

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

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

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Dated: April 29, 2005

CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

Pursuant to Circuit Rule 28(a)(1), the undersigned counsel of record certify as follows:

A. Parties and Amici

The following are parties in the consolidated proceedings in this Court:

1. Petitioners:

No. 04-1168: Cinergy Marketing & Trading, L.P.
No. 04-1170: Cinergy Trading Services
No. 04-1188: California Electricity Oversight Board
No. 04-1235: Public Utilities Commission of the State of California
No. 04-1237: Western Gas Resources, Inc.
No. 04-1238: Colorado Consumer Counsel, et al.¹

2. Respondent:

Federal Energy Regulatory Commission

3. Intervenors:

Edison Electric Institute
California Electricity Oversight Board
The Electric Power Supply Association
Avista Energy, Inc.
Puget Sound Energy
American Forest and Paper Association, Inc.
Mirant Americas Energy Marketing, L.P.
Process Gas Consumers Group
American Iron and Steel Institute
Wisconsin Public Service Corporation
Upper Peninsula Power Company
PJM Industrial Customer Coalition
American Public Power Association
Transmission Access Policy Study Group
Brooklyn Union Gas Company
Boston Gas Company
Colonial Gas Company
Energy North Natural Gas, Inc.
Keyspan Gas East Corporation

¹ Other petitioners in No. 04-1238 are 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. These petitioners are referred to collectively as “Consumer Advocates.”

Essex Gas Company
Duke Energy Corporation
American Electric Power Service Corporation
BP Energy Company
Constellation Power Source, Inc.
American Gas Association
Powerex Corp.
Proliance Energy, LLC
Sacramento Municipal Utility District
New England Conference of Public Utilities Commissioners
PacifiCorp
Morgan Stanley Capital Group Inc.
Morgan Stanley
National Association of State Utility Consumer Advocates

B. Rulings Under Review

The California Electricity Oversight Board, the Public Utilities Commission of the State of California (the “California State Parties”) and Consumer Advocates seek review of the following orders issued by the Federal Energy Regulatory Commission:

(1) *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); and

(2) *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).

C. Related Cases

By Order issued July 23, 2004, this Court consolidated *Cinergy Marketing & Trading, L.P. v. FERC*, No. 04-1168; *Cinergy Services, Inc. v. FERC*, No. 04-1170; *California Electricity Oversight Board v. FERC*, No. 04-1188; *Public Utilities Commission of the State of California v. FERC*, No. 04-1235; *Western Gas Resources, Inc. v. FERC*, No. 04-1237; and *Colorado Consumer Counsel, et al. v. FERC*, No. 04-1238. The consolidated cases on review were not previously before this Court.

A case involving similar issues regarding whether FERC's market-based rate tariffs comply with the requirements of the Federal Power Act is *California, ex rel., Lockyer v. FERC*, 383 F.3d 1006 (9th Cir. 2004). A case involving similar issues regarding FERC's remedial discretion in complaint proceedings pursuant to the Federal Power Act is *CPUC v. FERC*, United States Court of Appeals for the Ninth Circuit Court, Docket Nos. 01-71051, et al.

On February 28, 2005, the Court ordered the California State Parties and Consumer Advocates to file a joint petitioners' brief.

D. Rule 26.1 Certificate

Pursuant to Federal Rules of Appellate Procedure 26.1 and Rule 26.1 of this Court, counsel for petitioner, Public Citizen, Inc., filing on behalf of petitioners Colorado Office of Consumer Counsel, Rhode Island Attorney General, New Mexico Attorney General, Utah Committee of Consumer Service, Public Utility Law Project of New York, Inc., and the National Consumer Law Center, Inc., on behalf of its low-income clients (together, "Consumer Advocates"), certifies that:

(1) Public Citizen, Inc., is a non-profit corporation engaged in advocacy efforts on a range of issues including electricity deregulation. Public Citizen, Inc., has no parent company and no subsidiaries or affiliates that have issued shares to the public. No publicly held company has an ownership interest in it.

(2) Public Utility Law Project of New York, Inc., is a non-profit corporation representing the interests of utility consumers on issues affecting affordability of service, consumer protection and universal utility service. Public Utility Law Project of New York, Inc., has no parent company and no subsidiaries or affiliates that have issued shares to the public. No publicly held company has an ownership interest in it.

(3) National Consumer Law Center, Inc., is a non-profit corporation representing the interests of low-income clients on a range of consumer issues including electricity deregulation. The National Consumer Law Center, Inc., has no parent company and no subsidiaries or affiliates that have issued shares to the public. No publicly held company has an ownership interest in it.

April 29, 2005

Respectfully submitted,

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GLOSSARY

CAISO	California Independent System Operator Corp.
CEOB	California Electricity Oversight Board
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
FPA	Federal Power Act
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 ¶ 61,439 (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)
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)
RTO	Regional transmission operator

Rules

The Market Behavior Rules as finally adopted in the May 19 Order.

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FEDERAL ENERGY REGULATORY COMMISSION,

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

JURISDICTIONAL STATEMENT

Before the Court are petitions for review of a final order of FERC,² the November 17 Order, and the May 19 Order denying rehearing. JA _____. FERC asserted jurisdiction to issue these orders under section 206 of the FPA, 16 U.S.C. § 824e. This Court has jurisdiction pursuant to § 313(b) of the FPA, 16 U.S.C. § 825l(b). Petitioners timely filed petitions for review pursuant to § 313(b) (CEOB, Docket No. 04-1188, on July 18, 2004, JA _____; CPUC, Docket No. 04-1235, on July 15, 2004, JA _____; and Consumer Advocates, Docket No. 04-1238, on July 16, 2004, JA _____). On July 23, 2004, the Court consolidated Nos. 04-1188, 04-1235 and 04-1238 with four other petitions under the lead Docket No. 04-1168.

The CEOB, CPUC, and Consumer Advocates fully participated in the proceedings below, and have standing to sue. *See* November 17 Order, ¶ 10 & Appendix C, JA _____; *Maryland People's Counsel v. FERC*, 760 F.2d 318, 320-22 (D.C. Cir. 1985). Consumer Advocates include state agencies given express power under state law to represent utility consumers,³ and non-profit entities including PULP, whose mission of protecting electric ratepayers is undermined by FERC's abrogation of rate filing requirements (*see* Declaration of Gerald Norlander), and Public Citizen, Inc., whose membership is made up of consumers who pay intrastate utility bills (*see* Declaration of Tyson Slocum). Retail consumers are injured by FERC's orders setting future market-based rates under section 206 because the unjust, unreasonable and discriminatory wholesale rates allowed by FERC will result in higher retail electricity prices. *See Entergy Louisiana, Inc. v. Louisiana Pub. Serv. Comm'n*, 539 U.S. 39 (2003), and this injury confers standing on organizations of which they are members. *See Hunt*

² Capitalized terms and acronyms are defined in the Glossary.

³ *See* C.R.S. § 40-6.5-101, et seq.; RIGL § 39-1-19; Utah Code Ann. § 54-10-1, et seq; and NMSA § 8-5-1, et seq.

v. Washington State Apple Advertising Comm'n, 432 U.S. 333, 343 (1977). See also declarations attached hereto

ISSUES PRESENTED

1. Does FERC's market-based rate regime violate FPA sections 205 and 206, 16 U.S.C. § 824d and 16 U.S.C. § 824e?
2. Are FERC's orders, which restrict remedies for violation of the new Market Behavior Rules ("Rules") and impose 90-day limitations periods to initiate FERC investigations and complaint proceedings pursuant to section 206, unlawful, arbitrary or not supported by substantial evidence?
3. Has FERC unlawfully and arbitrarily premised liability for tariff violations on determinations of seller intent, motive, due diligence, and a direct nexus requirement?
4. Has FERC arbitrarily failed to prohibit in the Rules known manipulative practices, withholding of energy supply, and exercise of market power during periods of transmission congestion?

PERTINENT STATUTES AND REGULATIONS

Copies of pertinent statutes and regulations are attached hereto as an Addendum.

STATEMENT OF THE CASE

This case stems from the California energy crisis of 2000 – 2001. Wholesale sellers authorized by FERC to sell electricity at "market-based" rates – variable rates established pursuant to private negotiation or an auction-market mechanism, as opposed to specific cost-based rates pre-approved by FERC – manipulated the markets "on a massive scale" and overcharged billions of dollars while FERC "abdicat[ed] its regulatory responsibility" to ensure

just and reasonable rates. *See California, ex rel., Lockyer v. FERC*, 383 F.3d 1006, 1014 (9th Cir. 2004).

One year after the crisis began, in June 2001, FERC proposed that all market-based rate authorizations be conditioned on a prohibition against engaging in anticompetitive behavior or exercising market power, and an agreement by sellers to refund any resulting overcharges, with interest. *San Diego Gas & Elec. Co.*, 95 FERC ¶ 61,418, 62,565 (2001). Accordingly, in November 2001, FERC initiated the separate, underlying proceeding pursuant to section 206 to investigate the justness and reasonableness of all market-based rates, tariffs, and authorizations nation-wide. November 20 Order at 61,975-76 (2001), JA _____. According to FERC, the proposed condition would “ensure that rates collected pursuant to market-based rate tariffs and authorizations are just and reasonable and that customers have full refund protection against anticompetitive behavior and abuses of market power.” *Id.* at 61,975. FERC established a prospective refund effective date 60 days from notice of the proceeding. *Id.*

In its June 26, 2003 Order, FERC proposed compliance with specific “Market Behavior Rules” (the “Rules”) as a new tariff condition for all market-based rate authorizations. FERC also proposed a 60-day time limitation for filing complaints and a single monetary remedy for violation of these Rules: disgorgement from the seller of unjust profits on a transaction-specific basis. June 26 Order ¶¶ 1-16, 38-40, JA _____. FERC intended the Rules to address abuses it then acknowledged to have occurred in California and to establish standards of behavior on an industry-wide basis for the following: (1) generation unit operation; (2) market manipulation; (3) communications; (4) price reporting to index developers; (5) record retention; and (6) related tariff matters. *Id.* ¶¶ 4-6, 13, JA _____. FERC maintained that its Rules balanced three goals: (1) the need to provide effective remedies for anticompetitive and manipulative behavior; (2) the

need to provide “clearly-delineated ‘rules of the road’” without impairing FERC’s ability to remedy “market abuses whose precise form and nature cannot be envisioned today”; and (3) the need to “provide reasonable bounds” on enforcement “so as not to create unlimited regulatory uncertainty for individual market participants or harm to the marketplace in general.” *Id.* ¶ 5, JA ____.

As a result of comments responding to the June 23 Order, the November 17 Order found “that sellers’ existing tariffs and authorizations, without clearly delineated rules of the road to govern market participant conduct, are unjust and unreasonable.” November 17 Order ¶ 3, JA _____. FERC also revised certain of its proposed tariff conditions, including a 90-day limitation for initiation of FERC investigations and filing of section 206 complaint proceedings. November 17 Order, Appendices A& B, JA _____. The California State Parties and Consumer Advocates requested rehearing, maintaining that: (1) FERC has no statutory authority to allow market-based rates; (2) the new tariff conditions (a) do not comply with FERC’s mandates under the FPA to protect consumers and ensure just and reasonable rates, (b) unlawfully restrict remedies and impose limitations periods, (c) unlawfully premise liability for tariff violations on seller intent, motive and due diligence, and (d) fail to prohibit a number of manipulative behaviors identified during the California energy crisis, and are ineffectual to prevent market manipulation. FERC denied rehearing in its May 19 Order, JA _____. These petitions followed.

FACTUAL BACKGROUND

A. Statutory Background

The FPA, section 205(a), establishes that *all* rates and charges demanded or received for wholesale electricity must be just and reasonable and any that are not are unlawful. 16 U.S.C. § 824d(a). Section 205(b) likewise prohibits the making or granting of “any undue preference or advantage” to any person, or “maintaining any unreasonable difference in rates, charges, [or]

services.” 16 U.S.C. § 824d(b). Section 205(c) requires that energy sellers must file at FERC and keep open for public inspection rate schedules “showing all rates and charges and classifications, practices” for “any transmission or sale” subject to FERC’s jurisdiction. 16 U.S.C. § 824d(c).

To change any rate or charge on file, section 205(c) requires 60 days’ notice, specifying the changes to be made to the existing schedules unless FERC issues an order specifying the new changes and the time they will take effect. 16 U.S.C. § 824d(c). The purpose of this requirement of filing notice is to allow FERC and the public to review the filed rates, and to determine whether they should be suspended, set for hearing with the burden of proof on the seller, and/or made subject to an immediate refund obligation. 16 U.S.C. § 824d(e).

Whenever FERC finds after a hearing that any rate being charged is unjust and unreasonable, unduly preferential, or discriminatory, section 206 (a) requires FERC to fix the lawful rate prospectively by order. 16 U.S.C. § 824e(a). Section 206(b) requires FERC to establish a refund effective date, based on the newly fixed rate. The effective date may not be earlier than 60 days after the filing of the complaint nor later than five months after the 60 days has expired. 16 U.S.C. § 824e(b).⁴

B. How Market-Based Rates Are Established

To obtain market-based rate authority, FERC requires a seller to demonstrate that it lacks, or has adequately mitigated, the ability to exercise market power. *See, e.g., Lockyer*, 383 F.3d at 1009. If FERC grants a seller such authority, market-based rates are not filed and reviewed in advance by FERC, but are determined by agreement between buyer and seller. For long-term or “bilateral” transactions, the buyer and seller privately negotiate a price. For short-term

⁴ Charges in excess of filed rates are always subject to refund.

transactions necessary to balance supply and demand and to maintain system reliability, power is purchased and sold through centralized regional or “spot” markets operated by an independent system operator (“ISO”) or a regional transmission operator (“RTO”). Generally, the regional markets utilize a single-price auction mechanism where the rate is established as follows: (1) sellers bid in an offering price and amount of energy; (2) bid “stacks” are created, beginning with the lowest-priced bids and continuing up to the highest-priced bids; and (3) the amount of energy offered is added up, starting with the lowest bid and going up the “stack,” until the total amount of electricity needed by consumers is reached; (4) the price of the last-needed (and therefore the highest-priced) bid sets the price for the entire market, the “market clearing price.” Thus, even a seller that bid to sell energy at a lower price receives the market clearing price. *See generally In re Calif. Power Exchange Corp.*, 245 F.3d 1110, 1114 (9th Cir. 2001); *San Diego Gas & Elec. Co.*, 93 FERC ¶ 61,121 at 61,353, 61,355 n.32 (2000). In the regional markets, millions of dollars of transactions occur at market clearing prices in a single hour. Tens of millions are at stake in each longer-term transaction.

C. The California Energy Crisis

FERC’s orders must be viewed in the context of the California energy crisis, the history of FERC’s prior oversight of sellers with market-based rate authority, and the type of behavior the Rules are intended to prevent.

In June 2000, wholesale electric rates in California and the western United States in general rose to unprecedented levels. *See California Power Exchange*, 245 F.3d at 1115. On July 26, 2000, FERC directed its Staff to conduct a fact-finding investigation of the electric wholesale power markets, including volatile price fluctuations in various regions of the country. *See Order Directing Staff Investigation*, 92 FERC ¶ 61,160 (2000). On August 2, 2000, San Diego Gas & Electric Co. (“SDG&E”), a California utility, filed a complaint with FERC

alleging noncompetitive conditions in the California electric wholesale market and seeking relief from extraordinary prices. *San Diego Gas & Elec. Co.*, 93 FERC ¶ 61,121 at 61,349 (2000).

Rates for SDG&E's retail customers had risen 200% to 300%, and other California utilities were incurring billions of dollars of debt. *California Power Exchange*, 245 F.3d at 1115 & n.2.

On November 1, 2000, FERC's Staff issued a "Report to the Federal Energy Regulatory Commission on Western Markets and the Causes of the Summer 2000 Price Abnormalities – Part I" ("FERC Initial Staff Report"). Also on November 1, 2000, FERC ordered sellers to pay refunds for their excessive charges, but only for sales after October 2, 2000 – the refund effective date determined by FERC.. *San Diego Gas & Elec. Co.*, 93 FERC ¶ 61,121 at 61,349-50 (2000). Within 90 days of initiating its investigation – the same time period FERC has allowed as a limitations period for complaints by market participants or state commissions (*see* Section III.B., below), FERC was unable to reach any "definite conclusions" about individual seller misconduct or identify any "specific exercises of market power." *See id.* at 61,349-50, 61,370. Wholesale prices continued to rise in California, and by December 2000, they cleared at \$376.99/MWh, over eleven times higher than the average clearing price in December 1999. Report of the Dept. of Energy.⁵

In January 2001, the Governor of California declared a state of emergency. *Lockyer*, 383 F.3d at 1009-10. Because of rolling blackouts, the Governor directed the State Department of Water Resources to purchase wholesale power. *Id.* at 1010. In April 2001, California's largest utility, Pacific Gas and Electric Company, filed a voluntary petition in bankruptcy. *Id.* at 1009-10. By July 25, 2001 – almost one year after SDG&E had filed its complaint – FERC still had

⁵ <http://www.eia.doe.gov/cneaf/electricity/california/subsequentevents.html>.

not identified wrongful conduct attributable to any particular seller. *San Diego Gas & Elec. Co.*, 96 FERC ¶ 61,120 at 61,508 (2001).

In 2003, FERC Staff's "Final Report on Price Manipulation in Western Markets," Docket No. PA02-2-000 (March 2003) ("Final FERC Staff Report"),⁶ and subsequent FERC orders chronicled manipulative behavior, withholding of power, and false reporting of prices to publishers. *See, e.g., Fact-Finding Investigation into Possible Manipulation of Electric and Natural Gas Prices*, 102 FERC ¶ 61,108 (2003). Unlike the Initial FERC Staff Report, the Final FERC Staff Report found that there had been tariff violations that warranted refunds prior to the "refund effective date" of October 2, 2000, and recommended that all market-based rate authorizations be conditioned to prohibit a number of specifically enumerated transactions and market behaviors. *See* Final FERC Staff Report at VI-45 to VI-54.⁷ Nonetheless, FERC refused to grant any additional refunds to California. *San Diego Gas & Elec. Co.*, 102 FERC ¶ 61,317 at 62,083 (2003).

The more colorful descriptions of the manipulative practices prevalent in the California markets are: "ricochet" or "megawatt laundering" (selling power out of state with subsequent resale into state at higher price, thus evading price caps); "round trip trades" (artificially inflating transaction volume or price through the continuous sale of the same power); "hockey-stick bidding" (demanding an extremely high price for a small amount of energy in light of known inelastic demand); "Fat Boy" (withholding of previously agreed deliveries of power in order to sell the energy at a higher price in the spot market); "Get Shorty" (fabrication and sale of emergency back-up power); and "Death Star" (obtaining payment for relieving transmission congestion without doing so). *See, e.g., Lockyer*, 383 F.3d at 1014-15 & ns.6-8.

⁶ http://www.ferc.gov/industries/electric/indus-act/wem/pa02-2/Gelinas_at_a_glance2.pdf

FERC acknowledges that improper trading strategies were being used by a “broad cross-section of the industry.” June 26 Order ¶ 13, JA _____; *see also* <http://feinstein.senate.gov/04Speeches/enrontapes.htm> (excerpts from tape recordings of electricity traders).

Enron circulated an e-mail labeled the “California Sing-Along,” which contained lyrics sung to the theme music from the television program “Rawhide”:

Rollin’, rollin’, rollin’,
Though the state is golden,
Keep them blackouts rollin’, statewide.

Turn ‘em on, turn ‘em off,
Shut ‘em down, block ‘em out,
Turn ‘em on, turn ‘em off, statewide!
Brown ‘em out, black ‘em out,
Charge ‘em more, give ‘em less,
Let the pols fix the mess, statewide!

Keep movin’, movin’, movin’
Though they’re disapproving,
Keep them rates a-movin’, statewide.⁸

As one Reliant trader explained, in a conversation recorded on May 22, 2000, rules should only be followed if there were consequences for not doing so:

PERSON 2: Hey, guys, you know when we might follow rules? If there’s some sort of penalty.

PERSON 1: That’s right.

* * * * *

PERSON 1: So we don’t have a problem with that. But it needs to be a reliability issue. If it’s economics, it’s economics, and by God, that’s what rules.

PERSON 2: You’ll let the California ratepayers pay.

⁷ <http://elibrary.ferc.gov/idmws/common/opennat.asp?fileID=9666689>

⁸ <http://ag.ca.gov/publications/energywhitepaper.pdf> at 29.

PERSON 1: That's right. I don't have a problem with that. I have no guilty conscience about that.

PERSON 2: All right, man.²

Numerous energy traders and executives have pled guilty to, or been indicted on, criminal charges, and many have specifically admitted to market manipulation activities during the California energy crisis.¹⁰

SUMMARY OF ARGUMENT

A. **Consumer Advocates: FERC's Market-Based Rate Regime Violates the FPA**¹¹

After determining that past market rates were unjust and unreasonable due to manipulation, FERC adopted market behavior conditions but has allowed sellers to continue to set unfiled rates prospectively "by agreement" between the parties or by auction. FERC has provided no standard other than the market to identify what constitutes a just and reasonable rate or a zone of reasonableness, contrary to *FPC v. Texaco Inc.*, 417 U.S. 380, 398-400 (1974). FERC similarly has failed to set any standard for when a rate set "by agreement" is "unduly preferential or discriminatory" under the statute, and thus has abdicated its responsibility to prevent unlawful rates.

FERC has also illegally discarded the FPA mandate that sellers must give notice by filing all rates and charges. FERC has thereby impermissibly eliminated its own ability to review in advance rates and proposed rate increases to determine whether they are lawful. *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332, 340 (1956).

² <http://ferris.ferc.gov/idmws/search/fercadvsearch.asp>; accession number 20030303-0542, CA-0239 at 8-9.

¹⁰ <http://www.chron.com/cs/CDA/story.hts/special/enron/1620804>;
<http://www.fbi.gov/dojpressrel/pressrel04/energy040804.htm>.

¹¹ The California State Parties do not join in this argument.

FERC has eliminated all “changes” in rates and charges subject to filing and instead maintains only “reporting requirements, unilaterally eliminating the consumer protections contained in sections 205(d) and (e), which apply to any changes in rates or charges. The statutory mandates FERC has abandoned include: 60 days’ notice given by filing proposed changes for FERC and the public to review; the possibility of suspension of proposed rate increases; a hearing with the burden of proof on the seller; and collection of increases immediately subject to refund.

Congress provided not only the statutory goals but also the means of achieving them through the specific procedural and remedial requirements in sections 205(a), (b), (c), (d), and (e), and sections 206(a) and (b). An agency may not lawfully substitute other goals or means of its own choosing. *MCI Telecomms. Corp. v. Am. Tel. & Tel. Co.*, 512 U.S. 218, 231 n.4 (1994). Nonetheless, FERC has done exactly that.

B. Joint Petitioners’ Challenge to FERC’s New Tariff Conditions

If FERC’s market-based rate regime is lawful, FERC’s new tariff conditions nonetheless contravene FERC’s statutory mandates to protect consumers and ensure just and reasonable rates. *See, e.g., Farmers Union Cent. Exch. Inc. v. FERC*, 747 F.2d 1486, 1500 (D.C. Cir. 1984) (“In developing its enforcement policies, FERC must abide by the congressional mandate from which it derives authority”); *Lockyer*, 383 F.3d at 1011 (FERC obligated to ensure that wholesale power rates are just and reasonable and applied in non-discriminatory manner). FERC unlawfully limits monetary remedies to require only the seller in violation of the Rule to disgorge profits on a transaction-specific basis, and allows all other sellers who received excessive rates as a result of the violation to retain their booty. This limitation contravenes FERC’s general policy of providing full refunds for tariff violations. FERC also has unlawfully and arbitrarily imposed 90-day limitations periods for FERC to commence investigations and for

parties to commence complaint proceedings under section 206, although section 206 contains no limitations period. It took FERC Staff three years to issue the Final FERC Staff Report identifying market abuses in California, demonstrating that the 90-day limitations period is unreasonable. FERC further eroded its enforcement of just and reasonable rates by unlawfully predicated violation of its new Rules on seller intent, motive, and lack of due diligence and by imposing a “direct nexus” requirement to abrogate a contract based on a tariff violation. These determinations are irrelevant to whether the rate is just and reasonable; deviation from the filed rate is not allowed under any pretext. *See Lockyer*, 383 F.3d at 1011-12. Finally, the Rules imposed by FERC fail to prohibit known manipulative practices without reasoned explanation.

ARGUMENT

I. STANDARD OF REVIEW

This Court reviews FERC orders to determine if they are “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.” *ARCO Oil & Gas Co. v. FERC*, 932 F.2d 1501, 1502 (D.C. Cir. 1991) (citations omitted). Questions of law are reviewed *de novo*. *Arizona v. Thompson*, 281 F.3d 248, 254 (D.C. Cir. 2002). Whether FERC’s orders are contrary to the text of the FPA also is reviewed *de novo*. *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), *reh’g denied*, 468 U.S. 1227 (1984). Where “Congress has directly spoken to the precise question at issue,” and where the agency’s action conflicts with what Congress has said, the reviewing court must invalidate the agency’s action. *California Indep. Sys. Operator Corp. v. FERC*, 372 F.3d 395, 400 (D.C. Cir. 2004).

FERC must engage in a “reasoned decisionmaking process.” *PG&E Gas Transmission, Northwest Corp. v. FERC*, 315 F.3d 383, 389-90 (D.C. Cir. 2003). FERC’s factual findings must be supported by substantial evidence. *ANR Pipeline Co. v. FERC*, 771 F.2d 507, 516 (D.C. Cir. 1985).

II. FERC’S MBR REGIME—WHICH FERC CONTINUED IN THE ORDERS UNDER REVIEW—VIOLATES SECTIONS 205(a), (b), (c), (d), (e) AND 206(a) AND (b)¹²

The primary purpose of the FPA is to provide consumers “a complete, effective and permanent bond of protection from excessive rates.” *Atlantic Ref. Co. v. Pub. Serv. Comm’n of State of N.Y.*, 360 U.S. 378, 388 (1959). FERC turned this Congressional goal on its head by establishing a market-based rate (“MBR”) regime that impermissibly allows energy sellers to set rates without FERC review and eliminates most of the other statutory consumer protections of the FPA, without congressional change to the statute. Where Congress has established the means, as well as the goals, for consumer protections, neither FERC nor the courts may lawfully change them. *MCI*, 512 U.S. at 231 n.4.

A. FERC’s MBR Regime Violates Sections 205(a) and 206(a) and (b)

Section 205(a) states that rates and charges that are not “just and reasonable” are unlawful. Sections 206(a) and (b) authorize FERC after a hearing to modify existing unlawful rates to make them just and reasonable, the premise on which FERC acted in this case. However, although FERC may have broad authority to apply different ratemaking methods to determine what constitutes “just and reasonable” rates, *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), FERC must apply some ratemaking method. FERC specified no such method of rate regulation here. Rather, FERC is attempting to regulate electric markets through conditions on market participants in the hope of indirectly influencing their actual charges.

The Supreme Court held in *FPC v. Texaco Inc.*, 417 U.S. 380, 400 (1974), that the Commission cannot rely only on “markets” to determine just and reasonable rates, yet FERC is relying on its unsuccessful and ever-changing determinations of “market power” as a basis to

¹² The California State Parties do not assert or join the arguments in this section.

assume competitive markets exist. Even if FERC eventually finds a market competitive, FERC is still relying solely on the assumption that all rates set in competitive markets will be just and reasonable, contrary to *Texaco*. FERC attempts to distinguish *Texaco* and this Court's decision in *Farmers Union*, 747 F.2d at 1509, claiming that the MBR regime contains the required monitoring to ensure that rates remain within a zone of reasonableness. But FERC is merely monitoring the market to see if it is workably "competitive," with no objective standard to determine if the market produces just and reasonable rates, or rates within a zone of reasonableness. In *Texaco*, as here, FERC's predecessor claimed it had devised indirect methods to assure reasonableness of rates even if they were not filed in accordance with the statute, but the Supreme Court rejected that approach.

B. FERC's MBR Regime Violates Sections 205(b) and 206(a) and (b)

Section 205(b) forbids any jurisdictional seller from granting any undue preference or subjecting any person to an undue disadvantage, and sections 206(a) and (b) apply this prohibition to existing rates. This consumer protection is particularly important now that power marketers and energy traders can be owned by the same holding companies that own traditional public utilities. Even if FERC could rely on the market to set just and reasonable rates contrary to *Texaco*, FERC has not even offered a theory whereby the market can prevent rates that are unduly preferential or discriminatory. If the "filed rate" under FERC's MBR regime is set by agreement of the parties, FERC has no standard by which any rate could ever be found to be unduly preferential or discriminatory. If FERC has no standard for determining either undue preference or discrimination, it cannot fulfill its statutory duty.

C. FERC’s MBR Scheme Violates Section 205(c) Because It Fails to Comply with the Plain Statutory Language

Section 205(c), 16 U.S.C. § 824d(c), requires the filing of all rates and charges for any sale subject to FERC’s jurisdiction, and of the classifications, services, practices, regulations, and contracts affecting such rates, charges and classifications. Nonetheless, FERC deems this requirement satisfied if energy sellers file a tariff containing a statement that the rates will be established “by agreement” between the buyer and seller, while schedules showing actual rates, charges and terms of service are filed only after the fact pursuant to “reporting” requirements that invoke none of the statutory consumer protection provisions. *See Southern Co. v. Energy Marketing, L.P.*, 86 FERC ¶ 61,131 at 61,459-60 (1999). This procedure completely eliminates the possibility of prior review of actual charges by FERC or the public for either initial or changed rates, either as to the justness and reasonableness of the rates or as to whether they are unduly advantageous or discriminatory.

Federal regulatory agencies cannot “detariff” or “flexibly reduce” statutory rate filing requirements to encourage competition. *MCI*, 512 U.S. at 234; *Maislin Indus. U.S. v. Primary Steel Inc.*, 497 U.S. 116, 135 (1990). The existence of a competitive market “cannot provide the [an agency] authority to alter well-established statutory filed rate requirements.” *Id.*, 497 U.S. at 135. The Supreme Court has likewise rejected agency attempts to detariff only certain, non-dominant participants. In *MCI*, the FCC had allowed non-dominant carriers not to file their rates, relying instead on market forces, the complaint process, and the agency’s ability to re-impose tariff-filing requirements to protect the public interest. The FCC reasoned that such “detariffing” would benefit consumers by promoting competition, while meeting the substantive requirements of the Communications Act for just and reasonable rates. The Supreme Court held that in fact the agency was attempting a fundamental revision of the statute from complete rate

regulation “to a scheme of rate regulation only where effective competition does not exist.” *MCI*, 512 U.S. at 231. The Supreme Court did not dispute the FCC’s opinion that market forces would serve as an effective bulwark against unreasonable rates, but held that the FCC was “bound, not only by the ultimate purposes Congress has selected, but by the means it has deemed appropriate, and prescribed, for the pursuit of those purposes.” *Id.* at 231 n.4.

This Court both anticipated and followed the Supreme Court decisions in *MCI* and *Maislin*. In *Regular Common Carrier Conf. v. United States*, 793 F.2d 376 (D.C. Cir. 1986), this Court considered an ICC rule that allowed unpublished rates to be determined by averaging prior charges to the shippers. The statutory provision required that carriers “shall provide” service only if the rate is contained in a filed tariff, 49 U.S.C. § 1761(a), which then Judge Scalia found “utterly central to the Act.” 793 F.2d at 379. Without a rate contained in the tariff, the Court reasoned: “It would be monumentally difficult to enforce the requirement that rates be reasonable and nondiscriminatory . . . and virtually impossible for the public to assert its right to challenge the lawfulness of existing or proposed rates.” *Id.*, (citations omitted; emphasis added).

Following *MCI*, this Court in *Southwestern Bell Corp. v. FCC*, 43 F.3d 1515 (D.C. Cir. 1995), rejected an attempt by the FCC to permit a range of rates for non-dominant carriers. Quoting *MCI*, this Court held that the FCC could not ignore congressional directives simply because it believes “traditional tariff regulation” is “unnecessary”:

For better or worse, the Act established a rate-regulation, filed-tariff system for common-carrier communications, and the Commission’s desire “to ‘increase competition’ cannot provide [it] authority to alter the well-established statutory filed rate requirements,” . . . “[S]uch considerations address themselves to Congress, not to the courts.”

Southwestern Bell, 43 F.3d at 1519. It continued, “the clear and definite language of the rate-filing provision does not encompass the concept of ranges,” but something “more definite and specific than rate ranges.” *Id.* at 1521.

This Court and the Supreme Court have interpreted analogous provisions in the FPA, the Communications Act, and the Interstate Commerce Act (“ICA”) similarly, in recognition of the fact that the ICA served as the model for the FPA and the Communications Act. *E.g.*, *Northwestern Pub. Ser. Co. v. Montana-Dakota Utils. Co.*, 181 F.2d 19, 22 (D.C. Cir. 1950), *aff’d*, 341 U.S. 246 (1951). Thus, cases holding that the absence of a calculable rate serves to invalidate an otherwise binding tariff apply with equal force under the FPA.

Section 205(c) requires the filing of schedules showing not only “all rates and charges” but also “the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.” Section 205(c) is very “definite and specific” and cannot be satisfied by a simple statement that rates will be “by agreement.” *Southwestern Bell*, 43 F.3d at 1521. “Average rate” tariffs (like FERC’s market-based tariffs) do not contain any rates at all, just an “offer to negotiate.” *Regular Common Carrier*, 793 F.2d at 379, 380. Put otherwise, the term “rate,” as used in section 205, means the price to be charged. *Electrical District No. 1 v. FERC*, 774 F.2d 490, 492 (D.C. Cir. 1985) (“[T]he statute means what it says and requires that the rate itself be specified”); *see also Columbia Gas Transmission Corp. v. FERC*, 831 F.2d 1135, 1141 (D.C. Cir. 1987).

In *Southwestern Bell*, this Court concluded from the statutory heading of the ICA filing section, “filing; public display,” that “Congress wanted the rates to be filed such that they may be known to the public.” *Southwestern Bell*, 43 F.3d at 1520. The text of sections 205(c) and (d) is

much clearer, stating that schedules showing all rates and charges must be filed and kept open for “public inspection” in a convenient form and place. FERC’s elimination of the section 205 filing requirement, except for *subsequent* “informational” or “reporting” filings, precludes any prior review of the rates by the public or FERC until it is too late to invoke most FPA consumer protections and the burden of proof has shifted to the consumers and FERC.

There is no meaningful distinction between FERC’s MBR regime, eliminating the filing of actual rates, for utilities purportedly lacking “market power,” and the “flexible reduction” of filings for non-dominant carriers without market power and similar rules struck down by the Supreme Court in *MCI* and *Maislin*, and by this Court in *Southwestern Bell* and *Regular Common Carrier*. Indeed, where there are differences, the case for requiring filing actual rates under the FPA is even stronger.

Nevertheless, the Ninth Circuit in *Lockyer*, 383 F.3d at 1013, erroneously distinguished the FPA from other rate filing statutes. The court mistakenly relied on decisions in this Circuit that approved certain FERC market prices without addressing whether they complied with statutory mandates.¹³ In fact, *Lockyer* analyzed the issue exactly in reverse order of the Supreme Court’s analysis in *MCI* and *Maislin*. The Supreme Court looked at the plain language of the statute *first*, to determine whether the agencies could “detariff” or “flexibly reduce” rate filings to encourage competition; the Ninth Circuit instead looked to this Court’s decisions, which admittedly had not analyzed the FPA’s procedural requirements. Since a market rate tariff was therefore “within the scope of [FERC’s] FPA authority,” the court erroneously concluded that

¹³ June 26 Order ¶ 21 n.17, JA _____ (citing *Farmers Union Cent. Exch. Inc. v. FERC*, 747 F.2d 1486 (1984); *Louisiana Power Authority v. FERC*, 141 F.3d 364 (1998); *Elizabethtown Gas Co. v. FERC*, 10 F.3d 866 (D.C. Cir. 1993)).

FERC must have “broad discretion to establish effective reporting requirements for administration” of such a tariff. *Id.* at 1012.

However, decisions of this Court on which the Ninth Circuit and FERC relied specifically stated that they were *not* addressing arguments regarding either FERC’s failure to comply with statutory procedural requirements or the validity of FERC’s entire MBR program, because such claims either were raised too late or not at all. In *Elizabethtown Gas Co. v FERC*, 10 F.3d 866 (D.C. Cir. 1993), the panel specifically refused to consider arguments, raised belatedly in the petitioner’s reply brief, that the market-based price in the “Restructuring Settlement” at issue was contrary to the statutory requirements of the Natural Gas Act requiring pipelines to file rate schedules and give advance notice of rate changes.

Similarly, in *Louisiana Energy and Power Authority v. FERC* (“LEPA”), 141 F.3d 364 (D.C. Cir. 1998) , this Court applied *Elizabethtown* to rates under the FPA, but – in addition to the fact that *Elizabethtown* never addressed the statutory procedural requirements as quoted above – the panel in *LEPA* specifically noted that: “LEPA does not challenge FERC’s general policy of permitting market-based rates in the absence of market power.” *Id.* at 366 n.2. *See also Power Company of America LP v. FERC*, 245 F.3d 839, 841 (D.C. Cir. 2001) (“PCA has not identified with any specificity what regulatory obligations the Commission has shirked. It is not the court’s role to fill in the blanks in counsel’s argument”). In *Power Company*, a failure to make the proper legal arguments seems once again to have determined the outcome of a decision on FERC’s MBR regime, in this case regarding whether certain filings of short-term power sales under “umbrella tariffs” were “rate schedules” required to be filed under the FPA.

This is indeed a shaky foundation – two court decisions that clearly state that they are *not* addressing critical statutory ratemaking requirements – on which to build an entirely new

regulatory regime that is contrary to the plain language of the statute. As discussed at length in *MCI* and *Maislin*, the purposes of the “filed rate doctrine” are to ensure that only the rates and charges previously noticed to the public and reviewed by FERC are paid by customers, and to prevent the charging of preferential and discriminatory rates. The “filed rate doctrine” also prevents collateral attacks in the courts on rates lawfully determined by an agency, and prevents agencies from retroactively changing lawfully effective rates. *Montana-Dakota Util. Co. v. Northwestern Pub. Serv. Co.*, 341 U.S. 246, 251-52 (1951). Another purpose is providing necessary predictability of rates. *Electrical Dist. No. 1*, 774 F.2d at 493. FERC has made a mockery of this doctrine by contending that the “filed rate” in this case “will be the behavioral standards voluntarily incorporated into the seller’s tariff” (May 19 Order ¶ 158, JA _____), apparently along with the statement that rates will be set “by agreement.”

D. FERC’s MBR Scheme Violates Sections 205(d) and 205(e)

FERC claimed before the Ninth Circuit that it has broad authority to prescribe the time and form of filing schedules showing all rates and charges. This discretion, however, is not nearly as broad as FERC claimed and the Ninth Circuit accepted. *See Lockyer*, 383 F.3d at 1013. Section 205(d), for example, applying to “rate changes” or “new schedules,” not only requires 60 days’ advance notice to the FERC and the public, but also specifies that: “[s]uch notice shall be given *by filing* with the Commission and keeping open for public inspection *new schedules stating plainly the change or changes to be made in the schedule or schedules then in force* and the time when the change or changes will go into effect.” (emphasis added).

FERC’s ability to alter this statutory notice requirement is tightly circumscribed: Section 205(d) allows FERC to change this scheme, but only for good cause shown, and then only by an order “specifying the changes so to be made” and “the time when they shall take effect.” FERC lacks power to eliminate all prior notice and review of rate changes, particularly rate increases,

thereby eliminating most consumer protections from excessive charges. But even if FERC could have shown such “good cause,” FERC is still required *by the statute* to issue a specific order stating plainly the “changes to be made” and the time “when they shall take effect.” FERC’s blanket orders providing for market rate tariffs that simply state that rates will be set “by agreement” of buyer and seller and that subsequent reports will be filed after the new rates have been charged cannot possibly satisfy this “definite and specific” statutory notice-by-filing requirement. *See Southwestern Bell*, 43 F.3d at 1521.

A recent comic strip has an employee of the “Streets Dept.” declare: “We solved the pothole problem – we just reclassified them as ‘speed bumps.’” In a similar fashion, FERC “solved” the problem of having to provide consumers the statutory protections from rate increases by *reclassifying* such increased charges as being subject to mere “reporting” or “informational” requirements. *See Southern Co.*, 86 FERC at 61,459-60. This eliminates the 60 days’ prior filing and review of rate changes by FERC and the public (section 205(d)) and the opportunity for FERC to suspend and order a prior hearing where rate increases initially appear excessive, with the burden of proof on the filing utility and immediate refund protection for charges ultimately found to be unlawful (section 205(e)).

The Ninth Circuit saw through FERC’s defense that it still applies sections 205(d) and (e) to rate “changes” when they occur, noting that changes do not occur under FERC’s market rate scheme. *Lockyer*, 383 F.3d at 1017. FERC’s sweeping reclassification of “changes” in rates and charges as subject to mere “reporting requirements” has been done without explanation of how this satisfies the plain language, much less the consumer protection purposes, of filing schedules showing all new rates and charges. FERC also fails to describe its deviation from decades of FERC precedent in which the classification of rates as “changes” versus “initial” rates has been

well-litigated, both at FERC and in the courts, because of the different procedural protections associated with such classifications. *See, e.g., Fla. Power & Light Co. v. FERC*, 617 F.2d 809, 812 (D.C. Cir. 1980).

Indeed, this Court has specifically held that simply adding an index of new customers to an existing tariff, or adding a new service agreement to a tariff for an existing customer – actions analogous to those now subject to FERC’s “reporting requirements” – constitutes a “change in rates” under section 205(d). *Municipal Elec. Util. Ass’n of Ala. v FPC*, 485 F.2d 967 (D.C. Cir. 1973). This Court further held that customers must have an opportunity to challenge a previously approved tariff under section 205(e) *at the time that they become subject to it*, and that treating the addition of a new customer to an existing tariff as a change in rates represents “the minimum necessary to assure protection of the statutory rights of those customers with late-expiring contracts.” *Id.* at 976. This Court has thus interpreted the FPA quite differently from FERC’s current claim that the addition of a new service agreement to an existing “market rate” tariff is *not* a change in rate, but is merely subject to a “reporting” or “informational” requirement.

The Ninth Circuit, despite its reliance on decisions of this Court that FERC can allow market rates, could not reconcile FERC’s regime with parts of the FPA. The Ninth Circuit discovered what this Court’s decisions appear, oddly, either to have missed or shrugged off: that FERC’s market rate scheme entirely *eliminates* “changes” in rates and along with them all the consumer protections against unreasonable rate increases found in sections 205(d) and (e):

In other words, the § 205(e) refund remedy is, practically speaking, eliminated under the scheme as FERC would have us interpret it. Such an interpretation comports neither with the statutory text, nor with the Act’s “primary purpose” of protecting consumers.

Lockyer, 383 F.3d at 1017.

The Ninth Circuit was correct, but didn't go far enough: FERC has eliminated not only the section 205(e) refund authority, but all of the other consumer protections of sections 205(c), (d), and (e), including prior notice of rates to be charged, prior filing and review of new rates, opportunity for rate suspension and hearing with the burden of proof on the utility, and the immediate imposition of a refund obligation. These are consumer protections required by the FPA that neither FERC nor the courts may simply eliminate at their discretion.

The purpose of the notice provision is to permit FERC (and the public) to review rates before they may be charged. In *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956), the Court described the Commission's authority under section 4 of the NGA (the counterpart of section 205 of the FPA).¹⁴ After noting that utilities must provide notice and file all rates and rate changes, the Court concluded "that these requirements are necessary to permit the Commission to exercise its review functions." *Id.* at 340. They are also necessary to permit the public, customers, and their representatives to exercise their functions and prerogatives. *Regular Common Carrier*, 793 F.3d at 379.

As this Court has read the Supreme Court precedent, the FPA does not determine how wholesale electric rates may be changed, but simply provides that they *cannot* be changed without following the procedures for notice and review required by the statute. *City of Piqua v. FERC*, 610 F.2d 950, 955 (D.C. Cir. 1979). "[E]nsuring that rates are reasonable and

¹⁴ *FPC v. Sierra Pacific Power Co.*, 350 U.S. 348, 355 (1956). We note, however, that gas sales have since been largely deregulated by the National Gas Policy Act, 15 U.S.C. § 3301, *et seq.*, with no comparable change to the FPA. Also, the FPA has no provision comparable to Section 7 of the NGA, and FERC's promulgated behavior rules for gas sellers in a rulemaking, and for electricity sellers in an order under section 206. Thus, even if FERC now has authority to prescribe market rules for gas sellers, it lacks authority to substitute such rules for rate regulation under the FPA.

nondiscriminatory, would prove difficult if not impossible without definite rates filed.”

Southwestern Bell, 43 F.3d at 1523.

The Court noted that it appreciated that once a tariff has passed FERC’s scrutiny under section 205 and is made applicable to a particular customer, “the likelihood of retaining a rate reduction or alteration in terms or conditions of service by a proceeding under section 206(a) is indeed remote. *Id.* Not only would the customer bear the heavy burden of showing the tariff had become unlawful in the period since its approval, “but the cost and uncertainty of such proceedings made recourse to them problematical.” *Id.* By effectively eliminating the requirement of filing changes in rates, however, FERC has relegated ratepayers entirely to section 206 process for protection against unjust and unreasonable rates. *See Municipal Elec. Util. Ass’n of Ala. v FPC*, 485 F.2d 967 (D.C. Cir. 1973).

The fact that Cinergy Services, Inc. is challenging whether FERC met its burden of proof under section 206, in trying to substitute market behavior conditions for the statutory protections that FERC discarded, demonstrates one of the dangers of relying on section 206 complaints to protect ratepayers: it shifts the burden of proof, which often alone decides the case. A statutory interpretation that forces consumers to rely only on section 206 conflicts with the FPA’s consumer protection goals. Congress has not changed any of the relevant rate filing or review provisions of section 205 that FERC has eliminated.

E. FERC Erred By Failing to Determine in this Case the “Just and Reasonable” Rates for the Future as Required by Section 206

Section 206(b) requires that where FERC finds an existing rate or rule to be “unjust and unreasonable” after a hearing, it must “fix” the just and reasonable rate or rule to be prospectively in effect. FERC in this proceeding determined existing rates to be unjust and unreasonable because of obvious market manipulations, and has changed the behavioral “rules”

for utilities charging “market rates” for the future. But FERC has *not* said that rates privately adopted by sellers who obey these new market rules will be “just and reasonable.” The reason for the failure to adhere to the statutory mandate is that FERC has a “moving target” of constantly changing rulemakings and other proceedings regarding various parts of its “market rate” program. These render it impossible for FERC, a buyer, or a state utility commission or consumer advocate ever to know what the lawful rate will be, not only in advance – as required by the statute – but even in hindsight, since FERC lacks a lawful standard for determining “just and reasonable” rates.

This Court has reviewed the requirements for when rates set under section 206(b) become effective in a slightly different context and found:

Providing the necessary predictability is the whole purpose of the well established “filed rate” doctrine. . . . In direct frustration of this goal, FERC’s new policy of making rates effective as of the date of an order *setting forth no more than the basic principles pursuant to which the new rates are to be calculated* would make unforeseeable liabilities a regular consequence of rate adjustments under § 206.

Electrical Dist. No 1, 774 F.2d at 493 (emphasis added).

Here, FERC has not even provided “basic principles pursuant to which the new rates are to be calculated”; it has simply left rates to the agreement of the parties or to an auction, and to the behavior of the sellers.

F. FERC Was Arbitrary and Capricious in Failing to Address Petitioners’ Arguments Regarding Its Lack of Statutory Authority

It is axiomatic that agencies, including FERC, must proceed by reasoned decisionmaking. Nonetheless, FERC completely ignored the arguments made by Consumer Advocates regarding FERC’s lack of statutory authority to prospectively permit utilities to avoid the statutory filing requirements and other consumer protections of the FPA, and to continue to abdicate its

responsibility to review all rates to ensure that they are just and reasonable and not unduly preferential or discriminatory. FERC's orders cited this Court's decisions in *Elizabethtown* and *LEPA*, but made no response at all to these statutory challenges, properly and prominently raised below by Consumer Advocates.

FERC's silence in its orders on these basic statutory questions where, as here, FERC is determining future lawful rates under section 206 for *all* sellers of wholesale electricity at market rates is arbitrary and capricious. However, FERC's views are known from the Ninth Circuit *Lockyer* proceeding and its initial orders herein, and a remand for further explanation is not required because FERC's views are contrary to the plain language and purpose of the FPA's rate filing, notice and other consumer protection provisions and they must be rejected by this Court.

III. ASSUMING FERC'S MBR REGIME IS LAWFUL, FERC'S RULES UNLAWFULLY RESTRICT REMEDIES AND ENFORCEMENT OF TARIFF VIOLATIONS

A. FERC's Restriction of Monetary Remedies

FERC has determined that the monetary remedy for any violation of the Rules is limited to disgorgement of unjust profits "on a transaction-specific basis" and only from the seller that actually violated the Rule. May 19 Order ¶ 128, JA _____, and November 17 Order, Appendix B, JA _____. This exclusive, *a priori* limitation forecloses FERC from imposing more comprehensive remedies, such as full market refunds from both the individual seller found to have violated the Rule or other sellers who benefited from an unlawful rate because of the Rule violation. Such a restriction on remedies is unlawful because it: (1) conflicts with the FERC's statutory mandates under the FPA to protect consumers and ensure just and reasonable rates; and (2) lacks reasoned explanation.

Again, the core purpose of the FPA is to protect consumers from exploitation. *See Nat'l Ass'n for the Advancement of Colored People v. FPC*, 520 F.2d 432, 438 (D.C. Cir. 1975);

Electrical Dist. No. 1, 774 F.2d at 493 (D.C. Cir.1985). Even under a market-based rate regime, FERC must ensure that rates are just and reasonable and applied in a non-discriminatory manner. *See generally FPC v. Texaco*, 417 U.S. 380, 397-99 (1984) (FERC is not free to equate just and reasonable rates with the prevailing market price); *see also Farmers Union*, 734 F.2d at 1501-02, 1509-10; *Lockyer*, 383 F.2d at 1001. Any rate or remedy that conflicts with these statutory purposes constitutes an abuse of discretion. *See Farmers Union*, 734 F.2d at 1500; *Towns of Concord, Norwood, and Wellesley, Mass. v. FERC*, 955 F.2d 67, 74 (D. C. Cir. 1974).

Here, FERC cannot demonstrate that its profit disgorgement remedy is consistent with the FPA’s mandates. FERC maintains that limiting potential remedies to this particular disgorgement remedy is justified because this remedy (and, apparently only this remedy) strikes an “appropriate balance” between the sellers’ needs for “regulatory certainty” and “transaction finality” with the needs of market participants for an “appropriate remedy.” May 19 Order ¶ 128, JA _____. However, these perceived policy interests cannot trump consumer protection and the requirement of just and reasonable rates. *See Maine Pub. Serv. Co.*, 579 F.2d 659, 664 (1st Cir. 1978) (core purpose of FPA is consumer protection and any protection received by utilities is incidental); *cf. MCI*, 512 U.S. at 234 (FCC’s views of “desirable policy” and desire to promote competition do not provide authority to alter the established statutory filed rate).¹⁵ The asserted justness and reasonableness of market-based rates is based on the presumption that in the absence of market power, the terms of a transaction will be reasonable and the price will be close to marginal cost, so that a seller only makes a normal return on its investment. *See Tejas Power Corp. v. FERC*, 908 F.2d 998, 1004 (D.C. Cir. 1990). However, there appears to be no

¹⁵ The CPUC has argued previously that the filed rate doctrine does not apply to market-based rates generally because the tariffs contain no ascertainable “rate,” and because the filed rate protection presupposes a filed rate. If the filed rate doctrine does apply, FERC must enforce it.

connection between factors such as “transaction finality” and “regulatory certainty” or allowing sellers to retain overcharges resulting from Rule violations, and ensuring lawful rates. Indeed, “transaction finality” and “regulatory certainty” in this context seem to be nothing more than euphemisms for FERC’s view that lax rules and a remedy that allows sellers to keep all or some of their ill-gotten gains are perfectly acceptable. That is not the law. *See Farmers Union*, 734 F.2d at 1501-03 (FERC “overreaches the bounds of its statutory authority” when it authorizes rates that permit exploitation, abuse, overreaching and gouging, whether “egregious” or not).

FERC’s proposed remedy also is contrary to FERC’s general policy of granting “full refunds” of overcharges for violation of FERC tariffs. *Consolidated Edison Co. of New York v. FERC*, 347 F.3d 964, 972 (D.C. Cir. 2003); *Towns of Norwood*, 975 F.2d at 73; *San Diego Gas & Elec. Co.*, 97 FERC ¶ 61,275 at 62,185 (2001) (“The Commission’s practice has been to order full refunds of any amounts collected above the just and reasonable level, absent contrary equitable considerations”). If FERC diverges from this policy, FERC must consider the relevant factors and provide a reasoned explanation of why the remedy is equitable in light of the particular circumstances. *Consolidated Edison*, 347 F.3d at 973. FERC provides no explanation or authority allowing it to pre-judge and impose a one-size-fits-all remedy for any and all violations of the Rules absent knowledge of all of the particular circumstances. Nor does FERC explain how its limited disgorgement remedy constitutes “full refund” protection for consumers or is equitable regardless of the circumstances, including the impact of a Rule violation on other market prices. Conclusory statements about “transaction finality” and “regulatory certainty” do not constitute a reasoned consideration of all the relevant factors. *See id.*

While disgorgement of profits may be the appropriate remedy in certain instances, this is true only where consumers have sustained little or no harm from wrongdoers. *See, e.g., Jack J.*

Grynberg, 93 FERC ¶ 61,180 at 61,856 (2000). Indeed, FERC has much broader authority to deter market abuses and protect consumers. *See Columbia Gas Transmission Corp. v. FERC*, 750 F.2d 105, 109 (D.C. Cir. 1984) (“the Commission has broad authority to fashion remedies so as to do equity consistent with the public interest”); *Lockyer*, 383 F.3d at 1015. FERC can impose remedies even without specific findings of discrimination or the exercise of market power by a particular utility seller. *See Transmission Access Policy Study Group v. FERC*, 225 F.3d 667, 687 (D.C. 2000). Specifically in the context of market-based sales, where an unlawful rate is charged, either through intentional market manipulation or through inadvertent error, FERC previously has implemented a “make-the-market-whole remedy” by re-setting the market price and ordering refunds to all participants to make the market whole and eliminate or minimize windfalls to participants. *See San Diego Gas & Elec. Co.*, 97 FERC ¶ 61,275 at 62,185 (2001) (recalculating the market clearing price obtained in the single price auction is a restitutionary, rather than a punitive, remedy: “Because the statutory goal . . . is customer restitution, the Commission does not set refund levels based on a degree of culpability regarding overcollections”); *San Diego Gas & Elec. Co.*, 102 FERC ¶ 61,317 (2003) (prices re-set for entire market); *Cities of Anaheim*, 95 FERC ¶ 61,197 at 61,687 (2001), *reh’g denied*, 102 FERC ¶ 61,274 (2003) (tariff violation was corrected market-wide); *ISO New England Inc.*, 90 FERC ¶ 61,141 at 61,425 (2000); *NRG Power Mktg., Inc.*, 91 FERC ¶ 61,346 at 62,165 (2000).

Finally, FERC maintains that disgorgement of profits, and possible revocation of market-based rate authority, “would be a sufficient inducement for sellers to comply with our rules.” May 19 Order ¶ 131, JA ____.¹⁶ As an initial matter, it is important to note that this contention, even if supportable, does not pertain to disgorgement’s function as a remedy, much less justify

FERC's decision to make it the only possible remedy. In any event, FERC provides no explanation as to why this remedy would function as a sufficient deterrent. A seller that risks only disgorgement of profits for transactions in which it has been caught red-handed can never be worse off by cheating, and is likely to benefit from cheating. Even in the unlikely event that a seller is caught every time, it will still be in the position that it would have been in had it not cheated at all. Moreover, FERC's approach invites collusion. For example, in auction-based markets, on Day 1, Seller A withholds power, raising the market price collected by sellers B, C, and D. On Day 2, Seller B withholds power, raising the market price collected by all other sellers. And so on. Even if FERC identifies each violation and imposes its profit disgorgement remedy in each instance, each seller will retain the excess profits caused by the other sellers' manipulation.

In sum, FERC's limited remedy unlawfully gives preference to seller interests and fails to ensure a just and reasonable rate. FERC does not, and cannot without knowledge of the facts of a particular Rule violation, articulate any legitimate reason for its artificial restriction of monetary remedies, contrary to its general policy of full refunds, or any reason why it should not exercise its remedial discretion on a case-by-case basis. Accordingly, FERC's limitation of monetary remedies should be eliminated.

B. The 90-Day Limitations Period

FERC has imposed a 90-day limitations period for both its initiation of a preliminary investigation regarding a potential violation of the Rules, and initiation of a complaint proceeding by either a market participant or state commission. May 19 Order at ¶ 146, JA _____. FERC maintains these limits are necessary to provide a "reasonable balance" between

¹⁶ The threat of market-based rate revocation is hollow. FERC has imposed it only on a company that was already defunct.

the seller's interest in finality and the interests of those adversely affected by Rule violations. *Id.* For market participants and state commissions, the 90-day period runs from the end of the calendar quarter in which the alleged violation occurred unless "the complainant can show that it did not know and should not have known of the behavior which forms the basis for its complaint." *Id.* at ¶ 148, JA _____. Similarly, regardless of whether it is responding to a complaint, FERC must act within 90 days from the date it knew of the alleged violation or "knew of the potentially manipulative character of an action or transaction." *Id.* ¶¶ 148-149, JA _____.

1. FERC's limitations periods are unlawful

FERC's limitations periods are unsupportable, both as a matter of general law, and specifically under the FPA. As a general matter, federal agencies acting to enforce public rights or the public interest are not subject to statutes of limitations or laches. *See Guaranty Trust Co. of New York v. United States*, 304 U.S. 126, 132 (1938); *SEC v. Rind*, 991 F.2d 1486, 1491 (9th Cir. 1993). FERC's orders cite no authority to the contrary.

More specifically, FERC's imposition of a limitations period conflicts with the express mandates of the FPA. Section 206 confers on consumers a right to file a complaint proceeding alleging tariff violations, and seeking relief, and nothing in section 206 empowers FERC to restrict those rights by imposing limitations periods. *See* 16 U.S.C. § 824e. FERC's attempt to limit those rights by creating a limitations period not authorized by law, therefore, exceeds its authority. *See Atlantic City Elec. Co. v. FERC*, 295 F.3d 1, 3, 8-11 (D.C. Cir. 2002) (FERC cannot point to any statute giving it authority for its unprecedented decision to require party to cede rights granted under the FPA; agency authority is not "lightly presumed").

In addition, FERC's creation of limitations periods defies a common sense application of the governing principles and regulatory structure of the FPA. *See Lockyer*, 383 F.3d at 1016-17 ("The FPA cannot be construed to immunize those who overcharge and manipulate markets in

violation of the FPA”). The reasons that it is unlawful for FERC to limit the scope of available remedies apply equally here. It is fundamentally contrary to the purpose of the FPA to subjugate the interests of consumers to those of private suppliers and allow sellers to charge unlawful rates with impunity because Commission Staff, state commissions or other parties may not be able to act quickly enough. Such a rule rewards the very sellers who manipulate markets. *See id.* at 1017.

2. The limitations periods are arbitrary and violate due process

Even if FERC had authority to impose limitations periods, FERC cannot justify the unreasonably short limits it has proposed. As noted above, FERC’s stated purpose is to balance the sellers’ interest in finality with the interests of those adversely affected by the Rule violations. However, FERC offers no reasoned explanation or evidence that the chosen limitation periods imposed by FERC strike any such balance. Moreover, where, as here, the time allowed by a statute of limitations is “manifestly insufficient” and there is a substantial risk that meritorious complaints will be arbitrarily rejected, there is a denial of due process. *See Texaco, Inc. v. Short*, 454 U.S. 516, 527 n.21 (1982); *Logan v. Zimmerman Brush Co.*, 455 U.S. 422, 433 (1982).

FERC provides no explanation why its limitations periods afford a reasonable time to discover “hidden wrongful conduct,” or to obtain the information necessary to draft a complaint in compliance with the specific requirements of 18 C.F.R. § 385.200. *See* May 19 Order ¶¶ 148, 153, JA _____. FERC did not consider, for example: the complexity of market manipulation issues, the difficulty in detecting manipulation, the number of pending Commission proceedings, the backlog of enforcement, or the time necessary for discovery or analysis prior to the initiation of an investigation or proceeding. Without such evidence and explanation, there is no rational basis for FERC’s decision to impose a 90-day period, rather than 180 days, one year, or no

period at all.¹⁷ See *North Carolina Utils. Comm'n v. FERC*, 42 F.3d 659, 663 (D.C. Cir. 1994) (FERC's reasoning must demonstrate it considered the relevant factors). Compare *Rind*, 991 F.2d at 1492 (“[S]ecurities fraud may involve multiple parties and transactions of mind-boggling complexity. Market manipulation is notoriously hard to detect. Placing strict time limits on Commission enforcement actions therefore would quite plainly frustrate or interfere with the implementation of national policies.”).¹⁸

Indeed, the time it took FERC to identify market abuses during the California energy crisis demonstrates that the restrictive deadlines proposed are not administratively feasible and leave consumers unprotected. Although FERC initiated an investigation on July 26, 2000, as of July 25, 2001 – one year later – FERC still asserted that there was no evidence that sellers had acted inconsistently with their market-based tariffs. *San Diego Gas & Elec. Co.*, 96 FERC ¶ 61,120 at 61,508 (2001).¹⁹ Three years passed before the Final FERC Staff Report was issued and market abuses identified. See 102 FERC ¶ 61,108. Moreover, an independent audit by the General Accounting Office in June 2002 concluded that FERC was not adequately performing

¹⁷ Knowledge by FERC sufficient to commence the limitations period is either: (a) a properly filed complaint; or (b) information received via FERC's Hotline. May 19 Order ¶ 150, JA _____. No explanation is given regarding how specific the Hotline information must be in order to constitute knowledge; this nebulous standard fails to ensure meaningful enforcement of the Rules, and instead appears designed to infer knowledge based on the most minimal of information, thus making it easier for sellers to argue that FERC failed to timely act.

¹⁸ *Rind* also rejected the argument (embraced by the November 17 Order ¶ 147, JA _____) that without a limitations period, the door would be opened to the prosecution of stale claims, reasoning instead that the remoteness of the violation can and should be considered in determining the scope of relief. *Rind*, 991 F.2d at 1492.

¹⁹ Comparison with the limitation periods for private actions under the federal securities laws – for which damages, as opposed to the more limited monetary equitable remedies, are available, highlights the inadequacy of the 90-day limitations periods. That limitation is one year from discovery and within three years of the violation. See 15 U.S.C. § 78i(e).

market oversight and faced “significant challenges” in attracting and retaining staff competent to monitor a competitive electric wholesale market.²⁰

FERC also fails to explain why the limitations period should apply to state commissions. *Id.* ¶ 153, JA _____. Unlike market participants who are engaged in day-to-day market operations and have, at least to some degree, near real-time visibility of market conditions and transactions, state commissions may need to subpoena relevant information. The difficulty of obtaining information is very real. During the California energy crisis, the FERC-approved tariffs of the regional markets prohibited the release of seller-specific information. *See, e.g., Cal. Indep. Sys. Operator Corp.*, 90 FERC ¶ 61,316 at 62,047 (2000) (approval of six-month lag in the release of bid information to the market to protect confidentiality of bidding strategies). Moreover, although the CPUC issued subpoenas to a number of sellers, many sellers refused to comply. The CPUC filed motions to compel with FERC in 2000, but FERC has never ruled on these motions. State commissions acting to protect consumers should not be placed in the impossible position of having to struggle to obtain necessary information within an unreasonable time frame, and then later prove their complaints were timely filed.

C. FERC Unlawfully Premises Violations on Determinations of Seller Intent, Motive, Due Diligence and “Direct Nexus”

1. Seller intent and motive do not determine the lawfulness of rates

FERC has placed additional roadblocks to recovery of overcharges. Rule 2 purports to prohibit market manipulation, but applies only to “actions or transactions that are intended to or foreseeably could manipulate market prices, market conditions, or market rules.” *See* November 17 Order, Appendix A, JA _____. Further, with the exception of four behaviors explicitly

²⁰ *See* Report GAO-02-656, “Concerted Actions Needed by FERC to Confront Challenges that Impede Effective Oversight,” <http://www.gao.gov/new.items/d02656.pdf>, at 55-59, 66.

identified in subparts 2(a) – (d), Rule 2 only prohibits “actions or transactions that are without a legitimate business purpose.” Premising the justness and reasonableness of market-based rates on a showing of wrongful intent or motive has no basis in the FPA, which contains no language regarding intent that would allow rates to be unlawfully charged so long as the seller overcharged negligently or had a “legitimate business purpose.” Seller intent and motive are simply irrelevant. *See Am. Tel. and Tel. Co. v. Central Office Telephone, Inc.*, 524 U.S. 214, 222 (1998) (deviation from the filed rate is not permitted on any pretext); *Farmers Union*, 734 F.2d at 1502 (ratemaking does not protect only against “gross exploitation,” “unconscionable gouging” or “gross abuse”); *The Washington Water Power Co.*, 83 FERC ¶ 61,282 at 62,169 (1998) (“intent, or the lack thereof, is not a factor in our determination whether to impose sanctions” for violations of Standard of Conduct requirements conditioning market-based rate authorization); *see also Cities of Anaheim*, 95 FERC at 61,887 (finding that “Deviation from the [ISO tariff] is not permitted under any pretext”, and directing invoices to be retroactively adjusted on a market-wide basis, even if the violation was unintentional). FERC provides no explanation for its departure from this precedent. The FPA requires that all rates demanded or charged must be just and reasonable, no matter what the seller’s intent or motive. *See Farmers Union*, 734 F.2d at 1503.

2. Seller due diligence does not ensure lawful rates

For the same reasons that seller intent and motive do not determine whether an unlawful rate was charged, seller due diligence should not be a defense. Rules 2(b), 2(c) and 3 provide that specified behavior is prohibited “unless Seller exercised due diligence to prevent such occurrences.” November 17 Order, Appendix A, JA _____. A seller will not be “in violation of a Rule if the seller can demonstrate that it exercised due diligence to prevent the occurrence of the conduct in issue.” May 19 Order ¶ 65, JA _____. Rule 2(b) (submission of false information

to transmission providers or other entities) enables a seller to establish a rebuttable presumption that the seller did not violate the Rule by demonstrating that it exercised due diligence to prevent the occurrence of the conduct at issue. *Id.* ¶ 67, JA _____. On rehearing, FERC clarified that evidence that an individual employee personally knew that the information was false may be considered in the determination of due diligence. *Id.* ¶ 69, JA _____. But such evidence appears unlikely to defeat a due diligence defense:

Moreover it is the seller's intent that ultimately concerns us under these Rules, rather than the intent of individual staff. Therefore, I do not intend to hold a duly diligent seller liable for the actions of a rogue trader. Paragraph 68 states that the due diligence standard is not intended to bar consideration of evidence that an individual trader personally knew the information was false. I agree that a complainant should be allowed to introduce evidence that an individual trader acted with intent in order to establish a prima facie case. However, the seller who then establishes that it exercised due diligence to prevent such actions should be absolved of liability, and the state of mind of the individual trader should be irrelevant to the question of whether the seller did exercise due diligence.

May 19 Order (Brownell, concurring at ¶ 2), JA _____. Rules 2(c) (the creation of artificial congestion) and 3 (submission of false and misleading information or the omission of material information) also allow evidence of compliance procedures as a due diligence defense. *Id.* ¶¶ 82, 96, JA _____.

While encouragement of due diligence procedures is laudable, due diligence does not ensure a lawful rate, which is what FERC is legally required to ensure. *See Lockyer*, 383 F.3d at 1011. Allowing such a defense unlawfully elevates the interests of suppliers over consumers. If a seller submits false information or other prohibited conduct occurs, the seller must be liable and the market and consumers protected, regardless of due diligence procedures. FERC advances no reason why a seller should retain the benefits of a "rogue trader's" illegal conduct. Under Commissioner Brownell's interpretation, whenever a seller can make a showing of due

diligence, consumers have no remedy, regardless of the extent of the damage caused by the “rogue trader.”

3. The direct nexus requirement

FERC further erodes consumer protections against market manipulation by arbitrarily requiring a party seeking to abrogate or reform a contract based on a violation of the Rules to “demonstrate that such a violation had a direct nexus to contract formation and tainted contract formation itself.” May 19 Order ¶ 45, JA _____. This “direct nexus” requirement is unlawful for the same reasons that it is impermissible for FERC to restrict enforcement to intentional misconduct or to restrict remedies for tariff violations, as explained in Section III.A., above. If FERC is to enforce just and reasonable rates, it should not create rules that allow a seller who obtains higher prices through prohibited manipulative activity to keep the benefits of that misconduct simply because it cannot be shown that the seller’s misconduct directly affected a contract negotiation. Nor should a seller benefit at the expense of consumers from the misconduct of another supplier.

FERC fails to explain the basis for this extremely high standard, other than the conclusion that it is a restatement of unspecified principles and policies. *See id.* Commissioner Kelly’s dissent illustrates the arbitrary nature of the direct nexus requirement:

For example, a seller may enter, in good faith, into a contract that bases the contract price on an electricity price index. At some point after the formation of that contract, the seller may engage in wash trades, a per se violation of the Market Behavior Rule 2(a), in order to manipulate the electricity price index. The Commission should allow that evidence to be presented as part of a contract reformation or abrogation proceeding under FPA section 206, even though the rule violation does not have a direct nexus to the formation of the contract.

May 19 Order, (Kelly, dissenting, at 2), JA _____.

The “direct nexus” requirement should be eliminated. FERC should evaluate each complaint on an individual basis, and exercise its discretion based on the specific circumstances and equities presented.

IV. THE RULES SHOULD PROHIBIT KNOWN MANIPULATIVE PRACTICES

A. Withholding of Energy Supply

As demonstrated by the California energy crisis, sellers have, in fact, repeatedly used “withholding” strategies to drive up prices and take advantages of captive consumers. *See* FERC Final Staff Report,²¹ at VI-45 to VI -54; *Lockyer*, 383 F.3d at 1014-15. FERC’s Rule 1, ostensibly intended to address these abuses, fails to do so without reasoned explanation. FERC should be required to adopt a uniform rule unequivocally prohibiting these known manipulative practices.

Electricity, unlike other commodities, cannot be stored. A second unique characteristic of the electricity market is that supply must meet demand to ensure system reliability. Sellers can take advantage of these characteristics to increase their revenues by withholding supplies in order to diminish supply and drive up market prices. There are two types of withholding, economic and physical. Economic withholding occurs when a seller offers power to the market at a price so high that no one would buy it in a fairly functioning market – a price above both its full incremental costs and the current market price. This means that the seller is foregoing profits that could have been earned, an act that is economically irrational unless the seller is attempting to wield market power. The seller then wields its market power to meet the increased demand in the spot market (caused by reduced supply elsewhere) by increasing the amount of energy bid at a higher price. *See* November 20 Order at 61,976, JA _____. “Fat Boy”

²¹ <http://elibrary.ferc.gov/idmws/common/opennat.asp?fileID=9666689>

(withholding previously agreed deliveries of power to sell at a higher price in the spot market) and “hockey-stick bidding” (increasing the price for power when demand is known to be inelastic) are two of the economic withholding strategies that were utilized during the California energy crisis. *See Lockyer*, 383 F.3d at 1015 ns.7 & 8.

Physical withholding occurs when a seller fails to offer its power to the market during periods when the market price exceeds the supplier’s full incremental costs, thus foregoing profits in the short term in order to drive up prices by creating a shortage. For example, a generator may declare an unavoidable outage when its unit is not, in fact, experiencing mechanical problems, and when the market price is above the unit’s full incremental costs. November 20 Order at 61,976, JA _____. In January 2003, FERC entered into a settlement with Reliant Energy requiring payment of \$14 million for physical withholding from the “day-ahead” spot market over a two-day period in June 2001. *Fact-finding Investigation into Possible Manipulation of Electric and Natural Gas Prices*, 102 FERC ¶ 61,108 (2003).

1. Rule 1 is inadequate

Rule 1 does not prohibit withholding outright. Instead, the Rule provides:

Seller will operate and schedule generating facilities, undertake maintenance, declare outages, and commit or otherwise bid supply in a manner that complies with the Commission-approved rules and regulations of the applicable power market. Compliance with this Market Behavior Rule 1 does not require Seller to bid or supply electric energy or other electricity products unless such requirement is a part of a separate Commission-approved tariff or requirement applicable to Seller.

November 17 Order, Appendix A, JA _____. Rule 1 applies only to sales that take place in formal energy markets run by regional ISO’s and RTOs (“the applicable energy market”),²² and

²² As described in Factual Background, Section B, above, sales occur mainly in two ways: via virtually unregulated bilateral transactions between individual buyers and sellers, and via more formally controlled markets run by regional ISOs and RTOs.

then only requires sellers to comply with whatever (unspecified) rules that market might have. In adopting this Rule, FERC rejected stronger rules that would have imposed an industry-wide obligation and a “must-offer”²³ requirement. Such rules would have ensured that all sellers behave as they would in a competitive marketplace, offering their power any time the market clearing price equals or exceeds the seller’s variable cost.

FERC has offered two justifications for imposing its limited rule: (1) FERC does not want to alter any existing regional market rules in this regard; and (2) Rule 2 provides adequate protection. Neither justification satisfies even the minimum standards for reasoned decision-making with which FERC must comply.

FERC noted that Rule 1 “neither expands upon nor limits” any existing obligation applicable to sellers. May 19 Order ¶¶ 22, 24, 26, JA _____. FERC reasoned that if a seller complies with unspecified rules of the applicable regional power market (*e.g.*, an RTO or ISO), there is no need for a nationwide, FERC rule that may, hypothetically, conflict with a particular (unspecified) regional rule. *Id.* ¶ 24, JA _____. Thus, Rule 1 only requires sellers participating in regional markets to follow the rules contained in those regional tariffs with respect to bidding and operations. *See id.* ¶¶ 24, 26, JA _____. Although FERC has acknowledged the importance of preventing manipulative conduct that cannot be precisely envisioned at this time (*id.* ¶ 36, JA ____), it fails to explain how this Rule is adequate in the event that a regional market does not have sufficiently comprehensive rules. *See id.* ¶ 24, JA _____.

²³ For example, FERC’s efforts to stabilize the Western electricity markets included the imposition of a “must-offer obligation” on all sellers with market-based rate authorization which (with certain limited exceptions) required the seller to offer its available power during all hours of the regional “spot” markets, where purchases are made to ensure system reliability. *See, e.g., San Diego Gas & Elec. Co.*, 95 FERC ¶ 61,418 at 62,548-49 (2001).

Rule 1 also conflicts with FERC’s stated goal of providing an “effective remedy in the event anticompetitive practices or other market abuses are found to have occurred.” *Id.* ¶ 8, JA _____. FERC acknowledges that Rule 1 will not apply to sales arrangements outside of the formal energy markets. May 19 Order ¶ 20, JA _____. This limitation is arbitrary, and implies that what FERC considers as a requirement for lawful rates in formal power markets is not a requirement for all other market-based power sales where there are even fewer Commission-approved rules and regulations, or none at all. FERC fails to explain why Rule 1 is needed in regional markets where there are many other rules, but not needed in markets not covered by the regional market rules.

2. Rule 2 is not a viable enforcement alternative

FERC maintains that a general prohibition of withholding in Rule 1 is unnecessary because if a seller withholds power to manipulate market prices, such conduct will violate Rule 2 (Market Manipulation)²⁴ if the conduct is “without a legitimate business purpose.” May 19 Order ¶ 27, JA _____. With one exception, FERC declines to identify specific conduct as a *per se* violation of Rule 2 not allowing consideration of the seller’s intent or motive, stating only that such specificity would somehow create a “loophole” and restrict FERC’s ability to prohibit all forms of market manipulation. *Id.* ¶ 41, JA _____. This conclusory rationale is undercut by FERC’s determination that “wash trades” are a *per se* violation of Rule 2, not requiring an examination of intent or motive. *Id.* ¶ 42, JA _____. Thus, despite the lessons of the California energy crisis, FERC would allow sellers to evade liability for withholding by submitting

²⁴ “Actions or transactions that are without a legitimate business purpose and that are intended to or foreseeably could manipulate market prices, market conditions, or market rules for electric energy or electricity products are prohibited. Actions or transactions undertaken by Seller that are explicitly contemplated in Commission-approved rules and regulations of an applicable power market (such as virtual supply or load bidding) or taken at the direction of an ISO or RTO are not in violation of this Market Behavior Rule.” May 19 Order ¶ 29, JA _____.

evidence that certain known withholding strategies have a “legitimate business purpose.” As explained above, seller intent and motive do not control whether a rate is unjust or unreasonable.

Rule 2’s inadequacy is further highlighted by FERC’s rejection of proposed Rule 2(e),²⁵ which would have prohibited “hockey-stick” bidding – bidding an amount of supply at an excessively high price relative to the bid(s) on other supply from the same unit when demand is known to be inelastic. *San Diego Gas & Elec. Co.*, 95 FERC ¶ 61,115 at 61,360 (2001). During the California energy crisis, FERC recognized the need to condition sellers’ market-based rate authority to prevent hockey-stick bidding. *Id.*; *see also Lockyer*, 383 F.3d at 1015-16 (hockey-stick bidding prevalent during California energy crisis). Yet FERC abandoned this proposed rule, stating that: (1) it is redundant of Rule 1, which requires compliance with the bidding and operational requirements of the regional markets, and specific behaviors should not be addressed in rules of general applicability; and (2) it is redundant of Rule 2, which prohibits market manipulation absent a legitimate business purpose. May 19 Order ¶¶ 119-120, JA _____. As discussed above in Section IV.A.1, Rule 1 is limited in scope and Rule 2, with its intent requirement and caveat for legitimate business purposes, is ineffectual. Thus, FERC has failed to articulate any reasoned explanation for its failure to prohibit known withholding behavior.

B. Rule 2(c) Should Prohibit the Exercise of Market Power Whenever Transmission Congestion Exists

Rule 2(c) only prohibits “transactions in which an entity first creates artificial congestion and then purports to relieve such artificial congestion (unless the seller exercised due diligence to prevent such an occurrence).” Transmission congestion creates opportunities for the exercise of market power whether the congestion is created artificially or not. Instead of explaining why it

²⁵ Rule 2(e) would have prohibited bidding the output of or misrepresenting the operational capabilities of generation facilities in a manner which raises market prices by withholding available supply from the market. May 19 Order ¶ 119, JA _____.

did not prohibit the exercise of market power whenever transmission congestion exists, FERC merely concluded that this issue can and is being addressed by other, unspecified FERC-approved rules in the regional market. May 19 Order, ¶ 80, JA _____. *See Consolidated Edison*, 347 F.3d at 972 (conclusory statements are not reasoned decisionmaking). Logically, in order to ensure just and reasonable rates, Rule 2(c) should be expanded to prohibit all transactions in which market power is exercised during transmission congestion, no matter how the congestion was created.

CONCLUSION

For the foregoing reasons, Consumer Advocates asserts that the Court should declare FERC's market-based rate regime to be contrary to the mandates of the FPA and accordingly should vacate orders under review in their entirety, and remand with the direction that FERC: (1) prospectively 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 consumer remedies; (2) the limitations periods imposed for both initiation of investigations by FERC and section 206 proceedings by other parties; 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 prohibit withholding of energy supply and the exercise of market power during periods of transmission congestion.

Dated: April 29, 2005

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DESIGNATION PURSUANT TO FRAP RULE 30(c)

Pursuant to Rule 30(c) of the Federal Rules of Appellate Procedure, the California State Parties and Consumer Advocates designate the following parts of the record that they want to include in the deferred appendix. References are to Record Item Nos. set out in FERC's "Certified Index to the Record" filed in this Court on or about September 15, 2004: Record Item Nos. 1, 2, 7, 56, 60, 93, 140, 187, 202, 231, 256, 257, 262, 300, 320, 343, 346, 349, 350 378, 816, 817, plus the Petitions for Review filed by the CEOB on July 18, 2004, the CPUC on July 15, 2004, and Consumer Advocates on July 16, 2004.

**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 13,652 words.

Dated: April 29, 2005

ELIZABETH M. MCQUILLAN

ADDENDUM: PERTINENT STATUTES AND REGULATIONS

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DECLARATIONS RE STANDING

CERTIFICATE OF SERVICE

I, Martha Perez, 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 April 29, 2005, I served two copies of the attached **JOINT OPENING PETITIONERS BRIEF FOR 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 April 29, 2005, at San Francisco, California.

Martha Perez

SERVICE LIST
