occasions, buyers in our forward markets saved well over $700 million this year in the months of May through September.

Actually, there was an opportunity to save more but even the constrained limits that the IOUs that were not exercised fully, they could have probably saved maybe upwards of a billion, had they used them totally.

Secondly, our day-ahead markets and day-of markets. I want to differentiate those from the ISO real time market. There still is a need for a day-ahead market and a day-of market despite what you heard this morning about concentrating on forward market.

You need a valid hourly day-ahead market to help load-shaping capability, price disclosure that you need for demand responsiveness, and necessary reference price, or you are not going to get futures contracts and other derivatives which this market sorely needs and there is other benefits

that I will not go into right now.

I do want to differentiate the day-ahead market from the ISO real time market because their natures are a little bit different.

Secondly, if the mandatory buy/sell requirement is prematurely terminated, as indicated in your Order, then we will accept that decision and we will move on, and we will adjust accordingly.

However, the California Power Exchange must be allowed to operate on a level playing field which includes light-handed regulation from the FERC.

We must be able to be nimble, we must be able to move fast because we are going to be in competition.

Thirdly, the level playing field also requires that the price mitigation measures that you have suggested be applied consistently to all market transactions, and do not skew market behavior to the detriment of the market.

We have significant concerns about the $150 soft cap and the related reporting requirements and the refund liability suggestions.

We do not think these remedies are intended to apply to our forward markets but the Order is not clear on that. However, unless this type of limitation is applied elsewhere, other than just the Power Exchange and the ISO, in other words, throughout the WSCC market, you are going to

drive supply out of the California Power Exchange markets

and ultimately out of the California marketplace. And I am sure that is not the intent of your order.

So with that, I will be happy to answer any questions that you might have and I have submitted of course a little more extensive written information to you, and will be submitting more of a filing on the 22nd.

Thank you.

CHAIRMAN HOECKER: Thank you.

John Fielder from Edison?

MR. FIELDER: Thank you, Chairman Hoecker, Commissioners. It is a pleasure to be here and we are glad you invited us, because for us this literally is a matter of corporate life and death.

As you have heard and as your Staff report noted, we are bleeding profusely. Our under collections are over $2.5 billion. We added another $100 million last month. That is net of what we made in the market with our remaining generation. The gross figure was $283 million. And we can't go on like this. It is starting to have repercussions in parts of the business that it was never envisioned that the wholesale market would affect.

We are reducing employment, we are cutting back on capital investments because we just can't come up with the money to keep paying these high prices.

And so my overriding message to you is focus on

the short-term. Let's get something in place that stops the bleeding, as Senator Bowen said, because in the long-term, it is not a pretty picture, and when I am talking long-term, I am talking weeks and months, not the two-year time frame that the Order contemplates.

One of the advantages of coming later in the day is we get to comment on what has gone before us, and I would like to do that.

But first let me just give you our perspective on what the big picture issue is for this Commission to deal with. And of course, it has to do with your legal obligation to find that the wholesale market is yielding just and reasonable rates.

And the Staff report and your Order acknowledges that, at least this summer, the rates were not just and reasonable. We would contend that the rates are still not just and reasonable, and we think that you have an obligation every day, every week, every month, every year, to make an assessment to see whether the wholesale market, that is subject to your jurisdiction, is in fact yielding these just and reasonable rates.

We realize that is a matter of some judgment, that there is no formula that says this rate is just and this rate is unjust. However, when you are at ground zero

1 in California, particularly this summer, it is not hard to

tell when the rates are unjust and unreasonable, and we think that your Order and your Staff report in fact gets that part right.

As far as I know, there are only three reference points in the West as what a just and reasonable rate might look like. And it is not what the competitive market has been producing.

One place to look is what other customers in other states in the West are paying for electricity. And there are no retail customers in other states that surround California that are paying anything close to what our customers are paying, and what their liabilities are going to be.

The second place to look would be in our neighboring California utility. Right across the Los Angeles River from us is LADWP. Their rates are nowhere close to what our customers are paying, another reference point as to what a just and reasonable rate might look like.

The third reference point might be to look at what electricity was costing before we started this market. In 1996, the generation component of our electricity rates was less than four cents.

Now I know there have been some input cost changes and we can make adjustments for that, but

1 fundamentally, there is just no correlation between what the

wholesale market in California has been yielding, and what other markets in the area are charging their customers.

This leads to the issue of the price caps that we talked about, and just a couple of short comments on that. If you adopt the proposed soft or hard price cap, I think that one of the judgments that you have to make every month is looking at the operation of the market with that price cap to see whether or not it is yielding just and reasonable rates, and if it is not, you have an obligation to do something else.

That is the issue that the ISO Board was dealing with when we adjusted the price caps over the summer. We were on the front lines. We saw that the rates were not just and reasonable and the majority of the Board, on three different occasions, tried to deal with the fact that rates were not just and reasonable by adjusting the price cap.

Mike Florio talked about the last adjustment which I think has a lot of merit. It took the competitive prices that we saw in the market in 1999 and adjusted them for the changes in the input costs that have occurred with gas prices and emission credits and all the things that the Staff report noted.

And it produced a set of price caps that were relevant for different load levels. There is no reason,

1 last night at 8:00 o'clock in California, with loads less

than 29,000 megawatts, there is no reason why the price should have been $147 a megawatt hour.

I mean that is unconscionable in the middle of November when the loads are down, the weather's mild, and the costs are just keep running.

I would also like to make a brief comment about the forward contracting. We have been a supporter of forward contracting since early 1999. We applied to the Commission in early '99 to do forward contracting. We wanted to do more bilaterals. We were not given the authority to do that.

We have funded the development, I think George will acknowledge we have funded the development of a lot of the forward markets and the forward products that the Power Exchange has developed. We have funded those along the way.

We have very limited authority to do any hedging today, and we would welcome more authority to do that.

However, forward contracting alone isn't the total answer. If the suppliers have market power in the short-term market, they will have market power in long-term contracts. And we need to be aware of that.

I am not saying it will not produce lower prices, but if you have market power in the short-term market, you are going to have market power in the long-term markets,

1 particularly if all at once we have a gold rush to go sign

long-term contracts.

Secondly, I have to say this for my friends, Gary, Bill -- I am wrapping up, I am wrapping up -- that when we proposed to do long-term contracting to the PUC in early 1999, the entire generator and marketer community opposed us. And now it is the solution.

I have not figured out what that means. But it is a change of heart over the last year, once the market was turned around.

So I will be glad to answer questions when we get in the Q&A, and thanks again for inviting us.

CHAIRMAN HOECKER: Thank you.

Eric Woychik?

MR. WOYCHIK: Thank you, Mr. Chairman. Thank you, Commission, for the opportunity. It is a pleasure to be before you again.

As background, I have been an outspoken advocate for competitive electric markets now for more than a decade, and I am responsible for bringing the two largest residential consumer groups on board with regard to support for competition, and that now has been on-going for at least three or four years.

We explained to this Commission three years ago that sellers would use strategic gaming to take advantage of

1 the proposed market structure. The market structure has not

changed significantly from what it was. AB-1890 basically established a good part of that.

Two years ago, UCAN in turn pleaded for the Commission to recognize strategic gaming as a form of market power abuse, and we provided approximately 250 pages of comments to you on how that would occur on specific aspects of the market and the market structure.

So we have an unusual position in saying that this would actually occur, and furthermore in the Public Utilities Fortnightly, in January of '98, I published an article explaining exactly how this would occur. And the companion article was my colleague, Gary Ackerman, here saying that the generators did not have enough flexibility in the market and they probably would not make any money whatsoever.

I think we know how that came out.

The Commission has now found California's market to produced unjust and unreasonable rates as a result of flawed market rules and market power abuse. We fundamentally agree with that of course.

Yet the Commission denies refunds fails to make sellers responsible and leaves California problems largely undefined.

I will omit my train wreck analogy and the set of

1 other things here. You have heard it from many others. We

are obviously in crisis mode.

How can the promise of competition, which means downward pressure on prices, be fulfilled?

We offer these recommendations, and they go to some of the other points made earlier today.

Clearly define strategic gaming as a form of market power abuse.

Number two, distinguish market situations where resource-specific, cost-based bid caps must be imposed.

Number three, distinguish competitive market conditions from flawed, inefficient markets that allow separate sellers to exercise market power under the guise of chasing market opportunity costs.

Number four, define who is responsible for the cost impacts of strategic gaming, i.e., market power abuse.

And number five, define how consumers are to be reimbursed for the cost impacts of strategic gaming.

UCAN strongly urges the Commission to define competition more carefully. We would like to help you do that. We heard your comments and requests, Mr. Chairman, that we need to help offer the definitions that you need to use.

These non-competitive situations need to be defined clearly including penalties for strategic gaming.

I recognize that the Commission has not

previously even used the term, strategic gaming, and when I look even at your Website or any of your previous cases, market power abuse is usually defined in terms of generator or transmission dominance. You have not had, I think, the distinctions, the key tools that you need.

Commissioner Massey, Commissioner Breathitt, I appreciate your recognition today, especially of the need for those things.

So in general, as explained in our recent comments to you, we think it is the market structure that is the problem. We argue that the Commission should proceed with all haste to order California to adopt a market structure that fulfills the promise of competition, and that mitigates strategic gaming.

We are also listening to you, Commissioner Breathitt, in your comments saying you think you have experience from other markets now, and certainly these are in the northeast, that work.

We hope and expect that you can move more quickly responding again to, Commissioner Massey, your comment, can we do this now, what about PJM. We would be happy with any of the models, frankly. PJM, New York, or New England, and we think you have to move quickly.

Finally, we believe the current ISO management

1 must not be allowed to determine California's reformed

market structure. The ISO management is too strongly influenced by its primary client, which are generation sellers.

ISO management has placed reliability first and, at best, consumer costs a very distant second. The ISO management's rigid adherence to a flawed market structure that enables rampant strategic gaming is convincing evidence that it is anything but independent. And that of course relates to the choice of a new, independent Board, which we fully support, but we are concerned that you not use the ISO to help make that decision, because we do not view the ISO management as independent.

Thank you very much for the opportunity. We will be following up with detailed comments for you by the 22nd, and I look forward to questions.

CHAIRMAN HOECKER: You are on the Stakeholder Board, aren't you?

MR. WOYCHIK: Yes.

CHAIRMAN HOECKER: And you do not view the Stakeholder Board as independent?

MR. WOYCHIK: Absolutely not. And I would be delighted to resign and have an independent board that will create a market structure that works.

CHAIRMAN HOECKER: Our next witness is Gary

1 Ackerman from the Western Power Trading Forum.

MR. ACKERMAN: Thank you, Mr. Chairman.

The Western Power Trading Forum, because we might not be known to everybody here today, is a California non-profit trade association, and most importantly its 30 members do three different things individually or collectively. They sell, the buy, and importantly they exchange power throughout the Western region.

I am here today and pleased to present comments on the following areas in response to your Order issued last week.

First area are the price caps and their unintended consequences. The second area as a group would be the forward scheduling, the penalties, and the mandatory must-buy provision that you had in your Order. Third is independent governing boards. And fourth, if time permits, the needs for a viable retail market in California.

I heard your discussion of the Order last week and as I heard it, I was energized by what I heard you folks individually say. And I thought, I really want to be here today, I really want to talk to you.

If I could have afforded it, I would had a televideo and brought that in, but since I could not, all I can do is come out here, and tell you, even if it was only five minutes, less than that, if it was even only one

phrase, I would say one thing to you.

Thank you. Thank you for taking this bold and creative step in trying to revive California's wholesale power market, and having the courage to stand up to the parochial interests, which are entirely absent of any national policy goals.

The Commission's comprehensive approach to correcting California's problems utilize several measures, the first of which I would like to speak about is the $150 soft price cap.

WPTF believes that price caps send the wrong signal, both to suppliers and load. We have found that price caps mis-allocate resources and, as your Staff report demonstrates, increases exports of power to other parts of the grid where no caps exist.

Caps will provide another rule which market participants, I think as Senator Peace correctly pointed out, market participants are going to be able to say, well, how are we going to deal with this one and where are we going to move resources. The results are going to be not too pretty.

Price caps at the level you propose will do things, for example, as the bids approach $150, instead of bidding to the ISO and the PX where the burden of recording requirements will take place, will the market solution be as

1 simple as, for example, just bidding into another

competitive exchange, such as APX or All Trade or NYNEX?

Is this the kind of flip flop that you envisioned and that you want? This is a huge hammer, financial hammer that you are swinging around. It involves tens of millions of dollars moving between different market platforms in the space of an hour.

It also tilts the playing field between different exchanges with different requirements or different buyers with different requirements.

Is that really what you want to provide?

We have uniformly opposed price caps, and we continue to believe that they do much damage and do not protect consumers. The damages include prolonged high prices, reduced price discovery, and reducing the quantity of long-term offers, which is something you desperately want, and we agree with, that would afford consumers much needed price protection.

If you do have to utilize price caps, we would support the proposal put forward by Commissioner Hebert where it would start at $250 and increment upward by specific amounts at specific times. At least that kind of cap would have the least amount of damage.

On the other hand, we also believe that a formulaic price cap that moves with respect to demand or

fuel price, which has been discussed here today, would be

the most damaging.

Market participants cannot conduct business with this degree of uncertainty. Floating price caps wreak havoc because they inject more uncertainty and less stability. If price caps are necessary at all, please pick the least damaging approach.

Since time does not permit, I would like to skip then ahead and talk about governance. We are concerned that the rules you have laid out for replacing the Stakeholder Governing Board may not be enough.

There may be incredible pressure placed upon the existing Board members -- and I know you find that hard to believe after the California delegation came up here -- but honestly it is possible to select candidates that further the aims of those that claim to protect California consumers but in fact are making a power grab.

They are grabbing the steering wheel of California's restructuring model and driving it right into a ditch. WPTF promises this Commission, and I am here today to tell you that if we see anything which would undermine the independence of a new Board, I can assure you that I, individually, will be back here raising the voice of WPTF loudly in protest.

The California market simply cannot survive

1 serving two masters. The jurisdictional tug of war must end

quickly so that we all can move forward and pursue the goals set forth by this Commission in Orders 888 in 2000. On this, there is no compromise.

Thank you.

CHAIRMAN HOECKER: Our next speaker is James Bushnell from the PX Market Monitoring Committee.

MR. BUSHNELL: Thank you for the opportunity to be here. I guess I am playing the Frank Wallach role here today.

I am an employee from UC Berkeley from where these silly ideas to originate apparently. The Commission has taken a broad step in recognizing the extent of the problems in California, and I think the Staff really has produced an excellent piece of work, especially given the time pressures that we are under. I know I have had to try and do this myself.

I do have serious concerns about the price mitigation measures that have been proposed in the Order, some of which have already been voiced here. They have to do with where the measures would be applied and really the form that they take.

First, as George and Gary did mention, the measures would be applied only to the ISO and the Power Exchange apparently, and I assume that is because it is hard

1 to figure that these kinds of measures would be applied to a

bilateral market.

In and of itself, that would not necessarily be a huge problem except for the fact that we are also introducing this penalty on real time consumption at the same time.

Remember, we've had a price mitigation measure in place in the ISO real time market for about two years and it really has this effective biting out of the markets even though they don't have caps at nearly that level.

The idea is demand does have the option of buying from this last market where the mitigation measures have been applied. But once we introduce this up to $100 charge on consuming from the real time market, the measures that you apply to any advance market are going to be certainly a little less binding by at least $100. The pressure is going to be on the part of buyers to convince sellers that the $100 penalty is not something that is going to deter them from going to the real time market.

There is really not what we want to come out of this anyways. So I would propose that any mitigation measures really be focused only on the real time market and we try and develop an underscheduling charge that achieves both goals of reducing underscheduling and doesn't send the signal of essentially undermining any mitigation measures

you might try.

I think you could do that by reducing just the magnitude of the charge. I think $100 is a bit extreme at this point. We could start with something lower, ratchet it up if it turns out that it is not producing the desired result, and I think we should apply it at least equally to supply and demand so both sides are incentivized to try and reach some kind of an agreement on price ahead of time.

So that is the place where they might be applied.

The other half of this is the reform measures take themselves. As I understand the Order, we are creating something like a hybrid pay as bid uniform price market and I am not sure, I am not aware of any market that has operated like that, so I really do not know what kind of results might come out of it.

I have heard different theories about what kinds of games might be played between sort of around the $150 level and they all sound plausible to me. I am not sure exactly what would happen. And that really worries me.

And I am also not sure about how effective it would be in mitigating prices because I do not know what kind of standards the FERC would apply to these bids that do come in above $150.

There are parts of the Order that sort of have a flavor of cost-based regulation that talk about a bid that

is a pay-as-bid has to include something to recover fixed

costs because they are earning their bid, which is certainly true.

But remember logic like that carried through in the RMR process did get us rates around $4,000 a megawatt hour for certain units that operate infrequently. So when we take average cost pricing, we could get very high prices of that because there are some high fixed costs for some units.

But that was applied to only certain units. I guess that is something that would not necessarily be outrageous except the order also includes language about opportunity costs being a justification for a bid over $150, and I am not sure exactly what this means. For my reading of it, if we have a unit that has a really high average cost, say, and actually is taken by a buyer, that means there is a buyer out there that wants to pay that much.

And as I understand markets, that means the opportunity cost to just about everybody is that price. So I think everybody under an opportunity cost argument would be justified in bidding at that level. And that is basically a pay-as-bid market without any mitigation measure.

Which I have heard different sort of theories kicked around on this too, but I have not seen anything that

1 really convinces me that a pay-as-bid market would produce

lower prices in and of itself in a uniform price market.

Basically we have one or two things happening. Either we have average cost pricing of units above $150, in which case demand is seeing some kind of average price signal which probably impedes the efforts of trying to develop more efficient customer response, or we have a pay as bid market with no mitigation at all if we interpret the opportunity cost extremely literally, and I am not sure where that plays out.

But either one of those results worries me. And I guess there are alternatives. I think I would prefer something, if mitigation has to be applied, apply it to the ISO real time market and maybe take a route of something like a short-term contract to get us through the period. The existing hard cap is probably preferable to the hybrid that we are seeing proposed here also.

Even something like unit-specific bid caps, which I am not a big fan of, I think wold be preferable to what we are seeing here. I just do not know what would be produced here.

Again, I think it is important to think about where to apply it and also understand that the scheduling charge you are adopting is going to affect how that impacts the other markets and the relative distribution of where

1 people are trading.

Thank you.

CHAIRMAN HOECKER: Thank you.

Mr. William Hall from Duke Energy North America.

MR. HALL: Thank you.

I am responsible for the assets in California and I also not only am responsible for those assets, I work and live in California as well.

In fact, Commissioner Hebert, you will be pleased to know that even those of us with a southern accent aren't raised in California, and we have many good friends that enjoy living in the state.

(Laughter.)

MR. HALL: I mean that.

(Laughter.)

MR. HALL: I want to talk about three things very quickly. I want to talk about some of our development activities, I want to talk about your proposed order, but I am going to bypass some of my comments, because the comments from Dynegy this morning very much align with what I would say, but I do want to hit on a couple points there.

And then I want to talk a minute about the exchange that happened a minute ago between you and Panel Number Three, having been a resident there for three years.

Relative to our development activities, we

currently own about 3300 megawatts in California. We just

announced two weeks ago that we received the permits to build 1000-megawatt facility at our existing plant in Moss Landing, California, near Monterey.

This was a project that was virtually unopposed as we went through the process, but yet from the time that we submitted the application and it went through the data adequacy process into the formal permitting process, it took 17 months to get through that process, and with a two-year construction timetable, about three-and-a-half years to build this facility.

And we had general support not only from the local community but certainly from the state authorities and the Energy Commission, their cooperation and working with us, but meeting their mandate to live up to CWPA in California.

At the same time, we have been doing a project in Kingman, Arizona. I am pleased to say that unit will be on line early next summer providing output into California.

That process, from the time we started it to when we have that unit on line will take about two-and-a-half years.

And there is one final story about another project in California that we are developing, literally taking down the old plant, putting a new plant in its place,

1 will take us from the time we announced it till we get that

new unit on line, at least four-and-a-half years, and that is because we became the political agenda for that community.

And I am pleased to say that last Tuesday night, the incumbents who were up for reelection and who supported the project were unanimously reelected into office. But because of that process and the numerous public workshops we had, it is taken quite a bit of time to move forward with that project.

One other comment. We are replacing an existing plant. As we talk about the amount of generation that sits on the Website of the CEC, I hope that we understand that some of those megawatts coming on line are being, are replacing existing facilities, so there is effectively no net increase or minimal net increase of megawatt output there.

Now, relative to the proposed Order, again, we want to thank you for your efforts to move through the process. We generally agree with many of your recommendations and in the area of forward contracts, I guess what I would like to say, in addition to comments earlier today, is that we would urge the Commission to condition some of its proposals on state adoption but proposed for contractor reforms.

1 For example, the Commission can make prospective

refund liability contingent on California adopting proposed forward contracting recommendations.

And we heard Senator Peace say that many initiatives are beginning to take place. Maybe there needs to be some alignment between your initiatives to move forward in the state, so that they happen concurrently and not staggered.

Around $150 soft cap, as well as the potential prospective refund obligation, we have a couple comments there. We would recommend that suppliers be allowed to receive their bid price, if accepted, so long as there is no abuse of market power.

In addition, the Commission should preclude mitigation of bids or refunds of market prices after a relatively short period of time from when the market clears. We need some certainty on whether there is an issue and let's get it resolved, because that sends us very severe signals about what we should do in terms of our business in the future.

And finally the Commission should clarify that any soft bid cap is not intended to be a cost-based cap on suppliers' abilities to capture legitimate scarcity rents that are otherwise available to suppliers. This is especially important since the Commission's proposed soft

1 cap would not apply to non-jurisdictional suppliers who

would be free to charge what the market will bear without reporting requirements or refund liability.

And finally relative to what happened a minute ago on Panel three, and again having lived in that state for three years, I do not disagree with what Senator Bowen and Senator Peace said about the will of the people in California.

When you are emotional, you do irrational things. And we need to move through this process in a collective spirit of cooperation. And as a business person who expects that in the organization that he works in, if he can't get there with that, he is replaced. I am frustrated that I do not see more of the kind of banter that took place just now, because you humanize the process and you begin to understand each others issues and perspectives and you get to a solution much quicker.

We have been talking about this crap for months and months and, you know, we never seem to be able to make any progress. So I would like to see more of the kind of discussions that took place a minute ago on an on-going basis while you implement your proposed remedies, which we support.

Thank you.

CHAIRMAN HOECKER: Thank you.

1 Let me ask a couple of preliminary things, and

then I will ask Staff if they want to ask some questions.

Okay, do you want to go first? Very well.

COMMISSIONER HEBERT: Thank you, Mr. Chairman. Mr. Ferguson just informed me I have a family matter, so I am going to have to go take care of that real quick. Perhaps I may make it back, probably not but I will be glad to watch the video.

If I could request of the Chair, if I have any additional questions, I would submit them in writing not only for the record, but to you individually and the next panel as well.

CHAIRMAN HOECKER: That is fine.

COMMISSIONER HEBERT: Thank you.

CHAIRMAN HOECKER: Let me be clear about something. You mentioned that the pricing differences between California and outside of California this past summer.

Were you saying the prices in the West were much lower, or were you talking about outside of California and in California, you were talking about retail prices?

MR. FIELDER: Primarily retail prices.

If you look at the IOUs or munis that surround the IOUs in California, they all retain their generation

that is dedicated to their native load. I do not think that

they bid their generation that they own on a cost-of-service basis. They do not bid it into a higher cost market and then get higher cost generation for their customers to pay. So it is not a little playing field in the West.

At the margin, when they have to go into the wholesale market to buy an incremental bit of power, then they are competing in the same market that we are competing in for a very large percentage of our power was the point I was trying to make.

CHAIRMAN HOECKER: Thank you. So essentially other retail customers elsewhere in the West have a kind of 30-year hedge because they own their units.

And in the case of California, that buy back opportunity does not exist anymore, or at least not to the extent it might have, I suppose.

MR. FIELDER: Exactly.

CHAIRMAN HOECKER: It would be nice if we could figure out a way to unring that bell, wouldn't it?

Eric, you seem to question the reliability-first philosophy of the ISO. We heard certainly from other panels, particularly the last panel, how catastrophic blackouts and brown-outs would be in California, particularly in the digital economy where, you know, a millisecond of power outage in a chip manufacturing plant is

1 a disaster.

But how would you balance reliability and consumer interests, or interest in price, if you were -- well, you are on the Board of the ISO, but let's just assume you are looking at this objectively.

(Laughter.)

MR. WOYCHIK: Thank you, Chairman Hoecker.

I feel like, as a supporter of consumers, and I do not benefit from that directly, that I am an objective, independent Board member, by the way.

With regard to balancing, I think it is one of the most difficult questions and I will propose that I know, I have a formula that is superior to what others have offered, for example, in PJM or New York.

I do have the following perspective that I have to say is quite heavily influenced by some people I get to talk to quite a bit, a former Commissioner here, Charles Stalling.

And he suggests, and he reads the literature a lot, that when we separated the ISO and the PX, we took the interests for the economics of the entity and set it in the PX, and we left the ISO with the main responsibility for reliability.

And it is a very engineering-oriented group. In fact, I find except for the Market Surveillance Committee

1 and the Department of Market Analysis, which I think have

very little influence on the overall decision-making and the market structure and the operations of the ISO, the ISO's a fully engineering-oriented company.

Its only purpose is reliability. The chairman, Jan Smutny-Jones, says reliability first. Keep the lights on. And it is sort of to hell with the rates, pardon me.

And so in the current structure, with the separation of the ISO and the PX, and then the PX having to be very independent and very careful to maintain a constituency so people will come and play in their market, you have created -- we have created a situation where we cannot have a balance that is similar to an integrated -- and I am not saying you have to have the integrated ISO and PX, but the current ISO is so wholly-focused on liability and operations that it provides no objective view, in my view, of how to make the market structure work.

And as you have seen our comments recently, we think it is the market structure that is further more of the problem.

CHAIRMAN HOECKER: How do we get there in this Order?

MR. WOYCHIK: Well, I think you have to provide a market structure that almost works automatically. And the security constrained centralized dispatch of the PJM style

or the New York style does that.

And so then there is not as much influence on the structure and it is more, it is going to respond more to the economics and particularly if you have resource-specific bid caps that are applied by generators on almost an automatic basis, which is the way PJM works.

If they see that there is going to be local market power, they do not let a generator that could set price in and exert market power set the price. And they have a specific automated algorithm, a set of algorithms to do that.

So in that sense, the economics are more automatic, they are more independent, and the ISO can't influence those. And in that way, I think you start to get a better balance.

CHAIRMAN HOECKER: George, do you have any comment on that?

MR. SLADOJE: I supplied you with a letter I think about two weeks ago about providing the ISO with a Power Exchange.

CHAIRMAN HOECKER: I read it.

MR. SLADOJE: Thank you. Oh, you did? Okay, good. I find that there seems to be a trend, and of course two instances do not make a trend, but --

(Laughter.)

MR. SLADOJE: -- we have had some discussions

with the Midwest ISO and we have had some discussions in the southwest and in Texas, as well, and there does seem to be a trend to get the ISOs out of even the real time imbalance market, and to have as little to do with market as possible.

And I can understand that. I mean, the people at the ISO are good people. We have had a good relationship with them, but their focus is overwhelmingly towards reliability, and making sure things operate. And they are not as market-oriented as perhaps they should be.

So I can see some kind of a realignment or reassignment or reallocation of markets, maybe not right now but going forward.

CHAIRMAN HOECKER: Gary?

MR. ACKERMAN: Yes. At the Commission's insistence, as you well know, the ISO started comprehensive market redesign earlier this year. And when we first started our involvement in that redesign, my group, the Western Power Trading Forum, had a conference call with all the traders, with all the members, but from different parts of the country, to find out what are the pros and cons of the different types of systems that are used out there in New York, Pennsylvania, New England and California.

And what I took away from that, and something I

1 think is worth sharing with you here today, is that it was

not so much that traders in the eastern part of the United States felt there was something inherently good or bad about the nodal systems that are out there relative to the zonal system that we have in California.

They had problems that they were able to identify there that were driving up a wall--that is to say, in terms of recreating the outcomes with respect to prices--and we obviously know about some of the problems in California.

I think what was instructive there is you are going to have fundamental problems that you have to work through in each type of system.

And it does not make a heck of a lot of sense to turn the California zonal system upside down, after parties have collectively spent over a billion dollars to institute it, in order to get to the solution that you are looking for.

What we think is that you can get there by doing the modifications of the existing system without having to turn it upside down and going to a completely radical new system.

CHAIRMAN HOECKER: One question before I turn it to Staff.

Our last panel said that what this Commission needs to do, first and foremost, is to stabilize the patient

before we perform any surgery.

I am not altogether sure I know what that means, but I think what it might mean is let's go back to cost-based regulation. I think CMUA had recommended that.

Or let's, you know, stop the world for a little bit and try and fix some fundamentals in ways that really do not let this market work very freely, but that prevent the excesses from happening.

That is a very powerful political argument, but what do you all think about that? What do you think this Commission's priorities ought to be? Because quite frankly, I can't disagree that if we have successive market meltdowns here, that we are none of us going to be able to get this thing under control before somebody amends the Power Act or AB 1890 or whatever in serious ways that prevent us from having a real market in the future.

What should be our priorities.

MR. ACKERMAN: I would like to respond.

CHAIRMAN HOECKER: Fire away.

MR. ACKERMAN: Okay. One of the priorities should be providing for a stable market environment. Now there are times when the situation becomes desperate. Obviously you must take action.

And your Order speaks to some of those actions that you propose to take. And I think circumstances are

1 heightened by all the events of last summer, so you are

forced into a situation where you say, well, we must do something, let's do something that makes a lot of sense.

However, in anyone's, in any regulators zeal to affect the market and bring some order to what is now perceived as chaos, I would be concerned that if you do this stop/start stop/start, what you are really doing is jerking the market participants into am I here or am I there.

And you want to do that as little as possible. You talked about the sense of stability in terms of the governance of the ISO and PX, and we think that what we proposed is something that you need to do at this time, but you would not do that every year, right? You would not want it changing the fundamental rules if you did not have to, if you do it very carefully, you do it gingerly.

And I guess my greatest concern in terms of let's take a rest period and then start off is, it is a water hammer effect. It plows in like this. You close the door. The water retracts up the feed tube and then comes back and pounds you right again.

The economic forces start moving all over far quicker than you can respond as regulators, so that would be my concern.

CHAIRMAN HOECKER: So your recommendation would be, whatever we do, we do the maximum or the optimum right

1 away?

Is that right?

MR. ACKERMAN: I would say whatever you do, you have convinced yourself that you have to do it because the outcome for not doing it or the cost of not doing this is so far in excess of not doing it, you have to, you know, you feel like you are backed into a corner in some sense. But you would not do it lightly.

CHAIRMAN HOECKER: John?

MR. FIELDER: I think there are three things that you can do. First, you have got to stop the bleeding, and the way to do that is to put some realistic price caps in place in the short term.

I do not think the $150 price cap proposal does it because I think what we will see is that prices will hover right around $150, even in the off peak periods like they are doing today. It would be nothing that the price cap would prevent. The price last night at 8:00 o'clock would be $147.

Secondly, you can put some blood that was lost back into the patient. And this is the refund issue. We will brief the issue in the 22nd comments on retrospective. But clearly from October 2nd forward, there is no question about the authority of the Commission to order refunds, when they find abuses of market power, unjust and unreasonable

1 rates.

The third thing then is I think that we do need to put the patient on a long-term rehab program. I think that will involve a long-term contracting capability, but remember long-term contracts are two-party deals. And it can't just be all the load out looking for long-term contracts. It has to be the suppliers that have an incentive to stay in the forward market too and the long-term forward market.

And, by the way, if we do that, then I think the issue of price caps are not as important. Because the price caps are really applicable to the real time day-ahead markets. And if the generator that sold 95 percent of their output into the forward market and the load is contracted forward, neither one of us have very much risk in the real time markets where the price gaps are applicable.

So I think those are the three elements.

CHAIRMAN HOECKER: That is the way the rule works. That is your understanding of it.

MR. FIELDER: Well, what is not clear to me is that there is any pressure on the supply, on the marketers to be in the forward market. I mean they say they want to be, they say they want to be, but --.

CHAIRMAN HOECKER: Let's ask a supplier.

MR. HALL: Well, you know, we said this summer

1 and August that we were willing to provide those sorts of

hedged instruments. I mean, that is Duke's strategy anyway. Fundamentally, that is what we do, that is our niche in the marketplace, and we are willing to offer those products. We do not live on volatility in the markets.

I think you live and die. There is an upside, but there are tremendous downsides and we have an approach that says we are going to hedge our own risk and we are willing to take that experience and offer that to loads.

Just another comment around your question, Commissioner Hoecker, and that is, you know, the patient-- the situation is such that it is going to take more than one doctor. There are two doctors that have got to be in the operating room here; one's the FERC doctor and one's the State doctor.

Unfortunately, you know, those two doctors have somewhat different trains of thoughts and somehow collectively that has got to align.

And I think your order begins to set the way for that. I am optimistic that if the right tools are put into the portfolios of loads, that that creates option, it creates more liquidity in the market, and when they have the flexibility to go to different suppliers for their needs, then that helps to manage pricing behavior.

And again, we have heard that supply, you know,

1 folks are willing to build up their generation. We have

said, you know, in the face of what is going on with this regulatory uncertainty, we are going to continue to push forward. Certainly a move back to reregulation would cause us severe concern and we certainly would have to sit back and evaluate that.

But even with the folks on Panel Three, I have met with most of them personally, and I certainly heard the practical realization on their part that we can't go back the other way, but we have got to do something here to protect consumers in the interim and help deal with the emotional issue in California.

CHAIRMAN HOECKER: Yes, sir.

MR. SLADOJE: Yes, Commissioner. I think just to echo the stability issue, whatever actions you take need to have some longer-than-a-few-month effect.

We began to operate forward contracts in July of 1999 and nobody would trade them. We had four participants signed up for them. We have 19 now but--and we need more--but after we got through August or so, then we had a few trades.

Then we got into the fall and we had a few more trades; and then we got into the winter and we had more trades, and the thing started to gain some momentum.

And by the time we got to the summer, we had

1 quite a few transactions recorded in that forward market,

and like I said, we were up to 19 participants.

Well the price caps went from $750 to $500, as you know, early in the summer. Trading ceased in the forward market. It started to pick back up again, and then the price caps went from $500 to $250 and trading ceased.

Now we see a FERC order with the $150 soft cap. Trading stops.

So we do need to have some stability and these forward markets would get going.

Secondly, though, and I think probably more importantly, we need to reach some agreement on what's happened with this marketplace. Are we at a different plateau of price than we had?

You know, the first two years, two-and-a-half cents a kilowatt hour. And something happened in May of this year. In looking back at some statistics, the low of the ISO market in October of this year was almost identical to the low in April and May of this year.

And our average price at the Power Exchange for October was the same low that there was in April and May, was $103, and that is not peak, it is average.

The average price back in April was about $30 a megawatt hour, and the average price in May, I think two big price spikes, was about $47.

1 So we take a look at what happened in October.

Why are these prices where they are with the same loads that we had, and I can't even say one of the things I liked to blame was the ISO real time market, that everybody gravitated there, but that is not what happened. It was back to about one or two percent.

But we do see that about 3500 megawatts of nuclear power now out for maintenance. About 500 and 750 of gas-fired units out to maintenance, so that is 4500 megawatts we have lost since we had last spring.

Now is that enough to make the difference in these prices? Is that enough to cause these prices to double or even triple?

I think you have heard a lot of opinions today on what happened with these prices, and you have seen your Staff report. But it does seem to me that we are at a different plateau of price from where we were just a few months ago. And I think we all need to reach some kind of an agreement on why that is.

CHAIRMAN HOECKER: You think it might be these maintenance --

MR. SLADOJE: I think that is a big factor. I think that that is a big factor, but some people think that that is not a factor. And I think that there has to be some general agreement on where the reasonable price really is

now. It is obviously I think not in the same place it was

five months ago.

CHAIRMAN HOECKER: Umm hmm. You had?

MR. HALL: Just a brief comment on George's comments about the outages. Most of us who purchased these existing facilities did so knowing there were certain conditions in permits that we had to be in compliance with over the next couple of years.

So we, ourselves, have got most of our units in major outages this year and next year to install retrofitted with Nox reduction equipment and those kind of things to meet the new pollution control standards. And again, we knew when we bought the facilities.

So you are going to see some significant outages of these existing units over the next couple of years.

CHAIRMAN HOECKER: Jim?

MR. BUSHNELL: I think it is clear that there are some cost-based factors that are affecting prices this fall, gas prices is the obvious one. And we have the emissions permit issue, we have the outages issues.

I do not know how much agreement we will ever get. I think just common sense says there is some combination of cost factors and market power here. There is no reason to expect that we would not have market power in an electricity market like this.

1 I think the disagreement will largely be over,

you know, how extensive that market power is, and it looks like we have had more this summer than we have had in previous summers. I am not exactly sure why that is, but it looks like the problem has been worse.

I do not know exactly about this fall, but I think when we look at the price cap and how it was lowered and how average prices went up, I think it is probably a combination of costs went up. So when we lowered that price cap, we have higher--we had higher prices because costs were influencing that.

But I think we should not conclude that the price cap did not affect prices or actually raised prices based upon that observation, though.

CHAIRMAN HOECKER: Eric, one more answer, and then we will go to Staff.

MR. WOYCHIK: Thank you.

I want to just suggest that I think that the Order the Commission has put forward is very appropriate in many, many ways, and what it needs though is adjustment. And to echo previous comments from others, it needs to be stronger.

I agree completely with John Fielder. The changes I would make to the Order are, very quickly, the most important change is probably to use something like a

1 load differentiated price cap because there is the inherent

gaming that is underneath any fixed price cap, such as what the FERC, your Commission has proposed right now.

So--and if the one that Mike Florio and I tried to put forward and get the Commission, excuse me, the ISO to adopt, is not appropriate, let's adjust that. Let's use different gas prices, even move it up a little bit, whatever it takes.

Second, I think refunds are essential. The October date that John Fielder suggests again will restore some confidence that things can be done.

I am a soccer ref. My son is in competitive soccer. The first yellow card that comes out, everybody behaves. You have got to do something to say you are going to put the yellow card out, or you are willing to pull out the red card. And if you do not do that, I think that this market will continue to have very poorly-behaved aspects that are very deleterious.

And third, obviously the idea of forward markets, one of the things that is interesting is Calpine is willing to put forward $50 dollars as a price, but yet the generators rail at the idea of a load-differentiated price cap that starts at $68 bucks.

Let's see if they are going to go towards forwards. If you put the, a very apt question was posed by

your Staff, if you think the price cap is so difficult, go

forward. There is that option.

And then fourth, obviously I think you want to start the process, push the ISO, or however it is going to be implemented, to get the locational marginal cost pricing scheme to start its implementation.

Thank you.

MR. ARMSTRONG: I have just got one question I want to ask. This is my last opportunity, and it is about back on the schedule. I would like to ask it of Mr. Fielder of SoCal Edison.

If you look at the basket of fixes we have in the Order, and you are able to self-supply with the generation you still own, and if you were able to go out and get a more balanced portfolio in the futures market, if you do not have any collars on you or anything, and you are still able to be in the spot market, the day-ahead and the day-of, is it really that hard to have no more than five percent show up in real time?

MR. FIELDER: Richard, I think the answer to that is, yes, depending on how you measure it. If you measured it on a daily basis, you could have swings much greater than five percent just because of the weather variations. I mean, nobody's perfect at weather forecasting and load forecasting and the weather can shift your forecast by more

than five percent.

If you looked at it on an annual basis, to set it on a cumulative basis over a long period of time, five percent, eight percent might be in the ball park, if we were able to do the other things you have said, and we are only buying a little bit in the real time market.

MR. ARMSTRONG: Thank you.

CHAIRMAN HOECKER: Other Staff questions?

Kevin Kelly?

MR. KELLY: Mr. Hall, good afternoon. You suggested that the Commission might make forward refunds contingent on California implementing the forward contracting obligation and I was intrigued by that but didn't have enough detail to know how you would think about it or implement it.

Could you say a little more about the idea?

MR. HALL: Well, yes. That is what it is at this point is just an idea.

Really fundamentally it is more an expression of concern that if the FERC and the state initiatives are not appropriately aligned, then the expected and desired outcomes of this Order are not going to be fully realized.

And I just want to ensure that, you know, each entity properly incents the other to move forward collectively to implement your recommendations.

1 So again, we are thinking through that some more

and we will provide you with some more detailed thoughts in our November 22nd filing.

MR. KELLY: Just to maybe follow up since most generators are opposed to refunds, and you are in the generating business, would you view that such a deal, assuming it were fleshed out, as a deterrent to further investment in California, or would you be neutral toward it, or would you find it somehow supportive of further investment as stabilizing the environment?

MR. HALL: Well, you know, as somebody commented earlier today, the devil's in the details. So we want to understand certainly much better than the Order expresses today:

What are your standards for determining what's an unreasonable rate?

And then what level is reasonable?

And what is the differential that then you would expect a refund on, and who all does it apply to?

Because there are other entities that sell in these markets that FERC has no jurisdictional responsibility over. So, you know again, Duke has stated publicly many times that it as many of the other generators, we do things above board, and we are confident that if this is indeed what you intend to implement, we are going to play by the

1 rules and we are not going to be found to be doing anything

improper.

So we are confident we are not going to be required to provide refunds.

MR. KELLY: Thank you.

MR. WOYCHIK: Mr. Chairman, I have got one.

CHAIRMAN HOECKER: Do you have one response there?

MR. WOYCHIK: It is really in the form of a very short statement.

CHAIRMAN HOECKER: Just speak into the mike.

MR. WOYCHIK: Thank you.

Chairman and Commissioners, just one quick point I want to make. I do not think you can expect certainly the Stakeholder ISO Board or an independent ISO Board to implement a market structure that works for consumers and for suppliers in a way that will really cure our current market power problems.

So the problem is, from my view, you are the only one, as others have suggested, the Commission is the only one that can really create the impetus, through your authority, to implement a market structure that will work for California, and I do not like leaving that on your doorstep, but I think it rests there.

And the risk is if you do not order a market

structure that works, I mean, a final, a forward market

structure that works, California and the electric industry in the United States is at risk.

Thank you.

CHAIRMAN HOECKER: Commissioner Breathitt?

COMMISSIONER BREATHITT: I just have a few.

Mr. Fielder, one section of our Order--and Richard touched on this--talks about the fact that 60 days effective from the date of this order, we are eliminating the requirement for the IOUs to sell all of their generation into and buy all of their requirements from the PX.

And this will allow you, because you still own generation, correct?

MR. FIELDER: Yes, ma'am.

COMMISSIONER BREATHITT: To provide power from your own resources to serve your load and to still provide any necessary ancillary services.

Do you plan to do that?

MR. FIELDER: Commissioner, I think the approach you outlined in the Order is the right approach. This is one of those areas where the State Commission has a myriad of rules and requirements and it creates some real issues that the State Commission's going to have to deal with before we are able to do that.

COMMISSIONER BREATHITT: Such as?

MR. FIELDER: Such as the reasonableness of our purchases. Today we have guaranteed reasonableness if we buy out of the market and buy out of the PX.

But if we buy someplace else, there is no reasonableness associated with those purchases, such as the accounting for now taking our generation out of the market and dedicating it to our load, there has to be calculations done for stranded cost purposes, for credits to direct access customers, as to how that generation's going to be treated.

I am not saying it can't be done, but just has to be a number of issues worked through.

COMMISSIONER BREATHITT: Are you looking at it?

MR. FIELDER: Yes, ma'am. We are filing, I think today, taking up those issues with the Commission that says if the FERC Order adopts this provision, here are the things that we have to deal with on an expedited basis.

COMMISSIONER BREATHITT: My question was, on those two, whether this would be of some benefit to your company and to PG&E, and I wish I had asked that question to them because they own some generation still as well.

MR. FIELDER: Yes. I think it would be some benefit if the rules at the State Commission are set up to be complementary to the direction that the FERC Order

1 goes.

COMMISSIONER BREATHITT: I think that is it for right now.

No, let me ask, excuse me, let me ask Bill Hall a question that is a follow-up from a line of commentary that I had with the panel of officials from California, and that was how I, as a regulator, am going to be able to decide whether the, for lack of a better word, the threat of a referendum totally recalling restructuring California is so real versus the sellers' contention that price controls cause you to flee the market.

Therein lies whether or not there will be sufficient generation placed in California.

The plant that you mentioned that is coming on line is the base load plant?

MR. HALL: Umm hmm.

COMMISSIONER BREATHITT: What are your plans for continued investment in California?

MR. HALL: Well, we continue to move forward with that. Obviously we do it somewhat cautiously but again, I am optimistic that ultimately these issues are going to be worked out. And I say that from my earlier comment where we have met with people in the state, and it is part of recognition that we can't go back to the old days. So, you know, we monitor that closely.

1 But for the moment, Duke, as well as many other

generators, are moving forward with plants. We want to be viewed as part of the solution of this. That is why, you know, obviously we certainly do not have a taste for price caps, but we have not fled the state over that because, you know, I think I am representing a number of folks generators.

You know, we see the emotion, well, there is a perception there that somehow that is going to help it. Fundamentally, I am not sure it does, but that is why we have been supportive and we are continuing to deploy new assets.

I am not so much concerned about ultimately a sufficient generation being built in transmission. I am concerned about the timing of it. You know, some of us are being mighty aggressive in how quickly we think new supply, new transmission's going to come on line.

Somebody mentioned the Rainbow Project this morning. You know when you read the papers and you go down there, and Nembism is alive and well. And even some legislators in California are supporting the efforts to stop that project.

I do not know how you overcome that. It is extremely difficult. You can ultimately, we have proved that at our Morrow Bay facility where I mentioned it earlier

that it takes a long time because you have to build trust

and credibility with those communities; you do not do that overnight.

COMMISSIONER BREATHITT: One more question for you, Mr. Fielder.

You said you did not like the $150 soft cap. You did not say if you would remove it, and there would be none, or if you would lower that or raise that.

MR. FIELDER: I am sorry. I thought I was clear.

What we think would be appropriate is rather than a fixed cap for all those levels is some cap that is adjusted based on the loads and that is in the proposal that the ISO adopted also adjusts for movements in gas prices. So it is not a static cap forever. If the gas prices go up, the cap went up; the gas prices went down, the cap went down.

COMMISSIONER BREATHITT: You probably said that and late in the day, my mind could have been elsewhere.

MR. FIELDER: I understand.

COMMISSIONER BREATHITT: Thank you.

CHAIRMAN HOECKER: Thank you.

Commissioner Massey.

COMMISSIONER MASSEY: Mr. Bushnell, when we were in San Diego conducting our hearing, Mr. Wallach suggested that the Commission explore, as a kick start to the forward

1 market, that we explore defining a forward contract of 18

months to two years.

Coming to grips with a just and reasonable price for that contract, getting a front end buy-in by a State Commission, that for purchasers to buy that contract would be prudent, and attempt to get roughly 70 percent of the market in California on that contract.

Now since he suggested it, I have not heard a lot of discussion about that. It is an interesting idea to me. Rather than capping the spot market, it caps the forward market.

Now I want any of you on the panel to comment on whether you think this is a good idea, a bad idea, or what.

MR. SLADOJE: Certainly from the perspective of looking at your options for mitigating prices, and you know, I do not know the legalities of how you define a just and reasonable price for the contract, but if you just look at how you would mitigate market power with the least form of distorting the rest of the activity in the market, being able to overlay a contract, and I do not think you need to do 70 percent of the capacity, I am not sure what the exact number would be, but 70 percent, I am not sure that Frank came up with that number either.

But the idea is you are tying up a bunch of the supply of both the suppliers and you are hedging the cost of

1 demand, and the incentives of the suppliers for the rest of

their activity in the spot markets, their incentive to try and raise prices in spot market is mitigated because they have already tied up most of their sales with some advance price, and that is the notion behind that mechanism.

But it is still operating in the short-term market. You are still doing it based on what you think the short-term market conditions are, but you have less incentive to try and exercise market power because you have already tied up a bunch of your sales already at some fixed price.

COMMISSIONER MASSEY: Do any of the rest of you have a comment on whether this idea has a political legs?

MR. SLADOJE: Well, I think it does sound very attractive to the group in California last week that was recommending it.

However, however, however, as recently as May of this year, you could have bought a forward contract in our market for somewhere around $40 to $50 for the summer months of this year. Now, if you want to buy a forward contract for the summer months of 2001, it is about $120, $125, so what would have been deemed prudent for four or five, six months ago, you know, people are suggesting a price like $60 or something, would not be prudent today. It would not even be close to being prudent today.

And so in the end, I am not sure that that

resolves the problem that you are trying to get to as far as getting stabilized forward contract.

COMMISSIONER MASSEY: I think the idea is to create a little pain for everyone. Make the price for this contract lower than the price currently in the forward market, but in terms of what the generators were to offer it for, get a buy-in by the State Commission that that contract would be deemed prudent.

And so Mr. Fielder will buy that contract.

So my question to you, Mr. Fielder, is are you going to buy these $120 contracts?

MR. FIELDER: I hope not, Commissioner.

I think that you mentioned 18 months to two years. I think that a lot of the talk about forward contracting is looking at terms a little longer than that because the forward curves through next year are at the levels that George is talking about, Q3, 6 by 16, is now up around $126. It was with $105 October 31st. And so now, if you want to lock in those prices, with short term, you know, one- or two-year contracts, I think we are locking in some pretty high prices.

If you go out four or five years, what we are hearing from the suppliers is that you are down around into $40 or $50.

COMMISSIONER MASSEY: Are you going to buy those

contracts?

MR. FIELDER: If the Commission would give us the authority to do that, I am sure we would.

COMMISSIONER MASSEY: If they are offered through the PX, are they deemed prudent?

MR. FIELDER: Right now, the authority that the Commission has given us is that we are not able to buy forward in the PX forward markets past March of 2002. So we are buying in the forward markets a little bit, but the prices are very high and the margins are very thin between now and 2002, because if you were a generator, there is not a lot of new supply coming on the market between now and 2002, March 2002.

COMMISSIONER MASSEY: Well, I want to understand. If you buy a PX forward contract, is that per se prudent?

MR. FIELDER: As long as we do not buy past March of 2002.

COMMISSIONER MASSEY: I see.

MR. SLADOJE: We have five-year offers to sell out there for under $60, but the people that would ordinarily buy, the IOUs, do not have any safety beyond March of 2002, so these offers to sell are just kind of sitting there right now.

COMMISSIONER MASSEY: So you could buy a five-

1 year contract in the PX market that would be per se prudent

if you were allowed by the state to do that?

MR. FIELDER: Yes, sir.

CHAIRMAN HOECKER: That is not per se imprudent if you do it?

MR. FIELDER: Not per se imprudent but the 20/20, you know the reasonableness review always invites 20/20 hindsight. We have no upside and nothing but downside. If you make a good deal, well thank you very much. If you make a bad deal, we will take over the shoulders I guess.

That is just the way the system works.

MR. ACKERMAN: Just to follow on that line of answer, I think you are asking the very right and correct question because the question that faces us is, we know that over-the-counter trading outside of the PX, which is a very vibrant market in the Western region, a forward strip for next year in the southern part of California is selling for about $78 to $80 per megawatt hour.

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Now when Mr. Fielder talked about $43, he said $126, and that is consistent, because when they break it out quarter by quarter. Or you can buy all four quarters, and you average out the numbers, and it comes up to about $78 to $80. That is what the market says you can buy all heavy load hours for if you wanted to procure right now.

So the question we are asking is why are no buyers coming forward?

I think John here has given you some indication of the concerns they have of making sure their procurement is deemed reasonable.

That I don't believe is an issue before this Commission, but it is a question that I appreciate you asking, because it is a question we have, too. We just can't seem to understand if we are willing -- if the market is saying we are willing to sell at these prices, far below the $147 of a nighttime period that John had referred to earlier--let's think about this for a second--the market is saying we are willing to bear that risk at these kinds of numbers far, far lower than you probably heard before, don't know why buyers are not showing up.

COMMISSIONER MASSEY: It sounds like we can charge ahead encouraging forward contracting very aggressively, but we can't make it happen without the

cooperation of state authorities.

MR. ACKERMAN: I believe that.

COMMISSIONER MASSEY: Is that an accurate statement?

MR. ACKERMAN: I believe that to be true. I think it is a fair statement.

MR. WOYCHIK: As a former Commission advisor to the PUC and pretty knowledgeable about prudency reviews and how they work and watching them right now, I agree that they do need to make a decision and they are sitting on the fence.

One of the problems I think is in part that the problem it has been so dysfunctional. The political environment is so unsupportive of them doing anything, particularly to extend themselves to grant sanction for contracts that are longer term that they have no confidence that the market will prove out to them that they have made the right decision.

Again, if there was some action by this Commission to grant refunds from the October period, for example, the political environment is very difficult. So I think Loretta Lynch and the PUC, they are just -- if they do not have to make a decision yet, they are not going to make one. I do not know how that is going to work, but it is a difficult environment.

COMMISSIONER MASSEY: Yes. We have decisions to

make. They have decisions to make, but somehow we have got to find a bridge to where we can all march in the same direction, because it sounds to me like all of the jawboning in the world that this Commission does about forward contracting will not achieve it without state action. Yes?

MR. BUSHNELL: That does highlight the fact that eliminating the must-buy, must-sell from the Power Exchange, that was significantly loosened already over the summer. But, you know, you still do not see any long-term activity happening, and it seems to be because of the prudency issue that there is this stalemate between the buyers and their regulators about it.

But just to clarify, we are sort of talking about two different sets of contract solutions here. One is just a market-driven suppliers and buyers going out and reaching a mutually agreed upon long-term contract, of which usually you hear these five-year offers.

The other that was put forward was meant to be a short-term regulatory mechanism to sort of bridge the transition period offered as an alternative to a wholesale price cap or other forms of price mitigation.

COMMISSIONER MASSEY: Yes. The reason that intrigued me is that rather than focusing on the spot market, it was a focus on the forward contract market and

1 lift the price cap in the spot market. That is the only

idea on the table that I have heard that moves in that direction.

MR. ACKERMAN: And just one final comment on that. I think in terms of what the market is saying that should I think respond to your question of do we need to have a stabilization period, the market is very clearly saying if you want to buy just for 2001, heavy load hours, you are at about $80. If you want to buy five years, you are going to be around $50, $55. The market is saying we know that prices for natural gas are going to go down. We probably do not know what is going to happen to environmental emission credits. And we do know there is going to be more supply showing up.

So the market on its own volition, which in your Order says is unjust and unreasonable, is coming forward with lower prices over a time horizon of five years.

CHAIRMAN HOECKER: Thank you. I want to thank this panel for an excellent job.

MR. LARCAMP: Mr. Chairman, could I just ask one question today?

CHAIRMAN HOECKER: Oh, sorry, Dan. Sure. Go right ahead.

MR. LARCAMP: Compared to this $40 or $50 on the five-year hedge, what was the average price of generation

1 back in the good old days of cost of service in '96 when gas

prices were probably $2? I mean, I am trying to compare on a prudency issue how the forward's price on a five-year contract is comparing to the regulated rate, which had a reasonable rate of return because it was determined by Commission. So how are those two comparing?

MR. FIELDER: I think the comparison -- and we have done this -- is if you look at utility-owned generation and take out the queue-up payments, it is somewhere between 3.5 and 4 cents, counting the depreciation for the new, assume that all the rate-based generation that we owned, plus all the fuel and variable operating costs, the revenue requirement on an annual basis turned out to be about 3.5 to 4 cents.

MR. LARCAMP: And that was with what gas prices? If you normalized that to $5 gas, what would you see?

MR. FIELDER: I think it is around 5 cents.

MR. ACKERMAN: And we will provide a table which identifies the very answer to the question you are asking. We provided it in previous responses and comments to this Commission. You have to include the stream of cost payment, which is a fixed cost that the utilities are paying for the QF power, for the wholesale power contracts, and for any of the stranded costs they have.

And when you do that, for Edison it is around 7

1 centers per kilowatt hour, and for the state of California's

three IOUs I am doing now from memory, I believe it was 6.2 or 6.3 cents. I can show you those numbers. You can make the comparisons, and I think it is very revealing the number of months that the market prices have been below those numbers and sometimes quite significantly.

MR. FIELDER: We will provide some data in our November 22nd on that. Gary is right. But if you take the queue-up payments, that is over half of the revenue requirement.

MR. LARCAMP: But you will normalize for sort of the current emissions prices and everything else.

CHAIRMAN HOECKER: Other questions?

(No response.)

CHAIRMAN HOECKER: We may -- oh, Don, I am sorry. This is it. This is the last question.

MR. GELINAS: This is the last one. I will try to make it short. Jim, I would like to ask you something. I heard a lot of themes in your presentation which are consistent with some of the goals we are trying to achieve, including getting people into forward markets.

I have heard everything today from the fact that the soft cap is too high to it is too low, to it is too restrictive. So we are trying to walk a balance. We have to provide meaningful mitigation. We are trying not to

1 discourage supply. It is not a cap. I know it is meant as

a reporting requirement.

Taking all this into account that I have heard here today, if we have to propose meaningful price mitigation immediately -- 60 days after our Order -- something that we can do with a minimum amount of disruption, what would you recommend? I have heard a lot of things. Hear about a long term, and require cooperative endeavors with the state. But January 1st, with the assumption we need meaningful mitigation in place that can be in place, what would you recommend?

MR. BUSHNELL: My first preference for at least a format would be some kind of two-year arrangement that, you know, could either be scheduled through the Power Exchange. It could be some kind of block forward through the Power Exchange or some kind of contract basically that is set at a just and reasonable price for some amount of the volume.

MR. GELINAS: Some Commission-approved two-year contract price?

MR. BUSHNELL: And it would have to approved by both Commissions, the state for the buyers and the FERC for the sellers.

MR. GELINAS: And do you have a thought as to the standard we would use for approving that? Because, you know, I have heard everything today from let's go back to

cost-based rates to let the market roll. What would I do?

MR. BUSHNELL: I don't know, but I think Dan's questions were sort of heading in the right direction there.

MR. GELINAS: Well, if you could in your written comments on the 22nd, anything you can provide that would nail down what you think we can do and how we can do it, it would be very helpful.

MR. BUSHNELL: Okay. But as I said, I am not the person to ask on the legalities on this.

MR. GELINAS: No, no. I am asking --

MR. BUSHNELL: I can just sort of comment on how I think this is going to affect the markets' operation.

MR. GELINAS: Right. Right. I was asking this from an implementation standpoint. Thanks.

CHAIRMAN HOECKER: And you are welcome to tell us what a just and reasonable rate is if you want.

(Laughter.)

CHAIRMAN HOECKER: I am going to conclude this panel and suggest that some of us may want to submit some additional written questions to you to respond to when you file your comments.

Thank you very much. It is only ten to two in California, so we can go to our next panel.

(Laughter.)

(Recess.)

CHAIRMAN HOECKER: I would like to welcome our

last panel at this time and to compliment them on their fortitude and stamina.

We will try and keep this session to an hour so that we can adjourn by six. Again, I will suggest at the end of this panel some things that occur to me as matters requiring specific attention in your written comments, not just this panel but to all the panels.

But I have been very pleased with the presentations thus far today, and I think we will just go ahead and conclude with this panel.

Michael Manning representing the LADWP.

MR. MANNING: Thank you, Mr. Chairman, Commissioner Massey. Mr. Freeman, who is the -- David Freeman, who is the general manager of Los Angeles Department of Water and Power asked that I read a statement that he prepared, and I have provided copies to everyone here:

"As the General Manager for the City of Los Angeles, Department of Water & Power, I wish to express my appreciation for the opportunity to address certain issues in the Commission's November 1, 2000 Order that proposes remedies for California wholesale electric markets. DWP is the largest municipally-owned electric utility in the United States. It is a vertically-integrated electric utility,

owning and operating an extensive transmission system and

distribution systems within the City of Los Angeles and the Owens Valley of California.

"It is the third largest electric utility in California. DWP provides electric service to more than 3.8 million customers behind 1.4 million meters. Its customer base represents approximately ten percent of the total electricity market in California.

"The extensive high-voltage transmission system owned and/or operated by DWP reaches across California and into adjoining states, and is directly interconnected with the transmission grid controlled by the California Independent System Operator.

"DWP also has a diverse portfolio of energy resources consisting of renewable, hydroelectric, natural gas-fueled, coal-fueled and nuclear-fueled generation, located in California and in the western United States. With this substantial generation and transmission portfolio, DWP purchases, sells and exchanges substantial quantities of electricity at wholesale.

"I will address two issues contained in the November 1, 2000 Order. Specifically, my comment focuses on the selection process for the proposed California ISO and California Power Exchange Boards, and the soft cap and reporting limit for sellers of energy and ancillary services

1 into the California market.

"The Commission's proposed action to replace the current stakeholder Boards with independent ones is laudable. However to achieve the goal of independence, it is necessary that the new members be selected by an independent party, such as the Chairperson of the California Electric Oversight Board or a majority of voting members of the EOB.

"The second issue that I wish to address is the `soft cap' and reporting limits for sellers of energy and ancillary services. The November 1, 2000 Order proposes temporary measures to mitigate the potential for unjust and unreasonable prices -- a `soft cap' at $150/MWh. Understanding the goal of the `soft cap' to be just and reasonable rates for consumers, the cap must be set at $100/MWh and the one-price for all bids approach be abolished for all bids. The reason for the lower `soft cap' is that caps must be designed to achieve prices based on the cost of service plus a reasonable rate of return. The cap proposed by the November 1, 2000 Order does not meet that standard. As for the reporting requirements, reporting of cost information for all bids should be $120/MWh or greater."

Thank you.

CHAIRMAN HOECKER: Thank you. Let's go to Jim

1 Cunningham from Georgia-Pacific.

MR. CUNNINGHAM: Thank you. I am the General Manager of the Georgia-Pacific Mill in Bellingham, Washington. I am also a member of the Industrial Customers of Northwest Utilities, ICNU, a nonprofit trade association that represents the interests of 43 large industrial power consumers in the Pacific Northwest.

Prior to this summer, I spent most of my time focused on employee safety, environmental concerns, mill productivity and pulp prices. I knew very little about the energy market. We purchase our electric power from Puget Sound Energy based on an experimental five-year special contract, which expires May 2001. As an aside, we receive no power and thus no benefits from the Bonneville Power Administration.

The Bellingham Mill is roughly a 40 MW load. Under our contract, the price we pay for power is based on the Dow Jones Mid-Columbia index. The index prices have tracked the California PX prices, and in several instances have exceeded the PX. Since May, the energy component of our electrical bill has increased by 364 percent. In August of this year, we paid about $5.6 million for our electricity compared to one year ago, the price was $1.1 million. Typically, electricity has been approximately 7 percent of our production costs. However, it has now risen to 31

1 percent. In a competitive marketplace such as the pulp and

paper industry, this increase to our production costs has been crushing.

As a result of the recent surge in energy prices, a majority of my time is spent on energy issues. The Mill employs about 800 people and is one of the largest employers in the City of Bellingham. My total focus is to keep my Mill economically viable. As a direct result of these high energy prices, the Mill has operated at a loss. At one point because of these high prices, we shut down production for three days in June, which is extremely unusual and difficult to do, given a complex, integrated industrial operation like a paper mill. We have been forced on many occasions to run at less than full capacity to reduce electrical usage.

Currently due to electric prices, I have been forced to shut down one paper machine and am in the process of laying off 50 employees. I am sure that you can appreciate the number of sleepless nights I have worrying about energy prices and wondering if they will ever come down.

You may be thinking to yourselves, "well, this is unfortunate, but isn't this an issue to be resolved by the Washington Utilities and Transportation Commission?" The WUTC is a very good Commission, and is well equipped to deal

1 with certain issues. But addressing the causes and impacts

of problems with the West Coast wholesale power market obviously extends beyond the state of Washington.

I have read all 77 pages of your draft Order regarding the California wholesale markets. I support your conclusions, recommendations and directions for addressing this serious problem. However, I urge you to go further. I believe that the flaws identified in the California market are directly impacting the wholesale power markets in the Northwest, which is demonstrated by the dramatic increase in the Dow Jones Mid-Columbia index prices.

The problem in the Northwest is much larger than Georgia Pacific. INCU has 10 of its 43 members on special contracts or tariffs that are priced at the Mid-Columbia index. The Port of Seattle also has a special contract with Puget that is priced at the Mid-Columbia index. These are just a few of the industries in the Northwest impacted by high power prices at the Mid-Columbia. Many of these industries are experiencing the same high prices and eroding profits that are creating a uncertain future if electric prices do not stabilize. Please do not limit your focus to California, because the fact is, the California market and the Northwest power market are closely tied together, and the market flaws in California have translated into market flaws in the Northwest. Unfortunately, the California

1 problem is a West Coast problem.

In conclusion, I would like to leave you with these three points:

1. We support your draft Order and applaud your thorough, insightful and even creative approach to a very serious and complex problem.

2. We urge you to expand the focus of the investigation and recognize the direct impacts the flawed California market is having on the Northwest and specifically on transactions based on the Mid-Columbia indices.

3. Specifically, we urge you to also consider whether the wholesale prices comprising the Mid-Columbia indices in the Northwest are unjust and unreasonable.

Thank you for the opportunity to raise the concerns of the Northwest industrial consumers.

CHAIRMAN HOECKER: Thank you very much. John Stout, Reliant.

MR. STOUT: Thank you, Chairman Hoecker. One of the problems by being on the last panel is that all the really good things to say have already been said three or four times today.

So what I am going to try and do is to address a couple of questions I heard that I am not sure were

1 adequately addressed earlier. And the first question I

would like to address is the role the competition among buyers has had in raising market prices in California this summer.

What I am really trying to do is answer the question that Semper tried to dodge a little bit earlier today when it was asked by Curt Hebert.

Let me start with a simple example of an auction. I have got some beanie babies I want to sell, and so I go out on eBay and I put in a minimum bid for $100. And once it gets out there in the market, if someone were to offer me $100 for that beanie baby, I would be perfectly happy to sell it. But because of competition between buyers, they start bidding the price up. Ultimately, the beanie baby sells for $500. Now when it sells for a price that is greater than what my minimal offer was to sell, that extra $400 difference between what I would offered it at and what the winning bidder got it for is not an example of market power abuse on my part. It is simply a legitimate result of competition between buyers in the market. And that is what economists tell me represents scarcity rent.

Now let's take that simple example and translate it to the events that took place this last summer in California. And I am going to try and answer the question that I believe Chairman Hoecker asked about why prices this

1 year in the market went up so much. In my written

testimony, which I think those of you at the table have, has some pretty color graphs in it, so if you would like to follow on with those, feel free to do so. But I will try to verbally describe exactly what they show.

The example that I use is June the 29th of 2000. And I chose that date not because it is a good example of what I wanted to illustrate, but that is actually the date that the Lynch Kahn report highlighted as what I will call the poster child of the dysfunctional market. This was a day when the price jumped to about ten times the level it was the preceding year for virtually the equivalent load level.

When you look at the supply bids that were submitted by the suppliers in the market and look at each individual hour of the day, what you will quickly notice is that the bids are almost on top of one another. There really isn't a whole lot of change from hour to hour. And this raises a pretty big question almost immediately. Because if you look at what the clearing prices in the market were, they jumped from $175 per megawatt hour at 9:00 a.m. to $750 just four hours later at 1:00 p.m. They quadrupled. And the question is, if the buyers were bidding the same -- or excuse me, if the sellers were bidding the same thing, why did they jump so much?

1 Kind of interesting. If you really look closely

at the bids that were submitted by the sellers, you will actually find that between 9:00 a.m. and 1:00 p.m. the sellers actually lowered their bid price by about $100 per megawatt hour, yet the price quadrupled. The answer is obvious as to what caused this to happen if you look at the bids that were submitted by the buyers. Each hour that day, starting early in the morning, they jumped the bid of the previous hour by about another $100 per megawatt hour. In fact, between 11:00 and 12:00 a.m., they doubled their bid. They went from $300 to nearly $600 per megawatt hour. As a result, the market cleared progressively higher and higher prices that day.

What this data clearly shows is that buyers did bid up the price on the very day that has been highlighted as an example of market power abuse by sellers. And it is a classic example of what happens when you have scarcity rent. In fact, if you go back and look at the curves and just postulate what the clearing process would have been had the sellers in the market lowered their prices to just $1 per megawatt hour, you will find that the clearing prices really don't change at all, because the buyers are bidding so much higher than what the sellers are offering to sell for.

This example is not an anomaly. If you go back and look at the data, which is now publicly available for

June, you will find that this same occurrence repeats over

and over again every day, every hour.

Now I am sure that the folks at PG&E and Southern California Edison in San Diego have very good, legitimate business reasons for that sort of bid behavior. In fact, I am sure they would argue that their rationale was very just and reasonable for raising those bid prices every hour. And I guess if that in fact is the case, I think it calls into question whether the resulting market clearing prices were not also just and reasonable.

Last week when you had your final Order meeting or your initial Order meeting, you invited us to present new evidence that perhaps might justify a change in your perspective on the issues. And I believe that this evidence clearly does just that. I would ask that you request the staff to take a closer look at this sort of analysis and to stop and reconsider as to whether in fact there is a legitimate, justifiable reason for declaring that a lot of what happened this year, especially in the PX day-ahead market, was in fact the result of legitimate scarcity rent, not the result of market sellers trying to jack up the price.

Real quickly, I would like to add another comment on a question that was asked about the prognosis for next year. The answers that you got dealt mostly with the

1 physical reality of reliability. I would like to talk for

just a second about the financial implications for next year. The change that you have offered to make, which would allow the investor-owned utilities to basically use their own generation to serve their load, that produces an instant 50 percent hedge financially. That reduces dependence on the spot market, a huge step in the right direction.

And I believe that if you look at what can be done in the forward market, you really do not need to contract 70 percent of the forward market. You only need to contract about another 25 to 30 percent to get the prices next year down to a more moderate level. It is very achievable, I think, for prices to be in the 7 to 8 cent range over the next two to three years in California with the combination of your proposal to allow the physical generation --

SECRETARY BOERGERS: Mr. Stout, can you conclude if you would?

MR. STOUT: Okay. The simple comment is, you can manage this problem and you can get started very quickly with the proposed order that you have. Thank you.

CHAIRMAN HOECKER: Thank you very much. Jan Schori of SMUD?

MS. SCHORI: Thank you, Mr. Chairman. I would like to make three points this afternoon, or maybe this

1 evening. First, I know that there is great diversity in the

viewpoints both among FERC staff members as well as the Commissioners. You have certainly heard from the diversity in California.

I would like to start by simply saying, though, thank you for publishing this draft Order, and please publish a final Order. We do need some certainty, some stability, and as difficult as it may be to reach a consensus and come to a final decision here, I encourage you to stick to the schedule that you have proposed and go ahead and get an Order out here. Because what does happen, as I am sure you are fully aware, all trading stops while these issues are being debated, so we do need to get some resolution to be able to move forward.

My second point is on the question of to cap or not to cap. And the answer I guess from the municipal perspective is that all of our rates, of course, are cost-based and passed through to our customers at the retail level.

We recognize -- we have filed the petition before the Commission asking you to reimpose cost-based rates, but we are all in search of a compromise, recognizing the diverse viewpoints.

So what I would like to recommend is that the Commission adopt an interim firm cap. However, we would

1 argue that that firm cap at a minimum must be load

differentiated. Because if you look at the off-peak market data, pricing data on the off peak, where there is no scarcity, you will discover in the Power Exchange market analysis reports, in the ISO Market Surveillance Committee reports, in the reports that you staff has put together, and in the report that we will happily be filing with my testimony, that we are seeing dramatic what we feel is exercise of market power that is not related -- pricing not related to the fundamentals in the market. It is not related to gas prices. It is not related to availability of units. It is not related to load. It is simply high prices, as you heard earlier from Mr. Fielder.

So the SMUD study as a matter of fact will show that the average clearing price in June and July is 200 percent over marginal cost in the off-peak hours, and in August it was 300 percent over the off-peak.

We recognize that gas and emissions or other significant variables that have been identified in your staff report, and we actually would endorse reviewing footnote 34. We would support the ISO Florio/number of other authors reimposing that cap, which was a firm cap that ranged from a low of around $65, $68 up to $250 to reflect all the different variables.

I also wanted to mention that from our

1 perspective, the soft cap isn't really even a cap, because

marketers are being allowed to bid higher. The filing requirement is not going to deter them with the kind of money that is available that is available to be made in the market. I refer the Commission to a quote that was contained in the November 2nd Wall Street Journal from the president of Dynegy, one of the earlier witness' companies, who said that they would be bidding power at twice the cost, reading their interpretation of what you mean by "opportunity cost" in addition to cost-based filings that would be required as a result of this soft cap exceedence that would be allowed in the future.

The third comment I would like to make is on the desire to incentivize new generation in transmission in the state. We are all interested in promoting that, but I think we have to stop and recognize it is not going to happen by the year 2001. So you need to do something to help us on the price side for next year, because we are in trouble for next year, and I think we are looking at an absolute maximum opportunity for the exercise of market power in 2001. So we do need some certainty for next year with regard to investment over the long term to ensure that we do build new generation and transmission.

I want to comment on the investment assumptions that are contained in both the staff report and referred to

1 in the Commission Order. We think that the investment

assumptions related to new generation are too short from a time perspective and too high from a cost of capital and price perspective.

The payback that is being used in the report is a five-year payback with a capacity factor of 33 percent. You need to recognize, these are 30- to 50-year resources. People have joked earlier that the plants that are operating today are even older than that. We have gone to at least two investment bankers in the last two days to try and get quotes on what it would take a merchant plant investment company to put together a deal. They are telling us, at least this week, it is a 40 percent equity deal. The term would be five to ten years right now, but that would consist of a balloon payment that they would fully expect to refinance at the end of either term.

I think the Commission, it is reasonable to take into account the fact that these plants are going to be here for 30 years or more. And if you run some other assumptions, for example, a 40 percent equity factor, 8.5 percent debt rate, 20 percent return on equity and a 30 percent capacity factor, we would come up with $95 a megawatt hour as a five year proposal, $71 if you financed it over 15 years.

I am going to go ahead and file with the

1 Commission as part of my written testimony a graph that

shows all the analysis that we have tried to do in this area.

I also would comment on emissions. Emissions, if you are out in the market trying to buy them on a trading basis right now, are high, and your staff report documents that. However, if you are licensing a new plant to be on line, you are not going to be able to get away with that, frankly. The U.S. Environmental Protection Agency won't let you and neither will the State Air Resources Board. You have to go ahead --

SECRETARY BOERGERS: Ms. Schori, could you conclude your remarks?

MS. SCHORI: Yes. You would have to go ahead and buy those emission offsets up front or design your plant so that it does not emit toxic pollution. It would be part of the capital cost. Thank you very much.

CHAIRMAN HOECKER: Thank you. And our last panelist is Stuart Ryan from AES Pacific.

MR. RYAN: Good evening. Thank you very much for your patience. Thank you everyone that is in the room for that matter for your patience for waiting to hear me. Given my place in the batting order, I am going to deviate substantially from my prepared comments.

First of all, the AES Corporation is in the

1 electricity business all over the world. AES Pacific is in

the generating business, and we are attempting to be in the retail electricity business in the Western part of the United States. I want to make four comments, and a couple of them build in some of the things my colleagues on the panel just mentioned.

The first one is going to be about market structure. The second one is going to be about current cost. The third one is going to be about future supply. My fourth comment will be about future demand.

First comment. Market structure. I think FERC nailed it with this order. You hit right on. The key thing is get rid of this buy/sell option. My feeling is that if we eliminate the buy/sell, what we are doing -- I mean, the key things about making these markets work are to maximize sellers, maximize buyers, maximize the number of markets or venues, and maximize the number of products. By eliminating the buy/sell we are going to see the development of additional markets. And frankly, that is very helpful.

And if I have additional markets that I can pursue, I am less -- I am not hung up about the price caps in the PX. I am not hung up about the Subject 2 language. Likewise for the buyers, it is like the supermarket. If you don't like the way the vegetables are being displayed at Kroeger, go to Safeway. That is what you are going to

1 foster by getting rid of the buy/sell and it is very

helpful.

Second point. Current cost. I think to the extent there is a smoking gun out here in California in this whole mess it has been overlooked. There is one. It is NOx. The costs of nitrogen oxide emissions credits in the Los Angeles basin have skyrocketed. More important than that, the way the program was designed is the number of credits available to generating units was based on historical capacity factors, and there was some ratcheting down to clean up the air in LA.

What has happened is these units that this year have been called on to run two and three times the amount of the capacity factors or baseline assumptions that went into the emissions, that whole program right now is stressed to the point of maybe even breaking. And so what we have is a situation with units that are in the LA Basin, do not have selective catalytic control on them yet, because they are scrambling to get it installed and it takes six months to a year, those units are seeing NOx costs that exceed the cost of fuel. The variable running cost for thousands of megawatts of generation is exceeding 10 cents a kilowatt hour.

What is happening is we have a tradeoff, a short-term tradeoff. Because in the long term, I do not think

1 trading the environment for economics, I do not believe in

that. I think clean air in LA is a good economic thing for the world in the long run.

In the near term, we have a tradeoff between air quality in LA and electricity prices in the Western United States. Nobody's got the guts to stand up and say that. You tell that to people and they go, oh, no. That is the worst rock and a hard place there is. Somebody has got to stand up and say that.

I think people will accept it in the short term. They will not in the long, and they should not. But short term, that is a tradeoff, and somebody has got to have the guts to say it.

Third point. Future supply. I just want to comment on something some of my colleagues said earlier, not on this panel but before that. Number of permits or megawatt-seeking permits does not equal megawatts of generation. A permit to build a plant is an option. It is not a power plant.

A number of people are seeking permits. They are seeking options as they should. Whether or not they invest capital and, you know, start putting steel up is a completely different question. So let's make sure we do not get confused by that.

Secondly, I have a poster child also. Our poster

1 child is a project we call Huntington Beach 3 and 4. It is

450 megawatts of mothballed capacity, capacity that was mothballed about five years ago in a plant we bought from Edison two and a half years ago. Physically, we could bring that 450 megawatts online by next summer with selective catalytic reduction, gas-fired generation. It is a poster child for two things. It is a poster child for can the environment permitting process accommodate a clean resource already there, no new stacks, no new interconnection, can we do it?

We have talked with everyone out there. It is very challenging. It is less than 50-50 that we can get through the regulatory and permitting gauntlet that is out there. And no mal intent on anybody. But it is less than 50-50 that we get it on the line. It is also a poster child for why I need a different market. That unit will not compete with Calpine's new high efficient resource five years from now. With all due respect, Jan, that plant will not have an economic life of more than five to eight years. It will have a physical life, but not an economic life, because it will be displaced.

But with your elimination of the buy/sell, I can go now to the -- I am confident there will be other markets like the bilateral that I can go to and make that business work, and I am comfortable. I am willing to bet on that.

1 Last point. Future demand. I think it is key

that we get more, as I said, more suppliers. We need more customers. I would take the large commercial industrial customers in California and kick them out of the nest. These guys have the sophistication. They have the tools. They have the intellectual capacity to hedge that. What we get them is a lot of players, putting hedges in places to make sense for their business, getting demand-side -- demand response makes sense for their business. Those things help those business and help the market as a whole. It has been referred to as core/non-core with respect to gas.

Thank you very much.

CHAIRMAN HOECKER: Thank you. Commission Breathitt, do you want to start with you?

COMMISSIONER BREATHITT: Sure. Mr. Ryan, kicking them out of the next is a snazzy sounding option, but what if rather than kicking them out of the nest -- I am assuming that that means something like requiring that the incumbent utility is no longer in the merchant business.

What if it became a so much more attractive than it is now for industrial customers to switch and they got kicked out of the nest because there were incentives and products available to them that they would voluntarily leave the nest? Do you see that happening now or do you see that -- what are the impediments to that?

MR. RYAN: Well, when I say -- and you are right.

Actually I don't usually get credit for snazzy phrases, so I will take that as a compliment. But what I mean by that is eliminate default service as an option for those customers. Now are there ways to do that without eliminating default service? I think there are. But inevitably, as long as default service option is out there, I believe we the government, we the people, are continuing to write a safety blanket or making a commitment to them that we are going to take care of you. And so we need to fundamentally disconnect that I think to sort of go all the way to making those customers feel like they have a responsibility to procure --

COMMISSIONER BREATHITT: On which class of customers are you recommending that?

MR. RYAN: I would do it just for the largest ones, those that are the most sophisticated, those that have the loads that are sufficient in size to justify the real-time metering that is in place. Somebody earlier spoke about the need for information. That information product is already out there. Real-time information about electricity prices, those products are out there for large customers.

And large customers are not necessarily unreceptive to this. Because the flip side of the thing is if they stay in the -- they retain a default service option,

1 if you think about separating the option from the flow of

electricity, the fact that the utility has written an option for a customer, that option in and of itself has a cost. Whether or not the utility is actually procuring electricity at any given time for that customer, if they have written them an option at the government's request, that option has a cost, because they have to think about the fact that that customer can come back at any time. And if that option cost ever gets sort of properly costed out, that large commercial industrial customer is not going to necessarily want to pay for that option. Right now it is all mushed in with the cost of electricity.

COMMISSIONER BREATHITT: Would you agree with me that that is a decision, though, for the state Commission?

MR. RYAN: Yes I would. I think you can't do much more than jawbone on that.

COMMISSIONER BREATHITT: The comment that we heard from several generators, John, that if the forward markets work and there is a lot more movement to them and a lot more energy transactions that occur in the forward market, we have heard several generators say that the price cap then for that small percentage in the real-time market becomes more and more irrelevant.

Do you agree with that?

MR. STOUT: Yes, I absolutely agree. When you

1 put more and more of your energy supply in the forward

market, it dilutes the impact of a price spike in the real-time market. PJM, for example, has only about 15 percent of energy supplied in the real-time, yet they have $1,000 price cap, and they don't seem to having the same sort of volatility at the blended retail rate that you get when you mix that with the forward contracts that they have and the incumbent utility generation that they have.

We went back and did a calculation of what would happen in San Diego if they had that 15 percent ratio back in June, it would have reduced the cost of energy for San Diego customers down to about 6.5 cents, as I recall. And that was with the high prices that you saw in the day-ahead and real-time markets.

COMMISSIONER BREATHITT: Jan, what are SMUD's plans for participating in the marketplace through the RTO?

MS. SCHORI: We are planning to participate. We are, to talk a little bit about what our overall strategy has been, I think SMUD is basically doing what the Commission is trying to authorize the IOUs to do. We went into year 2000 with about 75 percent of our expected load covered through long-term contracts and our own generation.

We got hit very, very hard this last summer. All the municipals in the state of California. We took the hardest hit. Overall we ended up with a budget impact of

about I think it is $82 million. About $16 million of that

was gas-related from our own cogen plants, and the balance was a purchase power hit, particularly in the off-peak power markets where the prices were so much higher than anyone I think had forecasted.

So I just sent my Board yesterday the budget letter for next year. We have gone ahead and hedged all the way up to 90 percent of our load with longer-term contracts. I will say the market is not liquid. The markets are reflective of what the marketers expect to be able to earn in the short market. The week that this order came out, no one would bid to us on three-year deals.

So I have some practical experience, and that is why I am encouraging you to go ahead and let's finalize what we are going to do, because it does create a big challenge.

But I think as the Commission knows, the California municipalities in another docket are engaged with one of your Administrative Law Judges in a settlement proceeding attempting to resolve the issues that remain with respect to municipal participation in the Independent System Operator. I don't want to sound cynical, but right now I am feeling happy I voted myself off the island. But we are willing to join in as we work through those issues.

I do want to make it very clear, though, for the

1 record that we have entered into operational agreements with

the ISO with respect to operation of our transmission assets to assure that the access is there, the transmission is available. What we are arguing about are cost-shifting issues.

COMMISSIONER BREATHITT: Mr. Manning, I wasn't here for your presentation, but you represent the LADWP and Mr. Freeman?

MR. MANNING: Yes.

COMMISSIONER BREATHITT: Do they have a -- would it be fair to characterize their view as very opposite from SMUD's view in terms of RTO participation?

MR. MANNING: I don't want to characterize their view today because I am not exactly sure what that view is today. I know in the past they have -- certainly they have not joined.

COMMISSIONER BREATHITT: Thank you.

CHAIRMAN HOECKER: Commissioner Massey?

COMMISSIONER MASSEY: Well, Mr. Manning, on behalf of Mr. Freeman, you have suggested a $100 soft cap rather than $150 soft cap. Do I have that right?

MR. MANNING: Yes, Commissioner.

COMMISSIONER MASSEY: Where did you come up with $100?

MR. MANNING: It is my understanding and LA's

1 view that that is closer to what the cost-of-service-based

rate would be. As I indicated in reading Mr. Freeman's statement, that the reason for the lower soft cap is that caps must be designed to achieve prices based on the cost of service plus a reasonable return.

COMMISSIONER MASSEY: So you figure that that would allow them to pay for NOx credits, pay for natural gas, recover -- that exceeds their marginal cost and provides them some kickout amount of money to pay down their capital cost?

MR. MANNING: I don't know what the entire analysis that was considered in arriving at the $100. But I can only assume from reading the statement that that was -- the $100 is much closer to what a cost-of-service-based rate would be plus a reasonable return than the $150 soft cap that the Commission's established.

COMMISSIONER MASSEY: Mr. Cunningham, long term, do you believe that your company will achieve better results with a market-based approach or cost-of-service regulation?

MR. CUNNINGHAM: Long-term, we believe the market-based approach is best, but I would have to say that short-term, we don't see our way through this without some cost-based help, at least for the next two years. We continue to hear what has been presented today, that the next 18 to 24 months are going to be extremely high priced,

1 and after that, there is an expectation of more reasonable

rates.

COMMISSIONER MASSEY: Is there no way you can protect yourself from those high prices?

MR. CUNNINGHAM: Yes. We could hedge it. And we are using a financial tool. We are looking at that. We are also discussing as a class of industrial customers with our utility a buy/sell opportunity where an industrial class group could go to market and buy physical power in a similar way over a long-term contract. Right now we do not have that option.

COMMISSIONER MASSEY: Mr. Stout and Mr. Ryan, what do you think about this concept of the Commission defining a forward contract product setting a price that is just and reasonable, fair price, and getting a buy-in from a state commission, and the product would be, say, for two years to provide some breathing room for the market? What do you think about that idea generally?

MR. STOUT: Well, I guess I would like to respond on that. That is actually somewhat consistent with the direction which we have been recommending that the market take, but a slightly different twist. And that is that you do not have to set a price, but rather have the Regulatory Commission in California determine a new benchmark price that any deal that you do at or below that price is an

1 acceptable deal. That gets us past this hurdle of not being

yet able to get approval on bilateral contracts until well down the road.

And by simply establishing a benchmark price, give the parties the opportunity to negotiate terms and conditions that are mutually beneficial that allow them to beat that price. So it accomplishes the same goal you are trying to do.

COMMISSIONER MASSEY: Mr. Ryan?

MR. RYAN: My belief is that if you eliminate the buy/sell, we are going to see the forward markets flourish.

So my first comment would be I do not think it is necessary.

The second comment would be, you know, that different assets would go to different markets or back to my supermarket analogy, you know, different shoppers would actually gravitate to different markets.

For example, a tired old plant that has 15-year-old gas turbines does not lend itself to forward contracting if you do not know from week to week if those turbines are going to stay on the line. That particular physical asset lends itself to a short-term time horizon, whereas say something that is new and you are confident with lends itself to a longer-term.

1 So I would be cautious that specifying a

particular contract length say for all different generating units might lead to suboptimum sales from particular units.

COMMISSIONER MASSEY: Let me shift gears just a moment. Mr. Ryan, you said that for a new generating unit, it may have an economic -- or a physical life for 40 or 50 years, but an economic life of 5 to 8 years. I don't understand what you mean by that.

MR. RYAN: Well, if you will allow me, I will use that Huntington Beach 3 and 4 restart idea as an example. Because that particular unit is about 30 years old, its heat rate or its efficiency is on the order of 10,000 Btu's per kilowatt hour, which is maybe 40 percent higher than what you could get with a new combined cycle plant. And also its minimum start times, you know, how quickly you can turn it on and turn it off, its minimum load if you want to keep it running but not turn it off would be higher than say some other plants.

And as a result, if this market improves in terms of having more suppliers and more customers as we are all hoping it does, that unit will become obsolete in the sense that it will not be able to compete, because its variable cost will be higher than the variable cost of the least-efficient resources still in the mix.

COMMISSIONER MASSEY: So you are assuming that

the price for energy in a good market will go down steadily, and this unit will be uneconomic over time?

MR. RYAN: Yes. In fact, unfortunately, we put our money where our mouth was on that point. We believe wholesale markets are going to drive wholesale electricity prices, drive down in real terms. We hedged for 20 years all of the 4,000 megawatts we purchased from Edison, and we have been hurt by the wholesale prices this year, like some of the others.

But the hard things about say a unit like we are talking about, Huntington Beach 3 and 4, is if we were to examine the costs or the prices that unit achieved -- let's say we get it on next year and it sells electricity for a certain price next year. In looking at whether or not those prices it receives are reasonable, you have to factor in what you think the prices are going to be in the future to determine whether or not that is a reasonable return say on our capital. It could be there is a scenario where we would do well next year but never get our capital back if prices drop a lot in the year after. Or it could be that we do very well if electricity prices stay high for some period of time.

So that makes figuring out what is a reasonable return sort of impossible without knowing the future in this

market-based scenario.

COMMISSIONER MASSEY: Mr. Stout, I understand that you do not like the price cap idea, that you would rather not have a price cap. But if there is to be a price cap, why does not a load-differentiated price cap or price cap based upon in some way on the cost of particular generators one that is more carefully designed, why doesn't that make more sense?

MR. STOUT: I guess the first comment I would make is that the units that are most heavily impacted by price caps are peaking units. And from a system operations standpoint, while you may think that peaking units are predictably needed just when loads are at peak levels, that is not really the case. You can need a peaking unit just as badly at 3:00 a.m. in the morning in the middle of a very low demand day in November simply because you have an unexpected generation contingency.

Load levels may be extremely low at that time, and under the load-differentiated price cap proposal that the CPUC, or I should say that the ISO Board voted on the other day, we would have only been able to get, by our calculations, about $52 a megawatt hour for a peaker at that particular point in time. The problem is, our peaker has a variable cost of over $300 a megawatt hour today. So those load-differentiated price caps can get you in a bad trap,

because you need those peakers at very odd hours.

COMMISSIONER MASSEY: If you are building a new, let's say combined cycle gas plant, over what period of time do you expect to recover the cost of that facility?

MR. STOUT: Well, if you are building a new base load plant, chances are you are looking at something on the order of 15 to 30 years.

It just depends on your particular company's economic expectations. But it is a fairly long timeframe for a combined cycle plant.

COMMISSIONER MASSEY: In our Order, we assumed a payback period of five years for a plant that was operating a third of the time. Does that strike you as generous or about right, or how do you look at that?

MR. STOUT: Well, really, I cannot give you a definitive answer on that.

I do worry a little bit about the fact that you assumed it runs a third of the time, because I think that capacity factor assumption is the most critical element of figuring out what the average cost of a megawatt hour is. Because when you amortize those fixed costs to the unit, you start getting some very high numbers very, very quickly.

COMMISSIONER MASSEY: I am very interested in any of you in your written comments providing additional

analysis on this question of if one is to use a price cap,

how do you set the number? I realize the generators would rather not have one, so it may be an issue on which you do not want to comment, but I would like you to. And Ms. Schori, you already commented on that question. And did you say you are going to submit additional information in writing?

MS. SCHORI: Yes. We intend to develop more complete tables than what I have today. So rather than giving you what I have right now, I will say I can give you one just kind of interesting quick take.

And that is for a plant that is operating and wants a five-year payback, if they are operating only 5 percent of the year, then the model we have got would show, with the underlying assumptions I gave you earlier, $349. So it is very high if you do not run it at all and you have to recover the entire plant cost over five years.

If you are running at 85 percent over five years, your price only needs to be $21 a megawatt hour, and you would recover all of your debt back in five years. So if you stretch it out longer -- I mean, these things are all related. It is how you operate it and what your financing cost is and what your expected rate of return is. That is all going to be relevant. So I will submit some more tables

on that.

COMMISSIONER MASSEY: It all depends on what your assumptions are --

MS. SCHORI: Exactly.

COMMISSIONER MASSEY: -- the assumption with respect to natural gas, NOx credits, payback period, operating cost and so forth.

MR. STOUT: If I could add one other quick comment.

The ability to make a plant run longer is not something that is within the control of the generator. That is a function of the load shape. And as long as the loads have the tendency to spike only for a few hours per year, you are going to constantly run up against this problem of peaking and not being able to properly amortize or fix costs with a heavy price cap.

CHAIRMAN HOECKER: Mike, LADWP had a lot of excess power sale into the market this summer, didn't it?

MR. MANNING: Mr. Chairman, I am not totally familiar with that situation, so I am not sure.

(Laughter.)

CHAIRMAN HOECKER: Didn't you sell that part of the power into the market at $100, which you seem to think is the J&R rate?

MR. MANNING: Again, I don't know what they sold

it in the market for.

CHAIRMAN HOECKER: Well, you are a retooled gas attorney like I am. And a J&R rate, you are recommending that the cap be $100. Is that -- or is Mr. Freeman recommending that that be like an ordinary J&R rate of four as well as -- I mean is that --

MR. MANNING: That would be -- you all have looked at a soft cap. That would be his recommendation in terms of a soft cap.

CHAIRMAN HOECKER: Well, we did not say that the $150 was the J&R rate. And that is the assumption you are working under.

MR. MANNING: I believe that in terms of Mr. Freeman's position, he very strongly supports cost-based rates plus the reasonable return. He believes in viewing the proposal that the Commission has come up with that the soft cap of $150 is too high. That a cap in the neighborhood as reflect in his statement of $100 is much closer to what the cost-based, cost-of-service rate would be.

CHAIRMAN HOECKER: Well, if LADWP has power to sell in the market next year -- maybe you can ask Mr. Freeman to put this in writing -- is he going to be offering it for sale in the forward markets?

Is he going to be offering it at a price of $100

or less, do you know?

MR. MANNING: I do not know at this time obviously. But it has certainly got to be in the transcript.

CHAIRMAN HOECKER: Just as Commissioner Breathitt asked Ms. Schori, what are LADWP's views of the RTO, especially given the fact that Mr. Freeman was the first president of it -- or the ISO rather?

What is the future of LADWP's transmission in this market?

MR. MANNING: I can't comment on that because I do not have that information.

CHAIRMAN HOECKER: Okay. I would very much appreciate it if you would pass my questions on to the company and get their views on it.

MR. MANNING: Mr. Chairman, I will be happy to.

CHAIRMAN HOECKER: Thanks, Mr. Manning.

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Mr. Cunningham, in our report we did take a look at the whole Western market, and I certainly very much appreciate your view and your understanding that these markets are all tied together, that what happens in California affects the Northwest, and vice versa.

Now we know why the buyers in California relied on the spot market so much, but why did your members in the Northwest choose to expose themselves to spot market prices rather than negotiate fixed price contracts?

MR. CUNNINGHAM: Similar to some of the comments made earlier, four-and-a-half years ago, it was thought that that was the advantageous place to be and the mid-Columbia Index was the means to represent the market, believing that competition was going to bring sufficient supply and fair prices.

CHAIRMAN HOECKER: Do you think that some of this price volatility that you were exposed to had something to do with the things that were happening elsewhere in the West, and not just in California, including the water year that was being experienced in your neck of the woods?

MR. CUNNINGHAM: I believe so.

CHAIRMAN HOECKER: Does anyone have any closing thoughts about what exactly this Commission ought to be doing?

1 I think, Mr. Ryan, you've made your, you know,

your pitch for the ultimate forward market solution here pretty clear.

Ms. Schori has, this is very interesting. Her view is that the $150 cap is no cap at all. We've heard today from other parties that the $150 cap is a hard cap, and that what seems, what this all seems to tell me is that, you know, where you stand on this issue depends on where you sit. It's a matter of market psychology.

And so I guess the question, probably for John Stout, but I think for everybody, is if in fact the problem we're dealing with here is at least in part attracting supply into this market over the summer and making sure that people up north, like Mr. Cunningham's members, are enjoying reasonable rates as well.

What should the Commission do, if anything, in terms of price mitigation?

LADWP recommends that we just set a just and reasonable rate of 100 bucks.

What kind of an effect does that have on the investment strategy of AES or Reliant or, for that matter, even public power?

MR. STOUT: Well, I guess I think the most important thing the Commission can do is to get certainty as to exactly what the future regulatory environment's going to

1 be. The uncertainty that has clouded the issue this summer

has gotten into a very volatile situation at this point.

I think it's the primary reason that people are pulling back from the generation projects they've planned. So even though we may not like a price cap, and we'd like to see it go away as quickly as possible, if you do impose one, we need to have some certainty as to when it does go away or when it does escalate upwards, I think is very important in order to get people to invest in the market.

CHAIRMAN HOECKER: Is the load differentiated price cap uncertain by its very nature, or -- you've supported that proposition but how do you view that as a mechanism?

MR. STOUT: Well I commented, just a second ago, to Commissioner Massey about a couple of the pitfalls of a load-differentiated price cap. I think it's a gold mine for base load generation. Obviously, if you've got a price cap of $100 a megawatt hour, but you have a unit that runs all year long, and typical those that have solid fuel or nuclear, they can make a lot of money in that market, but it is an absolute disaster for peaking units which I think is one of the more important elements of fixing the problem in California especially.

MR. RYAN: Yeah. My comments go again to as long as I believe you're going to foster, you know, more super

1 markets, or more market venues, and I think by your decision

to eliminate the buy/sell, that will follow from that, then I'm not deterred by whatever you do with price caps.

I mean I sort of have the third position. Jan says no price cap, and somebody else says it's hard. I say I don't care because I think additional venues will be out there to accommodate peaking units that have a different cost profile, bilateral being a classic situation for a peaking unit where you have a demand payment and an energy payment.

So as long as I think there are going to be other markets fostered through the Order, then --.

CHAIRMAN HOECKER: What do you think about that, John?

MR. STOUT: Well, I certainly agree that the more markets you have, the more opportunity there is for a person to extract the value that they're looking for.

But in the case of California, there are some significant limitations on being able to get the power out of the state. And to the extent that you only have a couple of large buyers in California, I think you do have in fact a limited bilateral market as well.

CHAIRMAN HOECKER: Jan?

MS. SCHORI: I can't agree with John's earlier comments on disincentive for peaking generation, even at

1 $100 cap, because if I look at my numbers, if I'm an

investor and I'm willing to carry this debt for 15 years with a 20 percent rate of return at $100, I break even if you run my plant ten percent of the year.

If you are willing to run my plant 15 percent of the year, then my cost with that debt is $68 a megawatt hour based on the analysis that we've done. So that means I'm making -- I can't do the math at this time -- more than $30 a megawatt hour extra money so I'm making a good rate of return, and the more you're willing to run the plant, the better the deal gets.

So I don't think the $100 megawatt hour is an unreasonable proposal, and I would argue that during off peak, why would you want to have a cap that's set on the cost of your peaking resources?

I haven't heard a good argument as to why off peak prices should be reflecting the price of peaking resources when there is no scarcity. That's the presumption of off peak is you're not facing a load crunch.

So I think this is a really serious issue to get a handle on, as what are the assumptions people are using about what will it take to bring new investment in power plants into California.

CHAIRMAN HOECKER: John?

MR. STOUT: If I could give a quick answer to

1 that.

Certainly those numbers don't surprise me. What surprises me is when you look at the load shake in California, and say how many megawatts actually run ten percent of the time and how many megawatts only run for half a percent of the time.

You'll find that the last ten percent of the generation in California during 1999 was only needed for 33 hours. That's far less than one percent of the time. That's a fairly significant number of megawatts. That's over 5,000 megawatts.

MR. RYAN: And peaking resources will do fine. They'll come in the state as long as there are bilateral opportunities for the providers of those resources and the buyers to get together.

CHAIRMAN HOECKER: Don, I think you had a question?

MR. GELINAS: Well, I think he touched on it. I think you touched on it, Jim. I had, in the last panel, asked the question, we went all over the place on the $150, what are we going to do immediately because we have to do something immediately, and I think you covered that.

But Stuart, I think right now you're my favorite generator. I only tell you that so that you can carefully craft your answer to my question.

(Laughter.)

MR. GELINAS: I'm hearing from you, and it is true that leaving the $150 break point aside, you know, you break the clearing price and you go as bid, and all of the data that we've got on that.

That is listed as only the third in a list of three mitigation measures in our Order, and it's listed as the third one, not the first and not the second.

And the first and second ones are eliminating the monopoly market that the PX had to the buy/sell requirement and therefore trying to foster forward markets and bilateral markets, and to get people out of the real time market and a scheduling problem.

And it was certainly a thought of ours that with those huge changes in market structure that switching to as-bid at 150 in the spot markets would not deter suppliers.

I'm hearing, at least from your perspective, that you can live with that and you might even be able to say we might even have gotten something right.

You don't have to go that far, but that would really make me feel good.

MR. RYAN: I think my comment -- I'll stick to that --

MR. GELINAS: Just stop.

MR. RYAN: I'll just add one more thing. Not

1 only will we see bilateral and forward. I think the people

who have complained about the second price auction as being inappropriate, somebody's going to come up with an outcry auction and that's going to be the force supermarket, so if you don't like the last bid, there's going to be a new supermarket that's an outcry.

And that's for everyone's good.

CHAIRMAN HOECKER: Other Staff questions or inquiries?

(No response.)

CHAIRMAN HOECKER: I think I've run out of gas. I want to thank this panel. Great presentations and we're going to conclude this hearing today, but I want to suggest a couple of things.

Some list of topics that I just want to repeat so that all the participants have a chance to contribute to the record.

First of all, I would like to -- and I didn't really get a chance to get into this -- but have the CPUC comment a little bit about its prudence policies, how we can cooperate with them to promote responsible forward markets that recognize lower prices by spreading risk over time and not get hung up in regulatory prudence hearings in creating the uncertainty that goes with that.

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You mentioned this morning that the generators needed to do a better job of getting their story out about what happened this summer, their variable costs, their opportunity costs in the West, what their margins were, what their commitments are to invest in the California market in the future.

I would like people to share their observations on what, in light of our proposed Order, the division, proper division is between California and this Commission when it comes to administering the bulk power markets, since it at least occurs to me that the division that was made by AB1890 has some flaws in it.

I would like to know clearly what people's views are in the refund issue, but more than that, our deliberately ambiguous reference to other forms of equitable relief, whether there is anything, whether we are talking rate discounts, contributions to the economic welfare of San Diego that does not exist within the confines of the Federal Power Act strictly read might be available.

I would like to have people's observations about the selection process for the ISO Board. And if there is to be state input, how we can get that without resurrecting the kind of influence on that Board -- on the current Stakeholder Board that has been disruptive and unfortunate.

1 If we do not have a soft cap or a benchmark,

whatever you call it, what is the alternative?

And if we do have a soft cap, what kinds of criteria, what kinds of evaluation do we do when bids are above that level?

The second is price auction. We really have not talked about that a whole lot today, but should we get rid of the whole thing? Certainly LADWP advocates that. But we have preserved it in part, and I do not know if that is a mistake or not.

And how do we move California, continue to move California into the Western regional market, assuming that there is going to be a lag in retail access in the states adjacent to California?

All of those questions appear to me to be deserving of some additional writing and thought, and I hope that people apply themselves to that.

Are there closing comments from my colleagues, or should we let these people go have dinner?

COMMISSIONER BREATHITT: I have two other items I would like to add to the Chairman's list.

One is:

Did we get it right when we picked seven as the number for the Board?

And the other one was -- I can't think of it.

1 That's okay.

CHAIRMAN HOECKER: You will get that in writing from the Commissioner, right?

(Laughter.)

CHAIRMAN HOECKER: Well, thank you very much. And we are adjourned.

(Whereupon, at 5:58 p.m. on Thursday, November 9, 2000, the hearing was adjourned.)

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