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**UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT**

**Nos. 03-74207, *et al.*,
(consolidated)**

**PUBLIC UTILITIES COMMISSION OF
THE STATE OF CALIFORNIA, *et al.*,
PETITIONERS,**

v.

**FEDERAL ENERGY REGULATORY COMMISSION,
RESPONDENT.**

**ON PETITION FOR REVIEW OF ORDERS OF THE
FEDERAL ENERGY REGULATORY COMMISSION**

**BRIEF OF RESPONDENT
FEDERAL ENERGY REGULATORY COMMISSION**

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**ON PETITION FOR REVIEW OF ORDERS OF THE
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**BRIEF OF RESPONDENT
FEDERAL ENERGY REGULATORY COMMISSION**

STATEMENT OF THE ISSUE

Whether the Commission reasonably denied complaints seeking to abrogate contracts, upon finding that Petitioners failed to meet the *Mobile-Sierra* public interest standard or to demonstrate any other grounds to justify abrogation.

STATUTORY AND REGULATORY PROVISIONS

The pertinent statutes and regulations are contained in the Addendum to this brief.

STATEMENT OF JURISDICTION

Respondent agrees with Petitioners' Statement of Jurisdiction.

STATEMENT OF THE CASE

I. Nature of the Case, Course of Proceedings, and Disposition Below

In 2001, the California Department of Water Resources ("CDWR") entered into long-term contracts to purchase energy. In 2002, the Public Utilities Commission of the State of California ("CPUC") and the California Electricity Oversight Board ("CEOB") (collectively "Petitioners"), filed complaints seeking to abrogate or modify CDWR's contracts. The complaints alleged that the contracts were unjust and unreasonable, or not in the public interest, because the sellers imposed the contract terms through the exercise of market power in violation of the Federal Power Act ("FPA"), 16 U.S.C. § 824, *et seq.*

Public Utils. Comm'n of the State of Cal. v. Sellers of Long Term Contracts, 99 FERC ¶ 61,087 (2002) ("April 25 Order"), found that certain challenged contracts expressly limited parties' rights to amend the contracts unilaterally under FPA § 205, 16 U.S.C. § 824d, or § 206, 16 U.S.C. § 824e, (as well as limited third party FPA § 206 rights), and, therefore, Petitioners would have to satisfy the *Mobile-Sierra*¹ public interest standard to justify the requested contract

¹ *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956) ("*Mobile*"); *FPC v. Sierra Pac. Power Co.*, 350 U.S. 348 (1956) ("*Sierra*") (collectively "*Mobile-Sierra*").

modification. The Order also set for hearing whether dysfunctional California spot markets adversely affected the long-term bilateral markets, and, if so, whether modification of any contract was warranted. Following a hearing, an Administrative Law Judge (“ALJ”) determined that the *Mobile-Sierra* doctrine also applied to the contracts without express *Mobile-Sierra* provisions. *Public Utils. Comm’n of the State of Cal. v. Sellers of Long Term Contracts*, 102 FERC ¶ 63,013 (2003) (“Partial Initial Decision”).

Public Utils. Comm’n of the State of Cal. v. Sellers of Long Term Contracts, 103 FERC ¶ 61,354 (2003) (“Order on Initial Decision”), affirmed the ALJ’s finding. The order also denied the complaints, finding that Petitioners did not meet their burden of proof to show the public interest justified modifying any of the contracts at issue.

Public Utils. Comm’n of the State of Cal. v. Sellers of Long Term Contracts, 105 FERC ¶ 61,182 (2003) (“Rehearing Order”), denied requests for rehearing, reaffirming the conclusion that the record did not support modification of the contracts.

II. Statement of Facts

A. Statutory and Regulatory Background

The FPA gives the Commission jurisdiction over the rates, terms and conditions of service for the transmission and sale at wholesale of electric energy

in interstate commerce. FPA § 206(a) provides that whenever the Commission, after a hearing had upon its own motion or upon complaint, finds a rate “unjust, unreasonable, unduly discriminatory or preferential, the Commission shall determine the just and reasonable rate to be thereafter in force. 16 U.S.C. § 824d(a). The Commission or the complainant has the burden of proof in any § 206 proceeding. 16 U.S.C. § 824d(b).

The *Mobile-Sierra* doctrine further constrains contract modification. Under *Mobile-Sierra*, where parties have negotiated a contract that sets fixed prices or dictates a specific method for computing charges, and denies either party the right to change such prices unilaterally, FERC may abrogate or modify the contract only if the public interest so requires. See *Texaco Inc. v. FERC*, 148 F.3d 1091, 1095 (D.C. Cir. 1998); *Metropolitan Edison Co. v. FERC*, 595 F.2d 851, 855 (D.C. Cir. 1979).

B. Events Leading Up to the Commission Orders

1. The Crisis In California Spot Markets²

In 1996, the California legislature restructured the power industry in California. See *In re: California Power Exchange Corp.*, 245 F.3d 1110, 1114 (9th

² Spot market sales are sales for services lasting 24 hours or less, entered into the day of or day prior to delivery. Forward contracts are supply contracts for future delivery of a fixed quantity of power at a predetermined price, directly negotiated between buyer and seller.

Cir. 2001) (“*CalPX*”). As part of the restructuring, California created the California Power Exchange Corporation (“CalPX”) and California Independent System Operator (“CAISO”). The CalPX administered a single-price auction for day-ahead and day-of electricity trading, determining a single market clearing price based on demand and supply bids. *See CalPX*, 245 F.2d at 1114. The CAISO operates the California transmission grid and administers a real-time imbalance market to ensure that supply meets demand at the time of delivery. *Id.* at 1115.

California required the three largest California investor-owned utilities (“IOUs”) to divest substantial portions of their generation facilities, and froze the IOUs’ retail rates. *See CalPX*, 245 F.3d at 1114-15. To promote the CalPX spot market, the IOUs were required to bid their generation into and buy their requirements from the CalPX, and all purchases from the CalPX were deemed to be “prudent per se” by the CPUC. *Id.*

In the summer of 2000, wholesale electricity prices in California increased significantly, particularly in the CalPX spot markets. *CalPX*, 245 F.3d at 1115. On July 26, 2000, the Commission instituted an investigation of the California bulk power markets. *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, 93 FERC ¶ 61,121 at 61,354 (2000) (“November 1 Order”). FERC staff identified three major factors contributing to the high prices. First, competitive market forces played a major role due to significantly increased power production

costs, combined with increased demand due to unusually high temperatures, and a scarcity of available generation resources. *Id.*

Second, “[m]any of the market dysfunctions in California and the exposure of California consumers to high prices can be traced directly to an over reliance on spot markets.” *Id.* at 61,359. Under the CPUC’s market rules, the IOUS were over-exposed to spot market volatility. *Id.* at 61,354. The IOUs were required to buy and sell through the CalPX. *Id.* Frozen retail rates meant demand did not slack as the price of power rose, thus allowing prices to rise well above competitive levels. *Id.* at 61,354-55. While both suppliers and customers prefer to manage risk through forward contracts because of spot market volatility, the CPUC’s market rules prevented the IOUs from engaging significantly in forward contracts. *Id.* at 61,359. The limitations on long-term contracting in favor of spot markets purchasing produced chronic underscheduling, turning the CAISO’s real-time imbalance energy market, with its high volatility, from a market of last resort into a significant source of supply. *CalPX*, 245 F.3d at 1116.

Third, evidence suggested that circumstances created an opportunity for sellers to exercise market power in the spot markets (where market power is defined as prices above short-run marginal cost) at certain times. November 1 Order at 61,355. However, insufficient data precluded a determination regarding whether market power was exercised by individual sellers. *Id.*

Thus, the flawed California market rules and structure, in conjunction with the imbalance of supply and demand, caused “unjust and unreasonable rates for short-term energy (Day-Ahead, Day-of, Ancillary Services and real-time energy sales) under certain conditions.” *Id.* at 61,349-50. However, FERC did not find that spot market volatility caused forward contract prices to be unreasonable. While “[s]ellers will certainly be aware that supplies of power are tight and that the IOUs are now aggressively seeking to avoid the exposure of the spot markets,” two factors offset sellers’ ability to take advantage. *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, 93 FERC ¶ 61,294 at 61,994 (2000) (“December 15 Order”). First, “suppliers . . . benefit from the stable revenue stream of forward markets and have every bit as much incentive to avoid the volatility of the spot markets as do purchasers.” *Id.*³ Second, “suppliers will bargain knowing that the spot market's size will be greatly reduced [by more forward purchasing] and that next summer's spot prices will therefore not be fueled by frenzied buyers whose over-reliance on last minute purchases have forced them to bid up the prices to obtain needed supply.” *Id.*

³ *See id.* n. 33 (“While suppliers clearly benefit on the upside of price volatility, the risks of price swings move in both directions. A supplier that relies exclusively on spot markets is exposed to the risk that, due to favorable weather or supply conditions, prices will be too low to cover its costs.”)

The December 15 Order also eliminated the CalPX buy-sell requirement, which led to chronic underscheduling, effectively transforming the CAISO from supplying imbalance services to administering a sizeable real-time energy market. *Id.* at 61,195. Because the CPUC refused to eliminate its requirement that the IOUs purchase in the CalPX spot market, the Commission was forced to terminate the CalPX tariff. *Cal PX*, 245 F.3d at 1117.

FERC's mitigation measures aimed at reducing the size of the CAISO's spot markets to "levels more reflective of appropriate risk management." *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, 95 FERC ¶ 61,418 at 62,546 (2001) ("June 19 Order"). The Commission, however, denied requests to extend market mitigation measures to the forward contract market because it did not find that the forward contract markets were flawed. *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, 97 FERC ¶ 61,275 at 62,245 (2001) ("December 19 Order").

2. CDWR Enters Into Long-term Bilateral Contracts

The retail rate freeze and the CPUC's discouragement of forward market purchases, combined with the volatile prices in the CAISO and CalPX spot markets, made it impossible for IOUs to meet their "net short" requirements, that is, the difference between the total demand for power and the amount of power the IOUs could supply. In early 2001, Assembly Bill 1 of the 2001-2002 First

Extraordinary Session (“AB 1X”) was passed, authorizing CDWR to purchase, mostly through long-term contracts, the net short requirements of the IOUs. Order on Initial Decision ¶¶ 43, 47, Excerpts of Record (“ER”) 617-19.

CDWR assembled a highly sophisticated procurement team for its purchasing efforts. *Id.* ¶ 46, ER618. Following two Requests for Bids for Energy Purchase (“RFB”), CDWR received a total of 213 offers, and shortly was able to assemble approximately 41 commitments, totaling approximately \$43 billion. *Id.* ¶ 49, ER619-20. This competition reflected CDWR’s position as the largest creditworthy bulk buyer in California, and was heightened by threats of adverse publicity from the Governor’s Office if sellers failed to deal. *Id.* ¶ 53, ER621-22. Thus, CDWR was the single purchaser in the California market with real bargaining power, *id.* ¶ 52, ER621, who obtained many concessions from sellers, including immediate and/or near-term sales at below-market prices, *id.* ¶ 54, ER622. Contemporaneous statements made by CDWR and the Governor of California indicate that they fully supported the price, terms and conditions of CDWR’s contracts. *Id.* ¶ 50, ER620.

3. The Commission Denies Refunds for CDWR Contracts

In accordance with FPA § 206, the Commission made all sellers in the CAISO and CalPX spot markets during the relevant period subject to refund

liability.⁴ *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, 96 FERC ¶ 61,120 at 61,511 (2001). Refund liability was denied for the CDWR contracts, however, because as long-term contracts they were “distinctly beyond the realm of ISO and PX centralized market operations that have been the subject of this proceeding since its inception.” December 19 Order, 97 FERC at 62,195. Thus, while FERC found that “flaws in the rules and policies of the CalPX (as well as the CAISO) contributed to unjust and unreasonable short-term electricity rates under certain conditions,” *CalPX*, 245 F.3d at 1123 (citing November 1 Order, 93 FERC at 61,358), no similar finding was made regarding the long-term bilateral contract market.

C. The Challenged Orders

On February 25, 2002, the CPUC and the CEOB filed complaints seeking reformation of CDWR’s 2001 long-term contracts, alleging the contracts were unjust and unreasonable, or not in the public interest, due to the dysfunctions in the California spot markets. April 25 Order, ER11-12. The Commission dismissed the claims regarding CDWR contracts executed after FERC instituted market mitigation measures that stabilized spot market prices. April 25 Order, ER25 (affirmed in *Public Utils. Comm’n of the State of Cal. v. Sellers of Long Term*

⁴ The refund period generally is from October 2, 2000 until June 20, 2001. December 19 Order, 97 FERC at 62,171.

Contracts, 100 FERC ¶ 61,098 (2002) (“July 23 Order”) ¶ 21, ER47). The Commission set the remaining contracts for hearing on the issue of “whether the dysfunctional California spot markets adversely affected the long-term bilateral markets, and, if so, whether modification of any individual contract at issue is warranted.” April 25 Order, ER26.

Also at issue was whether the standard applicable to the complaints would be the just and reasonable or *Mobile-Sierra* public interest. Under *Mobile-Sierra*, where parties contract for a particular rate and do not reserve their rights unilaterally to propose a rate change, FERC cannot supersede that rate unless required by the public interest. Order on Initial Decision ¶ 4, ER602-03 (citing *Boston Edison Co. v. FERC*, 233 F.3d 60, 64-65 (1st. Cir. 2000)). While certain CDWR contracts contained provisions explicitly invoking the *Mobile-Sierra* standard, others did not, and the record was insufficient to determine the parties’ intent, necessitating a hearing. April 25 Order, ER 24.

After the hearing, the ALJ found that the contracting parties did not, nor did they intend to, preserve their rights to apply unilaterally for contract modification. Partial Initial Decision ¶ 43; *id.* at ¶ 45. FERC affirmed, ruling the public interest standard applies to all the contracts at issue. Order On Initial Decision ¶ 3, ER602.

The Commission then denied Petitioners’ complaints, finding that Petitioners did not satisfy the public interest burden of proof. *Id.* As Petitioners

largely focused on attempting to demonstrate that the contracts were unjust and unreasonable, Petitioners presented little evidence relevant to the public interest standard. *Id.* ¶ 39, ER616. Petitioners failed to demonstrate that the contracts caused financial distress for the Petitioners (or others they represent), threatening their ability to continue service; cast an excessive burden on customers; were unduly discriminatory; and also failed to present any other basis to find them contrary to the public interest. *Id.* ¶¶ 8, 39, ER605, 616.

In particular, the Commission found no evidence of market manipulation *specific to* these long-term contract negotiations, or of unfairness, bad faith, or duress. *Id.* ¶ 61-62, ER 624-25. In fact, extensive evidence showed CDWR had bargaining power during the negotiations, *id.* ¶¶ 42-60, ER617-24, that allowed it to acquire a portfolio with a weighted average price no higher than \$70/MWh, the average cost of energy supply reflected in IOUs' retail rates as of January 2001. *Id.* ¶ 40, ER 616-17. No evidence showed that the contracts were priced above long-run competitive prices, or were unduly discriminatory or preferential. *Id.* ¶ 40-41, ER 616-17. That left dissatisfaction with the bargain as Petitioners' only basis for contract modification, which is insufficient for reformation under the public interest standard. *Id.* ¶¶ 8, 62, ER605, 624-25.

On rehearing the Commission rejected Petitioners' assertions that dysfunction in the spot markets caused the rates in these long-term contracts to be

unjust and unreasonable from the outset and, that, therefore, the FPA's just and reasonable standard of review, rather than the *Mobile-Sierra* public interest standard, should apply. Rehearing Order ¶ 39, ER731. Not only was this assertion factually unsupported, but also a party to a *Mobile-Sierra* contract cannot avoid its public interest burden by claiming the rates were not just and reasonable at execution absent a showing of fraudulent inducement. *Id.*

Further, FERC's prior approval of the sellers' market-based rate authority meant sellers lawfully entered into these contracts. *Id.* ¶ 34, ER729. A showing that the seller lacks or has mitigated market power in the relevant market satisfies the FPA § 205 requirement that its sales at market-based rates will be just and reasonable.⁵ The grant of market-based rate authority is the analog to the initial review of rates in the cost-based rate context, and analyzes, not the particular prices agreed to by willing buyers and sellers, but whether the seller lacks or has mitigated market power so that its prices will be competitive, and thus fall within a zone of reasonableness. *Id.* ¶ 35, ER729.

The Commission also rejected arguments that, to protect the rights of third parties, California electric ratepayers, the just and reasonable standard, or at least a more flexible public interest standard, should apply. *Id.* ¶ 50, ER735-36.

⁵ *Id.* (citing *Louisiana Energy and Power Auth. v. FERC*, 141 F.3d 364, 365 (D.C. Cir. 1998); *Elizabethtown Gas Co. v. FERC*, 10 F.3d 866, 870 (D.C. Cir. 1993)).

Commission and court precedent does not support non-signatory challenges to a *Mobile-Sierra* contract under the just and reasonable, as opposed to the public interest, standard. *Id.* Likewise, even if protection of third parties allowed a more flexible public interest standard, Petitioners failed to show the contracts at issue imposed an excessive burden on California's ratepayers. *Id.*

Petitioners also asserted that the *Mobile-Sierra* public interest standard did not apply here because, purportedly, they should be considered third parties as CDWR, not they, executed the contracts. *Id.* ¶ 51, ER736. As California, through CDWR, was a party to the contracts, Petitioners, who are also agents of California, stepped into the shoes of CDWR for these purposes. *Id.*

The Commission also rejected the argument that the *Mobile-Sierra* doctrine applies only where a regulated utility is challenging a contract with rates that are allegedly too low; courts have applied the *Mobile-Sierra* doctrine to contracts containing rates that allegedly were too high. *Id.* ¶ 56, ER738-39 (citing *Public Serv. Comm'n of the State of N.Y. v. FPC*, 543 F.2d 757 (D.C. Cir. 1974) (“*PSCNY*”); *Potomac Elec. Power Co. v. FERC*, 210 F.3d 403 (D.C. Cir. 2000) (“*PEPCO*”)).

The Commission found Petitioners failed to produce evidence to meet their public interest burden either based on the three-part *Sierra* test or any other factors that would justify modifying the contracts. *Id.* ¶ 57, ER739. None of the *Sierra*

factors--whether the rate might impair the ability of the public utility to continue service, cast upon other consumers an excessive burden, or be unduly discriminatory--are present here, and the Commission considered the totality of the circumstances preceding and following contract execution and found that none justified contract modification. *Id.* ¶ 59, ER740.

Petitioners' claimed demonstration of bad faith, unfairness and duress based on spot market dysfunction was insufficient because, even if true, it does not show bad faith, unfairness or duress by any sellers in their negotiations with CDWR. *Id.* ¶ 86, ER750-51. Further, the Commission found no evidence of fraud, duress, or the exercise of market power at the contract formation stage. *Id.* ¶ 60, ER740-41. Finally, no evidence showed market manipulation specific to the long-term contract negotiations resulting in the prices and terms challenged here. *Id.* ¶ 65, ER743-44.

Petitioners' allegation that the contract rates exceed those currently available in today's markets, even if true, did not establish that the contract rates are contrary to the public interest. *Id.* ¶ 64, ER742-43. Commission precedent "makes clear that the fact that a contract has become uneconomic to one of the parties does not necessarily render the contract contrary to the public interest." *Id.* (citing *PEPCO*, 210 F.3d at 409). Even if the contract rates at issue will be passed through entirely

to ultimate customers, Petitioners failed to show that would be contrary to the public interest. *Id.*

Furthermore, Petitioners based their allegations that the contract prices are 33-60% in excess of the just and reasonable rate upon forward price curves, which the Commission rejected as an appropriate benchmark for just and reasonable rates. *Id.* ¶¶ 82-83, ER749. The Commission Staff Report, moreover, did not, contrary to Petitioners' assertion, find that forward prices in the 1-2 year class of contracts were unjust and unreasonable as a result of spot market dysfunction, but eschewed any findings regarding the justness and reasonableness of any contract rates. *Id.* In any event, such findings would not be relevant here because the just and reasonable standard is not applicable. *Id.* In short, nothing shows the contracts in question cast an excessive burden on customers. *Id.* ¶ 82, ER 749.

Petitioners objected to the ALJ's exclusion of evidence of spot market manipulation, which the Commission upheld. *Id.* ¶ 100, ER755-56. Additionally, Petitioners had the opportunity to present evidence adduced in the 100-Day Discovery Proceeding,⁶ in which parties conducted broad discovery into market manipulation during the western power crisis of 2000 and 2001, thus nullifying Petitioners' complaint of no opportunity to do so here. Rehearing Order ¶ 100,

⁶ *San Diego Gas & Elec. Co. v. Sellers of Energy and Ancillary Servs.*, 101 FERC ¶ 61,186 (2002).

ER755-56. Although Petitioners never pointed to or discussed any particular evidence from that proceeding, the Commission, in making its determination in this case, considered all of the evidence submitted in that proceeding, *id.* ¶ 101, ER756, and assumed it to be true, *id.* ¶ 86, ER750.

SUMMARY OF ARGUMENT

In 2001, CDWR was charged with procuring long-term energy contracts, on behalf of California ratepayers, on such terms and at such prices as CDWR deemed appropriate. Subsequently, Petitioners CPUC and CEOB filed complaints urging FERC to modify or abrogate the CDWR contracts because they were “tainted” by the dysfunctions in the California spot markets. In a finding unchallenged on appeal, the Commission ruled that the parties intended the CDWR contracts to be subject to the *Mobile-Sierra* public interest standard for contract modification. Petitioners thus bore the burden to demonstrate that the contract rates are contrary to the public interest.

Petitioners and Intervenors assert that *Mobile-Sierra* standard does not apply because these contract challenges are brought by nonparties to the contracts or involve contracts not previously approved by FERC. The caselaw does not support either contention and, in any event, neither circumstance is present here. CDWR entered into these contracts as the representative of the State of California, with a charge to contract for rates that it determined were just and reasonable for California ratepayers. This charge effectively removed any authority of the CPUC or CEOB to determine the justness and reasonableness of these contracts. As California charged CDWR with assuring that protection, and CDWR, consistent with that charge, agreed to these contracts, including the *Mobile-Sierra* provisions,

on behalf of the State, the State cannot, by filing a complaint through Petitioners, escape its prior assessment that these contracts, as executed, protected California ratepayers.

The prior approval of market-based rate authority to these sellers constitutes an initial finding that the resulting contractual rates will be just and reasonable, and therefore these contracts are not reviewed for the first time. The Commission's market-based rate authority analysis is fully consonant with its FPA rate obligations and supported by precedent.

Petitioners failed to adduce credible evidence to show that the contracts are contrary to the public interest. Petitioners' allegations that the contracts were 33-60% in excess of a just and reasonable price, leading to an alleged "dysfunction premium" of some \$1.4 billion, were unsupported in the record. To the contrary, the record showed that CDWR's portfolio yielded a weighted average price no higher than \$70/MWh, which was the average cost of energy supply reflected in the retail rates paid by California consumers prior to the energy crisis, which means there was no rate impact on California ratepayers. In fact, through its superior bargaining power, CDWR was able to contract for immediate and/or near-term sales at below-market prices, at a time when energy was critically needed.

Petitioners failed to prove that the contracts were priced above long-run competitive prices. The Commission rejected Petitioners' baseline, created from

published and seller-created forward price curves, finding that such curves constantly change based upon undisclosed assumptions that cannot be evaluated and, therefore, they were inappropriate benchmarks of what a just and reasonable rate would be. Even if Petitioners had shown that the contract rates exceed current competitive prices, that would not establish that the contract rates are unjust and unreasonable, or contrary to the public interest. The fact that a contract has become uneconomic to one of the parties does not establish that the contract is contrary to the public interest.

Petitioners ask the Court to assume, as a matter of “basic economics,” that showing dysfunctions in the spot markets translates to adverse impact on the long-term contract market. The Commission rejected this proffered link. As the Commission saw it, spot market volatility and pricing differ from those in long-term contract markets. Suppliers and purchasers benefit from the stability of forward markets, and have incentive to avoid the volatility of the spot markets. Due to considerable efforts to increase forward purchases, suppliers knew that the 2000-01 spot market's size would not be repeated.

Contrary to Petitioners’ assertions, Commission staff did not conclude that prices for long-term contracts were substantially inflated by dysfunction in California’s spot markets. Although staff concluded that forward contracts negotiated during 2000-01 in the western United States, particularly those for one

to two years, were influenced by then-current spot prices, staff made no findings regarding whether this influence caused unjust and unreasonable forward contract prices. Even if a finding had been made that dysfunctions in the spot markets caused forward bilateral prices to be unjust and unreasonable, that would only satisfy the just and reasonable standard, not the controlling public interest standard.

Petitioners also failed to substantiate their claims that CDWR's contracts were the product of bad faith, unfairness or duress. The caselaw is clear that contract abrogation under *Mobile-Sierra* requires findings that directly link the challenged contract to its impact on the public interest. Even assuming the allegations of manipulation in the spot markets to be true, Petitioners did not link that to the negotiations of the instant contracts. While Petitioners contend that a generic public interest finding can be made based upon the spot market dysfunctions, generic *Mobile-Sierra* public interest findings can be made only in extraordinary circumstances where all the contracts in a class are affected in the same way. No such showing was made here, and, contrary to Petitioners' suggestion, it cannot be assumed that alleged manipulation in the spot markets would affect identically, or indeed, at all, the long-term contracts at issue. Quite the opposite, the record showed that CDWR, as the largest credit-worthy bulk buyer in California, had considerable bargaining power over sellers, and contemporaneous statements by CDWR and the Governor fully supported the

contracts' terms. Accordingly, Petitioners failed to meet their burden of showing that modification of the challenged contracts was required by the public interest.

The Commission did not improperly constrain the record, but rather set for hearing the issue of whether the dysfunctional California spot markets adversely affected the long-term bilateral markets, and, if so, whether contract modifications were warranted. Petitioners had, moreover, the opportunity to present evidence adduced in the so-called 100-Day Discovery Proceeding, in which they participated. For purposes of this proceeding, the Commission assumed as true the evidence of spot-market manipulation elicited in that proceeding, as well as the evidence from the Staff Report.

The Commission dismissed Petitioners' complaint concerning a Pacificorp contract executed *after* price mitigation measures had stabilized the spot markets as facially deficient. While Petitioners now assert that the Pacificorp contract was priced in excess of a competitive level, and had never been subject to Commission review, neither contention is supported. Petitioners' proffered forward curve analysis evidence was rejected as discussed above, and, in any event, showing that long-term contract rates currently exceed a competitive level does not demonstrate the contract was contrary to the public interest. Similarly, Petitioners' argument that the contract has never been reviewed fails to take into account, as discussed above, the Commission's approval of Pacificorp's market-based rate authority.

ARGUMENT

I. STANDARD OF REVIEW

The Court's review of FERC's interpretation of the FPA is governed by *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984). *Chevron* requires a court to “decide (1) whether the statute unambiguously forbids the Agency interpretation, and, if not, (2) whether the interpretation, for other reasons, exceeds the bounds of the permissible.” *Barnhart v. Walton*, 535 U.S. 212, 218 (2002).

Deference is owed to the agency's reasonable interpretation of an ambiguous statutory provision intended by Congress to be left to the agency's discretion. *Dillingham v. INS*, 267 F.3d 996, 1005 (9th Cir. 2001); *see also City of Seattle v. FERC*, 923 F.2d 713, 715 (9th Cir. 1991) (court generally shows "great deference" to the Commission's interpretation of the law it administers). Likewise, the Commission's reasonable interpretation of its own orders will be upheld. *Mid-Continent Area Power Pool v. FERC*, 305 F.3d 780, 783 (8th Cir. 2002) ("We must give deference to the Commission's interpretation of its own orders."); *Texaco*, 148 F.3d at 1099.

The Commission's factual findings are conclusive if supported by substantial evidence. FPA § 313(b), 16 U.S.C. §825l(b). Substantial evidence “means such relevant evidence as a reasonable mind might accept as adequate to support a

conclusion. If the evidence is susceptible of more than one rational interpretation, [the Court] must uphold [FERC's] findings.” *Bear Lake Watch, Inc. v. FERC*, 324 F.3d 1071, 1076 (9th Cir. 2003) (quoting *Eichler v. SEC*, 757 F.2d 1066, 1069 (9th Cir. 1985)). The Court likewise defers to the Commission on questions of methodology and evaluating competing expert opinions. *Id.* at 1077. “It is the Commission’s function to reach conclusions on conflicting engineering and economic issues so long as its judgment is reasonable and based on the evidence.” *Sierra Pac. Power Co. v. FERC*, 793 F.2d 1086, 1088 (9th Cir. 1986).

II. PETITIONERS’ COMPLAINTS WERE PROPERLY DENIED FOR FAILURE TO SHOW THAT THE PUBLIC INTEREST REQUIRED CONTRACT MODIFICATION.

In 2001, CDWR was charged with procuring, on behalf of California ratepayers, long-term power contracts, “on such terms and for such periods as the department determines and at such prices the department deems appropriate . . .” Cal. Water Code § 80100. In the challenged contracts, CDWR either expressly agreed that the contract could be modified only in accordance with *Mobile-Sierra*, see April 25 Order at 61,383, or the Commission found after hearing that the parties intended *Mobile-Sierra* to apply,⁷ Partial Initial Decision ¶ 43; Order On

⁷ Parties to a contract may expressly agree that a contract can be changed either unilaterally or by FERC under the just and reasonable standard. See *United Gas Pipe Line Co. v. Memphis Light, Gas & Water Division*, 358 U.S. 103 (1958). Absent express agreement, the contract may be modified only if the requisite public interest finding is made. “The law is quite clear: absent contractual

Initial Decision ¶ 38, ER616, a finding not challenged on appeal. Under *Mobile-Sierra*, a contract that sets firm prices or dictates a specific method for computing charges and that denies either party the right to change such prices unilaterally, may not be abrogated or modified unless required by the public interest. See *Texaco*, 148 F.3d at 1095; *Metropolitan Edison*, 595 F.2d at 855. The complainant bears the burden of demonstrating that the public interest requires a change. Rehearing Order ¶ 33, ER728.

Petitioners complained under FPA § 206, urging modification of CDWR's contracts because they were "tainted" by the dysfunctions in the California spot markets. See ER4-5; ER9. Petitioners failed to adduce credible record evidence that the contracts were contrary to the public interest. Order On Initial Decision ¶ 39, ER616; Rehearing Order ¶ 81, ER749. Although Petitioners alleged CDWR's contracts unduly burdened California ratepayers with rates 33-60% higher than what Petitioners claimed just and reasonable rates would be -- resulting in an alleged "dysfunction premium" of some \$1.4 billion -- support for this allegation was lacking. Rehearing Order ¶ 82, ER749. Petitioners failed even to substantiate their claims that the contracts were priced above long-run competitive prices, or

language 'susceptible to the construction that the rate may be altered while the contract [] subsists,' the *Mobile-Sierra* doctrine applies." *Texaco*, 148 F.3d at 1096 (quoting *Appalachian Power Co. v. FPC*, 529 F.2d 342, 348 (D.C. Cir. 1976)).

that spot market dysfunctions caused unjust and unreasonable rates in the forward contract market. *Id.* ¶ 83, ER749. Petitioners relied on extrapolations from published and seller-generated forward price curves as a just and reasonable benchmark. This was rejected because the forward price curves were based on undisclosed assumptions that cannot be properly evaluated as evidence of what future just and reasonable rates would be. *Id.* ¶ 41, ER732.

To the contrary, evidence showed that CDWR achieved its objective of a contract portfolio yielding a weighted average price no higher than \$70/MWh, which was the average cost of energy supply already reflected in the retail rates paid by California customers. Order on Initial Decision ¶ 40, ER616. Thus, this evidence showed no rate impact on California ratepayers. CDWR's superior bargaining power as the largest creditworthy purchaser in California enabled it to contract for immediate and/or near-term sales at below market prices, at a time when energy was critically needed. Rehearing Order ¶¶ 75-76, ER747. In any event, even if Petitioners had succeeded in showing that these contract rates were unjust and unreasonable, that still would not satisfy the *Mobile-Sierra* standard. Order on Initial Decision ¶ 37, ER615.

On this latter point, Petitioners failed to substantiate their claims that manipulation in the spot market meant that the instant contracts were the product of bad faith, unfairness or duress. Petitioners failed to show a link between

findings related to the spot markets and what actually occurred in the contract negotiations at issue here, and did not independently show bad faith, unfairness or duress by any seller in the negotiations of these contracts. Rehearing Order ¶ 86, ER750. The record showed that CDWR, as the largest, creditworthy bulk buyer in California, had “a great deal of bargaining power over sellers of long-term contracts.” Order on Initial Decision ¶ 53, ER621. In addition, contemporaneous statements by CDWR and the Governor indicate that they fully supported the price, terms and conditions at the time the contracts were executed. *Id.* ¶ 50, ER620. Accordingly, Petitioners failed to meet their burden of showing that modification was required in the public interest. Rehearing Order, ¶ 2, ER716.

Notwithstanding that CDWR agreed, as California’s agent, that the *Mobile-Sierra* standard would apply, Petitioners and Intervenors⁸ now contend the *Mobile-Sierra* standard should not apply. Further, Petitioners challenge certain of the Commission’s evidentiary rulings. These contentions have no merit.

A. The Commission Properly Applied The Agreed-Upon *Mobile-Sierra* Public Interest Standard.

Mobile-Sierra balances assuring stability of supply arrangements by preserving contract integrity, which is essential to properly functioning energy

⁸ Intervenors are Public Utility District No. 1 of Snohomish County, Washington, Nevada Power Company, Sierra Pacific Power Company, and Southern California Water Company.

markets, with the “paramount power of the Commission to modify [contracts] when necessary in the public interest.” *Mobile*, 350 U.S. at 344. *Sierra* limited the Commission’s power under FPA § 206 to remedy unjust and unreasonable rates in a *Mobile-Sierra* contract to protection of public, not private, interests. 350 U.S. at 354-55. Where a utility has agreed to what proves to be an improvident bargain, “the sole concern of the Commission would seem to be whether the rate is so low as to adversely affect the public interest – as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory.” *Id.* at 355. *See* Rehearing Order ¶ 33, ER729. Petitioners have the burden to demonstrate that the contract rates are contrary to the public interest. *Id.*

1. The *Mobile-Sierra* Public Interest Standard Applies To All Challenges To The Contract.

Mobile-Sierra thus allows “contracting parties to determine for themselves whether and under what conditions rates may be altered – subject, of course, to the overriding regulatory power of the Commission to adjust rates in the public interest.” *City of Oglesby v. FERC*, 610 F.2d 897, 902 (D.C. Cir. 1979). Here, Petitioners and Intervenors do not dispute that CDWR agreed to be bound by the *Mobile-Sierra* standard. Partial Initial Decision ¶ 43; Order On Initial Decision ¶ 38, ER616.

Notwithstanding CDWR's agreement, Petitioners and Intervenors claim *Mobile-Sierra* only binds the parties to the contract, and Petitioners are not parties to the contract. Pet. Br. at 45-52; Intvr. Br. at 46-51. Intervenors further argue that *Mobile-Sierra* is limited to its "specific facts," Intvr. Br. 39, *i.e.*, cases where utilities unilaterally seek to *increase* contract rates, *id.* 37-38. The Commission properly determined that *Mobile-Sierra* applies to all challenges to the contract. Rehearing Order ¶ 50, ER735; ¶ 56, ER738-39.

Neither Court nor Commission precedent support the right of a non-signatory party to challenge a *Mobile-Sierra* contract under the just and reasonable, as opposed to public interest, standard. *Id.* ¶ 50, ER735. In fact, the First Circuit reversed orders reaching that conclusion. *Northeast Utils. Serv. Co.*, 50 FERC ¶ 61,266 at 61,838 (1990), held that a nonparty challenging a *Mobile-Sierra* contract under FPA § 206 need only show that the rate is unjust and unreasonable. The Commission also found that, even if the public interest standard applied, it had authority "to modify a contract where: it may be unjust, unreasonable, unduly discriminatory or preferential to the detriment of purchasers that are not parties to the contract." *Id.* at 61,839. The Commission then modified the contract upon finding it unjust and unreasonable.

Northeast Utils. Serv. Co. v. FERC, 993 F.2d 937, 961 (1st Cir. 1993) ("*Northeast Utilities I*"), ruled that the Commission improperly conflated the "just

and reasonable” and “public interest” standards. “The distinction between the ‘just and reasonable’ and ‘public interest’ standards loses its meaning entirely if the Commission may modify a contract under the public interest standard where it finds the contract ‘may be unjust [or] unreasonable.’ The parties’ express intent was to avoid review of rate schedules under the just and reasonable standard. *Mobile-Sierra* protects their right to do so, leaving the Commission with the power to modify rates only when required by the public interest.” *Id.* While the *Mobile-Sierra* doctrine “allows for intervention by FERC where it is shown that the interests of third parties are threatened,” the standard to be applied “as formulated by the Supreme Court, is the protection of outside parties from ‘undu[e] discriminat[ion]’ or imposition of an ‘excessive burden.’” *Id.* (quoting *Sierra*, 350 U.S. at 355). In evaluating the contract at issue, “the Commission was bound to follow the *Mobile-Sierra* doctrine as explicated by *Papago* [*Tribal Authority v. FERC*, 723 F.2d 950 (D.C. Cir. 1983)], and therefore should have evaluated the [contract] under the public interest standard, not the just and reasonable standard.” *Id.* at 962.

On remand, the Commission applied the public interest standard, following *Papago*. *Northeast Utils. Serv. Co.*, 66 FERC ¶ 61,332 at 62,081, 62,085, *reh’g denied*, 68 FERC ¶ 61,041 (1994). Although *Papago* found the public interest standard to be “practically insurmountable,” 723 F.2d at 954, the Commission

concluded that the *Mobile-Sierra* doctrine cannot impose a “practically insurmountable” standard for initial review of a contract, particularly a contract not negotiated at arms-length. *Id.* at 62,086-87. The First Circuit affirmed, finding that “[w]e do not think that *Papago*, read in context, means that the ‘public interest’ standard is practically insurmountable in all circumstances. It all depends on whose ox is gored and how the public interest is affected.” *Northeast Utils. Serv. Co. v. FERC*, 55 F.3d 686, 691 (1st Cir. 1995) (“*Northeast Utilities IP*”).

Petitioners, therefore, err in asserting that “[t]he cases do not hold, however, that the just and reasonable standard is inapplicable when, as here, it is the public whose ox is being gored.” Pet. Br. 46 (citing *Northeast Utilities II*, 55 F.3d at 691). *See also* Intvr. Br. 38. To the contrary, *Northeast Utilities II*, like *Northeast Utilities I*, was clear that the public interest standard must be applied, even to challenges brought by, or in the interest of, third parties. The “whose ox is gored” quote went *solely* to the issue of whether or not the public interest standard was “practically insurmountable” -- not to whether it should be replaced with the just and reasonable standard -- where third party interests were at stake. *Northeast Utilities II*, 55 F.3d at 691.

Accordingly, *Boston Edison*, 233 F.3d at 65 (cited Pet. Br. 50) reversed the Commission for failure to apply the *Mobile-Sierra* public interest standard, notwithstanding that the Commission itself initiated the § 206 investigation, and

determined the contract rates to be unjust and unreasonable. *Id.* at 63, 68. The Court recognized that even unjust and unreasonable rates may not be contrary to the public interest. *Id.* at 68.

Likewise, *PEPCO* does not, *see* Pet. Br. 48-49, hold that the public interest test is satisfied upon showing ratepayers are paying unjust and unreasonable rates. Rather, *PEPCO* affirmed dismissal of PEPCO's complaint -- despite a showing that PEPCO's contract rate was twice that charged others -- because PEPCO failed to show an excessive burden on ratepayers or undue discrimination. 210 F.3d at 409. "While FERC retains the statutory authority and duty to correct or prevent an electric rate schedule that 'might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory,'" FERC "acted within its discretion to conclude from the face of the complaint that the rates in the previously approved agreement that PEPCO fully supported and claimed was justified were not contrary to the public interest." *Id.* at 412 (citations omitted). Although the Court found that "PEPCO's position undoubtedly would have been strengthened had there been evidence in the record to support the assertions in its briefs regarding the asserted impact on ratepayers," the Court nevertheless "express[ed] no opinion" on what evidence would be necessary to meet the public interest burden. *Id.* at 411.

PEPCO similarly belies the claim, Intvr. Br. at 37-39, that *Mobile-Sierra* applies only to sellers' claims that rates are too low, as *PEPCO* applied *Mobile-Sierra* to a buyer's claims that its rate was too high. 210 F.3d at 407. See Rehearing Order ¶ 56, ER738-39 (citing *PSCNY*, 543 F.2d 757, and *PEPCO*, 210 F.3d 403). Likewise (and contrary to Intervenors' contentions, Intvr. Br. 39-40), *PSCNY* fully supports the proposition that *Mobile-Sierra* applies to buyers as well as sellers. See 543 F.2d at 798-99. Finding that "[e]xcept as the exigencies of the public interest demanded, the Commission was no more at liberty to alter the lease sale contract to the prejudice of the producers than to do so in their favor," the Court modified the contract so that "the economic positions of both parties would then be harmonized with *Mobile-Sierra* requirements." *Id.* at 798. Both parties, not just buyers, are entitled to the protections of the *Mobile-Sierra* doctrine.

To assure integrity of contracts, both parties to a contract must be subject to the *Mobile-Sierra* doctrine. Although *Sierra* specifically addressed a seller's attempt to raise rates, it may be inferred that purchasers as well may be held to bargains that later prove improvident. *Boston Edison Co. v. FERC*, 858 F.2d 361, 372 (1st Cir. 1988). "In our view, the policies enunciated by Congress are in no way demeaned by requiring primary energy distributors and their wholesale customers alike to exercise reasonable self-interested vigilance and to act promptly to protect their respective positions." *Id.*

Intervenors claim an inconsistency with FERC's December 19 Order, 97 FERC at 62,217-18, application of the just and reasonable standard, rather than the *Mobile-Sierra* standard, to spot market rates in the CAISO and CalPX markets. *See* Intvr. Br. at 42-44. As the Commission explained, spot market sales in the CAISO/CalPX markets are not subject to the *Mobile-Sierra* doctrine, even though the long-term forward contracts at issue here are. Rehearing Order ¶ 94. ER 753. While Intervenors see this as a "novel proposition," Intvr. Br. at 44, *Mobile Sierra*, which protects rates set by agreement in bilateral contracts, has no application to single-clearing-price spot-market auctions where the same price is applied to all sellers. Thus, while the Commission is bound by a public interest standard in reviewing the complaints about bilateral contracts here, a just and reasonable standard applies in reviewing single-clearing-price auction sales in the CAISO/CalPX spot markets. Rehearing Order ¶ 94, ER 753.

Intervenors also contend FERC's determination here contravenes a "pledge" in the December 15 Order "to vigorously monitor prices of long-term contracts and entertain complaints that such prices were not just and reasonable." Intvr. Br. at 45-46 (citing 93 FERC at 61,982). Such a "pledge" does not appear on the referenced page. Later, the Commission did state that: "[t]o address concerns about potentially unjust and unreasonable rates in the long-term markets, we will monitor prices in those markets," 93 FERC at 61,994, but this statement did not,

and did not intend to, commit review of all unilaterally proposed contractual changes to a just and reasonable standard of review. Rehearing Order ¶ 52, ER737. Similarly, the statement at 61,982, about use of a benchmark price “in assessing any complaints regarding the justness and reasonableness of pricing of such long-term contracts negotiated under current market conditions,” did not promise that the just and reasonable standard would control. While use of a benchmark helps to spot problems, it does not override *Mobile-Sierra* where parties have not contractually preserved their rights unilaterally to propose rate changes. Rehearing Order ¶ 52, ER737. The Commission cannot, and did not attempt to, trump the mandates of that long-standing doctrine by using a benchmark in assessing the validity of a complaint. *Id.*

Additional authority cited provides no more aid to Intervenors. *Pennsylvania Elec. Co. v. FERC*, 11 F.3d 207, 210 (D.C. Cir. 1993) (Intvr. Br. at 46-47), “speaks in general terms about the Commission’s statutory duty to ensure just and reasonable rates,” Rehearing Order ¶ 50, ER735-36, but does not mention, let alone purport to apply, *Mobile-Sierra*. *Tejas Power Corp. v. FERC*, 908 F.2d 998, 1003 (D.C. Cir. 1990) (Intvr. Br. at 47), while citing *Mobile* and *Sierra* for the proposition that the Commission was “justified in according some weight” to the fact of agreement in approving a settlement, did not purport to apply the public interest standard to the settlement agreement. Likewise, *Laclede Gas Co. v. FERC*,

997 F.2d 936, 946 (D.C. Cir. 1993), (cited Intvr. Br. at 47), does not mention *Mobile* or *Sierra*).

Southern Co. Servs., 67 FERC ¶ 61,080 at 61,227 (1994) (Intvr. Br. 46); *Florida Power & Light Co.*, 67 FERC ¶ 61,141 at 61,398 (1994) (Intvr. Br. 44); *Carolina Power & Light Co.*, 69 FERC ¶ 61,078 (1994) (Intvr. Br. 48) (Letter order following *Carolina Power & Light Co.*, 67 FERC ¶ 61,074 at 61,205 n. 11) (1994)); and *PJM Interconnection, LLC*, 96 FERC ¶ 61,206 at 61,878 n. 13 (2001)⁹ (Intvr. Br. 48), all purport to follow *Northeast Utilities*, 66 FERC ¶ 61,332, which assessed a rate agreement under the public interest, rather than just and reasonable, standard notwithstanding that the agreement was newly filed and that the investigation was FERC-initiated.¹⁰ *See, e.g., PEPCO*, 210 F.3d at 408 (finding that *Southern Company*, 67 FERC ¶ 61,080 and *Florida Power*, 67 FERC ¶ 61,141, reaffirmed the position that the public interest standard may not be “practically insurmountable” when the Commission acts *sua sponte* or at the request of nonparties to change rates).

⁹ In *PJM Interconnection*, the Reliability Assurance Agreement explicitly permitted PJM to submit filings under FPA § 206. Rehearing Order ¶ 50, ER 735-36 (citing *PJM*, 96 FERC at 61,878 n.12).

¹⁰ *See Northeast Utils. Serv. Co.*, 68 FERC ¶ 61,041 at 61,136-37 (1994) (on remand, “[t]he Commission has done what the First Circuit directed the Commission to do: reconsider the modifications to the Seabrook Power Contract under a public interest standard of review”).

Thus, far from “black letter law,” Intvr. Br. 47, no court precedent supports finding *Mobile-Sierra* binding only on the parties to the contract, let alone binding only on the seller. Rather, courts addressing the issue, such as *Northeast Utilities I* and *II*, have concluded that the public interest standard applies irrespective of “whose ox is gored.”¹¹

2. Even If A More Flexible Standard Applied to Nonparty Claims, Or Initial Contract Review, Neither Circumstance Exists Here.

Absent a just and reasonable standard, Petitioners argue that the *Northeast Utilities* “more flexible” public interest standard should apply here because, purportedly, FERC had not previously approved the contracts at issue under FPA § 205, and Petitioners are not parties to the contract. Pet. Br. 49-50. This Court, however, need not address what “more flexible” means as this case involves neither an initial-rate review nor a complaint initiated by FERC on behalf of third parties. The Commission properly regarded Petitioners as standing in the shoes of CDWR for purposes of challenging these contracts, and therefore Petitioners are not “nonparties” to the contracts. Likewise, sellers entered into these contracts

¹¹ In any event, *Northeast Utilities*’ “more flexible” public interest standard is not the equivalent of the just and reasonable standard. Rather, the *Northeast Utilities* standard is more flexible with regard to new rate agreements and nonparty interests than the “practically insurmountable” standard, but both are still public interest standards that are more restrictive than the FPA § 205 just and reasonable standard, see *Atlantic City Elec. Co. v. FERC*, 295 F.3d 1, 14 (D.C. Cir. 2002).

pursuant to their previously approved market-based rate authorization under FPA § 205.

a. Petitioners Were Properly Regarded As Standing In The Shoes Of CDWR.

Petitioners' assertion that they are not parties to the challenged contracts, Pet. Br. 57-60, overlooks that the State of California, through CDWR, was a party to the contracts. Order on Initial Decision ¶ 76, ER631; Rehearing Order ¶ 51, ER736. As Petitioners, like CDWR, are also agents of the State of California, in bringing these complaints, Petitioners stepped into the shoes of CDWR as a representative of the State. Rehearing Order ¶ 51, ER736. That CDWR stands in the shoes of the State is seen by CDWR's invocation of sovereign immunity as an "arm of the state" specifically with regard to its purchasing activities under AB1 X, *see California Indep. Sys. Operator Corp. v. Reliant Energy Servs., Inc.*, 181 F. Supp. 2d 1111, 1122-23 (E.D. Cal. 2001), and CPUC is likewise an arm of the state in carrying out its statutory functions, *see Sable Communications of Cal., Inc. v. Pacific Telephone & Telegraph Co.*, 890 F.2d 184, 191 (9th Cir. 1989). Because both agencies (as is CEOB) are arms of the state, it must be concluded that the "state is the real, substantial party in interest." *See Regents of the Univ. of Cal. v. Doe*, 519 U.S. 425, 429 (1997). Petitioners' rehearing request acknowledged that

the buyer under these contracts was the State of California.¹² CDWR and Petitioners, as arms of the State, each act as a representative of California.

Petitioners' argument that Petitioners and CDWR have "different statutory obligations," Pet. Br. 57, ignores the fact that CDWR was given the statutory charge, normally reserved to the CPUC, of protecting the California ratepayers from unreasonable rates in these contracts. *See* Cal. Water Code § 80110. CDWR's power purchasing program was instituted "for the welfare and the benefit of the people of the state, to protect the public peace, health and safety." *See id.* § 80003(a). AB 1X divested the CPUC of its authority to review CDWR's purchases for justness and reasonableness. Under § 80110 of the Water Code, CDWR has exclusive authority to assure that the contracts resulted in just and reasonable retail rates for California customers, a determination that would typically be made by the CPUC under § 451 of the Public Utilities Code. Likewise, at the time CDWR entered into these contracts, the CEOB had no authority over the CDWR contracts – its authority under California Public Utilities Code § 335 was limited to certain matters concerning the CalISO and CalPX.

¹² Rehearing Order ¶ 51, ER736 (citing Petitioners' Reh'g Request at 48 ("the State of California was forced to step in as the entity responsible for purchasing California's 'net short,'); Petitioners' Reh'g Request at 32 ("it was necessary for the State of California to take the unprecedented step of becoming the buyer for most of the load of the entire state. It did so by authorizing CDWR to purchase the State's 'net short'"); Petitioners' Reh'g Request at 63 ("the State on the public's behalf . . . enter[ed] the long-term contracts").

While § 335(e) now provides the CEOB with authority to “investigate” matters related to the wholesale electricity market, that provision was not even enacted until after CDWR’s contracts were executed, by Assembly Bill No. 28, 2001-2002 2nd Extraordinary Session.

CDWR’s sole authority to judge the justness and reasonableness of its contracts has been recognized by court and CPUC decisions. *See Pacific Gas and Elec. Co. v. DWR*, 112 Cal. App. 4th 477, 486 (2003) (quoting CPUC Decision No. 02-02-052) (“the Legislature has expressly committed the determination of whether DWR’s power procurement costs are just and reasonable to DWR, and not to [CPUC]. Accordingly, determination of the justness and reasonableness of DWR’s total costs under [Public Utilities Code] Section 451 is beyond the scope of this order.”); *id.* (quoting CPUC Decision No. 02-02-051) (pursuant to AB 1X, CDWR “has exclusive authority to conduct any review of the justness and reasonableness of the costs it seeks to recover in electric rates under [Public Utilities Code section] 451.”)

In short, California decided how responsibilities among California state agencies would be divided for the contracts at issue here, allocating to CDWR the authority to judge their reasonableness usually possessed by CPUC. Far from ignoring California’s power to structure its own government, *see* Pet Br. 59, FERC’s conclusion that “CPUC and CEOB act in the same capacity as CDWR,”

and therefore “the same standard of review applies to these complainants as would apply to a similar complaint filed by CDWR,” is fully consistent with California’s apportionment of responsibilities. April 25 Order, ER23.

Petitioners’ citations, Pet Br. 58, are inapposite. *People v. Hy-Lond Enter., Inc.*, 93 Cal. App. 3d 734, 753 (1979), found that the District Attorney of Napa County lacked authority to bind the Department of Health without its consent in a prosecution involving a nursing facility, where the Department of Health was the agency responsible for regulating nursing facilities. In contrast, here, the State (including its agents, CPUC and CEOB), properly is bound to contracts executed by CDWR, who was delegated full and sole authority to enter into the contracts and to pass upon their justness and reasonableness on behalf of California ratepayers. *State Water Resources Control Bd. v. Office of Admin. Law*, 12 Cal. App. 4th 697 (1993), cited Pet. Br. 58, has no apparent relevance here as it concerns whether water quality control plans are subject to the APA.

b. The Sellers’ Market-Based Rate Authorization Had Previously Been Approved Under FPA § 205.

Petitioners assert that the Commission has never “opined on justness and reasonableness of the rates in these contracts.” Pet. Br. 52-53. *See also* Intvr. Br. 21-24. To the contrary, these contracts were lawfully entered into pursuant to the sellers’ previously-approved market-based rate authorization under FPA § 205. Rehearing Order ¶ 34, ER729.

While in the context of market-based rates, the Commission does not review individual contracts prior to the commencement of service, “[t]his is not to say the Commission fails to consider the reasonableness of the use of market-based rates prior to their effectiveness.” *State of Cal. ex rel. Bill Lockyer v. British Columbia Power Exch.*, 99 FERC ¶ 61,247 at 62,063 (2002), *on reh’g*, 100 FERC ¶ 61,295 (2002), *appeal pending*, *State of Cal. ex rel. Lockyer v. FERC*, No. 02-73093 (9th Cir.) (“*Lockyer*”). The prior review consists “not of the particular prices agreed to by willing buyers and sellers. Rather, it consists of analysis to assure that the seller lacks or has mitigated market power so that its prices will fall within a zone of reasonableness.” Rehearing Order ¶ 36, ER730 (quoting *Lockyer*, 99 FERC at 62,063).

Thus, “[i]n the case of market-based rates, the just and reasonable standard of FPA § 205 is satisfied by the Commission’s determination, prior to the effectiveness of those rates, that the utility (and its affiliates) lacks market power or has taken sufficient steps to mitigate market power.” *Lockyer*, 99 FERC at 62,063. Lacking market power, a seller sells in competitive markets at competitive prices. Courts have affirmed that “when there is a competitive market the FERC may rely upon market-based prices in lieu of cost-of-service regulation to assure a ‘just and reasonable’ result.” *Elizabethtown Gas*, 10 F.3d at 870. *See also Tejas Power Corp.*, 908 F.2d at 1004; *Louisiana Energy and Power Auth.*, 141 F.3d at 365;

Cajun Elec. Power Co-op, Inc. v. FERC, 28 F.3d 173, 176, 179, 180 (D.C. Cir. 1994).

Approving market-based rate authority pre-determines under FPA § 205 that a seller's market-based rates will be just and reasonable, in effect, making a "blanket" just and reasonable determination which applies to subsequent market-based sales made by that seller. Rehearing Order ¶ 34, ER730. The Commission, therefore, properly rejected the argument that its market-based rate authorization fails to satisfy FPA § 205. *Id.* ¶ 37, ER731.

Intervenors contend that, under *Lockyer*, there is no predetermination of the justness and reasonableness of market-based sales, but only approval of the utility's "umbrella tariff." Intvr. Br. 22. *Lockyer*, however, is clear that, while "umbrella tariffs" are filed to obtain market-based rate authority, their approval "preauthorizes the seller to engage in market-based sales and puts the public on notice that the seller may do so." *Lockyer*, 99 FERC at 62,063. See Rehearing Order ¶ 34, ER729.

Intervenors assert that market-based rates are within FERC's authority only if FERC steps in immediately to correct market flaws that threaten to produce unjust and unreasonable rates. Intvr. Br. 18. Of course, FERC did precisely that with regard to the dysfunctional spot markets, adopting monitoring and mitigation plans to correct problems in those markets consistent with its obligations under

FPA § 206. *See* June 19 Order, 95 FERC at 62,558. This Court has recognized that FERC has flexibility “under the FPA to address conditions leading to unjust and unreasonable rates in a market-based system by reforming market structures.” *CalPX*, 245 F.3d at 1125; *see id.* (“FERC’s formulation of its prospective structural remedies for the California wholesale market is consistent with its obligations under § 206(a) of the FPA”). But, because Petitioners and Intervenors did not show any dysfunction in the long-term contract market, FERC did not have to step in to assure rates under these contracts were just and reasonable.

Where market-based rate authority is in effect, the only avenue to challenge contract rates is FPA § 206, but this does not preclude “a meaningful chance to correct contracts that arose from market dysfunction, manipulation or abuse.” *Intvr. Br. 24.* Rather, it is consistent with “the purpose of the *Mobile-Sierra* doctrine [] to preserve the benefits of the parties’ bargain as reflected in the contract, assuming that there was no reason to question what transpired at the contract formation stage.” *Atlantic City*, 295 F.3d at 14 (citing *Town of Norwood v. FERC*, 587 F.2d 1306, 1312 (D.C. Cir. 1978)).

Relying on *Atlantic City*, *Norwood*, and *Northeast Utilities I*, 993 F.2d 937, Intervenors contend the public interest standard is met whenever evidence shows that the bargaining process was not the product of a functionally competitive market. *Intvr. Br. 34-36.* The contracts in *Northeast Utilities* and *Norwood* were

reformed not because “the bargaining process giving rise to the contract was tainted by a dysfunctional market,” *see* Intvr. Br. 59-60, but because the bargaining parties were potential or actual merger partners, causing concern about the lack of arms-length negotiation. *See Norwood*, 587 F.2d at 1313 (discussing allegations of a “sweetheart” deal between two companies engaged in merger discussions); *Northeast Utilities I*, 993 F.2d at 961 (Commission found no arms-length bargain because the contracting entities were about to merge). The orders here are consistent with that approach, as they focus on whether Petitioners had shown any fraud, duress or the exercise of market power at the formation stage of these individual contracts. Because Petitioners failed to make any such showing, there was no reason to overturn these contracts. Rehearing Order ¶ 60, ER 741; ¶ 91, ER 753.

Petitioners contend that the initial grant of market-based rate authority “cannot ensure that the seller will continue to lack market power,” and thus that its rates will remain just and reasonable. Pet. Br. 54-55; *see* Intvr. Br. 30-31. A similar situation applies to review of cost-based rates. In both situations, the initial determination that resulting rates will be just and reasonable rests on a factual determination tied to specific circumstances that may, over time, change. *See Lockyer*, 99 FERC at 62,064 and n. 39; Rehearing Order ¶ 38, ER731. The same statutory approach applies in both situations. Initially under FPA § 205 a utility

has the burden to show its rates (cost-based or market-based) will be just and reasonable.

The Commission's initial review of cost or market-based rates cannot assure that the approved rates the seller charges will remain just and reasonable under all subsequent circumstances.¹³ Rehearing Order ¶ 47, ER734. FPA § 206 sets the procedures to change approved rates under either a cost-based or market-based rate regime. "If those same rates later appear to be excessive, they can be changed only (assuming the [seller] does not file new rates) through FPA § 206 procedures, which place the burden on the moving party, not the [seller]." *Lockyer*, 99 FERC at 62,064 and n. 39. This means in cases, as here, where the contracts at issue are subject to *Mobile-Sierra*, the higher public interest burden of proof must be met to support modification of such contracts. Rehearing Order ¶ 38, ER731.

Intervenors cite *Southern Power Co.*, 104 FERC ¶ 61,041 (2003), and *Entergy Servs., Inc.*, 103 FERC ¶ 61,256 (2003), Intvr. Br. 31, as supporting Intervenors' view that utilities with market-based rate authority must show their contract rates are just and reasonable. These decisions are inapposite as they involve affiliate dealings. *See Southern* ¶ 3; *Entergy* ¶ 3. The Commission requires additional safeguards for affiliate transactions because, while in arms-

¹³ The Commission requires that sellers renew their application for market-based rate authorization every three years. Order on Initial Decision ¶ 84, ER634.

length transactions, “the buyer will be able to protect itself against excessive charges or unreasonable contract provisions and thus, in turn, similarly protect ultimate consumers,” in the case of affiliate transactions “the buyer has less incentive to bargain for the lowest possible rates.” *Northeast Utilities*, 66 FERC at 62,089.

Intervenors point to an asserted inconsistency in the language of market-based rate orders to the effect that acceptance for filing of the proposed rate schedules “*does not constitute approval of any service, rate, charge, classification, or any rule, regulation, contract or practice affecting such rate or service provided for in the filed documents*” Intvr. Br. 24-25 (emphasis added by Intervenor). The quoted language is standard boilerplate, used in both market-based and cost-based settings, to reiterate the general proposition that a FERC order “permit[ting] a rate schedule or any part thereof . . . to become effective shall not constitute approval by the Commission of such rate schedule or part thereof” 18 C.F.R. § 35.4 (2003). Indeed, the orders accepting the contracts challenged in *Mobile* and *Sierra* contained substantively identical language. See *Pacific Gas & Elec. Co.*, 7 FPC 832 (1948) (accepting contract challenged in *Sierra* for filing and stating that “[n]othing contained in this order shall be construed as constituting approval by the Commission of any service, rate, charge, classification, or any rule, regulation, contract or practice.”); *United Gas Pipe Line Co.*, 5 FPC 770 (1946) (accepting the

contract challenged in *Mobile* for filing and stating that “[n]othing contained . . . shall [] be construed as constituting approval by this Commission of any service, rate, charge, classification, or any rule, regulation, contract or practice.”)

Intervenors also argue that the market-based rate program is inconsistent with *Prior Notice and Filing Requirements*, 64 FERC ¶ 61,139 at 61984 (1993), *clarified*, 65 FERC ¶ 61,081 (1993). In *Prior Notice*, see Intvr. Br. 26, the Commission found that permitting a utility to commence service in advance of filing a service agreement entered into under an umbrella tariff was “not in any way a declaration that such service is just and reasonable as extended to a particular customer.” *Prior Notice*, 64 FERC at 61,984. This holding is not inconsistent with the Commission’s holding here; contracts for sales of electricity for which market-based rate authorization is allowed are treated differently than contracts for transmission, which must be entered into under an umbrella Open Access Transmission Tariff. While service agreements must be filed in the latter situation to permit the Commission “to evaluate the justness and reasonableness of the tariff rate as applied to a particular customer,” see Intvr. Br. 26 (quoting *Prior Notice*), in the market-based rate context, Commission examination of each service agreement is “unnecessary because [a just and reasonable] determination has, in effect, already been made in the acceptance, and continuing effectiveness, of the

market-based rate tariff pursuant to which a long-term service agreement is filed.”

Order on Initial Decision ¶ 84, ER634.

As the Commission recently explained in *El Paso Elec. Co.*, 105 FERC ¶ 61,131 at ¶ 27 (2003) (quoting *Prior Notice*, 64 FERC at 61,984) (footnotes omitted):

The two situations are different. When the Commission grants market-based rate authority and accepts a market-based rate tariff, it is saying that individual service agreements under the utility’s market-based rate tariff will not be subjected to the same level of scrutiny when they are filed; the individual transactions (which occur at market-driven prices) are reasonable because the Commission has determined that the utility seller does not possess market power. In contrast, for a cost-based OATT and the service agreements thereunder, while the OATT is a tariff of general applicability, as the Commission explained in *Prior Notice* the Commission still needs to ensure that the rate for service to a particular customer is reasonable and “that determination can be made only after the service agreement is filed . . . and only after the Commission has had the opportunity to evaluate the justness and reasonableness of the tariff rate applied to a particular customer.”

Intervenors point to footnote 30 in Order No. 2001,¹⁴ *see* Intvr. Br. at 27, as evidence that FERC has held that contracts entered into pursuant to market-based rate authorization are not pre-determined to be just and reasonable, and that FERC will not be bound by *Mobile-Sierra* provisions in contracts that FERC has not approved. Unfortunately for Intervenors, the discussion in that footnote was

¹⁴ *Revised Public Utility Filing Requirements*, Order No. 2001, 67 Fed. Reg. 31,043 (May 8, 2002), FERC Stats. & Regs. ¶ 31,127 (2002), *reh’g denied*, Order No. 2001-A, 100 FERC ¶61,074, *reconsideration denied*, Order No. 2001-B, 100 FERC ¶61,342 (2001).

vacated on rehearing of Order No. 2001. *See* Order No. 2001-A, 100 FERC ¶ 61,074 at ¶ 5 (“The Commission is vacating its discussion in footnote 30 of Order No. 2001”)

In essence, Petitioners and Intervenors want parties to individual market-based contracts to be subject to a second finding that their rates are just and reasonable, notwithstanding the fact that the market rate authorization indicated at the outset that a seller’s rates would be the product of competitive market forces and thus just and reasonable. *See* Rehearing Order ¶ 35, ER730. This argument has no support in either the statute or the relevant Commission or court precedent, and, indeed, this approach would create uncertainty in the market, as a party who suddenly thinks that its bargained-for deal has become uneconomical can, without showing harm to the public interest, undo the terms. *Id.* This is precisely what the *Mobile-Sierra* doctrine was designed to avoid, and the Commission saw no support for an exception to that established doctrine simply because a party has contracted in a market-based rate regime. *Id.*

The preservation of contracts is, if anything, even more critical in the context of market-based rate authority than in a more heavily regulated environment. Order on Initial Decision ¶ 64, ER 625; Rehearing Order ¶ 54, ER738. Competitive power markets cannot attract the capital needed to build adequate generating infrastructure without regulatory certainty, including certainty

that the Commission will not modify market-based contracts unless the public interest so requires. Rehearing Order ¶ 54, ER738. The essential point is not, however, that sanctity of contracts is even more important in a market-based rate system, but that sanctity of contracts remains vitally important in both cost-based or market-based regulatory systems. *Id.* ¶ 55, ER738.

B. Petitioners Failed To Meet Their Burden To Show That The Public Interest Required Modification Of These Contracts.

1. The Commission Properly Applied The Public Interest Standard.

The Commission’s function in applying the *Mobile-Sierra* test is “not only to appraise the facts and draw inferences from them but also to bring to bear upon the problem an expert judgment and determine from analysis of the total situation on which side of the controversy the public interest lies.” *Metropolitan Edison*, 595 F.2d 851. Here, the Commission properly considered the totality of the circumstances in concluding that Petitioners failed to meet their burden of proof. Rehearing Order ¶ 59, ER740. While Petitioners contend that the Commission was required to define with specificity what constitutes the public interest, Pet Br. 61-62, as the First Circuit recognized, “nowhere in [*Mobile*] is the term ‘public interest’ defined,” and, “[i]ndeed, the Court seems to assume that the Commission decides what circumstances give rise to the public interest.” *Northeast Utilities II*,

55 F.3d at 690. *Accord Metropolitan Edison*, 595 F.2d at 859 (determination of the public interest is in FERC’s discretion).

Intervenors contend that the Commission erroneously limited the measure of the public interest to the “three-prong” *Sierra* public interest test.¹⁵ Intvr. Br. 53-57. The Commission appropriately considered those factors; *Northeast Utilities I* in fact instructed the Commission to apply those factors in evaluating on remand whether the contract was so detrimental to third parties as to offend the public interest. “[T]he *Mobile-Sierra* doctrine allows FERC to modify the terms of a private contract when third parties are threatened by possible ‘undue discrimination’ or the imposition of an ‘excessive burden.’ We invited FERC to demonstrate such a threat upon remand.” *Northeast Utilities II*, 55 F.3d at 691 (citing *Northeast Utilities I*, 993 F.2d at 961-62).

The three-part *Sierra* “test” was not, however, the sole measure of the public interest standard applied here. Petitioners failed to demonstrate any of the three public interest factors addressed in *Sierra* or any other factors showing that modifying the contracts is required by the public interest. Order on Initial Decision ¶¶ 8, 39, ER605, 616; Rehearing Order ¶ 57, ER 739. Petitioners’ claims

¹⁵ In *Sierra* the Court stated that “the sole concern of the Commission would seem to be whether the rate is so low as to adversely affect the public interest – as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory.” 350 U.S. at 355.

were not rejected because the Commission believed it was restricted to considering only the three factors enunciated in *Sierra*, but because Petitioners did not satisfy any possible public interest burden. Rehearing Order ¶ 57, ER739.

For their part, Petitioners contend that the Commission “assess[ed] only whether there was ‘fraud’ in the inducement of the contract” in evaluating the public interest. Pet. Br. 61. The Commission did instruct the ALJ to consider, and the parties to submit evidence on, “the totality of purchases and sales and the conditions present at the time the contracts were entered into,” because “a showing of fraud, duress, or bad faith between the parties at the contract formation stage could be an alternative ground for modifying the challenged contracts.” Rehearing Order ¶¶ 90-91, ER752 (quoting April 25 Order, ER26). However, the Commission fully considered these issues *and* Petitioners’ other public interest claims, *id.* ¶ 57, ER739, and Petitioners failed to show fraud, duress or bad faith, just as they failed to meet the *Sierra* three-prong test, or to demonstrate that contract modification was justified based on other grounds derived from the totality of the circumstances, *id.* ¶ 91 ER753.

2. Petitioners Failed To Show That The Contracts Unduly Burden California Ratepayers Or Even That The Contracts Exceed Competitive Rates.

Petitioners' primary contention appears to be that, as a result of the alleged effect of dysfunction in the California spot markets on the long-term contract market, the contract rates here were inflated by a "dysfunctional premium" of over \$1.4 billion, Pet. Br. 47, 61-62, a number derived from the assertion that the contract prices were 33-60% above what Petitioners propose as a just and reasonable price. The Commission rejected this claim because Petitioners failed to cite a basis for it and the Commission saw none in the record. Rehearing Order ¶ 82, ER749. As the Commission found this alleged premium entirely unsupported, the Commission certainly never found that this alleged premium was "not 'excessive,'" as Petitioners allege. Pet. Br. 61.

Petitioners' citation to the tables at ER429-30, Pet Br. 47, provides no support for this calculation. The tables are based on forward price curves, used purportedly to demonstrate that the contract rates were inflated over long-run competitive prices. Rehearing Order ¶¶ 76, 83, ER747, 749. *See* Pet Br. 70-75. The Commission rejected this analysis. Rehearing Order ¶ 41, ER732. All forward price curve models involve estimates of various input costs (*e.g.*, the cost of gas, NOx emission allowances) and of expected future supply and demand conditions. *Id.* The resulting forward price curves project what the curve's creator

thinks forward spot market prices for delivery of electricity will be in the future. *Id.* Individual forward price curve models are internally generated, proprietary information used by each seller and buyer for its own purposes with updates made daily, or even more often if circumstances change rapidly. *Id.* ¶ 43, ER732. Each model has different assumptions, and, therefore, will produce different price estimates. *Id.* Thus, while these models may be useful for resource planning and contract negotiation purposes, the Commission found them too variable and ephemeral to set just and reasonable rate projections. *Id.* Not only are forward curve models not designed (and have never been used by FERC) for that purpose, but also they lack the requisite transparency for rate review purposes. *Id.* Moreover, the Commission has never addressed or approved any one particular forward curve model for this purpose, and the Commission found that, even if it were possible to do so, the record here did not have adequate information to make a choice. *Id.* Accordingly, the Commission found that it would be inappropriate to rely on the forward price curves and related testimony as showing what a just and reasonable rate level would be. *Id.*

Petitioners assert that the forward price curve evidence was not intended to show that the contract rates were unjust and unreasonable simply because they exceeded the forward contract prices, *but see* Pet. Br. 72 n. 23, but rather that the forward price curves were themselves inflated as a result of the market

dysfunctions and the competitive price was below that evidenced by the price curve. Pet. Br. 72-73. Thus, Petitioners claim that because the contract rates exceed the curves, this shows that the contract rates exceed competitive rates “even without regard to B [the forward price curve information].” Pet. Br. 73. To reach this conclusion, Petitioners simply assume that the forward curves are “the *measure* of the dysfunction and abuse in the spot market.” Pet Br. 72. But that assumption is unsupported. *See id.* (lack of any record citation for assumption). It is equally plausible (and equally unsupported) to assume that the curves factored in FERC’s corrections to the spot market structure, and thus projected forward prices to be lower than in a freely competitive market. Further, forward price curves of the spot market were not shown to correlate to what forward prices for the *long-term, bilateral* market might be. In short, the Commission correctly determined these curves lacked record support to justify their use as showing whether the contract rates at issue are just and reasonable.

Petitioners fail to undermine the other grounds upon which the Commission rejected the forward price curves claims. Petitioners’ assertion that the forward price curves are transparent because they are public, Pet Br. 74, falls far short of warranting use of the curves. The concern with lack of transparency is the failure to disclose the assumptions that drive the price curve, without which it cannot be challenged or evaluated. The fact that the resulting price curve is public discloses

nothing about the assumptions that went into its development, particularly given that each price curve is developed separately by different parties based on different, undisclosed and therefore unchallengeable, assumptions. This lack of transparency renders them inappropriate for use in a litigated matter as a standard of comparison (or the measure of dysfunction and abuse) to determine just and reasonable rates. Rehearing Order ¶ 43, ER732.

Thus, the Commission reasonably rejected Petitioners' evidence offered to support its claim that the contract rates were inflated over competitive rates. The Commission's evaluation of expert testimony and methodology are matters for which the Commission should be afforded deference. *Bear Lake*, 324 F.3d at 1077. "It is the Commission's function to reach conclusions on conflicting engineering and economic issues so long as its judgment is reasonable and based on the evidence." *Sierra Pacific*, 793 F.2d at 1088.

Accordingly, Petitioners failed even to show that the contract rates were above long-run competitive prices. Order on Initial Decision ¶ 40, ER617. Nor did Petitioners show a burden on California ratepayers. *See* Pet. Br. 47. Petitioners and Intervenors have not disputed the Commission's finding that CDWR achieved its central contracting objective of a portfolio yielding a weighted average price no higher than \$70/MWh, the average cost of energy supply reflected in the IOUs' retail rates, as of January 2001. Order on Initial Decision ¶ 40,

ER616-17. This fact undercuts any claim that the contract rates required an increase in retail rates, and therefore adversely affected California ratepayers. In fact, through its superior bargaining power as the largest creditworthy purchaser in California, CDWR was able to contract for immediate and/or near-term sales at below market prices, at a time when energy was critically needed. Rehearing Order ¶¶ 75-76, ER747. Moreover, record evidence demonstrated that market fundamentals such as increased demand, reduced generation and increased fuel costs contributed significantly to the escalation in market prices. *Id.* ¶ 88, ER750-51.

Even if Petitioners had shown “the contract rates currently exceed those available in today’s markets, that allegation, even if true, does not establish that the contract rates are contrary to the public interest.” *Id.* ¶ 64, ER742. Commission precedent looks to prices over the length of the contract, and “makes clear that the fact that a contract has become uneconomic to one of the parties does not necessarily render the contract contrary to the public interest.”¹⁶ Additionally, even if the contract rates at issue are passed through entirely to ultimate customers, they fall within the existing retail rate level, and thus Petitioners failed to show pass-through would be contrary to the public interest. *Id.* ER742-43.

¹⁶ *Id.* (quoting *PEPCO*, 210 F.3d at 409).

3. Dysfunctions In The Spot Markets Did Not Provide Grounds To Modify These Contracts.

Petitioners and Intervenors contend that, because of alleged seller manipulation in the spot markets, the rates in these long-term contracts could not have been just and reasonable at the time of negotiation, therefore allegedly “rebutting” the presumption that sellers’ market-based rates were just and reasonable, Pet. Br. 53-55; Intvr. Br. 35-36, and providing a basis for questioning what transpired at the contract formation stage. Intvr. Br. 35-36. *See also* Pet. Br. 63. Petitioners and Intervenors therefore contend that they satisfy the public interest standard as to these contracts by making a generic showing of manipulation in the spot markets. *See* Pet. Br. 66-67; Intvr. Br. 62-63. These contentions fail because a generic showing does not suffice to show these contracts are violative of the public interest, and further, as a factual matter, Petitioners failed to establish a connection between the spot market dysfunctions and these long-term contracts.

a. A Generic Showing Does Not Suffice To Establish That These Contracts Are Contrary to the Public Interest.

Petitioners cannot rely on a generic showing of manipulation related to spot markets to show that these contracts are contrary to the public interest. Any showing of manipulation must be “specific to” the contracts here. Order on Initial Decision ¶ 61, ER624. Contract abrogation under *Mobile-Sierra* requires findings

specific to the challenged contract and its impact on the public interest. “FERC’s rulemaking authority requires only that it point to a generic public interest in favor of a proposed rule; the public interest necessary to override a private contract, however, is significantly more particularized and requires analysis of the manner in which the contract harms the public interest and of the extent to which abrogation or reformation mitigates the contract’s deleterious effect.” *Texaco*, 148 F.3d at 1097. *See also Transmission Access Policy Study Group v. FERC*, 225 F.3d 667, 709 (D.C. Cir. 2000) (“TAPS”) (recognizing that *Mobile-Sierra* determinations are usually made on a case-by-case basis).

FERC has under extraordinary circumstances made generic determinations of the *Mobile-Sierra* public interest. *See* Intvr. Br. 58-60. However, such findings are appropriate only where the circumstances relied upon “affect an entire class of contracts in an identical manner.” *TAPS*, 225 F.3d at 710, 711. For example, Order No. 888¹⁷ “fundamentally change[d] the regulatory environment in which utilities operate, . . . and affect[ed] all utilities in a similar way.” *Id.* *See also United Distribution Cos. v. FERC*, 88 F.3d 1105, 1126-27 (D.C. Cir. 1996) (involving the

¹⁷*Promoting Wholesale Competition Through Open-Access Non-Discriminatory Transmission Service by Public Utilities and Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, Order No. 888, FERC Stats. & Regs. ¶ 31,036 (1996), *order on reh'g*, Order No. 888-A, FERC Stats. & Regs. ¶ 31,048 (1997), *order on reh'g*, Order No. 888-B, 81 FERC ¶ 61,248 (1997), *order on reh'g*, Order No. 888-C, 82 FERC ¶ 61,046 (1998), *aff'd in relevant part sub nom. TAPS*, 225 F.3d 667, *aff'd sub nom. New York v. FERC*, 535 U.S. 1 (2002).

Commission’s “sweeping changes” in the gas industry by requiring mandatory unbundling of pipeline sales and transportation services); *FPC v. Louisiana Power & Light Co.*, 406 U.S. 621, 628, 646 (1972) (affirming Commission modification of all pipeline contracts to require curtailment plans in light of serious natural gas shortages); *Permian Basin Area Rate Cases*, 390 U.S. 747, 758 (1968) (Commission proceedings beginning a “new era in the regulation of natural gas producers”).

El Paso Natural Gas Co., 99 FERC ¶ 61,244 (2002), *on reh’g*, 104 FERC ¶ 61,045 (2003), cited Intvr. Br. 61, follows the same approach: “only in extraordinary circumstances, and only where the public interest so requires, will the Commission order contract modification. For example, the Commission has ordered contract modification in connection with its restructuring of the natural gas and electric industries.” Rehearing Order ¶ 68, ER744 (quoting *El Paso*, 99 FERC at 62,005 (footnotes listing citations omitted)). *El Paso* restructured firm requirements contracts (guaranteeing delivery of a customer’s full requirements each day) into contract demand contracts (providing specific delivery rights up to a specified maximum at specified points) to remedy oversubscription, which prevented existing contract demand customers from receiving the firm service for which they had paid. Again, the generic public interest finding was one that affected a class of customers identically.

In contrast, here, as in most cases, the circumstances relevant to the public interest determination are unique to the affected contract. *TAPS*, 225 F.3d at 710. Generic *Mobile-Sierra* findings are not appropriate where differing circumstances affect individual contracts. In *Atlantic City*, 295 F.3d at 14-15, the Court reversed the Commission for modifying a contract based on generic *Mobile-Sierra* findings because “petitioner PSE&G had a *Mobile-Sierra* contract that was negotiated at arms length with Old Dominion and designed to provide both parties with long-term price certainty and FERC made no findings that modifications to this contract were required by the public interest.” *See also PEPCO*, 210 F.3d at 410 (FERC appropriately did not extend Order No. 888 generic public interest finding, based on market power of sellers over requirements customers, to nonrequirements contracts because “in the majority of circumstances, such long-term supply contracts are voluntary arrangements in which neither party had market power.”) (citation omitted). Intvr. Br. 58-60.

Here, the “extreme circumstances” of the generic *Mobile-Sierra* cases simply do not exist. April 25 Order, ER23-24. There is no broad policy initiative underway that similarly affects all utilities, and that would be served by modifying these contracts. Rehearing Order ¶ 61, ER741. Contract modification here is, if anything, contrary to the Commission’s policy of respecting contract sanctity and

creating the regulatory certainty needed to attract sufficient capital to competitive power markets. *Id.*

b. In Any Event, No Showing Was Made That Spot Market Dysfunctions Resulted In Unjust And Unreasonable Rates In The Long-Term Markets.

Even if a generic *Mobile-Sierra* finding could be appropriate here, it has not, in any event, been shown that the spot market dysfunctions in fact result in even unjust and unreasonable rates for long-term contracts. Petitioners ask the Court to assume, as a matter of “basic economics,” Pet Br. 65, that the existence of spot market dysfunctions are sufficient to show adverse impact on these long-term contracts. *See also* Intvr. Br. 35 (contending that it is “axiomatic” that the dysfunctional spot markets could not produce just and reasonable rates). The Commission has, however, rejected assumptions that the spot market dysfunctions necessarily resulted in unjust and unreasonable rates *in the long-term contract markets*. Notwithstanding the fact that, as a result of spot market dysfunctions, “[s]ellers will certainly be aware that supplies of power are tight and that the IOUs are now aggressively seeking to avoid the exposure of the spot markets,” two factors offset their ability to take advantage. December 15 Order, 93 FERC at 61,994. First, “suppliers also benefit from the stable revenue stream of forward markets and have every bit as much incentive to avoid the volatility of the spot

markets as do purchasers.” *Id.*¹⁸ Second, “suppliers will bargain knowing that the spot market's size will be greatly reduced [by more forward purchasing] and that next summer's spot prices will therefore not be fueled by frenzied buyers whose over-reliance on last minute purchases have forced them to bid up the prices to obtain needed supply.” *Id.*

As a result, the Commission denied requests to extend market mitigation measures designed for spot markets to the forward contract market, December 19 Order, 97 FERC at 62,245, or to order refunds for the CDWR transactions to parallel refunds allowed in the spot markets, *id.* at 62,195. Although the spot market rates were unjust and unreasonable, the Commission had not found the forward contract markets to be similarly flawed.

Petitioners assert that Commission staff concluded that prices in California markets for forward power were substantially inflated by dysfunction in the spot markets. Pet. Br. 47. Commission staff found that forward contracts negotiated during 2000-01 in the western United States, particularly those contracts for one to two years, were “influenced” by then-current spot prices. ER573. The Staff Report did not find that forward prices in the 1-2 year class of contracts were

¹⁸ *See id.* n. 33 (“While suppliers clearly benefit on the upside of price volatility, the risks of price swings move in both directions. A supplier that relies exclusively on spot markets is exposed to the risk that, due to favorable weather or supply conditions, prices will be too low to cover its costs.”)

unjust and unreasonable as a result of spot market dysfunction. Rehearing Order ¶ 83, ER 749 (“The Staff Report did not make any findings regarding the justness and reasonableness of any contract rates. . . .”).

Furthermore, even if the Staff Report had found 1-2 year forward contracts to be unjust and unreasonable, or other evidence had demonstrated the same, any such findings would not be sufficient to satisfy Petitioners’ public interest burden. *Id.* ¶ 83, ER749. “Under the ‘public interest’ standard, to justify contract modification it is not enough to show that forward prices became unjust and unreasonable due to the impact of spot market dysfunctions; it must be shown that the rates, terms and conditions are contrary to the public interest.” Order on Initial Decision ¶ 37, ER615-16 (footnotes omitted).

Moreover, contentions that sellers exercised market power in the negotiations for these contracts, *see, e.g.*, Intvr. Br. 35-36, are rebutted by the evidence. Just the opposite, the record shows that CDWR had a great deal of bargaining power over sellers. Order on Initial Decision ¶ 53, ER 621-22. CDWR negotiated with sellers on an individual basis and controlled information regarding the success of their procurement efforts, thereby gaining negotiating leverage with each agreement reached with sellers. *Id.* ¶ 50, ER620. CDWR was able to demand and obtain many concessions from sellers, including obtaining immediate and/or near-term sales at below-market prices. *Id.* ¶ 54, ER622.

Additionally, contemporaneous statements made by CDWR and the Governor of California indicate that they fully supported the price, terms and conditions in the contracts at the time they were executed. *Id.* ¶ 50, ER620. “On May 24, 2001, counsel and a negotiator for CDWR, prepared a memorandum to a CDWR representative, at the latter’s request, in which he stated that ‘[e]ach power purchase agreement was the subject of often protracted negotiations. Frequently, sellers had to concede numerous points to obtain the terms and provisions they ultimately ended up with in the agreements.’” *Id.* ER620. CDWR’s lead negotiator stated that:

I can’t get terribly upset by these critics who say oh, by gosh, this is higher than what the price might be. Well, hell, they don’t know. We didn’t just fall off a turnip truck. I am not saying we took the shirt off their back. But I am saying that these were fair, negotiated, hard-fought deals.

Id. ER620-21.

PEPCO found similar factors (*i.e.* contemporaneous statements and available options) to outweigh claims that a contract was the product of the seller’s market power. 210 F.3d at 410. The Court observed that *PEPCO*’s statements to FERC at the time of contract approval fully support the fixed-rate agreement, and *PEPCO* had at no time alleged bad-faith negotiation on the part of the parties to the agreement. *Id.* Thus, that record did not support a conclusion that the seller’s market power dictated contract terms. *Id.* “To the contrary, *PEPCO* has admitted

that it had other supply options when it entered the agreement with APS in 1987.” *Id.* While the availability of other options does not necessarily obviate the existence of market power, contemporaneous representations that a transmission agreement was cost-justified and represented a cost savings over other supply options supports that conclusion. *Id.* “Accordingly, absent any claim, much less evidence, of unfairness or bad faith in the original negotiations, it is reasonable for FERC to require parties ‘to live with their bargains as time passes and various projections about the future are proved correct or incorrect.’” *Id.* (quoting *Norwood*, 587 F.2d at 1312-13).

C. The Commission Did Not Erroneously Constrain the Record.

In response to Petitioners’ complaints, the Commission set for hearing the issue of “whether the dysfunctional California spot markets adversely affected the long-term bilateral markets, and, if so, whether modification of any individual contract at issue is warranted.” April 25 Order, ER 25-26. In a separate proceeding, Commission staff investigated potential manipulation of electric and natural gas prices in the West. *Id.* n. 28, ER 25. Thus, the Commission set “the instant contracts for hearing under section 206 of the FPA based on the arguments that the dysfunctional spot markets in California cause long-term contracts not to be reasonable, whereas the investigation is looking at whether there was improper behavior by sellers that may have caused prices not to be reasonable.” *Id.*

Following this direction, the ALJ concluded that “the issue of alleged exercise of market power was not within the scope of the issues set for hearing in this proceeding.” Partial Initial Decision, ¶ 6. The Commission affirmed the ALJ’s interpretation as prohibiting discovery on and excluding information on market power and market manipulation issues in this proceeding. Order on Initial Decision ¶ 24, ER611; Rehearing Order ¶ 100, ER755.

This ruling did not prejudice Petitioners: “by excluding the issue of alleged exercise of market power in the instant proceedings, the Commission sought to provide the State with an opportunity for expedited review of the subject contracts based on the less arduous showing that the dysfunctional spot markets in California caused long-term contracts not to be reasonable; that is, to pursue their complaint allegations without the added burden of having to prove allegations of exercise of market power as the basis for seeking modification of the subject contracts.” Partial Initial Decision, ¶ 6. In other words, evidence that sellers manipulated the spot market was unnecessary to Petitioners’ case because “[t]he Commission has already concluded that the California ISO and PX spot markets were dysfunctional during the relevant period and that rates in those markets were unjust and unreasonable. Evidence of market manipulation merely suggests yet another cause of the spot market dysfunctions and the unjust and unreasonable rates in the spot markets.” Order on Initial Decision ¶ 37, ER615.

In any event, Petitioners had the opportunity to present evidence adduced in the so-called 100-Day Discovery Proceeding, *see San Diego Gas & Elec. Co.*, 101 FERC ¶ 61,186, in which parties were allowed to conduct broad discovery into market manipulation during the western power crisis of 2000 and 2001. Rehearing Order ¶ 100, ER755-56. California, through its Attorney General, as well as Petitioners CPUC and CEOB, participated in the discovery process and submitted evidence in that proceeding. *Id.* Moreover, the Commission assumed the evidence of market manipulation elicited in that proceeding, as well as the evidence from the Staff Report, to be true for purposes of evaluating Petitioners' claims. Order on Initial Decision ¶ 34, ER614; Rehearing Order ¶ 86, ER750.

Thus, far from prohibiting Petitioners from taking discovery and offering evidence on a requisite element of their claim, Pet. Br. 67, the Commission fully allowed pursuit of such discovery and evidence, even though it accepted, for purposes of this hearing, Petitioners' assertions on this element as true. Even so, Petitioners were unable to prove their claims. Rehearing Order ¶ 101, ER756. ("After carefully considering all of the evidence submitted by Complainants in this proceeding, the Staff Report, and the evidence submitted in the 100-Day Discovery Proceeding, we found that Complainants did not sustain their burden under the public interest standard to justify the modification of these contracts.").

Petitioners assert that they had no meaningful opportunity to conduct the requested discovery in the 100-Day Discovery Proceeding, Pet Br. 68, as it was “another proceeding concerning different issues,” *id.* 69. This assertion is belied by Petitioners’ indication that the evidence they want to adduce here concerns market manipulation by sellers in the spot markets, which is precisely the evidence the 100-Day Discovery Proceeding was designed to adduce. When this Circuit granted “leave to adduce additional evidence of market manipulation by various sellers before FERC,” *see San Diego*, 101 FERC at 61,733 ¶ 4 (quoting *Public Utils. Comm’n of the State of Cal. v. FERC*, Nos. 01-71051, *et al.* (9th Cir. August 21, 2002)), the California Parties (the California Attorney General, the CPUC and the CEOB) then requested and were granted an order allowing them to conduct discovery for a period of 100 days “to discover any matter relevant to the issue of sellers’ market manipulation or reasonably calculated to lead to the discovery of relevant evidence,” and allowing parties to submit evidence from other proceedings, to the extent relevant. *Id.* ¶¶ 6, 26.

Thus, the evidence adduced in the 100-Day Discovery Proceeding, upon the motion of the California Parties themselves, is precisely the evidence they complain of being unable to discover here. As the Commission considered the evidence from the 100-Day Discovery Proceeding in evaluating Petitioners’ claims, Rehearing Order ¶ 101, ER756, and indeed assumed it to be true, *id.* ¶ 86,

ER750, Petitioners have no cause to claim that they have been deprived of the ability to substantiate their claims.

D. The Commission Properly Dismissed Petitioners' Complaint As To The Pacificorp Contract.

In the June 19 Order, the Commission extended price mitigation to all spot markets in the Western Systems Coordinating Council area. 95 FERC ¶ 61,418. The challenged contract between CDWR and Pacificorp¹⁹ was executed on July 6, 2001, approximately three weeks after the June 19 Order. Accordingly, the Commission dismissed Petitioners' complaint seeking to modify the Pacificorp contract because "the effect of the West-wide mitigation was to stabilize prices." April 25 Order, ER25. On rehearing, the Commission rejected Petitioners' arguments that, while the contract was signed after mitigation went into effect, it was negotiated prior to mitigation. "CDWR could have postponed execution of the contracts and demanded renegotiation of contract terms after it learned of the Commission-directed implementation of the West-wide mitigation." July 23 Order ¶ 21, ER47.

Petitioners do not challenge these findings. Rather, Petitioners assert that the Pacificorp contract was unjust and unreasonable, and was not reviewed by the Commission. Pet. Br. 75. Neither contention is supported nor does either have

¹⁹ On January 15, 2003, "PacifiCorp Power Marketing, Inc." changed its name to "PPM Energy, Inc."

merit. Petitioners proffer no support for the proposition that the Pacificorp contract is unjust and unreasonable; to the extent Petitioners rely on the evidence they proffered with regard to other contracts, that evidence was rejected as discussed above, and in any event a showing of unjust and unreasonable rates does not prove the contract contrary to the public interest. Similarly, Petitioners' argument that the contract has never been reviewed fails to take into account the Commission's approval of Pacificorp's market-based rate.

This does not contradict the Commission's determinations with respect to the other contracts challenged by Petitioners. Pet. Br. 76. Petitioners' complaints as to all contracts were based on the allegation that the spot market dysfunctions caused unjust and unreasonable rates in the forward contract markets. As the spot market dysfunctions had been stabilized prior to execution of the Pacificorp contract, Petitioners' allegation was facially inadequate as to the Pacificorp contract, and therefore dismissal of it was proper. As no facial inadequacy applied to pre-June 19 contracts, the Commission permitted Petitioners to attempt, unsuccessfully, to prove their contentions regarding the effect of the spot market dysfunctions on long-term contracts.

CONCLUSION

For the reasons stated, the Commission's orders should be affirmed in all respects.

STATEMENT OF RELATED CASES

Respondent has no related cases to add to those listed by Petitioners.

Respectfully submitted,

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