

ORAL ARGUMENT NOT YET SCHEDULED

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

Nos. 04-1168, et. al. (Consolidated)

CINERGY MARKETING & TRADING, L.P.,

Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,

Respondent.

On Petition for Review
from the
Federal Energy Regulatory Commission
Docket No. EL01-118

**PETITIONERS' JOINT REPLY BRIEF
FOR CALIFORNIA STATE PARTIES AND
CONSUMER ADVOCATES**

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GLOSSARY

| | |
|--------------------------------|---|
| CAISO | California Independent System Operator Corp. |
| CEOB | California Electricity Oversight Board |
| California/Consumer | California State Parties and Consumer Advocates |
| California State Parties | CEOB and the CPUC |
| Commission | Federal Energy Regulatory Commission |
| Consumer Advocates | Colorado Office of Consumer Counsel, the Rhode Island Attorney General, the New Mexico Attorney General, the Utah Committee of Consumer Services, the Public Utility Law Project of New York, Inc., the National Consumer Law Center and Public Citizen, Inc. |
| CPUC | Public Utilities Commission of the State of California |
| FERC | Federal Energy Regulatory Commission |
| FERC Brief or FERC Br. | FERC Reply Brief dated October 17, 2005 |
| FPA | Federal Power Act |
| Intervenors' Brief or Int. Br. | Brief for Intervenors in Support of Respondent Federal Energy Regulatory Commission, dated November 16, 2005 |
| IOUs | Investor-owned utilities |
| ISO | Independent System Operator |
| June 26 Order | Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations, Docket No. EL01-118-003, 103 FERC ¶ 61,349 (June 26, 2003) |
| May 19 Order | Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations, "Order on Rehearing," Docket No. EL01-118-003, 107 FERC ¶ 61,175 (May 19, 2004) |
| MBR | Market-based Rates |
| November 17 Order | Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations, "Order Amending Market-Based Rate Tariffs and Authorizations," Docket Nos. EL01-118-000 and EL01-118-001, 105 FERC ¶ 61,218 (November 17, 2003) |

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|-------------------|--|
| November 20 Order | Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations, “Order Establishing Refund Effective Date and Proposing to Revise Market-Based Rate Tariffs and Authorizations,” Docket No. EL01-118-000, 97 FERC ¶ 61,220 (November 20, 2001) |
| Opening Brief | California/Consumers Advocates Opening Brief dated April 29, 2005 |
| RTO | Regional transmission operator |
| Rules | The Market Behavior Rules as finally adopted in the May 19 Order. |
| section 205 | section 205 of the FPA, 16 U.S.C. § 824d |
| section 206 | section 206 of the FPA, 16 U.S.C. § 824e |

SUMMARY OF ARGUMENT

I. **Consumer Advocates: FERC’s Market-Based Rate Regime Violates the FPA**¹

FERC does not contest that Consumer Advocates’ challenge to its market-based rate regime is properly before this Court in this case, and it defends its actions on the merits. FERC’s defense, however, falls flat.

FERC’s Brief concedes that the agency failed in the FPA section 206 proceeding below to “fix” or establish “just and reasonable” rates for the future, after finding that existing “market rates” were not just and reasonable. This failure to comply with the statutory requirements leaves the ultimate consumers paying rates that have been found unlawful by FERC, subject to “behavior rules” that FERC admits do not ensure lawful rates.

FERC claims that ensuring a competitive market “by itself” provides an objective standard for determining whether “market rates” are “just and reasonable.” But the cases cited by FERC state that reference to the market “alone” is *not* enough to determine that rates are just and reasonable.

Moreover, FERC can cite only the cost-based-rate standard, which its market regime has abandoned, as the test for determining whether or not market rates are unduly preferential or discriminatory. Where rates are left to the parties’ agreement, there is no way to identify, much less correct, undue preference or discrimination.

FERC attempts to reduce the FPA’s prior notice and filing provisions to mere after-the-fact “reporting requirements,” and to eliminate altogether the prior review, suspension, hearing and immediate refund protection for all increased charges provided by FPA sections 205(d) and

¹ The California State Parties do not join in this argument.

(e). FERC claims that, once a public utility adopts a “market-based rate,” there are never again any “changes” in rates and charges. FERC’s virtual abolition of section 205(e), eliminating *by definition* the possibility of all future “changes” in “market-based rates,” constitutes a total rewriting or elimination of statutory mandates that this Court, and the Supreme Court, has repeatedly held that only Congress itself may accomplish.

This Court should vacate and remand the orders under review with instructions to FERC to fix wholesale rates that are just and reasonable, as the statute requires; to adopt an objective standard, other than the market, for determining whether rates are “just and reasonable” or unduly preferential or discriminatory; and to establish notice and filing procedures that comply with the statutory mandates.

II. Challenge to FERC’s New Tariff Conditions

Supposedly promulgated to enhance consumer protection in its market-based rate regime, FERC’s Rules and complaint procedures unlawfully limit liability and remedies and, without a rational basis for the distinction, arbitrarily make it more difficult to establish a Rule violation than any other type of tariff violation. Rather than squarely address these legal defects, FERC’s Brief repeatedly tries to justify the orders under review by ignoring their text, and offering new interpretations or new rationales. FERC may not evade judicial review by mischaracterizing its orders and relying on the *post-hoc* rationalizations of counsel. More specifically:

Restriction of monetary remedies: Although FERC has prematurely determined that transaction-specific disgorgement from the individual seller is the only potential monetary remedy for any and all Rule violations, regardless of the circumstances, FERC does not dispute that both the FPA and FERC’s own precedent allow other monetary remedies for tariff violations. FERC does not even attempt to justify this *a priori* limitation, and instead

impermissibly recharacterizes the orders under review, claiming that they impose no limitations on available remedies when they expressly do so.

Imposition of limitation periods: Petitioners demonstrated that FERC’s imposition of limitation periods is not authorized by the FPA, and even if it were, FERC had failed to provide a rational basis for having chosen a 90-day period. Opening Br. at 31-35. FERC fails to respond to either demonstration. It offers no citation to any provision of the FPA that authorizes imposition of a limitations period. And it fails to cite any evidence supporting its choice of 90 days. Instead, it simply parrots the conclusory statement found in the defective orders under review that – for some unexplained reason – the 90-day period strikes an appropriate “balance.” FERC Br. at 50.

FERC improperly conditions liability for disgorgement on intent, motive, diligence and “direct nexus”: Petitioners argued that, contrary to precedent, FERC unlawfully premised seller liability for overcharges on determinations of intent, motive and due diligence. FERC now claims that this precedent does not apply because disgorgement of profits for a Rules violation is a different “remedial approach” than a refund of unjust and unreasonable rates. FERC Br. at 53. This *post-hoc* rationale is impermissible and does not explain why seller intent and motive are relevant in a proceeding seeking disgorgement, but not relevant in a proceeding seeking a refund of unjust and unreasonable rates. That consumers may have some alternate remedy also is not a reasoned explanation for FERC’s “direct nexus” standard, which requires proof that the Rule violation directly tainted contract formation in order to obtain abrogation or reformation of a negotiated contract based on the violation. FERC provides no response at all to explain its due diligence defense, which relieves sellers of liability for intentional Rule violations of their employees.

Inadequacy of specific rules: FERC’s response to challenges that its Rules fail to prohibit known manipulative practices is that these practices can be prohibited by regional rules. If this constitutes a reasoned explanation, then it would constitute a rationale for no national rules whatsoever.

ARGUMENT

I. FERC’s MBR Regime is Unlawful²

A. FERC Concedes It Failed to Fix “Just and Reasonable” Future Rates

FERC’s Brief admits that the agency did not set future “just and reasonable” rates as FPA Section 206(a) requires when it ordered “behavior rules” to accompany market-based rates prospectively. Moreover, FERC acknowledges that, “as the Commission recognized . . . rates may be unjust and unreasonable for reasons other than a failure to follow the market behavior rules.” (FERC Br. at 69 n. 15.)

The statute requires that all rates demanded or received by any public utility “shall be just and reasonable,” and states that any rates that are not are “unlawful.” FPA section 205(a). When FERC finds, as it did in the section 206 proceeding below, that existing rates are unjust and unreasonable, FERC *must* fix the future lawful rates. FERC admits it has not done so, and cannot do so in a market-based regime, because merely establishing behavior rules will not ensure that the “market-based” rates are just and reasonable. (FERC Br. at 69 n.15.)

Intervenors claim that FERC need not fix just and reasonable rates for the future, but may fix only a just and reasonable “rule.” (Int. Br. at 15.) If that were the case, however, FERC should find that, once such a rule was in place, the rates “thereafter in force” would meet the statutory standard for lawfulness. But FERC itself has conceded that this is not the case. (FERC

² The California State Parties do not join in this section of the brief.

Br. at 69 n. 15.) Consumers, who are supposed to have a “complete, effective and permanent bond of protection” from paying excessive rates,³ are left without ever knowing what “market rates” are just and reasonable, either in the present or in the future. After years of investigation under section 206, FERC allows “market rates” to continue to be charged without fixing lawful rates.

B. FERC Is Wrong That the Only “Ratemaking Method” That It Need Apply Is Assuring a Competitive Market

Consumer Advocates have long claimed that FERC does not have an objective standard by which it can determine whether or not “market rates,” negotiated by the parties, meet the statute’s “just and reasonable” standard. FERC no longer uses a cost-of-service standard for wholesale electric sales, and has not identified an alternative objective test. FERC responds in its brief that the *only* standard that it need use is whether or not the electric market is “competitive.” FERC Br. at 63.

FERC cites *Tejas Power Corp. v FERC*, 908 F.2d 998 (D.C. Cir. 1990), and *Elizabethtown Gas Co. v. FERC*, 10 F.3d 866 (D.C. Cir. 1993), as support for its argument that competitive markets *alone* are sufficient. *Id.* In fact, *Elizabethtown* says exactly the opposite, as FERC’s own quote from that decision shows (Br. at 63):

In *Texaco*, the Commission ...appeared to apply *only* the “standard of the marketplace” in reviewing the “reasonableness of a rate.”...Here, *in contrast*, the FERC has made it clear that it will exercise its § 5 authority upon its own motion or upon that of a complainant to assure that the market (*i.e.*, negotiated) rate is just and reasonable.

Elizabethtown Gas, 10 F.3d at 870 (citations omitted, emphases supplied).

³ *Atlantic Ref. Co. v. Pub. Serv. Comm’n of State of N.Y.*, 360 U.S. 378, 388 (1959).

Clearly, the Court in *Elizabethtown* believed that FERC had some standard other than *only* the “standard of the marketplace” to use when it looked at the rates under its prospective NGA § 5 (or FPA § 206) authority to determine whether such rates were in fact “just and reasonable.”

FERC’s quote from *Tejas* (FERC Br. at 63) also fails to support FERC’s claim that *only* the market need be referenced to determine statutory “just and reasonable” rates. The court there stated in *dictum*:

In a competitive market, where neither buyer nor seller has significant market power, it is rational to assume that the terms of their voluntary exchange are reasonable, and specifically to infer the price is close to marginal cost, such that *the seller makes only a normal return on investment.*

Tejas, 908 F.2d at 1004 (emphasis supplied).

This is an objective standard – looking at whether or not the seller is making “only a normal return on investment” – that FERC *could* employ to determine whether or not negotiated rates are in fact “just and reasonable.” But FERC does not do this, nor has it adopted this “objective standard” for measuring or monitoring “just and reasonable rates.”

Indeed, if such a standard were used, few current rates might be found to be just and reasonable. For example, a single auction market by definition provides the same price for electricity supplies generated by widely different plants and fuels, and thus may result in dramatically different returns on investment. Electricity from a coal plant long since depreciated by payments from ratepayers under cost-of-service rates, for example, would receive the same price per kwh or kw as a new, gas-fired “merchant” plant, with the highest bid setting the price for all. The difference in the rates of return can therefore be astronomical. But FERC makes no claim that, in “monitoring” rates, it looks at rates of return on investment, which is, after all, a cost-of-service notion.

It is ironic that FERC relies so heavily on the *Tejas* decision as support for its position (Intervenors, interestingly, do not reference the case), since *Tejas* repeatedly states that FERC may not rely only on the *agreement* of gas sellers and buyers (local distribution companies or “LDCs”) to determine whether the *public interest* has been served:

[N]either the Commission nor we may merely assume, without analysis, that the LDCs’ protection of their own interests (if indeed they were able to protect them) will inure to the benefit of consumers; as regulated utilities, the LDCs might not have a sufficient incentive, in dealing with the pipeline, to minimize their costs. . . .

On remand, FERC must consider whether an LDC’s customers are “saddled with unwarranted expenses that the LDC may have had little incentive to avoid.” *Compare, e.g., Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953, 970 (1986) (filed rate doctrine bars State from preventing seller of power “from recovering the costs of paying [a] FERC-approved rate”)

Id. at 1004.

In summary, this Court recognized in *Tejas* that agreement by the wholesale buyer – when the buyer can pass through his prices to retail customers – cannot be assumed to provide adequate protection for those end consumers. Even if a competitive market can be assumed to result in a price that is “reasonable” from the point of view of the wholesale buyer, it does not follow that it results in a statutory “just and reasonable” price for the end user who will ultimately pay it. Yet this assumption is the basis of FERC’s entire market-rate regime.

Surprisingly, both FERC and Intervenors place their chief reliance for FERC’s market-based rate authority, begun in 1986, on a 2004 decision of the Ninth Circuit. FERC claims that the validity of its market based rate regime “has been litigated many times previously,” but only cites *California ex rel., Lockyer v. FERC*, 383 F.3d 1006 (9th Cir. 2004), *rehearing pending*

(FERC Br. at 59), which FERC claims was “following this court’s instruction in *Tejas*, *LEPA*,⁴ and *Elizabethtown*....” (FERC Br. at 68). The Ninth Circuit in *Lockyer* indeed relied on these decisions of this Circuit as though they represented settled law as to FERC’s statutory authority to allow utilities to charge market rates, without reference to the explicit caveats in each of this Court’s opinions that they were *not* addressing the agency’s statutory notice and filing provisions⁵ or its entire market based rate scheme.⁶

Indeed, FERC’s legal support for its whole electricity (and natural gas) market- rate scheme appears to boil down to the sentence of dictum in *Tejas* quoted above at p.4. This dictum appears to be the basis for the holding in *Elizabethtown Gas*, although, as discussed above, that case does *not* support FERC’s view that it can rely on the marketplace alone to set just and reasonable rates. The third decision of this court, *LEPA*, in turn relied on *Elizabethtown Gas* for the assumption that FERC has the authority to allow market rates for wholesale electric energy. *LEPA* itself focused on whether a particular FERC determination that a seller lacked “market power” was arbitrary or capricious. However, the *LEPA* decision expressly noted that no challenge to FERC’s entire market rate scheme had been raised in that case.⁷

Intervenors claim that FERC’s market power screens ensure that wholesale customers have “genuine alternatives....” Int. Br. at 11. However, FERC itself determined in its section 206 investigation that such “genuine alternatives” did not result in “just and reasonable rates.” Indeed, the whole concept of the need for “behavior rules” for market participants belies

⁴ *Louisiana Electric Power Association v. FERC*, 141 F.3d 364 (D.C. Cir. 1998) (“*LEPA*”).

⁵ *Elizabethtown Gas*, 10 F.3d 866 at 871.

⁶ *LEPA*, 141 F.3d at 364 n.2.

⁷ *Id.*

the idea that markets by themselves will result in “just and reasonable” rates. And even with such rules, FERC admits it cannot be sure the rates will be lawful.

C. FERC Can State No Standard for Determining Whether “Market-Based” Rates Are “Unduly Preferential or Discriminatory”

In response to Consumer Advocates argument that it has no standard for determining whether “market rates” are unduly preferential or discriminatory as prohibited by FPA Section 205(b), FERC claims that its legal standard “remains what it has always been: disparate rates for similarly situated customers that are receiving the same service.” (FERC Br. at 63).

Of course, this standard “has always been” applied to cost-of-service rates, such as the cost-based *pro forma* transmission tariffs that FERC cites in its Brief (pp. 63-64). But the standard has no known application to “market-based” rates where the seller and buyer are free to negotiate their own rate, irrespective of what other sellers and buyers have agreed upon for the same service. And, although a wholesale buyer would arguably try to get the best price, even though it can pass through its FERC-accepted rates to retail customers, there is nothing about the assumptions underlying “market-based” rates that would cause a wholesale customer to object to *receiving* undue advantages or preferential treatment.

FERC repeatedly insists that it has “mechanisms” and “means” to prevent discriminatory or preferential rates. FERC Br. at 64. Intervenors similarly contend that “any concerns about disparate treatment...can be identified through the quarterly reporting requirement.” Int. Br. at 11. But without an objective standard for determining when such preference or discrimination occurs, all such means, mechanisms and monitoring are meaningless. How can FERC identify “disparate treatment” when the parties are free by the clear terms of their “tariff” to engage in any treatment they find agreeable?

D. FERC Fails to Show That the Range of Rates Offered by Its “Market-Rate Tariff” Conforms to FPA Sections 205(c) and (d)

The actual form of FERC’s MBR deregulatory regime is most similar to the “range of rates” disapproved by this court in *Southwestern Bell Corp v. FCC*, 43 F.3d 1515 (D.C. Cir. 1995). There, the court found that allowing a “reasonable range of rates” to be charged, rather than a fixed rate as required by the statute, was impermissible.⁸ Similarly, FERC’s use of a “tariff” that states that future charges will be whatever the parties agree establishes a broad “range of rates.” A broad statement that the rate will be “by agreement” of the parties cannot substitute for the “definite and specific” charges which the court decisions have agreed are required to be filed by FPA section 205(c) and (d).

Giving “notice” that future rates and charges and services will be whatever the parties agree to, whenever they agree to change them, is equivalent – in sports terms – to the infamous “lookout block” of an offensive lineman in football, who, failing to protect the quarterback by stopping the rusher, is reduced to yelling: “Look out!” This is not the “complete, effective and permanent bond of protection from excessive rates” that the statute had in mind.

Intervenors ignore *Southwestern Bell*, while FERC relegates it to a footnote (FERC Br. at p.67, n. 14), which attempts to distinguish its own scheme “because the FERC quarterly reports require each seller to list the terms of each transaction individually.” FERC states that *these data* are specific and do not constitute a range of rates similar to the scheme rejected in *Southwestern*. (*Id.*)

The fatal flaw in this argument is that the next page of FERC’s Brief states that these same quarterly reports are *not* rate filings under the FPA, but merely satisfy “reporting

⁸ *Id.* at 1519.

requirements,” (a term that appears nowhere in FPA sections 205 or 206). FERC argues (FERC Br. at 68) that *Lockyer* was correct in finding that only the initial adoption of a “market-based rate tariff” itself constitutes a change in rate that must be filed under section 205(d), and may be suspended and set for hearing with burden of proof on the seller and immediate refund protection under section 205(e). It follows from FERC’s own argument that the market-based rate tariff *itself*—not the quarterly reports—is the “rate schedule” that must contain “definite and specific” charges to satisfy the statute. FERC’s argument defeats itself.

Intervenors claim (Int. Br. at 14) that Consumer Advocates are arguing that the quarterly reports are “changes” to market-based rate tariffs. To the contrary, we argue that the *charges* reflected in the quarterly reports are, indeed, changes to the rates that consumers pay, and thus are “rate changes” – whether increases or decrease—that must be noticed in advance *by being filed* under the statute. Section 205(d). When the statute itself requires that *prior* notice must be given “by filing” the schedule of charges – so that the rates can be reviewed for possible suspension and refund – arguments that mere “reports” of such charges three months after the fact would offer the same statutory protections are unsupportable.

Intervenors take language out of context from section 205(d) to argue that the prior notice requirements for rate changes do not apply at all if “the Commission otherwise orders.” Int. Br. at 14. They ignore the last sentence in section 205(d) that requires the Commission, if it issues such an order, to specify “the *changes so to be made* and the *time when they shall take effect* and the manner in which they shall be filed and published.” 16 U.S.C. § 824d, Appendix A, (emphases supplied). Nothing in a “market-based rate tariff” that states that rates will be “by agreement” of the parties can be said to “specify” what such rates and charges will actually be or when they will become effective, much less how they can be reviewed, challenged, suspended

and set for hearing with the burden of proof on the seller, and made subject to immediate refund as sections 205(d) and (e) provide.

E. FERC and Intervenors Ignore Supreme Court and Other Precedent

Neither FERC nor the Court is writing on a blank slate when it comes to interpreting the notice, filing, suspension, and refund provisions of the NGA and the FPA. Our Opening Brief notes (at 24) that as early as 1956, the Supreme Court held:

[T]he filing requirements are obviously necessary to permit the Commission to *exercise its review functions*, and the requirement of 30-days' advance notice of changes is essential to afford the Commission a reasonable period in which to determine *whether to exercise its suspension powers under § 4(e)* [equivalent to FPA 205(e)].

United Gas Pipe Line Co. v. Mobile Gas Serv. Corp., 350 U.S. 332, 342 (1956) (emphasis supplied).

FERC and Intervenors ignore this precedent as well as the other cases cited by Consumer Advocates regarding the importance to consumers of whether a filing constitutes a rate “change” or not in terms of consumer protections that would be available. (Opening Brief at 23-24.)

Under “FERC’s system,” the burden of proof, once market-based rates are allowed, will always be on either FERC or the consumers to show that market-based rates are *not* just and reasonable. Indeed, the basis for Cinergy’s petition in this case is that such a burden was not met.

Even *Lockyer*, on which FERC purports to rely, recognized that something was very wrong with “FERC’s system,” which appeared to eliminate section 205(e) refund protections altogether. The court remanded the case for FERC to rethink its refund authority. However, refunds are just one of the consumer protections provided by FPA sections 205(d) and (e). And even if FERC has authority, as directed by the Ninth Circuit, to provide “substitute remedies for

the obtaining of refunds for the imposition of unjust, unreasonable and discriminatory rates,” *Lockyer*, 303 F.3d at 1016, FERC would also have to provide “substitute remedies” for the remaining consumer protections offered by sections 205(d) and (e) – such as prior notice by filing and review of specific charges, possible suspension, and hearing with the burden of proof on the seller.

Ultimately, however, neither a court nor an agency can provide “substitutes” for the statutory remedies that the Congress has provided. FERC’s entire market rate scheme is unlawful because it substitutes “FERC’s system” for that of Congress in the FPA.²

F. Intervenor’s Argument That Statutory Changes Made in 2005 Support Their Interpretation of 1935 FPA Sections Is Unavailing

Intervenors, but not FERC itself, claim that the Energy Policy Act of 2005 supports FERC’s “interpretation” of the notice and filing requirements of the FPA because it provides rules for preventing manipulation of “market rates.” Int. Br. at 11-13. However, the views of the Congress in 2005 are no help to the court in interpreting the views of the Congress in 1935, when the notice and filing requirements of the FPA were enacted. *Cf.*, *Exxon Mobil Corporation v. Allapattah Services, Inc.*, 125 S. Ct. 2611 (2005) (“[T]he views of the 2005 Congress are not relevant to our interpretation of a text enacted by Congress in 1990.”)

² *See, e.g., MCI Telecomms. Corp v. Am. Tel. & Tel. Co.*, 512 U.S. 218 (1994) (regulatory agency lacks power to waive statutory rate filing procedures for utilities lacking dominant market power), *citing Maislin Indus. U.S. v. Primary Steel Inc.*, 497 U.S. 116 (1990) (compliance with rate filing provisions is “utterly central” to administration of the statute); *Southwestern Bell Corp. v. FCC*, 43 F.3d 1515, 1519 (D.C. Cir 1995) (regulatory agency may not ignore congressional directives and allow a “range of rates” because it believes “traditional tariff regulation” is “unnecessary” and “unproductive”); *Regular Common Carrier v. United States*, 793 F.2d 376 (D.C. Cir. 1986) (regime of unpublished rates ripe for challenge; material that was filed was not a “rate”); *Electrical Dist. No. 1 v. FERC*, 774 F.2d 490, 492-93 (D.C. Cir. 1984) (Federal Power Act requires the rate actually charged to be determinable and specified in tariffs; principles for setting rates were not sufficient.)

The most that can be inferred from the new statutory language is that the Congress in 2005 was aware that FERC is allowing market-based rates to be charged. This does not necessarily say anything about whether such rates now comply or could comply with other parts of the statute, and the fact that the Congress did not specifically overturn those other parts indicates that the majority did not have the inclination to do so.

G. Intervenor’s Lack of Notice Claim is Frivolous

Intervenors (Int.Br. at 2) argue that they lacked notice that the FERC might actually find market based rates to be unauthorized by law when FERC set for hearing the justness and reasonableness of market rates for electric energy in 2001. Because Consumer Advocates have argued the justness and reasonableness of market rates from early in this proceeding, this argument is frivolous. Moreover, neither Intervenors nor any other party can have a reasonable reliance interest in FERC’s continuation of a regulatory regime for which it lacks any statutory authority.

II. FERC’s Orders Unlawfully Restrict Remedies and Enforcement of Tariff Violations and Arbitrarily Fail to Prohibit Known Manipulative Conduct

A. Limitation of Monetary Remedies

The Opening Brief at 27-31 demonstrates that FERC may not, *a priori*, limit monetary remedies for a violation of the Rules to disgorgement of unjust profits on a transaction-specific basis, and only from the seller found in violation of the Rule. In the orders under review, FERC explicitly and summarily rejected even the possibility of imposing market-wide remedies. *See* November 17 Order ¶ 151, JA _____, and Appendix A; May 19 Order ¶¶ 129, 131, JA _____. FERC’s Brief now recharacterizes its orders, and asserts that although limited disgorgement is the “principal remedy” for a violation, it will consider additional and different remedies on a

case-by-case basis. FERC Brief at 46-47.¹⁰ FERC also now implies that a market-wide remedy may be an appropriate remedy for violations that affect the market-clearing price in auction markets. *Id.*

Although this newfound flexibility is welcome, it is not found in FERC's orders under review, as noted above. If FERC has changed its mind, FERC should issue an order that clearly states that other monetary remedies may be imposed, including but not limited to a make-the-market whole remedy. FERC cannot, however, pretend its formal orders say what they do not, and evade judicial review on the basis of *post-hoc* rationalizations of counsel. *See Florida Mun. Power Agency v. FERC*, 411 F.3d 287, 291 (D.C. Cir. 2005) (“We may uphold agency orders based only on reasoning that is fairly stated by the agency in the order under review, *post hoc* rationalizations by agency counsel will not suffice”) (citations and quotations omitted).

In any event, FERC fails to address the specific defects in the orders it *did* issue, noted in Petitioners' Opening Brief at 27-31. For example, FERC's *a priori* restriction on available remedies for these tariff violations conflicts with the purposes of the FPA and FERC's prior orders, and as such constitutes an abuse of discretion. The purposes of the Rules, even according to FERC, are to “ensure the level of protection required by the FPA,” to “ensure that all rates remain just and reasonable,” and to ensure that buyers have an “effective remedy” – “full refund protection” – for market abuses. *See* FERC Br. at 4, 18; November 20 Order at 61,975, JA _____; November 17 Order ¶¶ 3-4, JA _____; May 19 Order ¶ 8, JA _____. FERC ignores

¹⁰ The language cited regarding “case-by-case analysis” actually refers to FERC's evaluation of whether to impose a disgorgement remedy, and not whether other monetary remedies may be imposed. November 17 Order ¶¶ 149-50, JA _____. FERC's Brief at 46 also makes general reference to “reliance on existing procedures or other remedial tools as may be necessary,” but specifically refers only to generic rule changes and civil penalties. *See* November 17 Order ¶ 149 & n.87, JA _____.

Petitioners' argument, and its orders and Brief nowhere explain how the *a priori* limitation of remedies fulfills these purposes. Instead, FERC now asserts, for the first time, that that disgorgement of unjust profits by an individual seller yields the same recovery to consumers as refunds to a just and reasonable level. FERC Br. at 47. This assertion is both irrelevant and untrue.

This *post-hoc* rationalization is irrelevant because the issue is not a choice between disgorgement and refunds (whatever FERC means by that term; *see* note 14, below). The issue is FERC's decision to eliminate – *a priori* – all other potential monetary remedies for these tariff violations – remedies that FERC indisputably *may* legally impose. For example, this new rationale ignores the fact that disgorgement only by the particular seller in violation of a Rule may be inequitable where, for example, the violation raises the market price paid to all sellers, and other sellers will be allowed to retain the unlawful rate, and not return those to consumers. *See, e.g.*, June 26 Order ¶ 62,381 (Massey Concurring in Part), JA _____. FERC continues to fail to provide any explanation – reasoned or otherwise – for this decision.

The assertion is untrue because it mischaracterizes the orders under review. Although FERC now asserts that “disgorgement” means taking back from the seller *all* of its profits, FERC's orders clearly require disgorgement only of “unjust” or excess profits, not all profits. *See, e.g.*, May 19 Order ¶ 129, JA _____. That is, the orders only contemplate disgorgement of profits above the just and reasonable rate. Once again, FERC may not ignore the orders under review and rely on the *post-hoc* rationalizations of counsel to justify its position. (Moreover, even if disgorgement were to apply to all profits and not merely to “unjust” profits, the remedy may be inequitable in certain circumstances, as compared to market-wide relief, for the reasons noted above.)

Finally, to the extent that the Rules are intended to deter seller misconduct, disgorgement of transaction-specific profits is a patently insufficient sanction deterrent for a Rules violation (as distinct from a remedy for consumers), because sellers have no incentive to *not* try to cheat – they are only punished when and if they are caught, and then only for the “unjust” profits. Opening Br. at 30-31. FERC has no response at all to this fact, save for its mischaracterization of the orders under review and to now claim that it really meant disgorgement of all profits.

B. The 90-Day Limitations Periods

FERC fails to refute Petitioners’ arguments that imposition of a 90-day limitations period for complaint proceedings alleging a violation of the Rules finds no authority in the FPA, conflicts with rights conferred by section 206, and lacks any reasoned explanation. *See* Opening Br. at 31-35. In fact, FERC concedes that nothing in the FPA, including section 206, authorizes FERC to impose limitations periods for consumer complaints seeking relief for tariff violations.¹¹ FERC Br. at 48.

FERC instead now argues – for the first time – that section 206 is irrelevant. *See* FERC Br. at 48-49. This argument is yet another impermissible *post-hoc* rationalization of counsel. FERC actually relied on section 206 as the basis for its authority to adopt the Rules and also rejected arguments that its disgorgement remedy for past violations was contrary to the refund limitations in section 206(b) or the filed rate doctrine, and cannot now disavow the relevance of section 206 to its orders. *See* May 19 Order ¶¶ 157-161, JA ____; November 17 Order ¶¶ 158-162, JA ____.

¹¹ Contrary to the argument in the Intervenors’ Brief at 3, the 90-day limitation for initiation of consumer complaints does not commence upon reasonable discovery, but rather its application is subject to an *exception* if the complainant can establish that it did not or should not know of the violation.

Second, section 206 – regardless of whether FERC relied on it or not – gives consumers an unqualified right to complain about unjust and unreasonable rates, whether caused by changed conditions or sellers’ violation of their tariffs or other applicable law, and FERC has discretion to award not only prospective, but retroactive, relief in a section 206 complaint proceeding. *See Consolidated Edison Co. of New York v. FERC*, 347 F.3d 964, 974 (D.C. Cir. 2003); *Towns of Concord, Norwood, and Wellesley, Mass. v. FERC*, 955 F.2d 67, 73 -76 (D.C. Cir. 1974).¹² FERC cites no authority allowing it to restrict consumers’ rights pursuant to section 206, and FERC cannot imply such authority based on “policy considerations.” *See Atlantic City Elec. Co. v. FERC*, 295 F.3d 1, 3, 8-11 (D.C. Cir. 2002).

Third, even if FERC were authorized to impose a limitations period, FERC’s Brief, as was the case with the orders under review, fails to demonstrate that its 90-day limitations period, as opposed to any other time period, resulted from reasoned decisionmaking. FERC cites no evidence, offering only the same conclusory statement found in the underlying orders, that the 90-day period is the appropriate balance “between encouraging due diligence in protecting one’s rights, discouraging stale claims, and encouraging finality in transactions.” FERC Br. at 50.¹³ Nothing in FERC’s Brief points to any evidence at all in the record – much less substantial evidence – that supports its conclusion that a 90-day period “will ensure that a reasonable person

¹² The assertion at p. 49 of the FERC Brief that there are “different possibilities,” and a party may “have to decide whether filing for rate relief under FPA section 206 or for disgorgement under these Rules would better remedy the alleged problem” implies an election of remedies. This assertion conflicts with other arguments in FERC’s Brief that these remedies are neither “mutually exclusive nor redundant.” *See* FERC Br. at 53. Because these Rules are included in the sellers’ tariffs, a Rules violation is a tariff violation. FERC may award retroactive relief for tariff violations (*see Towns of Concord and Consolidated Edison*, cited above), as well as prospective relief in a section 206 complaint proceeding, and nothing in the FPA supports any such election of remedies.

¹³ Notably, all of these policy considerations give primacy to sellers’ interests, and there is no (continued . . .)

exercising due diligence will have sufficient time to discover hidden wrongful conduct and to submit a claim” May 19 Order ¶ 148, JA _____. Conclusory statements are not reasoned decisionmaking. *Consolidated Edison*, 347 F.3d at 972. And that FERC may grant exceptions to its limitations period does not make the 90-day period any less arbitrary.

Finally, contrary to the assertion in Intervenor’s Brief at 4-5, Petitioners are not challenging FERC’s exercise of its enforcement discretion, but whether FERC can arbitrarily restrict its ability to exercise that discretion by imposing a 90-day limitations period for its initiation of enforcement proceedings for Rule violations. FERC is not constrained by any limitations periods for enforcement action with respect to violation of any tariff condition other than the Rules. Moreover, nothing in the record supports a conclusion that 90 days is a reasonable timeframe for FERC to investigate potential violations and commence enforcement proceedings. FERC’s reaction to the California energy crisis demonstrates to the contrary.

C. Intent, Motive, Due Diligence and Direct Nexus

FERC does not dispute the precedent that seller intent, motive and diligence are irrelevant to whether a tariff has been violated and that deviation from the tariff is not permitted under any pretext. *See* Opening Br. at 36. Nor does FERC provide any principled basis for departing from this precedent. Instead, FERC raises another argument not raised below – that FERC does not need to justify these requirements because the disgorgement remedy is a different remedial approach than a “refund remedy,”¹⁴ and that this distinction somehow justifies different

mention of FERC’s primary mandate under the FPA, consumer protection.

¹⁴ “Refund remedy” is nowhere explained in FERC’s orders under review or FERC’s Brief. It appears that “refund remedy,” means only prospective relief – resetting rates to a just and reasonable level, and ordering refunds not for the full damage caused by a seller’s unlawful manipulation of the market, but only for damage caused since the section 206-specified refund effective date. FERC Br. at 48-49.

standards. FERC Br. at 53. This new rationale, however, even if FERC were permitted to raise it for the first time in its answering brief, is as flawed as FERC's original rationale: It is impossible for FERC to explain – and it does not even attempt to do so – why seller intent and motive are determinative in a proceeding seeking disgorgement of profits, but irrelevant in a proceeding seeking a “refund remedy” for unlawful rates.¹⁵ The distinction FERC attempts to draw therefore is entirely arbitrary and cannot support the orders under review.

FERC similarly fails to provide a reasoned explanation for the requirement of a “direct nexus” between contract formation and a Rule violation that “tainted” contract formation in order to obtain reformation or abrogation of a negotiated contract (as opposed to a transaction through the regional auction markets) based on the Rule violation. *See* Opening Br. at 38. In its orders, FERC vaguely referred to unspecified policies and principles, and noted that if this elevated standard cannot be satisfied, consumers may attempt to obtain some relief by filing a separate section 206 complaint alleging the contract rates are unjust and unreasonable or not in the public interest, as required by the contract terms. May 19 Order ¶ 45 n.28, JA _____. The fact that there may be an alternate remedy might, in FERC's view, mollify the effect of FERC's irrational limitation on liability, but it does not constitute a reasoned explanation for imposition of the requirement.¹⁶

¹⁵ As FERC acknowledges, since the Rules do not supersede or replace other rights under section 206, rates may be found unlawful in cases where no Rules violation occurs. FERC Br. at 53. But this statement is true in general with respect to tariff conditions other than the Rules. Imposing an intent requirement solely on the basis that “a Rules remedy may be warranted in the absence of unlawful rates” (FERC Br. at 53-54 n.10) – for example, when an attempt to manipulate the market prices fails – cannot be justified on the difference between disgorgement and a “refund remedy,” as FERC acknowledges in most such instances there will be no profits to disgorge. November 17 Order ¶ 40 n.27, JA _____.

¹⁶ In any event, the alternate remedy that FERC posits in its wash trade example does not constitute “full refund protection.” FERC Br. at 55-56. Under FERC's example, although (continued . . .)

Finally, FERC just fails to respond to the challenge that its orders fail to provide any explanation for the due diligence defense, which, for example, would absolve a seller for the intentional Rule violations of its employees as long as the seller had implemented compliance procedures.¹⁷ See Opening Br. at 37.

D. The Rules Fail to Prohibit Known Manipulative Behavior

Petitioners challenged FERC's arbitrary refusal to implement Rules expressly and unequivocally prohibiting the withholding of energy supply, hockey stick bidding and the exercise of market power during periods of transmission congestion (as opposed to only prohibiting the creation and relief of artificial transmission congestion). Despite the lessons learned from the California energy crisis, FERC maintains that national rules are not necessary because sellers' conduct will be controlled by the rules of the regional markets. If this constitutes a reasoned explanation, it would constitute a justification for no national rules whatsoever, as FERC could argue that all of the behaviors prohibited by the Rules should be controlled by region-specific rules. Moreover, FERC fails to demonstrate that the rules of the regional markets effectively prohibit such behavior. Even assuming the regional rules were adequate, with the exception of the CAISO, the western United States has no formal regional markets. FERC provides no reasoned explanation as to why specific rules are necessary for regional power markets, but not for transactions outside of these formal markets.

profits from the wash trade are disgorged in the complaint proceeding for the Rule violation, in the separate section 206 complaint proceeding for abrogation or reformation of a bilateral contract tied to a price index manipulated by the wash trade, the contract price is only re-set for the future, allowing the seller to retain the past profits from the increased contract price caused by the wash trade.

¹⁷ Rules 2(b), 2(c) and 3 prohibit intentional false reporting of information to transmission providers, intentional creation and relief of artificial congestion, and false or misleading (continued . . .)

CONCLUSION

Consumer Advocates contends that the Court should declare FERC's market-based rate regime to be contrary to the mandates of the FPA, vacate the orders under review in their entirety, and remand with the direction that FERC: (1) fix just and reasonable rates that are consistent with the statute; and (2) consider what refunds should be paid to parties in the underlying proceedings as a result of rates charged unlawfully, along with any other equitable remedies that this Court finds appropriate.

If the Court does not conclude that FERC's MBR regime is unlawful under the FPA, the Court should vacate the orders in part to eliminate: (1) FERC's limitation of remedies; (2) the limitations periods imposed for both initiation of investigations by FERC and complaint proceedings; and (3) FERC's conditioning of Rule violations on determinations of seller intent, motive, due diligence or a finding of a direct nexus. The Court also should remand the orders to FERC to modify the Rules to specifically prohibit the known manipulative practices specified above.

communications with the FERC, market-monitors, RTOs or ISOs, only where the seller failed to exercise due diligence to prevent the occurrence.

Dated: December 22, 2005

Respectfully submitted,

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**CERTIFICATION OF COMPLIANCE WITH FED. R. APP. P. 32(a)(7)(C)
AND D.C. CIRCUIT RULE 32-1**

I certify that pursuant to Federal Rule of Appellate Procedure 32(a)(7)(C) and D.C. Circuit Rule 32(a)(1), the attached opening brief is proportionately spaced, has a typeface of 11 points or more and contains 6,954 words.

Dated: December 22, 2005

ELIZABETH M. MCQUILLAN

CERTIFICATE OF SERVICE

I, Perrine Salariosa, declare:

I am a citizen of the United States, over 18 years of age, employed in the City and County of San Francisco, and not a party to the subject cause. My business address is the California Public Utilities Commission, Legal Division, 505 Van Ness Avenue, San Francisco, California 94102.

On December 22, 2005, I served two copies of the attached **PETITIONERS' JOINT REPLY BRIEF OF THE CALIFORNIA STATE PARTIES AND CONSUMER ADVOCATES** on the parties and intervenors in these proceedings, by mailing, first class, postage pre-paid, to the entities listed in the Service List, below:

I declare under penalty of perjury that the foregoing is true and correct.

Executed on December 22, 2005, at San Francisco, California.

Perrine Salariosa

SERVICE LIST

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