Attorney General's Energy White Paper

A Law Enforcement Perspective on the California Energy Crisis

Recommendations for Improving Enforcement and Protecting Consumers in Deregulated Energy Markets

Attorney General Bill Lockyer
State of California
April 2004

This report was prepared by staff from the Attorney General's office, with significant contributions by Ken Alex and Paul Stein.

Other contributors included Tom Greene, Damon Connolly, Margarita Padilla, Kirk McInnis, Clarence Binninger, Chris Crook, Tom Dresslar, Meg Halloran, Sandra Michioku, Nini Redway, Julie Cipolla, and Vickie Whitney.

TABLE OF CONTENTS Ê

Page 6 **I. Executive Summary**
Introduction and Summary of Key Recommendations

13 **II. The Report**

A. Background: The Deregulation of Electricity in California
1. California Deregulates its Energy Markets
2. The Calm Before the Storm
3. The Crisis Begins
4. Natural Gas Prices Explode
5. Rolling Blackouts Start
6. The Clean Up

25 **B. Overview of Government Entities with Responsibility for Market Oversight and Enforcement**
1. Federal Energy Regulatory Commission
2. Independent System Operator
3. Public Utilities Commission
4. California Attorney General
5. Other Enforcement Entities

28 **C. FERC: The Single Entity with Power to Avert the California Energy Disaster**
1. FERC's Entity by Entity Market Power Determination
2. Market Oversight: Failed Reporting Requirements
3. Price Caps
4. Enforcement
5. Refunds for Overcharges
6. Other Remedies
7. Consumer Participation

38 **D. The Impact of the "Filed Rate Doctrine"**
1. The Filed Rate Doctrine: A Summary
2. What is the "Rate" in a Market System?
3. FERC's Misapplication of the Filed Rate Doctrine to Market-Based Rates
4. Other Consequences of the Filed Rate Doctrine

42 E. ISO: The Need for More Oversight and Enforcement
1. System Reliability and Governance of the Markets
2. Enforcement

43 F. State Regulation of Electricity is Highly Constrained
1. Electricity Oversight Board
2. California Public Utility Commission
a. PG&E's Attack on the PUC's Control of Retail Rates
3. California Energy Commission

46 G. Limitations on Enforcement of State Laws and the Need for Greater Cooperation Among Enforcement Authorities
1. Limitations on Enforcement of State Law
a. Preemption and Preclusion by Federal Law and Actions of the Federal Government
2. Cooperation Among the Attorney General and Other Government Entities With Enforcement Authority
3. Private Lawsuits

50 H. The Need for Continued Regulation of Utility Holding Companies and the Failure of the Securities and Exchange Commission to Enforce the Public Utilities Holding Company Act

54 I. PG&E's Bankruptcy Action

57 J. Forcing the State Into Federal Court and the Issue of Sovereign Immunity

58 K. Natural Gas and Its Relation to the Electricity Crisis
1. A Brief Description of the Natural Gas Industry and Legal Actions Against El Paso
2. The El Paso Settlement
3. Gas Indexing Manipulation: Natural Gas Trading and the Price of Electricity
4. The Indexes and Methods of Manipulation

65 III. Conclusion and Recommendations

69 IV. Glossary

79 V. Appendix

I. EXECUTIVE SUMMARY Ê

California's first effort at open competition among power companies has failed to fulfill its promise of cheap and reliable power — like a light bulb that stays dark when the switch is flipped. Instead of seeing prices reduced by the deregulated electricity market, ratepayers and taxpayers were stunned by blackouts and huge bills as they watched energy generators and traders game the system, inflate prices and stuff their own pockets.

Three years later, the state still is reeling from the Energy Crisis of 2000-01 and trying to understand what went wrong. In the search for answers, one has become readily apparent: the statutory and the regulatory framework that govern California's energy market, and the agencies and entities responsible for enforcing the rules, failed in key respects.

This report examines the breakdown in the state's deregulated energy market from a law enforcement perspective. It details flaws in the laws and regulatory agencies that policed the market, and how existing remedies for market abuses fell short. Finally, the report offers recommendations to improve consumer protections, invigorate oversight and ensure active and responsive enforcement.

California must take steps to stabilize its energy future by increasing investment in its electricity infrastructure and by creating effective incentives to provide new power supplies. This can be achieved in a variety of ways, and Californians will need to work together to ensure success. This report does not attempt to address these issues, the merits or demerits of deregulation or proposals to modify the system. Instead, it focuses on what this office has learned from its three-year investigation of the market; its continuing effort to recover monies lost by California businesses, government and ratepayers; and the need to meaningfully improve the enforceability of the laws and rules that govern the delivery of power to Californians.

The Energy Crisis brought California power blackouts and economic hardship. In 1999, the first full year of deregulation, Californians paid $7.4 billion for wholesale electricity. A year later, these costs rose 277 percent — $27.1 billion. In 2001, wholesale power costs held fast at the exorbitantly high level of $26.7 billion.

Price Comparisons: January 2001 — Average Cost per Megawatt Hour

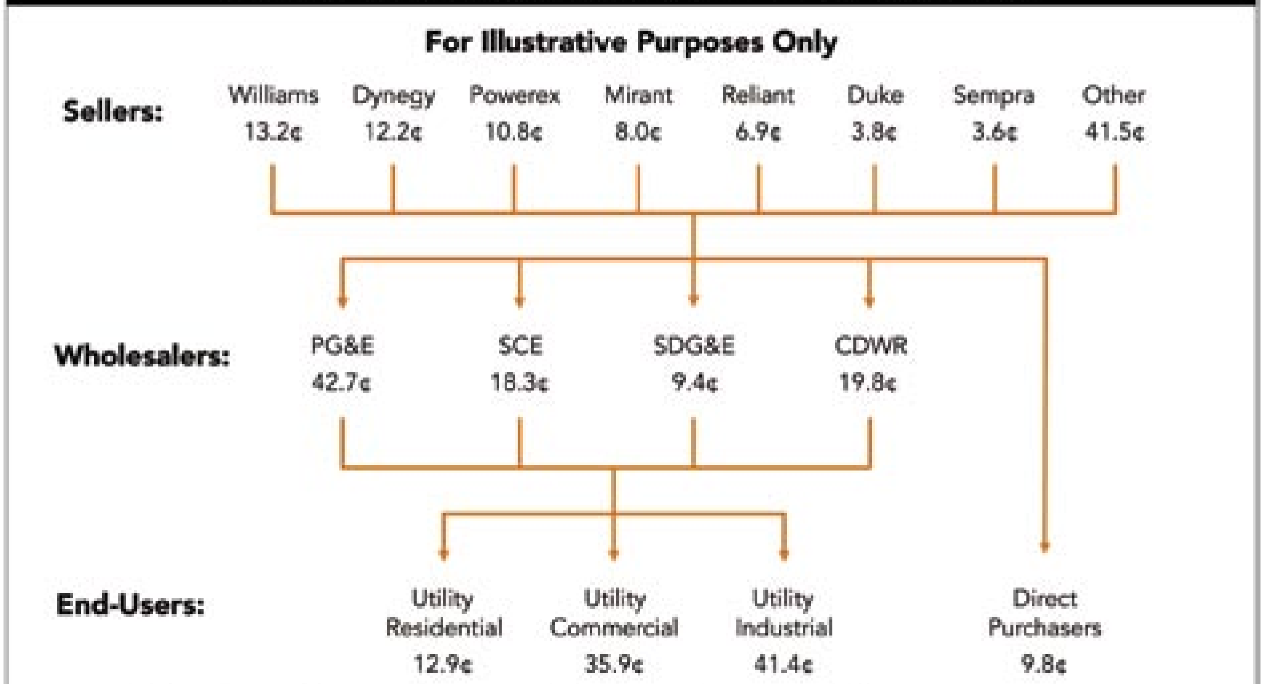
State	Cost
California	$313/MWh
New England	$74/MWh
New York	$63/MWh
Pennsylvania	$39/MWh
New Jersey	$39/MWh
Maryland	$39/MWh

As evidence substantially demonstrated, generators and power traders manipulated the market, played Enron-style games and withheld power to artificially inflate prices. Under the deregulation scheme, federal and state regulators should have been monitoring the electricity market, detecting misconduct and intervening to protect ratepayers. In reality, they could not or did not act effectively during the energy crisis.

From July to December 2000, during hours when Californians most needed electricity, generators on average withheld enough megawatts from the grid to power more than 1 million homes. According to testimony submitted to the Federal Energy Regulatory Commission (FERC), on eight occasions when the state's grid operator declared power emergencies, generators falsely reported units inoperable due to mechanical problems. Another 22 times during system emergencies, generators shut down units purely to maximize profits. A FERC judge found that a major natural gas company withheld capacity on its pipeline system to artificially drive up prices in a market increasingly driven by gas-generated electricity.

Deregulation dramatically expanded FERC's role in the oversight of prices and market conduct. The state's deregulation law, AB 1890, transferred control of crucial electricity power plant and sales activities from the California Public Utilities Commission (PUC) to FERC. Furthermore, while the state still regulates retail sales of electricity, those prices are determined to a significant extent by wholesale prices. This has further increased FERC's dominant role, since it regulates wholesale prices from Washington, D.C.

An Estimated Allocation of Each FERC Refund Dollar



These numbers reflect possible FERC allocations and not the views of the various California Parties. This chart estimates how refund dollars will flow from sellers to wholesalers and finally to end-users. The refund proceedings are not final and FERC has not yet defined precise formulations for allocations. The figures in the first two rows of the chart are based on best available data and information. The aggregate level of refunds to utility customers is based on the assumption that the CPUC will pass all refunds to end users. While the CPUC has yet to define a methodology for allocating refunds among customer classes, the figures in the third row of the chart assume that refunds will be allocated pro rata with the way the burden of increased retail prices was shared.

This report discusses how FERC disregarded its responsibilities during and after the crisis and how it applied the laws it enforces, most notably the Federal Power Act (FPA) and Natural Gas Act (NGA). FERC's performance, as documented in this report, was abysmal and marked by an abject failure to protect the public interest. During the energy crisis, generators and traders overcharged Californians by roughly $9 billion. Three years later, ratepayers have yet to receive significant relief. FERC has obtained settlements totaling less than $85 million from energy companies, despite acknowledging that rates charged in the wholesale market were unjust and unreasonable. In addition, FERC has dramatically limited the availability of refunds. FERC's decisions could deprive California ratepayers of more than $6 billion in compensation.

An emerging body of academic opinion supports this report's conclusion that FERC did not act quickly or decisively enough to stem abuses during the California energy crisis.[1] Equally troubling, the U.S. General Accounting Office (GAO) recently found that FERC is still unable to adequately police national energy markets.[2]

This report focuses on the following areas of concern:

Failures and deficiencies in market oversight and enforcement: Ê

- California's experience shows that FERC's methodology to determine whether a generator can exercise "market power" was terribly flawed. Before allowing a generator to charge market-based rates,[3] FERC must find that the generator cannot wield market power. The absence of market power means a generator does not control enough of the electricity market in California — or in a recognized segment of the California market — to exercise improper control over price or supply. FERC has conceded that its method for determining the existence of market power was inadequate. In late 2001, FERC abandoned its test in favor of a new, interim methodology. Unfortunately, the new approach also has been strongly criticized.

- FERC requires electricity sellers to file quarterly reports on their sales and purchases of wholesale power. FERC itself has described these reports as necessary for FERC to ensure that rates are just and reasonable and to adequately monitor the market. But when sellers failed to file this information for a period of years, FERC did not act until well after the energy crisis. In fact, there is no record of any FERC enforcement action, before or during the California energy crisis, against any generator operating in the California market.

- Gaps in market oversight and enforcement at the California Independent System Operator (ISO), PUC and the Electricity Oversight Board (EOB), as well as limitations to the enforceability of state laws, left California vulnerable to abuses. Adequate resources must be made available to detect and

---

1 Frank A. Wolak, *Lessons from the California Electricity Crisis,* University of California Energy Institute CSEM WP-110 at 5 (2003). ("crisis was not a market failure, but a regulatory failure.") See http://www.ucei.berkeley.edu/pubs-csemwp.html.

2 U.S. General Accounting Office, pub. No. GAO-03-845, Energy Markets: Additional Actions would Help Ensure that FERC's Oversight and Enforcement Capability is Comprehensive and Systematic (2003)

3 Market-based rates are unconstrained by price regulation.

punish abuses of the system. Additionally, greater cooperation among the various enforcement agencies, state and federal, will ensure more timely and efficient enforcement.

Misapplication of the Filed Rate Doctrine to benefit power companies and harm consumers

- In turning to FERC and the judiciary for redress, Californians have struggled up a steep hill, shouldering a boulder called the "Filed Rate Doctrine." This obscure but crucial legal doctrine, created by the courts in the early 20th Century, was developed when energy suppliers were heavily regulated. Prices, or rates, were based on the cost of service plus a reasonable profit as determined by the regulatory agency. Under the Filed Rate Doctrine, once a rate is filed and approved by a regulated utility, that rate cannot be challenged except through noticed regulatory proceedings. Even then, the rate only can be challenged going forward, after the notice, not retroactively. The doctrine also precludes a court from scrutinizing the regulatory agency's evaluation and approval of the rate.

- The Filed Rate Doctrine has no place in California's deregulated system where the market, rather than a regulator, sets rates. Nevertheless, FERC and some courts have applied the doctrine to the market-based rate system. In today's wholesale electricity markets, FERC has determined that the "filed rate" essentially is whatever price a buyer and seller negotiate in the market. Under FERC's construct, then, no specific market sale can be challenged retroactively because the seller's "rate" has been filed. Consequently, even though FERC determined California wholesale electricity purchasers paid unjust and unreasonable prices from May 1, 2000 through October 1, 2000, FERC has refused to grant refunds for overcharges incurred before October 2, 2000, or sixty days after the first rate challenge was filed at FERC.

- Meanwhile, some courts have afforded these market-based rates the full protection of the Filed Rate Doctrine. That, in turn, has limited remedies under California's antitrust and unfair competition statutes. If this interpretation stands, sellers in today's deregulated electricity markets would be free of both traditional regulatory controls and state and federal laws that forbid price fixing, monopolization, fraud and unfair competition. The effect would be to deliver a one-two punch to California's efforts to obtain remedies for unjust rates negotiated in California's wholesale electricity market. In pending litigation, the Attorney General is challenging both FERC's formulation of the "filed rate," and the application of the Filed Rate Doctrine.

Need to regulate utility holding companies to avoid abuses such as those seen in the diversion of assets by Pacific Gas & Electric Company

- The report evaluates some of the legal structures surrounding the operation of California's Investor Owned Utilities (IOUs) — Pacific Gas & Electric (PG&E), Southern California Edison (SCE)[4], and San Diego Gas & Electric (SDG&E).[5] The U.S. Securities and Exchange Commission exempted these entities — improperly in the Attorney General's view — from full scrutiny

---

4 In addition to the IOUs electricity distribution functions, they also served as natural gas distribution companies to supply natural gas to end-users. The IOU's role in the natural gas markets will be discussed separately.

5 San Diego Gas & Electric is a fully owned subsidiary of Sempra Energy Corp.

under the Public Utilities Holding Company Act (PUHCA). This exemption may have exacerbated the problems in California. PUHCA was designed to prevent utilities' parent companies from siphoning funds from the utility and its ratepayers to finance other ventures and pay dividends to holding companies' shareholders. PG&E's upstreaming of $4 billion in earnings to its parent corporation — even as the utility was facing severe losses and possible bankruptcy — escaped proper SEC scrutiny because of the exemption.

Each of these issues illuminates a larger theme. Adequate remedies for market abuses, essential to any deregulated market, currently are not available to consumers. Policymakers must understand the nature of California's energy crisis, create the ways and means to forestall another such crisis and assure that enforceable rules and adequate remedies are in place to address market abuse.

It is important to note that in California's deregulated electricity markets, unlike similar markets in other jurisdictions, the major utilities were required to purchase all of their energy requirements in the short-term markets, meaning they were unable to enter into long-term contracts. The reasons for this policy included a concern by new energy traders that the utilities had too much negotiating power. Regardless of its underlying rationale, the policy likely increased the harm caused to consumers by the gaming and withholding that plagued the short-term markets. Still, this report's recommendations remain relevant, even if long-term contracts are employed to a greater extent. Indeed, California eventually did enter into a series of long-term energy contracts. And that experience shows that the misconduct that inflated prices in the short-term market also drove up the costs of the long-term contracts.

This report reflects the analysis of the Attorney General's Energy Task Force, created by the Attorney General in 2000 to investigate the California energy crisis and seek remedies for harm caused by unlawful conduct. While substantial litigation and investigation continue, settlements reached thus far by the Attorney General have a combined value of more than $2.1 billion, including more than $1.6 billion in ratepayer benefits paid by power companies. A significant portion of the total settlement value, $1.6 billion, represents a settlement with El Paso Natural Gas Company.

The Attorney General's Office conducted much of its investigation pursuant to statutory subpoena and deposition authority that requires the material to remain confidential. This report adheres to those confidentiality requirements, and therefore cannot and does not contain a thorough discussion of all of the evidence reviewed by the Attorney General.

Finally, the Attorney General's Office is making an extraordinary effort to use litigation to undo the worst effects of the energy crisis and to recover the dollars lost to our economy. After-the-fact litigation, however, will never be a satisfactory substitute for the good planning and wise policies needed to avoid future energy crises.

The Attorney General's primary objective in issuing this report is that policymakers use it to help improve the state and federal regulatory structure, ensure meaningful state and federal enforcement, promote early detection of market abuses, streamline responses to avoid future crises, and provide real remedies for California consumers and businesses when they are harmed by unlawful and unfair practices.

KEY RECOMMENDATIONS Ê

The following is a summary of key recommendations of this report. The complete set of recommendations is listed in the final chapter.

Market Oversight and Enforcement: The Filed Rate Doctrine and FERC's Oversight of Market-Based Rates

- *Amend the FPA and the NGA to state specifically that the filed rate doctrine does not apply to market-based rates. This may be the most important action that can be taken to ensure fairness and deter future attempts to manipulate energy markets.*

- *Amend the FPA and NGA to clarify that in a market-based rate system, there can be no ban on retroactive refunds.*

- *Establish at FERC written criteria for market monitoring, identification of gaming, and steps to be taken when markets fail to function properly. Provide sufficient funding to the FERC enforcement staff to investigate and prosecute wrongdoing.*

Consumer Participation in FERC Proceedings Ê

- *Create a mechanism, similar to that in California Public Utilities Code section 1801, to encourage direct consumer participation in proceedings before FERC by entitling representatives who make a "substantial contribution" to the outcome of proceedings to recover their reasonable costs of participation.*

The Independent System Operator and California's Other Regulatory, Enforcement and Legal Structures

- *If the ISO is to be relied on as an effective enforcer and market monitor, compliance and monitoring staff must be increased.*

- *Ensure the ISO has specific administrative enforcement authority. The ISO's authority to investigate violations of the tariff, to assess penalties, and to refer cases to FERC needs to be clearly delineated.*

- *Currently, the PUC appears before FERC as a party with status similar to that of generators. The PUC can file complaints and seek redress as a party. In situations involving market dysfunction, the PUC (through federal legislation) should be given a status different from that of regulated entities to enable the PUC to work with FERC to re-establish market functionality.*

- *For the most egregious violations, when discovered by the PUC, the EOB, or the ISO, provide for automatic referrals to the Attorney General for prosecution. Consider a uniform mandatory referral system for the most egregious violations. The PUC has substantial regulatory and administrative* *enforcement authority, which is sufficient for all but the most drastic situations, such as the energy crisis. Creating a specific referral process, whereby the PUC could request representation for specific enforcement action by the Attorney General, could benefit both the PUC and the Attorney General by linking the Attorney General's investigatory and enforcement litigation expertise with the PUC's expertise on issues concerning matters within its jurisdiction.*

Cooperation Among Enforcement Agencies

- *Amend federal law to require FERC's full and complete cooperation with state and local investigations of fraud, antitrust violations, unfair competition and other misconduct in the energy markets.*

- *Amend Federal law to allow grand jury material to be shared with state and federal criminal and civil investigators in order to promote cooperation and avoid overlapping investigations. These amendments could be modeled on similar provisions in the federal Financial Institutions Reform, Recovery, and Enforcement Act.*

- *Consider the creation of a multi-jurisdictional interagency energy task force. USDOJ, Attorney Generals, FERC, the Commodities Futures Trading Commission, the SEC, the state PUCs, the FBI, and other regional, state and local agencies have a strong interest in ongoing coordination of enforcement policies and actions.*

Regulation of Utility Holding Companies

- *If Congress amends or rescinds the PUHCA, Congress should retain PUHCA's underlying regulatory concepts and strip PG&E Corporation and, if appropriate, other California holding companies of their current exemption from such regulations.*

II. THE REPORT Ê

A. Background: The Deregulation of Electricity in California

1. California Deregulates its Energy Markets

In 1996, following a study by the California Public Utilities Commission (PUC) and extensive negotiations in the Legislature, the state enacted AB 1890 to transition California from a system of regulated monopolies to a competitive wholesale electricity market. Then Governor Wilson said the legislation was "a major step in our efforts to guarantee lower rates, provide consumer choice and offer reliable service, so no one literally is left in the dark."[6] PG&E, the nation's largest utility, estimated that its customers would see their bills drop from the then current average of $65 per month to $50 per month in 2001, or a 20+ percent reduction in average retail rates.[7] AB 1890 itself projected both increased competition and lower prices after deregulation.[8]

The new law also made dominant the role of wholesale electricity rates and markets, and market-based pricing. While the state continued to regulate retail rates based on the cost of providing service, FERC had implemented a market-based system in the wholesale markets, thereby moving the state away from cost-based pricing to market-based pricing. However, the new law contemplated the eventual deregulation of retail electricity sales. The idea was that local competitors would vie for retail customers using power they produced or purchased from wholesalers.

For the wholesale markets to be competitive, California also needed to create additional sellers. To achieve this, AB 1890 encouraged California's three major investor-owned utilities (PG&E, SCE, and SDG&E, collectively "IOUs") to sell or divest certain power generating facilities. As planned, the IOUs sold all of their fossil fuel plants (retaining nuclear, hydroelectric and some other generation assets) to five large wholesale energy companies, including Duke, Mirant, Dynegy/NRG, AES/Williams, and Reliant, known as merchant generators. Control of transmission lines owned by the IOUs was turned over to the ISO, an entity subject to a FERC oversight.

Before passage of AB 1890, the three utilities provided power to 77 percent of the state, pursuant to strict price regulation based on the cost of providing the service. The other 23 percent of the state obtained power from municipal utility and irrigation districts that typically provide power on a

---

6 Dan Morain, *Deregulation Bill Signed by Wilson; Utilities: Law Will Make Electricity Providers Competitive by 2000. Firms Will Cut Residential Rates but Can Add Charges to Recoup Bad Investments*, L.A. TIMES, Sept. 24, 1996, at A3.

7 Greg Lucas, *State Panel Approves Restructure of Electricity Industry/Monopoly Would Be Phased Out*, S.F. CHRON., Aug. 28, 1996, at A13.

8 See California Public Utilities Code § 330(x).

cost-of-service basis. The state also imported power. In the summer months approximately 20 percent of California's power was imported, most from northwestern hydroelectric sources. In winter, flows typically reversed, with California power producers supplementing Northwest supplies.

In the years following passage of AB 1890, after the IOUs divested their generation assets, the IOUs produced less than 50 percent of their customers' power needs. They had to purchase the additional electricity needed to supply their customers through a wholesale auction market created by AB 1890 called the Power Exchange or PX. As this market evolved, it became clear that because merchant plants could ramp up or down as demand changed, they could and did largely control the price of power in California. Ultimately, as a result of the energy crisis, the PX market collapsed, declaring bankruptcy in December 2001.[9]

Under the new deregulated system, the merchant generators that purchased the crucial power plants from the IOUs became sellers of power in the wholesale markets, outside the control of state regulators. In addition, the IOUs were required to sell all of the electricity produced at generating plants they retained into the PX, and to purchase all of their power from the PX, which operated under federal authority. This massive shift in regulatory authority from state to federal regulators went largely unappreciated until the crisis.

AB 1890 also created the ISO to manage the day-to-day operations of the electricity grid, the elaborate system of transmission lines, towers and equipment that carries electricity throughout the state. In carrying out this role, the ISO was expected to purchase limited amounts of power and capacity to balance minor disturbances in the electrical grid during the day. Because electricity, for the most part, cannot be stored and because transmission lines and systems can become congested, such purchases are crucial to grid reliability and are made in "real-time," i.e. at the time the power is needed. Although the PX and ISO were created by state law as public benefit corporations, it is the federal agency FERC that approves the regulations or tariffs under which these two entities operate, and has primary oversight of these entities under federal law.

AB 1890 created a pricing system that was a compromise among IOUs, consumers and merchant generators.[10] Since wholesale prices were expected to fall dramatically, policy-makers projected that new merchant generators, unencumbered by investments in more expensive forms of generation imposed upon IOUs during regulation ("stranded costs"), could sell power far cheaper than the state's incumbent utilities. If the market was allowed to find its own level, IOUs were not expected to be able to recover substantial investments in such things as contracts for alternative energy and nuclear power plants.

---

[9] Because the PX no longer operates energy markets, this report does not discuss the PX in any detail. The recommendations concerning the ISO and market reform, however, apply with equal force to any future short term market that may replace the PX.

[10] Carl Blumstein et al., *The History of Electricity Restructuring in California*, University of California Energy Institute CSEM WP-103, at 15-16 (2002). See http://www.ucei.berkeley.edu/pubs-csemwp.html.

AB 1890 addressed this problem by setting the retail prices an IOU could charge for power at what were expected to be artificially high levels through March 31, 2002, or until the utility had recovered its stranded costs, whichever came first. IOUs were allowed to recover their stranded costs from the difference between the expected lower wholesale costs of energy and the mandated retail price. Once these costs were recovered, the retail price would be set by the market, presumably below the price specified in the legislation. To make this compromise, intended to protect the IOUs, more palatable to retail customers, consumers and small businesses were given a 10 percent rate cut financed by state bonds.[11]

AB 1890 became law on September 24, 1996.

2. The Calm Before the Storm

The PX and the ISO became operational in 1998. Because of the political process that created both agencies, representatives of generators and their trade associations served on "stakeholder boards" governing both the ISO and the PX, voting regularly on policy matters affecting their industry.[12]

The generating units divested by the IOUs were sold in relatively large blocks to five out-of-state generating companies: Duke, Mirant (formerly Southern), Dynegy/NRG, AES/Williams, and Reliant. Each company took groups of generating units representing approximately 20 percent of the IOUs' thermal generating capacity. These plants in turn represented roughly 38 percent of the capacity in California. Sales of these large industrial plants included management agreements under which technicians and operators from the selling IOUs ran the plants on a day-to-day basis during a transition period, which expired in the spring of 2000.

Each new generator was subject to review by FERC to determine if it could exercise "market power" in California. In other words, FERC determined if any entity controlled enough of the electricity market in California — or in a segment of the California market — to exercise improper control over price or supply. These determinations were based on a formula that resulted in approval if a generator controlled 20 percent or less of the market.[13] No account was taken of the ability of generators to increase prices during periods of peak demand. Nor did the analysis take into account transmission constraints between various areas of the state, also most acute during times of peak demand. However, based on its 20 percent formula, FERC typically concluded "the seller and its affiliates do not have, or have adequately mitigated, market power in generation and transmission and cannot erect other barriers to entry."[14] With the FERC certification in hand, a generator could charge anything the market allowed.

---

11 California Public Utilities Code §§ 842, 846.2.

12 California Public Utilities Code § 338.

13 James Bohn et al., *The Design of Tests for Horizontal Market Power in Market-Based Rate Proceedings*, Vol. 15, Issue 4 The Electricity Journal 52, 53-54 (2002).

14 See generally, Ocean Vista Power Generation L.L.C., 82 FERC ¶ 61,114, 61,405 (1998). This methodology has been updated by FERC. However, the new approach has also been severely criticized by economists. See James Bohn et al., *The Design of Tests for Horizontal Market Power in Market-Based Rate Proceedings*, Vol. 15, Issue 4 The Electricity Journal 52, 53-54 (2002).

Unlike other jurisdictions that had ordered similar divestitures, the merchant generator purchasers were not required to enter into long-term contracts with the selling IOUs in order to stabilize prices.[15] This was a considered policy decision, much criticized later, which was based on (1) concerns voiced particularly by Enron and other market participants that the IOUs would use their market power to keep wholesale prices down; (2) a desire for a "transparent" market price that could be used reliably to assist in the process of paying off stranded costs; and (3) bad experiences historically with long-term utility contracts during the petroleum emergencies of the 1970's.

From 1998 through the spring of 2000, the new market system appeared to be functioning reasonably well. However, there were warning signs of market dysfunction. Prices for replacement reserve — a type of generating capacity procured by the ISO to balance the grid — briefly hit $9,999 per megawatt (MW) in the summer of 1998. In May 1999, Enron dramatically overloaded smaller power lines between Silver Peak, Nevada and California, and was then paid to eliminate the congestion it had itself created. This action elevated prices across the state.[16]

Even so, prices generally hovered in the area of $35 per megawatt/hour (MWh), a fraction of what they would be during the crisis. And the IOUs made rapid progress in recovering their stranded costs, with PG&E alone sending over $4 billion in such revenues to its corporate parent.

3. The Crisis Begins

The beginnings of the California energy crisis became evident soon after May 22, 2000. On that date, energy prices hurtled upward and did not fall again for over a year. The impacts to retail customers were felt first by electricity consumers in the SDG&E service area. Because SDG&E had recovered its stranded costs early, its consumers faced the full impact of the high market rates early in summer 2000. Retail electric bills for SDG&E customers doubled.

San Diego consumers, however, were not alone. Both PG&E and SCE saw their wholesale costs dramatically exceed their retail rates, so the utilities lost money on every megawatt of power they bought. In June 2000 alone, California's energy costs exceeded $3.6 billion, roughly 50 percent of the total energy costs in 1999.[17] On the other hand, new merchant generators like Reliant, and energy traders like Enron, saw profits skyrocket, and their stock values jumped to unprecedented levels.

---

15 Carl Blumstein et al., *The History of Electricity Restructuring in California*, University of California Energy Institute CSEM WP-103, at 18 (2002). See http://www.ucei.berkeley.edu/pubs-csemwp.html.

16 Bethany McLean & Peter Elkind, The Smartest Guys in The Room: The Amazing Rise and Scandalous Fall of Enron 268-269 (2003).

17 Rick Jurgens, *The Power Crisis Electricity Suppliers Weather Summer But Expected Heat And Plant Maintenance In The Next Two Months Put The State At Shortage Risk*, Contra Costa Times, Sept. 5, 2001, at A1. See also, James L. Sweeney, The California Electricity Crisis 166-171 (2002).

Hard-hit consumers began accusing generators of profiteering. The industry blamed California, arguing that the state got into trouble because citizens were unwilling to set aside environmental concerns and build new plants. Ken Lay, then chairman of Enron, lectured that consumers weren't paying enough:

> Certainly in California and elsewhere, we need to remove a lot of the price caps, which are really distorting the market and in fact discouraging the kind of investments in new power plants that are needed.[18]

Enron's Jeff Skilling, then the CEO of Enron, argued that the crisis reflected a fundamental mismatch between supply and demand, also claiming that not enough plants had been built in California.[19]

Economists now indicate that only some of this was true.[20] Hydroelectic supplies were tight but not in drought conditions as spring began in 2000. Supplies were in fact larger than they had been the year before. Demand was up somewhat in California and neighboring states, but peak demand was lower than it had been the year before. Generators and the new energy traders were generally accurate in saying that California had not built any new traditional power plants in the 1990's. However, this ignored the fact that the state had added substantial power to the grid in the form of co-generation[21] and other alternate sources of electricity. And additional plants were under construction, expected to come on line the following year.

What apparently had changed the most in the California energy picture in spring 2000, other than unprecedented high prices, were dramatic reductions in the productivity of the plants divested by the IOUs, now being managed directly by the merchant generators. Power that was needed, particularly during the hot peak of the day, simply wasn't there anymore. Indeed, one economist determined that California thermal plants were operating at 50.3 percent of capacity, far below the operational levels of similar plants owned and operated by the same companies in other parts of the country.[22] In addition, exports of energy from California significantly increased, also reducing supplies in California. The U.S. General Accounting Office, for example, found that monthly

---

18 *Enron CEO Elect; Chmn & CEO* (Interview with Kenneth Lay, Chairman and CEO, Enron) CNBC/Dow Jones Business Video (Dec. 13, 2000).

19 *Enron Sees New Plants, Increased Access Helping California*, Vol. 5, Issue 171 Megawatt Daily (Sept. 7, 2000).

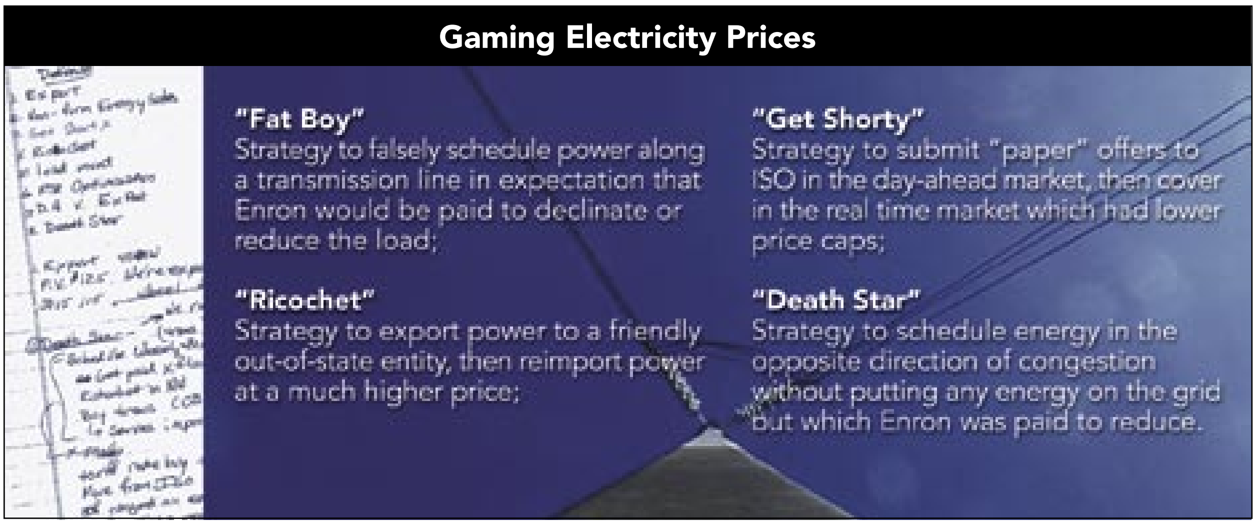
20 Carl Blumstein et al., *The History of Electricity Restructuring in California*, University of California Energy Institute CSEM WP-103, at 21-23 (2002). See http://www.ucei.berkeley.edu/pubs-csemwp.html.

21 Co-generation is the generation of power typically from waste heat generated by industrial processes. The generation is in conjunction with production of other products.

22 *The Effect of the Bankruptcy of Enron on the Functioning of Energy Markets, Hearings Before the Subcomm. on Energy and Air Quality of the House Comm. on Energy and Commerce*, 107th Cong., 2d Sess. (2002) (statement of Robert McCullough). See http://energycommerce.house.gov/107/action/107-82.pdf.

exports from California between May and October 2000 were approximately 200 percent higher than in the same months in 1998 and 1999.[23]

Although the withholding of power through reduced production and redirection of California production out of state explain a significant part of the crisis,[24] a series of so-called "games" were also run against California. These games came to light when Enron, responding to subpoenas issued by the California Attorney General, made available internal reports on its strategies for manipulating the California markets. The games had catchy monikers such as "Fat Boy" and "Get Shorty," but a single purpose — to take money from California's energy market and other western state energy purchasers.



Many of these trading strategies are highly complex, making detection, proof, and enforcement extremely difficult.

By the end of calendar year 2000, California consumers and industry had paid $27 billion for energy, over three and one-half times the $7.4 billion they paid in 1999.

4. Natural Gas Prices Explode

Starting in the late fall of 2000, natural gas prices began to increase dramatically on the major pipeline serving southern California. By winter 2000 – 2001, prices were *four times* what they were the year before.[25] These price hikes were immediately felt in increased prices for electricity generated by gas-fired boilers. However, as dramatic as these natural gas price increases were, they explain only part of the dramatic run-up in electricity prices.

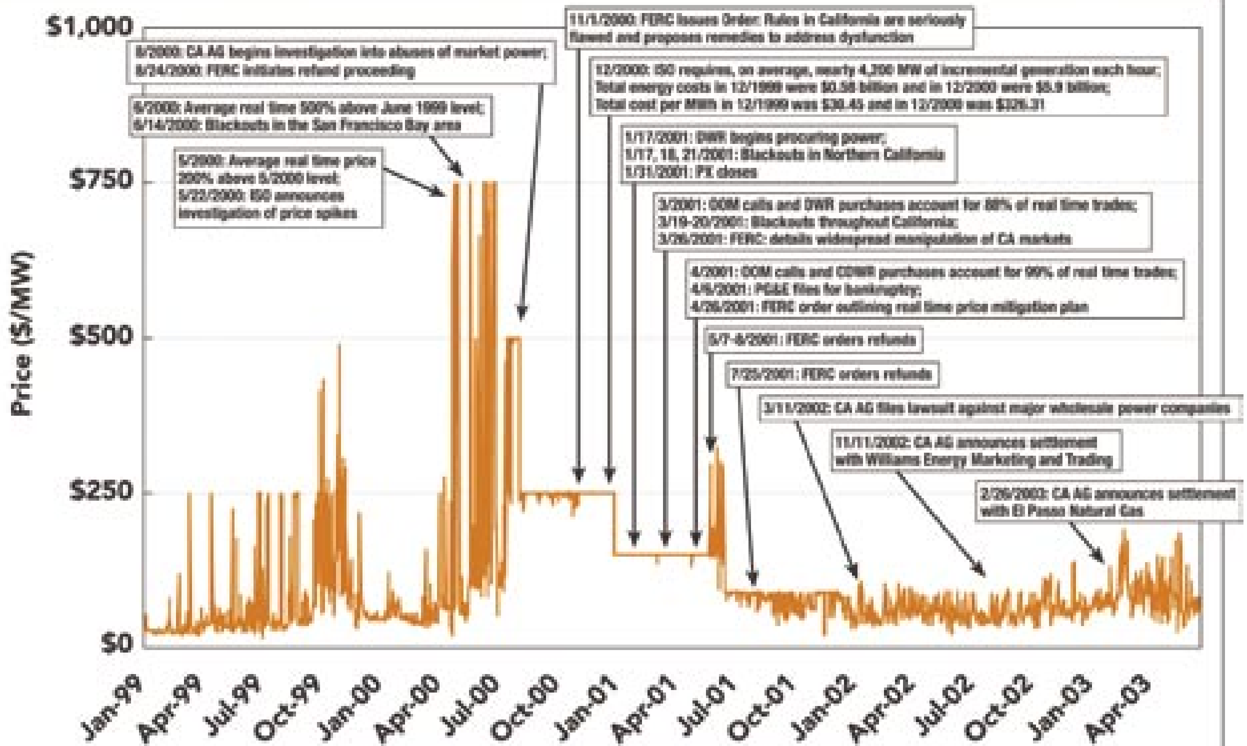
---

23 U.S. General Accounting Office, Pub. No. GAO-02-828, Restructured Electricity Markets: California Market Design Enabled Exercise of Market Power 32 (2002).

24 James Bushnell, *Market Power and Market Manipulation: Definitions, Measurement and Mitigation*, University of California Energy Institute, 2002 CSEM Policy Conference, Slide 4.

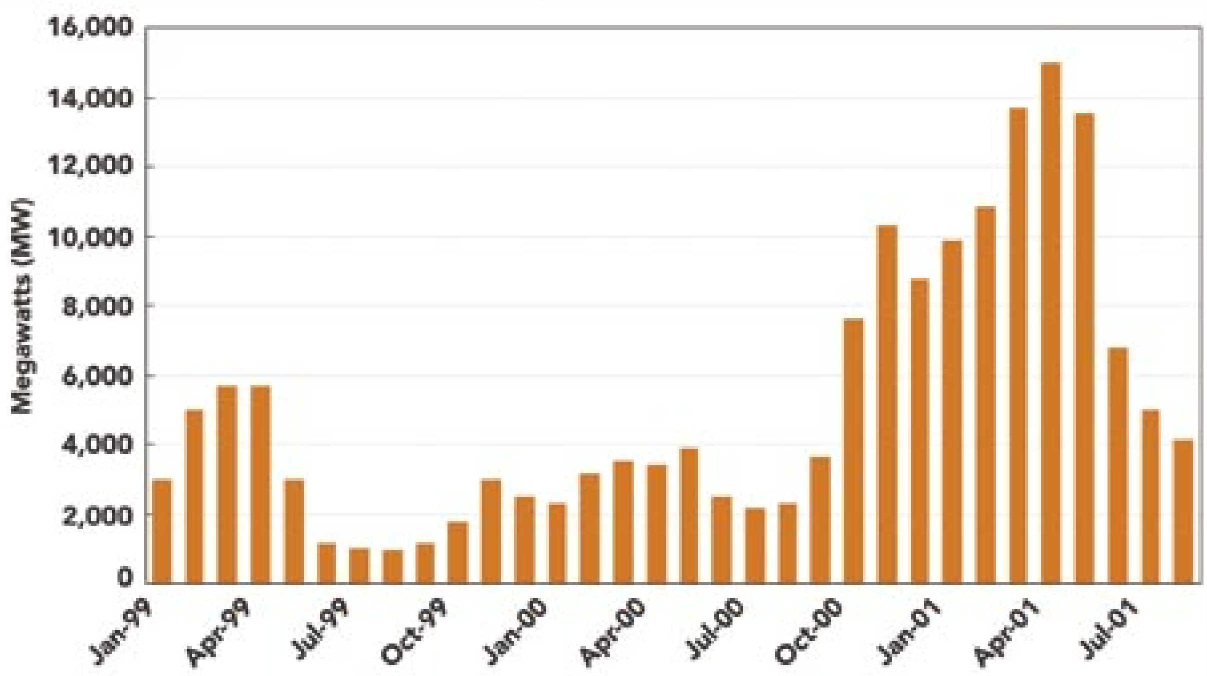
25 *Public Utilities Commission of California v. El Paso Natural Gas, et al.*, 100 FERC ¶ 63,041 (2002). See http://ferris.ferc.gov/idmws/File_list.asp?document_id=4033592.

Daily Maximum Real Time Market Clearing Price: January 1,1999 - June 30, 2003

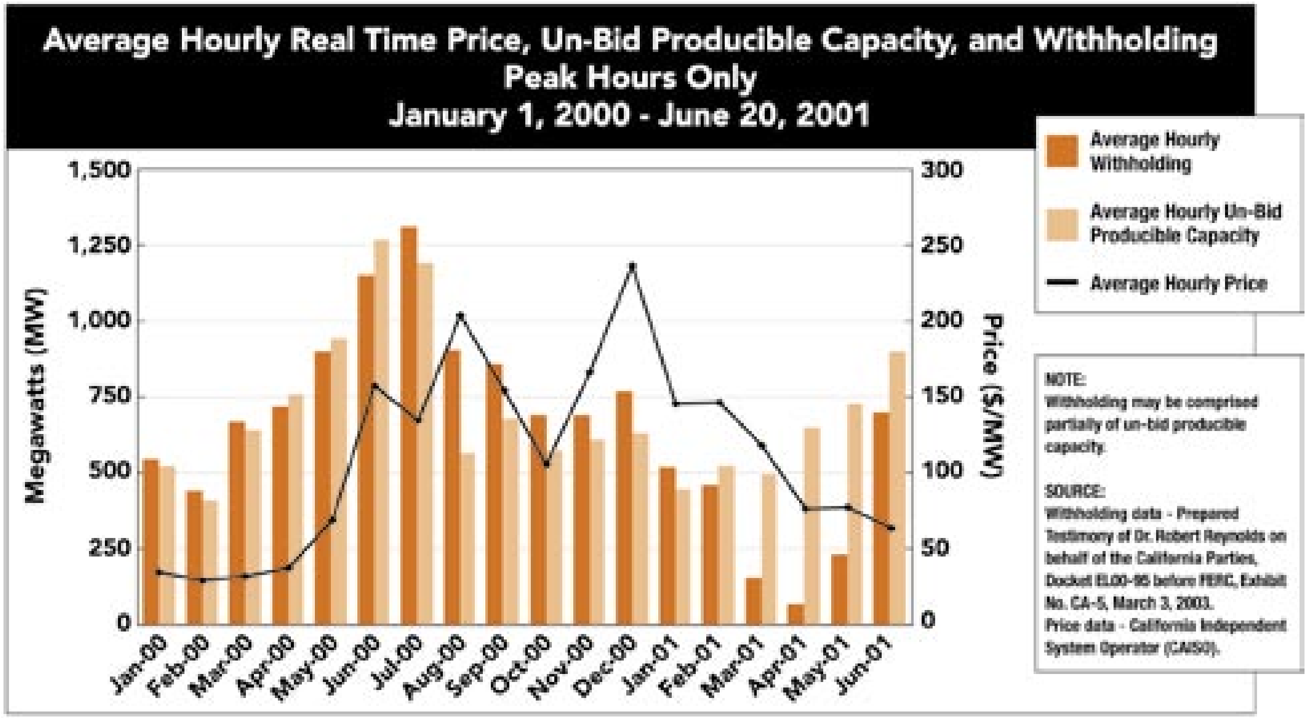


Note: Prices are calculated as the maximum real time price observed each day.
Source: Price - California Independent System Operator (CAISO). Commentary - CAISO Department of Market Analysis Monthly Report, California Public Utilities Commission, Report on Wholesale Electric Generation Investigation, September 2002.

Average Generating Capacity Off-Line: January 1999 - August 2001



Source: Sweeney, James L., *The California Electricity Crisis* (2002), page 158.



5. Rolling Blackouts Start

The state faced its first energy emergency on June 14, 2000. The public was alerted to the possibility of power shortages. Non-firm load,[26] typically associated with industrial plants, was turned off. Strong, but voluntary, conservation measures were implemented. Similar emergencies took place in the months of July, August and September. After a short break, emergencies erupted again in November and December. As part of a state effort to reduce loads, California consumers, already among the most frugal in the nation, reduced energy demand an additional 6 - 8 percent.[27] Despite aggressive conservation efforts, the first rolling blackout hit California on January 17, 2001, although demand was well below summer peaks.[28] The ISO ordered involuntary load shedding, which meant that lights and power were shut off in alternate blocks across the grid. Energy emergencies again became common, with blackouts occurring on January 18, and again on March 19 and 20.

Generators claimed they were straining to do the best they could to meet the emergency needs of California consumers. An April 30, 2001 Enron e-mail, offers another perspective. With the subject line "California Sing-along," the following was circulated widely in the industry:

---

26 A utility customer can choose to enter into a contract for the delivery of non-firm load. In exchange for cheaper utility costs for the customer, the utility can turn off the non-firm customer's power when there is insufficient power to serve all customers.

27 Charles Goldman et al., *California Customer Load Reductions during the Energy Crisis: Did They Help Keep the Lights On*?, University of California Berkeley LBNL-49733 (2002). See http://eetd.lbl.gov/ea/EMS/reports/49733.pdf.

28 James L. Sweeney, The California Electricity Crisis 166-171 (2002).

California Sing-Along Circulated by Generators

And to start off the week... California's new State Song! *The Rolling Blackout Theme Song*
(To the theme music from the TV western "*Rawhide*")

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

A little colder weather,
And we all freeze together,
Wishin' more plants were on the line.
All the things I'm missin',
Like lights and television,
Are waitin' 'til we can pay the price.

(Chorus)

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 disapprovin',
Keep them rates a-movin', statewide.

Don't try to understand 'em,
Just raise, charge, and collect 'em.
Soon we'll be livin' high and wide.
My heart's calculatin',
Nuclear plants will be waitin',
Be waitin' at the end of my ride.

(Chorus)

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!

STATEWIDE! Hyaah! [29]

---

[29] E-mail from Jeffery Fawcett to Lorna Brennan, et al. transmitted on April 30, 2001 at 11:17 a.m., Subject: California Sing-along; http://fercic.aspensys.com, Bates number ECD-000369619.

On the same day California Sing-along circulated among generators and traders, the *Los Angeles Times* reported on a list of 50,000 creditors disclosed by PG&E in its bankruptcy proceeding.[30] One creditor, a seller of fan blades used to cool transformers, noted ruefully, "We are a small business... We may have to eat peanut butter and jelly for four or five months." [31] Energy emergencies continued through July 2001, with two more blackouts occurring in May.

6. The Clean Up

The California energy crisis left behind a great deal of economic wreckage. Actions before FERC seeking refunds for overcharges in electricity prices became a top priority for the state. The California parties, led by the Attorney General, PUC, EOB, SCE and PG&E, bolstered by substantial support from other parties, demanded recovery of up to $9 billion in overcharges, calculated as any charges above a presumed just and reasonable rate.[32] FERC rebuffed a significant portion of these claims on technical grounds and appeals were filed in the Ninth Circuit.[33] On August 21, 2002, in response to a motion from the California Parties, the Ninth Circuit issued an order directing FERC to permit the California Parties to obtain and introduce into the record of the Refund Proceeding evidence concerning sellers' market manipulation, so that *all* such evidence could be considering in evaluating the appeals by the California Parties.[34] FERC granted California 100 days to complete both discovery related to the massive economic upheaval resulting from the energy crisis and make an evidentiary filing with FERC.[35]

This "100-day proceeding" continues. While FERC has initiated a series of investigations, under FERC rules, the California parties are excluded from these proceedings. FERC has designated them as "investigatory" proceedings and excluded all parties from all aspects of the matter, including settlement. The proceedings have generated several small settlements.

A major issue in the 100-day proceeding is the time period for which recoveries may be allowed. FERC's position is that FERC's initial approvals of market-based rate certificates for generators precludes FERC from ordering repayment for overcharges paid before October 2, 2000. Under FERC rules, refunds are only allowed for rates going forward, after a formal rate challenge has been filed with FERC. FERC maintains this position even though it has determined that the California

---

[30] On April 6, 2001, PG&E Company filed a voluntary "Chapter 11" bankruptcy petition in the U.S. Bankruptcy Court for the Northern District of California.

[31] Tim Reiterman, *The California Energy Crisis: List of PG&E Creditors Shows Firm's Wide Reach in Business*, L.A. TIMES, Apr. 30, 2001, at A3.

[32] The California parties include the Attorney General, the EOB, the PUC, SCE, and PG&E.

[33] *San Diego Gas & Electric Company, et al.*, 96 FERC ¶61,120 (2001), petition for review filed sub. nom. *CPUC v. FERC*, Ninth Circuit Court of Appeals No. ____

[34] See *Motion of the Cal. Parties for Leave to Adduce Additional Evidence Before FERC,* Ninth Circuit Case No. 01-71051, *et al.* (Consolidated) (June 5, 2002); *Order*, Case Nos. 01-71051, *et. al.* (Consolidated) (Aug. 21, 2002).

[35] *San Diego Gas & Electric Co., et al.*, 93 FERC ¶61,186 (2002).

market was dysfunctional prior to October 2, 2000,[36] and even though, because of overwhelming criticism of its original methodology,[37] it has attempted to reform the methods it uses to determine if a market participant exercises market power. In fact, FERC has refused to revisit its original approvals of individual sales of plants to generators that demonstrably exercised market power during the crisis. Nor has FERC accepted responsibility for the market that made high prices possible. The effect of FERC actions so far, unless reversed by appellate courts, has been to foreclose a remedy for a significant time period of the energy crisis. The claims FERC will not consider are worth billions of dollars to California consumers and industry.

FERC has also opined that the purchases made on the spot market by the state when the IOU's were no longer financially capable of entering into purchases should not be subject to refund. Moreover, FERC has decided that DWR's long-term contracts — signed under enormous economic pressure during the height of the crisis — cannot be reformed to reflect normal energy prices.[38] The PUC has challenged these two decisions in court; if sustained, however, they will leave billions of dollars in the hands of generators.

FERC is attempting to develop systems that are better able to address market abuses. But FERC has yet to develop the crucial test for market power that would enable consumers and prosecutors alike to identify improper transactions. In this regard, FERC Commissioner Nora Mead Brownell candidly noted:

> [A] fundamental concern [is] that we've allowed markets to form without a full appreciation of what constitutes a market let alone the market dynamics that foster a truly competitive market. For example, what defines a competitive market and what constitutes scarcity pricing? These questions remain largely unanswered.[39]

While FERC wrestles with the most basic question presented by deregulation, it remains hampered by too few resources and too little political will to police large, dynamic energy markets.

Meanwhile, the once high-flying energy sector is now most frequently described in the financial press as "troubled." PG&E sank into bankruptcy in January 2001, and is only now emerging. Enron collapsed, and went into bankruptcy. Mirant (formerly Southern) has sought bankruptcy protection, as has NEG, an unregulated trading subsidiary of PG&E's parent company. Other energy traders and generators are also flirting with bankruptcy or reorganization.

The California Attorney General has filed a series of legal actions challenging, among other things, apparently fraudulent sales of power to the ISO, anticompetitive sales of power plants, and generators'

---

36 *San Diego Gas & Electric Co. et al.*, 93 FERC ¶61,121, at 61,349-61,350 (2000).

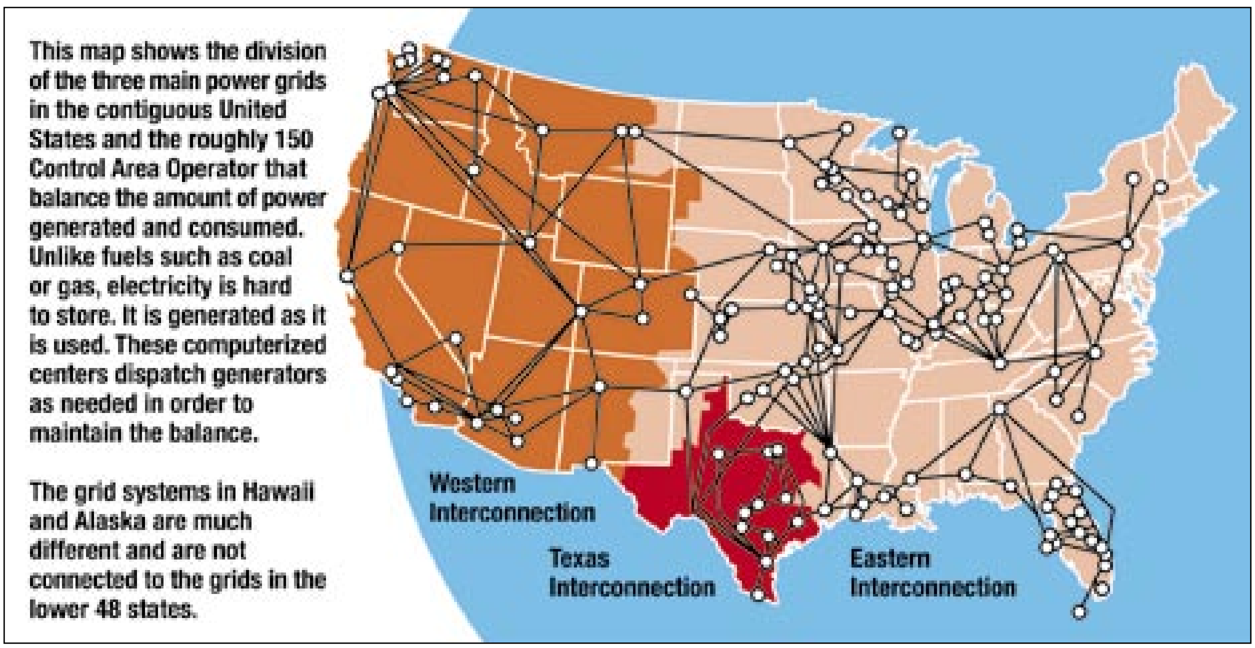
37 *San Diego Gas & Electric Co. et al.*, 102 FERC ¶61,317 (2003).

38 *Public Utilities Comm'n of the State of California v. Sellers of Long Term Contracts to the California Dep't of Water Resources*, 103 FERC ¶61,354 (2003).

39 *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations,* 103 FERC ¶61,349 (2003) (Brownell, concurring).

failure to file actual rates, which effectively prevented FERC from exercising any real market oversight. Civil actions on behalf of large industrial users of energy, and class actions on behalf of consumers, have been filed against all of the major generators and traders involved in the crisis. These suits challenge sales of both natural gas and electricity. A key defense in these actions is the filed rate doctrine, which the generators invoke as a shield against any financial liability beyond that approved by FERC, even when the challenge is based on allegations of fraud or price-fixing. Federal criminal actions are also pending. Most notably, Timothy Belden, Enron's chief trader for the California market, has pled guilty to federal criminal charges. As part of his plea bargain, he is cooperating with prosecutors in their ongoing investigations. Administrative, civil and criminal litigation arising from the California energy crisis is expected to continue for years.

B. Overview of Government Entities with Responsibility for Market Oversight and Enforcement



Sources: Distributed Energy Resources, NERC, Energy Information Administration, Office of Coal, Nuclear, Electric and Alternative Fuels. Based on data contained in EIA-861, "Annual Electric Utility Report."

Oversight of electricity markets and enforcement of the tariffs, regulations, and laws that govern the markets and the marketers are surprisingly limited. This section of the report briefly describes the major regulatory entities responsible for oversight of the electricity markets. The following sections then detail deficiencies in the mechanisms for monitoring and enforcement, discuss the implications of those deficiencies, and make recommendations for improvement. Included after the section on FERC is an in-depth discussion of the filed rate doctrine, and the unjust results from its misapplication to market-based wholesale electricity markets. In each and every aspect of the current system, FERC occupies the central position for market structure, operation, governance, and enforcement, with significant authority delegated to the ISO for more immediate market control.

1. FERC

FERC has broad jurisdiction with respect to wholesale electricity and natural gas, including authority over transmission, price, and market regulation issues. It has statutory authority under the NGA and the FPA to promulgate regulations, and it can enforce both the regulations and the statutes to ensure compliance. FERC has an investigatory staff and an enforcement branch. Perhaps owing to philosophy, inadequate resources, lack of data or a combination of these factors, FERC insufficiently monitored California's energy markets. It has since limited its investigation of anomalies and market manipulation, failed to take meaningful and timely enforcement action, and failed to order full refunds even after determining that prices during the crisis were unjust and unreasonable. Congress should act to ensure, in a market-based rate system, that unjust and unreasonable rates are subject to refund, whenever they occur. FERC should define and implement an effective oversight approach, to ensure adequate monitoring and timely enforcement of the laws governing the wholesale electricity and natural gas markets.

2. ISO

The ISO is primarily responsible for running the electric grid that serves California, making sure power is available to keep the grid operating and prevent interruptions in service. To do this, the ISO runs numerous short-term wholesale electricity markets. The ISO has the authority, delegated from FERC and under California law, to ensure compliance with market rules and tariffs. Initially, the ISO was governed by a board made up of "stakeholder" interests, such as power generators and traders, as well as large and small energy users. That Board has been replaced with appointees of the Governor. The ISO has a small enforcement unit. Although the ISO's market monitoring unit provided key insights, still largely ignored by FERC, into the uses and abuses of market power during this crisis, the agency needs significantly increased resources for monitoring and enforcement, and a clear mechanism for enforcement and compliance, as discussed below.

"Because the California energy crisis lasted so long, the California Attorney General sought injunctive relief in a number of cases to help ease the crisis."

3. PUC

The PUC has investigatory authority and administrative enforcement power, primarily with respect to retail electricity. It plays a more limited role with respect to wholesale electricity and natural gas. This distinction is of key importance in the California electricity markets. The PUC, at least under the current structure, acts secondarily to FERC on issues of wholesale supply and price. In most instances, the PUC has the same status as a regulated entity when it seeks redress at FERC for issues concerning wholesale electricity. The relationship between FERC and the PUC must be revised in order to ensure a more prominent state voice in governing wholesale electricity markets, supply, and price. This issue is developed below.

4. California Attorney General

Because the California energy crisis lasted so long, the California Attorney General sought injunctive relief in a number of cases to help ease the crisis. Normally, however, the Attorney General seeks criminal or civil penalties, and redress for damages, after the fact. The Attorney General has at his disposal a number of blunt enforcement tools, including antitrust laws, criminal laws, racketeering and fraud laws, and unfair business practice laws. While these tools provide some remedy for improper market operation, they are not tools of first resort because, at least in this circumstance, pursuing legal recourse through the courts is not as efficient as regulatory enforcement. And as discussed below, clarification of the scope of the filed rate doctrine in particular is required to ensure judicial enforcement actions will be effective.

5. Other Enforcement Entities

Many other governmental entities have some amount of enforcement authority, including federal agencies (the Securities and Exchange Commission, the Commodities Futures Trading Commission, the U.S. Department of Justice, and the U.S. Attorneys Offices), local governments (including district attorneys and county counsels), and other states. These entities often face jurisdictional and other constraints, but play an important role in overall enforcement. In addition, private parties, including class action plaintiffs, have pursued actions as "private attorneys general." These other avenues of enforcement are discussed below.

C. FERC: The Single Entity with Power to Avert Ê the California Energy Disaster Ê

Under the FPA and the NGA, FERC has wide ranging authority over electricity and natural gas systems in the United States. While market design and state legislation certainly played a major role in creating the system that was subject to gaming and manipulation, California's electricity crisis spiraled out of control primarily because federal authorities failed to act quickly and decisively. As Stanford University's professor Frank Wolak noted recently, "What allowed the California crisis to exist was not a shortage of observers with radar guns recording the speed of cars on the highway; it was the lack of traffic cops writing tickets and imposing fines on cars that exceeded the posted speed limit."[40]

From FERC's initial inadequate review and analysis of whether the large California merchant generators could exercise market power to its crabbed, after-the-fact refund proceedings, the agency has failed to grasp fully the nature and extent of energy market manipulation, has failed to act in a timely manner, and has failed, to a significant extent, in its primary statutory duty to protect electricity and natural gas consumers.

1. FERC's Entity by Entity Market Power Determination

FERC's wholesale electricity market concept consists, primarily, of two parts. First, for defined areas, there must be a market operator. In the case of California, the state is the defined area and, today, the ISO operates the primary markets.[41] Tariffs govern most aspects of the ISO markets. While the ISO develops its own market tariffs, each tariff must be approved by FERC. The state has some oversight authority with respect to the ISO through the EOB, a board now appointed by the Governor of California.[42] But the entity with primary regulatory authority over market tariffs and the operation of the ISO is FERC.

The second part of FERC's wholesale electricity market concept is the notion of "market power." Under FERC's market rate scheme for wholesale electricity, FERC initially determines whether a given generator controls enough of the electricity market in California — or in a segment of the California market — to exercise market power, meaning improper control over price or supply. If FERC decides the generator does not have market power, that generator can participate in the California wholesale electricity market, and can charge any price the market will bear. According to FERC,

---

40 Frank A. Wolak, *Lessons from the California Electricity Crisis,* University of California Energy Institute CSEM WP-110, at 31 (2003); http://www.ucei.berkeley.edu/pwrpubs/csem110.html.

41 State law originally created the PX and the ISO, with the idea that the PX would operate day-ahead and block forward electricity markets in which the bulk of electricity sales and purchases would take place. The generators and the IOUs learned that the ISO markets could be more profitably "gamed," so sales in the PX plummeted, forcing most sales into the "real-time" ISO markets. The PX, during the energy crisis, declared bankruptcy and went out of business.

42 See pages 60-61 for a discussion of the EOB.

once FERC makes its market power determination, the generator's market rates cannot be reviewed, and refunds cannot be considered, until sixty days after a party files a price challenge with FERC. The first challenge to California electricity prices during the energy crisis was filed on August 3, 2000.

In California, all generators and marketers, with the exception of government-owned utilities were the subject of FERC review for market power. With respect to Reliant, one of the biggest generators in the state, FERC approved, after a single day of review, the applications for market-based rate authority of three Reliant subsidiaries, based on FERC's antiquated market power evaluation[43] that one leading expert has testified is "fatally flawed."[44]

FERC's expertise with respect to antitrust and market power issues is limited,[45] but FERC's market power decisions have had a substantial adverse impact on the ability of California to obtain refunds for massive overcharges, and on the ability of the Attorney General to enforce antitrust and fair competition laws.

FERC reasons that its market power determination creates the authority for a generator to charge a market rate, and that such approval precludes retroactive challenge to any price charged. Applying this logic, FERC concluded that California is not entitled to refunds for overcharges in the price of electricity before October 2, 2000, sixty days after the first price challenge was filed on August 3, 2000, even though FERC itself has determined that prices from May 2000 to October 2000 were unjust and unreasonable. FERC's position, based on its initial market power decision, is that even unjust and unreasonable prices must stand because all pre-October 2, 2000 prices are "filed rates" not subject to retroactive attack.[46]

The generators that obtained market rate authority from FERC have used the same theory to support their contention that the Attorney General cannot pursue them for violations of antitrust and unfair competition laws. They argue that by authorizing them to charge market rates based on the absence of market power, FERC has created a "filed rate" that cannot be challenged by an antitrust or unfair competition enforcement action.[47]

---

43 *Ocean Vista Power Generation*, 82 FERC ¶61,114 (1998).

44 *Asleep at the Switch: FERC's Oversight of Enron Corporation, Hearings before Sen. Com. on Government Affairs*, 107th Cong., (2002) (statement of Frank A. Wolak, Professor of Economics, Stanford University, Chairman, Market Surveillance Committee, CAISO). See also, generally, Severin Borenstein et al., *Diagnosing Market Power in California's Restructured Electricity Markets*, University of California Energy Institute PWP-064 (2000).

45 See generally, *Northeast Utilities Services Co. v. FERC*, 993 F.2d 937 (1st Cir. 1993).

46 Not surprisingly, the Attorney General and others vigorously dispute FERC's interpretation. Those challenges will be heard this year by the United States Court of Appeals for the Ninth Circuit. Unless the court reverses FERC's decision, FERC's market power determination will block the recovery of billions of dollars of overcharges for California ratepayers.

47 The filed rate doctrine and its implications are discussed in detail in section below. The Attorney General's antitrust action is discussed in the next section.

"Notwithstanding the obstacles imposed by FERC's market power determinations and its filed rate theories, the Attorney General is pursuing an antitrust claim in a series of cases."

Clearly, FERC's market power evaluation has very substantial implications, far out of relation to the limited market power review performed by FERC. In a true market system, market participants would be subject to all market-based enforcement actions, including full refunds for unjust and unreasonable prices (to the extent that such prices could occur), and all antitrust and unfair competition lawsuits. FERC's insistence that its determination of no market power immunizes a generator from retroactive refunds and antitrust actions is inconsistent with a market system and creates massive unfairness, making consumers the guarantors of overcharges with little recourse. Further, as one seasoned observer of electricity markets has noted, "[t]he physical attributes of electric energy make it inherently vulnerable to the exercise of market power."[48] This inequity must be addressed to avoid continuing unfairness. FERC's evaluation of market power, while relevant to the functioning of the market, cannot be dispositive. Other mechanisms, including legal recourse and retroactive refunds, are essential.[49]

Notwithstanding the obstacles imposed by FERC's market power determinations and its filed rate theories, the Attorney General is pursuing an antitrust claim in a series of cases. Under AB 1890, the deregulation legislation, the IOUs were encouraged to sell their gas-fired generating units. The IOUs sold those units, in groups of two or three, to five generators. Through purchase of those units grouped in particular markets, the generators obtained sufficient generating capacity to impact prices in those markets during periods of scarcity. The Clayton Antitrust Act prohibits acquisitions that might result in a lessening of competition in the market place.[50] The Attorney General alleges that

---

48 James Bushnell, *Looking for Trouble: Competition Policy in the U.S. Energy Industry*, University of California Energy Institute CSEM WP-109, at 28-34 (2003). See http://www.ucei.berkeley.edu/pubs-csemwp.html.

49 It is of note that FERC withdrew Enron's market-based rate authority because of "deceptive conduct," but refused to withdraw market-based rate authority of any other market participant even though it found that at least some of them exercised market power. In addition, FERC rejected California's request to invalidate long-term contracts that were negotiated with entities that were exercising market power. It is difficult to harmonize these rulings, which suggest that FERC trivializes the notion of market power.

50 Clayton Antitrust Act, 15 U.S.C. §§ 12-27 (2003).

the Reliant and Mirant companies illegally acquired market power in the California wholesale energy markets in 1998 when they purchased power generation plants from SCE and PG&E, respectively, and that the illegality of those purchases was not manifest until the parties exercised their market power, starting in 2000, by withholding supplies from the market in order to drive up prices.

Each case alleges a different wholesale energy market that exists only during periods of net high demand. The Reliant case alleges a Southern California market, while the Mirant case alleges a Northern California market. In situations of high net demand, these generators can withhold supplies because they know that no other generators are physically able to meet the demand. The Attorney General's complaints allege that Reliant and Mirant achieved their respective heightened levels of generating capacity and market power when they acquired the generating plants from SCE and PG&E. The complaints requested damages and divestiture of the power generating plants purchased from the utility companies in 1998. On defendants' motions to dismiss the complaints, the court ruled that damage actions were barred by the filed rate doctrine, but allowed the federal antitrust suits seeking divestiture of the generating plants to proceed.

2. Market Oversight: Failed Reporting Requirements

In June 2002, the General Accounting Office concluded that, "FERC is not adequately performing the oversight that is needed to ensure that prices produced by these markets are just and reasonable and therefore is not fulfilling its statutory mandate. . . . As the California energy crisis has made adequately clear, FERC simply cannot let the markets continue to go unmonitored for this length of time."[51]

FERC requires electricity sellers to file quarterly reports that are intended to provide FERC with a summary of a seller's business transactions. Even though FERC has described these quarterly reports as "necessary" for FERC to ensure that market-based rates are just and reasonable and to adequately monitor energy markets, FERC did not know — or simply chose to ignore — that dozens of generators were not filing the required information.[52] FERC did not discover the generator's chronic failure to file the quarterly report information until well after the energy crisis, when the Attorney General brought it to FERC's attention. When confronted with its failure to obtain and review the "necessary" information, FERC opined that in the case of California, the generators' failure to report was "essentially a compliance issue." FERC merely ordered the generators to file amended reports.

In no small part due to FERC's failure to compel and review the quarterly reports, FERC failed to detect hundreds of "round trip trades," "hockey-stick bidding," and countless other market manipulation actions by participants in the markets. It would not be fair to expect FERC to catch every act of manipulation or keep track of the markets in real-time; at least some of that responsibility belongs

---

51 U.S. General Accounting Office, Pub. No. GAO-02-656, Energy Markets: Concerted Actions Needed by FERC To Confront Challenges That Impede Effective Oversight 50-51 (2002).

52 *Enron Power Marketing Inc.*, 65 FERC ¶61,305 (1993); *Revised Public Utility Filing Requirements,* 99 FERC ¶61,107 (2002).

to the ISO. But it is reasonable to expect FERC to review and monitor market activity in a meaningful manner, particularly in a situation where price and supply have so clearly become disrupted.

It is evident in hindsight, from an enforcement perspective, that FERC failed or was unable to monitor the market adequately. That failure prevented timely intervention and had devastating impacts. Specific monitoring functions and adequate resources are essential for a fair market. In addition, the market must be far more transparent for regulators and the public. Even if the generators had filed the quarterly reports required by FERC regulations, market participants and consumers would not have sufficient information about the market in a time-sensitive manner. The California Attorney General believes that FERC's current reporting requirements, even if followed by the generators, are inadequate and violate the requirements of the FPA because rates are not filed in advance and so cannot be reviewed for reasonableness. This is discussed in more detail in the section of this report dealing with the filed rate doctrine. FERC must re-evaluate the rate reporting system in light of the requirements of the FPA and the obvious need for more aggressive market oversight.

3. Price Caps

The ISO instituted various "bid caps" in the California markets beginning in 1998, but it was not until June 2001 — more than a year after the crisis began — that FERC ordered price controls that helped rein in prices. In July 1998, shortly after FERC granted generators authority to charge "market-based rates" for ancillary services, prices for ancillary services spiked out of control. To control the damage, ISO adopted a buyer's "bid cap" of $250 per megawatt hour, which limited the amount it would pay sellers for various types of ancillary services. Later that year, ISO adopted a buyer's "bid cap" of $250 per megawatt hour in the imbalance energy market. FERC noted that as the purchaser of ancillary services and imbalance energy, "the ISO has the discretion to reject excessive bids."[53] FERC further held, however, that "if the ISO is unable to elicit sufficient supplies at or below its announced purchase price ceiling, it will have to raise its price to the level necessary to meet its needs."[54] Thus, FERC made clear that it had no intention of regulating the prices sellers could charge.

ISO raised its "bid caps" in the imbalance energy and ancillary services markets to $750 per megawatt hour in September 1999.[55] In March 2000 — two months before the crisis erupted — the ISO Board rejected a proposal to reduce the bid cap to $500 per megawatt hour.[56] That changed on June 28, 2000, when the ISO determined that "during high load conditions, the [ISO's] … markets are not working competitively."[57] ISO lowered the cap to $500 per MW/h, and then to $250 per MW/h on August 7, 2000.

---

53 85 FERC ¶61,123 (1998).
54 89 FERC ¶61,169 (1999).
55 *Id.*
56 92 FERC ¶61,112 (2000).
57 *Id.*

On October 26, 2000, as the crisis raged, the ISO Board approved load-differentiated wholesale price caps based on actual power prices in 1999. FERC rejected that cap, and froze the cap at $250 per MW/h for 60 days.[58] Following the 60-day period, FERC installed a "soft" cap of $150 per MW/h, making bids over $150 subject to FERC review and precluding such bids from setting the market clearing price. On December 13, 2000, U.S. Energy Secretary Bill Richardson ordered suppliers to sell any available electricity to California. On February 6, 2001, after new U.S. Energy Secretary Spenser Abraham withdrew the order to sell electricity to California, a federal district court ordered generators to continue such sales. On April 26, 2001, FERC ordered "price mitigation" when supplies reached emergency levels, meaning that generators would receive cost-of-service plus a specified profit.[59] On June 19, 2001, FERC finally ordered price mitigation on a cost-plus basis for all sales in the western region.[60] FERC replaced the cost-plus regime with a bid cap of $250 per MW/h on October 1, 2002.

4. Enforcement

There is no record of any FERC enforcement action, before or during the California energy crisis, against any generator operating in the California market. Confronted in December 1998 with allegations of numerous generators "double selling" ancillary services capacity in violation of the ISO tariff, thereby getting paid millions of dollars for services they never provided, FERC simply implemented prospective tariff changes. FERC took no action to make the violators return their ill-gotten gains.

FERC's inaction on enforcement creates an enormous incentive for marketers to cheat. The following excerpt from a transcript of dialogue between Reliant traders reflects the common view among marketers:

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

SPEAKER 1: That's right.

SPEAKER 2: I would never suggest it, but it seems like the writing would be on the wall.

SPEAKER 1: Well, I mean, there's — you know, our position is if it's a reliability issue, then reliability comes over the economics.

SPEAKER 2: Right.

SPEAKER 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 what rules.

---

58 93 FERC ¶61,121 (2000).

59 95 FERC ¶61,355-56 (2001).

60 95 FERC ¶62,548 (2001).

SPEAKER 2: You'll let the California ratepayers pay.

SPEAKER 1: That's right. I don't have a problem with that. I have no guilty conscience about that.[61]

After the crisis, and only following the revelations about Enron, which came to light as the result of California investigations and the Enron bankruptcy, FERC pursued investigations of various Enron-style gaming tactics by other market participants. Those investigations have so far resulted in modest penalties against very few companies. FERC has acknowledged that the markets were dysfunctional and manipulated by gaming. It has also determined that rates charged during the crisis period were unjust and unreasonable. The California parties to the refund proceedings submitted extensive analyses of the withholding of electricity by California generators, and FERC itself released transcripts of Reliant traders specifically discussing actions reflecting market power and price manipulation. While FERC has threatened to withdraw market-based rate authority from one or two entities, it has not taken any such action at this point (except with respect to Enron, which had already suspended trading) and it seems unlikely that it will.

In 1999, Californians paid about $7 billion for electricity. In 2000, electricity costs soared to $27 billion. Californians paid another $27 billion in 2001. Both demand for electricity and weather induced spikes were basically the same in all three years. In essence, Californians paid an additional *$40 billion* for electricity over two years, with the damage to the state's economy and its tax revenues significantly higher. FERC's response, so far, has been to obtain penalties of less than *$85 million* and to limit the availability of refunds.[62]

Because of FERC's central role in monitoring, oversight, and regulation of the wholesale markets, FERC must pursue meaningful enforcement. There is some indication that FERC is becoming relatively more aggressive in redressing injury. Unfortunately, FERC's enforcement branch appears to be underfunded, understaffed, and without sufficient legal authority to take any significant action that would act as a meaningful deterrent to large-scale illegal behavior.

---

[61] California Parties' Supplemental Evidence of Market Manipulation by Sellers, Proposed Findings of Fact, and Request for Refunds and Other Relief at Exh. CA-239, at 6-7, *San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Service Into Markets Operated by the California Independent System Operator and the California Power Exchange* FERC Dockets Nos. EL00-95-000, EL00-98-000 (March 3, 2003).

[62] El Paso Electric: $15.5 million; Portland General Electric: $8.5 million; AEP Service Corp.: $45 thousand; Aquila Merchant Services: $76 thousand; Glendale: $25 thousand; Redding: $6 thousand; Coral Power: $7.7 million; Duke Energy : $549 thousand; Dynegy Power: $3 million; Idaho Power: $83 thousand; Mirant: $333 thousand; Modesto Irrigation District: $14 thousand; Morgan Stanley Capital: $857 thousand; PacifiCorp: $68 thousand; Portland General Electric: $13 thousand; Powerex: $1.3 million; Puget Sound Energy: $17 thousand; Reliant Resources: $836 thousand; SDG&E: $28 thousand; Sempra Energy: $7.2 million; Williams Energy Services: $45 thousand; Reliant Energy Services: $25 million; Reliant: $13.8 million.

Since the energy crisis, both Congress and FERC have taken steps toward reforming the laws and regulations that govern wholesale power markets to provide more effective oversight, but those changes, even if they become law, fall far short of adequately protecting consumers. Proposed legislation drafted by a congressional conference committee would authorize civil penalties of up to $1 million for violations of the FPA, or any rules, orders, or tariffs promulgated by FERC.[63] But the Energy Bill proposed in Congress in 2003 failed to address the single biggest gap in the federal enforcement scheme — FERC's claimed inability to order refunds for spot market rates that exceed a "just and reasonable" level. California is still fighting for *billions* of dollars in refunds. While civil penalties are a welcome addition to FERC's arsenal, they are not a big enough hammer to prevent generators and marketers from attempting to drive up prices in the future. Moreover, civil penalties generally are paid into the federal treasury, and are not designed to compensate consumers for out-of-pocket losses due to the charging of unjust and unreasonable rates.

FERC recently adopted rules that would prohibit generators and marketers from engaging in activities designed to "manipulate" the market, but its chosen remedy is limited to making the violator return any "unjust profits" it collected.[64] In single, clearing price auctions like the ones administered by the ISO, where one participant's illegal activities can dramatically inflate the price paid to *all* sellers, resulting in millions of dollars in overcharges, FERC's chosen remedy is blatantly inadequate to make consumers whole. And it has virtually no deterrent effect. This must be remedied both by Congress and by FERC internally. Congress needs to add enforcement authority and mechanisms along with funding, and give the states specific authority to enforce the FPA or state law provisions where FERC fails to act. Such actions (discussed in our Recommendations) are essential to avoiding a repeat of the California disaster.

5. Refunds for Overcharges

"[T]he ultimate conflict between the FERC and the state of California does not appear to be over whether wholesale prices in California during the summer and autumn of 2000 were illegal under the Federal Power Act. Instead, the ultimate regulatory conflict that led to the California crisis appears to be over the appropriate remedy for these unjust and unreasonable prices."[65]

FERC has so far determined, based on its interpretation of the FPA and its determination precluding "retroactive" refunds, that California may not recover billions of dollars of overcharges for the time period from May 2000 to October 2, 2000. Instead, FERC's approach for pre-October 2000 sales transactions has been to limit relief to recovery of profits gained by individual wrongdoers for isolated

---

63 Chairman Pete Domenici, U.S. Senate Committee on Energy and Natural Resources, Chairmen's Proposed Conference Report (108th Cong.) Section 1283(e) (Nov. 17, 2003).

64 *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations* 105 FERC ¶ 61,218 (Nov. 17, 2003).

65 *Asleep at the Switch: FERC's Oversight of Enron Corporation, Hearings before Sen. Com. on Government Affairs*, 107th Cong., (Nov. 12, 2002) (statement of Frank A. Wolak, Professor of Economics, Stanford University, Chairman, Market Surveillance Committee, CAISO).

acts of market manipulation. This approach ignores the fact that those individual acts caused damage to the overall market that was cumulative in nature and allowed all sellers to receive grossly inflated prices. In addition, FERC determined that DWR (the power purchaser for California in place of the non-creditworthy IOUs) is not eligible for refunds, because its power purchases, according to FERC, were bilateral (i.e., direct purchases from specific generators) rather than purchases through the ISO markets. The Attorney General and others are vigorously disputing these determinations before FERC and at the Ninth Circuit Court of Appeals.

Regardless of whether FERC's interpretation of the FPA as limiting refunds is correct with respect to the energy crisis overcharges, this approach must be changed prospectively. It is an enormous incentive to generators to cheat if unjust and unreasonable prices are not subject to refunds. If retroactive refunds and bilateral refunds for overcharges during the energy crisis are denied, large generators will have achieved a windfall of over $6 billion directly from California consumers. The most obvious and direct way to address this injustice is simply to ensure, through federal legislation if necessary, that retroactive refunds are not precluded under the FPA and that overcharges in bilateral contracts may be subject to refund where the underlying market is dysfunctional, impacting bilateral sales. Without such a fix, the incentives to game the market, create dysfunction and increase volatility will continue to be very substantial. This is a profound problem that cannot be ignored.

6. Other Remedies

FERC has a number of regulatory tools at its disposal to control market behavior and to impose sanctions for past violations. To this point, FERC has chosen to use very few of these tools. FERC, for example, could have withdrawn market-based rate authority (precluding market rate transactions on the ISO markets) for an actively trading entity charging unjust and unreasonable rates. Unfortunately, the potential for market manipulation remains high, and the incentives for market gaming in the absence of meaningful sanctions, remain strong. FERC has yet to adopt a rule prohibiting the exercise of market power. Absent such a rule, consumers remain subject to market power abuses with no viable monetary remedy. Prospective rate changes provide no relief to consumers for past market abuses.

To make matters worse, FERC is trying to erect new hurdles for consumers challenging rates for power sold under long-term contracts. Third-parties seeking to modify or abrogate long-term contracts between wholesale market participants would have to meet a heightened standard of proof, even where it can be demonstrated that the seller had market power, or that the contract was negotiated in a dysfunctional market. This requirement, again, would allow wholesale marketers to charge unjust and unreasonable wholesale power rates with little chance of regulatory consequence.

FERC, through its "standard market design" proposal and other initiatives, and the ISO, through changes to its oversight and enforcement procedures, are in the process of adopting various rules designed to combat market manipulation strategies like the ones employed by Enron. But the FERC proposal is limited. While requiring sellers to disgorge "unjust profits" obtained through illegal gaming strategies, FERC's standard market design proposal would not make the market (i.e., the consumers) whole, where a seller's misconduct caused an increase in the market clearing price of energy paid to *all* sellers. This is because California markets rely on the market clearing price to determine the market-wide price. The market clearing price is the price at which supply equals demand, or the price reflecting the last offer accepted in any given market. If a seller artificially drives up the market clearing price, it would result in overcharges being paid to all sellers in the market, not just to the one that set the market-clearing price, thereby greatly magnifying the damage to buyers.

7. Consumer Participation

Congress should create a mechanism to encourage direct consumer participation in proceedings before FERC by entitling representatives who make a substantial contribution to the outcome of proceedings to recover their reasonable costs of participation. Consumers, such as residential and small business customers, historically have played little or no role in FERC proceedings. During the California energy crisis, FERC decisions that significantly affected retail electricity rates were largely made without direct input from consumers.

In California, consumer representatives who make a "substantial contribution" to the outcome of proceedings before the California PUC are entitled to recover their reasonable costs of participation.[66] Most of these awards are funded through utility charges, but the financial benefits to consumers far outweigh the costs. Congress should adopt a similar mechanism to ensure that consumers, FERC's most important constituency, have the means to make themselves heard in critical regulatory matters.

A large percentage of the electricity system delivering power to California consumers today is now regulated not by the PUC, but by FERC through the wholesale electricity markets. FERC regulates an increasingly large portion of each dollar spent by consumers on utility service. As FERC itself has noted,

> [p]ublic utilities today purchase significantly more wholesale power to meet their load than in the past. Indeed, from 1989 through 2000, their wholesale purchases increased from 18 percent of their total available electric energy to over 37 percent, and this percentage is expected to continue to grow.[67]

This sea change for the electricity industry means that FERC, which has to date focused its resources on fostering competition in the wholesale power market, must pay more attention to the needs and concerns of ordinary consumers who are impacted by wholesale prices. State regulatory commissions such as the California PUC frequently represent consumer interests at FERC, but its resources are limited. Moreover, by necessity, state commissions represent consumer interests at large, but consumer interests are not monolithic. Allowing consumer representatives to recover their reasonable costs of participation would improve participation for all consumer interests.

---

[66] California Public Utilities Code § 1801 et seq.

[67] *Remedying Undue Discrimination Through Open Access Transmission Service and Standard Electricity Market Design*, Notice of Proposed Rulemaking, FERC Docket No. RM01-12-000, Slip Opinion at 2 (July 31, 2002).

D. The Impact of the "Filed Rate Doctrine"

Most Californians are surprised to learn that generators and traders claim that even if they commit fraud or engage in price-fixing, they are immune from suit under state law.[68] But this is exactly what they assert, often with FERC's participation, using a 20th century legal concept called the "filed rate doctrine."

This section sets forth the filed rate doctrine, its historical underpinnings, its strained application by FERC and some courts in the context of the energy crisis, and recommendations to remedy this serious inequity.

1. The Filed Rate Doctrine: A Summary

In the 19th century, railroad monopolies became notorious for charging different rates to different customer classes for the same services.[69] Small customers, who had no bargaining power, paid exorbitant rates, while large entities with economic clout obtained far more favorable rates. In response, Congress created the Interstate Commerce Commission (ICC) and made it responsible for ensuring that the railroads charged just, reasonable, and non-discriminatory rates.

Congress' chosen method of meeting these goals was to require the railroads to file all rates with the ICC in advance. That way, both consumers and the agency would have an opportunity to block any unjust, unreasonable, or discriminatory rates from taking effect. Congress eventually applied the same form of price regulation to other industries, including the wholesale power industry, which fell under the jurisdiction of FERC's predecessor, the Federal Power Commission.

Congress also required public utilities to publish their rates in official documents called "tariffs," or "rate schedules" in an effort to make rates definite and certain. Any special discounts or rebates from the filed rate that were not made available to all similarly situated customers could be easily identified, and were strictly prohibited. In addition, consumers had a clear understanding of what they would be required to pay for utility service, and had an opportunity to file a protest with the agency on the ground that the rate was unfair or unduly discriminatory.

For decades in order to determine whether a given rate was just and reasonable, regulatory agencies like FERC relied on cost-of-service ratemaking techniques, under which utilities were permitted to recover their operating costs plus a reasonable profit, as determined by the regulator. In the wholesale power market, utilities negotiated long-term, fixed rate contracts, and then filed those contracts with FERC so the agency could review the rates to ensure they were just and reasonable.

---

68 For example, Reliant's counsel argued exactly this point before the Ninth Circuit Court of Appeals on August 12, 2003, on behalf of a consortium of generators sued by the Attorney General for allegedly fraudulent sales of reserve capacity to ISO.

69 *Maislin Industries U.S., Inc. v. Primary Steel, Inc.*, 497 U.S. 116, 138 (1990) (Stevens, J., dissenting).

> *"Most Californians are surprised to learn that generators and traders claim that even if they commit fraud or engage in price-fixing, they are immune from suit under state law."*

In the 1920s, the U.S. Supreme Court created the filed rate doctrine, a judicial construct designed to prevent consumers from challenging the legality of rates that are already "on file" with and approved by the administrative agency.[70] The doctrine has several applications, the most important of which for this discussion is its use as an extremely powerful defense to claims alleging that a filed rate is excessive or otherwise injurious because the rate is, for example, the product of a price fixing conspiracy. The Supreme Court held that the filed rate is the only legal rate, and unless and until the filed rate is changed through the agency's official procedures, courts have no power to order a utility to pay damages or other financial remedies designed to compensate aggrieved consumers. Consumers' only remedy, the Court held, was to seek redress at the administrative agency. This limitation is particularly acute with respect to the wholesale power industry; FERC, unlike the ICC, has no statutory authority to make a utility pay damages or reparations on the grounds that the filed rate was unjust and unreasonable, or that it is otherwise illegal or contrary to public policy. The FPA specifies that FERC may "fix" the just and reasonable rate going forward, but may not order retroactive relief to consumers.[71]

Courts have invoked the filed rate doctrine for two key reasons. First, they have held it is necessary to "preserve the agency's primary jurisdiction over the reasonableness of rates."[72] In particular, courts have held that because utility ratemaking is highly complex and resource intensive, Congress entrusted it to expert administrative agencies like FERC. Second, courts have held that the doctrine is necessary to prevent "discriminatory rate payments."[73] If a utility were ordered by a court to pay damages to a particular consumer or group of consumers, then the award would be tantamount to granting them a discount from the filed rate, which, in turn, would violate the congressional purpose of ensuring non-discriminatory rates.

In recent years, the filed rate doctrine has been strongly criticized as an anachronism in light of changes in the law as well as the increasing reliance on competitive market forces, instead of detailed, cost-of-service ratemaking, to determine the prices consumers pay for utility services. The Supreme

---

70 See *Keogh v. Chicago & Northwestern Rwy. Co.*, 260 U.S. 156 (1922).
71 16 U.S.C. § 824d.
72 *Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571, 577-78 (1981).
73 *Towns of Concord, Norwood and Wellsley v. FERC*, 955 F.2d 67, 71 (D.C. Cir. 1992).

Court has retained the doctrine on the grounds of *stare decisis* only, and has cautioned that the doctrine should not be expanded.[74]

The market-based rate regime employed by FERC fundamentally changes the relationship of the regulatory agency to the commodity, and sweeps away the underpinnings of the filed rate doctrine. FERC no longer brings its unique expertise to bear on rate setting: the *market*, not the agency, sets the rate. In such a system, courts no longer need to defer to agency expertise. Indeed, courts have greater expertise in evaluating antitrust behavior than administrative agencies like FERC. And courts are perfectly capable of calculating damages where, as in the wholesale power market, prices are determined by market forces. In addition, courts need not be concerned about price discrimination. Market forces will, under FERC's theory, prevent unjust discrimination. For these reasons, California state courts do not recognize the filed rate doctrine as a defense to challenges to rates regulated at the state level.[75]

Despite the inapplicability of the purposes of the filed rate doctrine to a market-based system, FERC and some courts have continued to apply the doctrine, preventing California from recovering overcharges for unjust and unreasonable rates. FERC itself found that pre-October 2000 prices were unjust and unreasonable, but refused to order refunds, citing the filed rate doctrine. In addition, generators that sold electricity in the California market contend that the filed rate doctrine precludes any action for damage recovery — even for violations of antitrust law — because only FERC can remedy illegal rates.

The continued application of the filed rate doctrine to the market-based system in California is unjust and improper. It has resulted in a massive redistribution of wealth from California ratepayers to out-of-state energy companies. If the doctrine is not reformed by the courts, Congress must act to make it inapplicable to market systems. Failure to act on this issue will ensure repeated unfairness and ongoing market abuse.

2. What is the "Rate" in a Market System?

Traditionally, FERC-regulated utilities filed tariffs specifically stating, for each wholesale transaction, their prices or the rate formulas they used to calculate the applicable rate by plugging in the appropriate values. Rates had to be filed sixty days before they became legally effective, unless, for good cause shown, FERC reduced the notice period. In the late 1980s, FERC determined that the process of reviewing the specific terms and conditions of all transactions impeded the development of competitive markets by preventing sellers from being able to quickly react to changing market conditions. In order to promote competition, FERC drastically cut back the filing requirements for sellers transacting at market-based rates.

---

74 *Square D Co. v. Niagara Frontier Tariff Bureau Inc.*, 476 U.S. 409, 420 (1986).

75 *Cellular Plus, Inc. v. Superior Court*, 14 Cal.App.4th 1224 (1993).

> *"The consequences of FERC's application of the filed rate doctrine to market-based rates are profound and disturbing."*

As a result, sellers of wholesale electricity are no longer required to file their proposed prices or any cost support for their proposed prices. Instead, sellers are required to file a generic "market-based tariff," which states only that rates will be determined "by agreement" between the parties to the transaction. In order to obtain tariff approval (known as "market-based rate authority"), sellers are required to demonstrate that they lack market power in the relevant market, or that they have taken steps to mitigate any market power they may have.

Sellers with market-based rate authority are also required to file quarterly, after-the-fact reports listing transaction-specific information (i.e., the actual prices they charged in the market) about all of their sales and purchases during the prior three-month period. These reports, however, are submitted for "informational purposes" only. FERC uses them, in theory, to monitor the seller's ability to exercise market power and to determine whether the seller's rates are just and reasonable. If FERC perceives a problem based on the information contained in quarterly reports (or for any other reason), the seller's rates can be adjusted, but *prospectively only*. FERC takes the position that the market-based tariff, not the quarterly report, is the "filed rate" for purposes of determining whether the filed rate doctrine applies. FERC's acceptance for filing of the market-based tariff amounts to blanket authorization of *any* price charged pursuant to the market-based tariff. The Attorney General believes that FERC's formulation of the market-based tariff as a "filed rate" is fatally flawed, and is currently seeking judicial review.[76]

3. FERC's Misapplication of the Filed Rate Doctrine to Market-Based Rates

The consequences of FERC's application of the filed rate doctrine to market-based rates are profound and disturbing. Under FERC's construction, no specific market can be challenged because the seller's "rate" has been filed, thereby immunizing all past sales.

FERC has used just this formulation to bar refunds, likely in the billions of dollars, for California consumers for much of the crisis period. FERC determined that California purchasers of wholesale electricity are entitled to refunds for unjust and unreasonable prices only for the time period after October 2, 2000, even though FERC determined that purchasers were charged unjust and unreasonable prices between May 1, 2000 and October 1, 2000. In FERC's view, because San Diego Gas & Electric filed the first California rate challenge on August 3, 2000, no refunds can be granted until sixty days after the filing date.

---

[76] *State of California ex rel. Lockyer v. FERC*, Ninth Circuit Court of Appeals No. 02-73093.

FERC maintains that the "filed rate doctrine" applies even though generators and marketers uniformly failed to report their rates to FERC for market monitoring purposes. As a result of these reporting violations, FERC had no seller-specific information on the prices being charged in the market during the Energy Crisis, the single biggest disaster in the history of the wholesale power industry. Yet, FERC has held repeatedly in the past that quarterly reporting is essential to ensure that consumers and the agency have the ability to detect unreasonable prices and, if needed, intervene in the market.[77]

Compounding FERC's reliance on the filed rate doctrine, and its failure to enforce the generators' rate reporting requirements, a number of courts have held that the filed rate doctrine bars claims for damages, even where defendants allegedly conspired to fix prices. If this interpretation is allowed to stand, sellers in today's deregulated electricity markets might be free of both traditional regulatory controls and state and federal laws forbidding price fixing, monopolization, fraud, and unfair business practices. To prevent repetition of these inequitable and unjust outcomes, Congress must act to make the antiquated filed rate doctrine inapplicable to market-based wholesale electricity transactions.

E. ISO: The Need for More Oversight and Enforcement Ê

The ISO is a non-governmental public benefit corporation created by state law, but its operations are governed by FERC. The ISO is responsible for operating the electrical transmission system (the grid) throughout most of California. Its central responsibilities are to ensure grid reliability, operate the imbalance energy and ancillary services markets, obtain power during periods of shortfall, and enforce tariffs governing each of these obligations. The ISO relies on various auction markets to obtain energy and ancillary services to match supply and demand when needed, relieve congestion, and ensure that the lights stay on in the state. It is a significant and complex set of responsibilities.

1. System Reliability and Governance of the Markets

Unlike some other commodities, electricity cannot be stored. Furthermore, transmission lines are extremely sensitive. Too much or too little power running through a line can trip the system, creating outages across the grid. In order to ensure grid reliability, the ISO procures standby generating capacity known as "ancillary services" or "operating reserves." Specifically, the ISO pays generators to keep a certain amount of capacity in reserve until called on if needed in the event of a plant or transmission line outage, or to correct a routine imbalance on the grid.

In addition, the ISO operates an "imbalance energy market," also known as the "real-time market," in which electricity is bought and sold in ten-minute increments. This market was designed to provide only the electricity needed to address imbalances between load and generation on the transmission grid when they occur. Historically, the real-time markets provided 5 percent or less of the state's electricity needs. But during the period leading up to the energy crisis and during the crisis itself, generators and IOUs learned that the ISO real-time market could be manipulated. They bought and

---

77 *Enron Power Marketing, Inc.,* 65 FERC ¶61,305 (1993).

“Unlike some other commodities, electricity cannot be stored. Furthermore, transmission lines are extremely sensitive. Too much or too little power running through a line can trip the system, creating outages across the grid.”

sold less electricity in the day-ahead markets operated by the PX, deciding instead to do business in the real-time markets. This created massively greater volumes on the real-time market, strained the ISO’s ability to govern the market, and, at times, overwhelmed the ISO.

2. Enforcement

Although it has only a small staff, and a limited enforcement section, the ISO produced some of the most cogent analyses of the California energy crisis. The testimony of its market monitoring experts has been used extensively. They, along with the ISO’s market surveillance committee, developed important perspectives on what went wrong in California. But the ISO did not have sufficient staff to broadly investigate generator withholding or multi-party ricochet deals.[78]

The ISO enforcement staff is responsible for ensuring compliance with thousands of tariff provisions, and reviewing hundreds of thousands of transactions in half a dozen markets involving billions of dollars of sales. Some review is done by computer, but much of it is done by hand. A primary responsibility of the ISO is as a manager of the grid. Due to this and limited resources, ISO attempted to induce compliance with its tariffs by refining market rules and incentives.

Various proposals have sought for ISO to become a primary line of defense against market abuse, potentially reasonable proposal in light of the ISO’s experience with and knowledge of the markets. But, as the California experience shows, this strategy will succeed only if the ISO has the staff and resources to enforce its tariffs. Additionally, it must also have the authority to refer the most serious cases to the Attorney General.

F. State Regulation of Electricity Is Highly Constrained Ê

The state has a limited role in the regulation of the wholesale sale, and transmission of electricity. While the PUC, the EOB, and the California Energy Commission (CEC) each play a role in oversight of the energy markets in this state, the enforcement capabilities of these entities needs to be expanded, and, where appropriate, combined.

---

[78] Such as those perpetrated by Enron.

The FPA preempts aspects of the sale and transmission of wholesale electricity. State regulators, therefore, focus on the retail purchase, sale, and delivery of electricity, and primarily on transactions between the IOUs and their retail customers. The PUC, however, has a limited ability to prevent utilities from passing FERC-regulated, wholesale power procurement costs through to their retail customers.

1. Electricity Oversight Board

The ISO and the PX, created by AB 1890, are California public benefit corporations, but not state agencies. The EOB, also created by AB 1890, is a state agency that provides the state with some authority over the ISO and the PX.[79]

In 2002, the Legislature amended the EOB's enabling legislation, allowing the EOB to "investigate any matter related to *the wholesale market* for electricity to ensure that the interests of California's citizens and consumers are served, protected, and represented in relation to the availability of electric transmission and generation and related costs, during periods of peak demand."[80] Paradoxically, while the EOB does have authority to issue investigatory subpoenas, it has no clear enforcement authority under state law, and, due to the FPA, it is unlikely that a change to state law could expand that authority.

The EOB has jurisdiction over appeals of certain decisions made by the ISO.[81] Again, that jurisdiction is limited by the FPA to issues concerning retail electric services and sales and actions of the ISO related directly to state law (such as the ISO's duties as a public benefit corporation). The EOB's primary function is to ensure, through oversight of the ISO, the reliability of transmission of electricity and the grid. It also monitors the operation of the ISO market, but apparently can take no action other than filing complaints at FERC.

The EOB's oversight authority would benefit from the ability to refer specific violations of law (both state and federal) to both FERC and the California Attorney General. This can be achieved primarily through state statute.[82] Lawmakers should also consider giving the EOB authority to rule on administrative appeals of the ISO's compliance actions if the ISO is given enforcement authority for violation of its tariffs.

If both the ISO and the EOB had increased enforcement and referral authority with regard to specific violations of both state and federal law, violations could be addressed meaningfully at the

---

79 California Public Utilities Code § 334 et seq.
80 California Public Utilities Code § 335(e) (emphasis added).
81 California Public Utilities Code § 339.
82 Referrals to the Attorney General, as noted elsewhere, would best be limited to the most serious or repeat violations, where prosecution would be most effective.

administrative level with recourse to FERC and the Attorney General (for the most serious violations) as appropriate. Currently, market participants face little threat of action for violation of tariffs, rules, regulations, and statutes.

2. The California Public Utilities Commission

Under California law, the PUC regulates public utilities such as PG&E, SCE, and SDG&E, with a focus on retail electricity rates and the utilities' obligation to provide service in a just and reasonable manner.[83] The PUC's authority is both far reaching and constrained. It regulates aspects of the transmission and delivery system; the sale, purchase, and construction of new generation facilities by the IOUs; retail rates and markets; and the purchase and sale of electricity through direct access (rather than through the IOUs), among many other things. But the PUC's jurisdiction is severely limited by aspects of FERC's jurisdiction, including FERC's exclusive authority over the determination of just and reasonable rates for wholesale electricity.

As noted earlier, the role of wholesale electricity rates and markets is becoming increasingly dominant, thereby limiting the PUC's ability to respond to spikes in wholesale prices. Retail rates must to a large extent reflect wholesale rates. The PUC's jurisdiction extends to the prudence of electricity procurement decisions by the IOUs, but not to the reasonableness of wholesale rates charged by sellers. Specifically, the PUC may prevent a utility from recouping wholesale procurement costs through retail rates if the PUC finds that the utility had cheaper alternatives available, such that its purchasing decisions were "imprudent." In addition, the PUC is authorized to regulate the procurement options available to the utilities by, for example, restricting the utilities' ability to enter into long-term, bilateral contracts. At the outset of the restructuring of California's electricity markets, the utilities were required to purchase all of their energy requirements from short-term markets operated by the PX and the ISO. In July 1999, the PUC authorized the utilities to purchase prescribed amounts of long-term ("block forward") power through the PX. In August 2000, the PUC lifted the restrictions on long-term, bilateral contracting.[84]

The PUC has extensive investigative and administrative enforcement authority, but that authority is largely limited to retail rates and the requirement that those rates be just and reasonable. As to wholesale rates, the PUC may appear, as any other party would, in proceedings before FERC.

The PUC should have additional authority and standing with respect to issues within the purview of FERC. The PUC should also establish a formal procedure to refer serious violations to the California Attorney General. The Attorney General, working with the PUC, would then pursue civil or criminal remedies in appropriate cases.

---

[83] California Public Utilities Code § 451 et seq.

[84] PX Block Forward Markets allowed purchase of capacity for particular months, up to one year in advance. They do not constitute an alternative to long-term contracts.

a. PG&E's Attack on the PUC's Control of Retail Rates

In November 2000, PG&E sued the PUC, contending that the retail rates set by the PUC during the energy crisis precluded PG&E from recovering its wholesale costs through retail sales to consumers. PG&E argued that the filed rate doctrine, which essentially insulates wholesale rates from legal challenge, prevents the PUC from setting retail rates at a level that precludes the utility from recovering its wholesale costs.

In its litigation against the PUC, PG&E attempted to limit the court's focus solely to the period of market dysfunction and high wholesale prices, urging the court to ignore the massive profits PG&E made in the period immediately preceding the energy crisis in 2000, (and which it subsequently transferred to PG&E's parent corporation). The PUC and the Attorney General, defending the suit, argued that: (1) PG&E's rates during the entire period of deregulation must be considered in evaluating the claim that retail rates set by the PUC prevented PG&E from re-capturing its wholesale costs; and (2) the filed rate doctrine has no application to market rates.

Although PG&E's lawsuit has now been settled as part of the overall resolution of PG&E's bankruptcy, the Attorney General has directly challenged the filed rate doctrine in another case now pending before the Ninth Circuit Court of Appeals.[85] If the court determines that the filed rate doctrine does apply to market-based rates, the PUC's ability to set retail rates, and to impose price caps to control market prices in the face of wholesale market manipulation, will be severely impaired.

3. California Energy Commission

The California Energy Commission (CEC) is the state's primary energy policy and planning agency. Created by the Legislature in 1974, the CEC has five major responsibilities: (1) forecasting future energy needs and keeping historical energy data; (2) licensing thermal power plants that generate 50 megawatts or more; (3) promoting energy efficiency through appliance and building standards; (4) developing energy technologies and supporting renewable energy; and (5) planning for and directing the state response to energy emergencies. The CEC does not have authority to investigate violations of law by energy companies, nor does it have enforcement authority.

G. Limitations on Enforcement of State Laws and the Need for Greater Cooperation Among Enforcement Authorities

By nature, state and federal regulatory and enforcement entities and jurisdictions are somewhat balkanized. Greater coordination and cooperation are possible, however, and should be pursued.

The California Attorney General has taken responsibility for major portions of the investigation of the causes of the energy crisis, with a focus on illegal actions by market participants. He has also pursued numerous enforcement cases for both systemic relief and recovery of damages and penalties.

---

85 *Lockyer v. FERC*, Ninth Circuit Case No. 02-73093.

"The Attorney General's involvement reflects a regulatory system unable or unwilling to police the very industry it governs."

While such a role is essential in the wake of the energy crisis, it is neither efficient nor ideal. The Attorney General's involvement reflects a regulatory system unable or unwilling to police the very industry it governs.

It is not the Attorney General's job, in the first instance, to regulate electricity or natural gas markets, or to ensure the lawful operation of those markets. The Attorney General has the constitutional duty to ensure that state law is adequately enforced.[86] This includes exercise of the Attorney General's statutory authority to investigate unlawful conduct, initiate civil and criminal prosecutions, and negotiate settlements.[87]

The Attorney General's office entered the energy fray primarily after the market was manipulated. It pursued emergency actions in coordination with the Governor, launched an investigation, and filed after-the-fact enforcement actions.

Through its investigators and deputies, the Attorney General's office issued dozens of investigatory subpoenas, reviewed millions of pages of documents, interviewed and deposed hundreds of witnesses, sifted through enormous quantities of data from multiple sources, and conducted one of the largest investigations in the nation's history, which continues to this day. As a direct result of this investigation, multiple instances of improper, illegal, criminal, and manipulative behavior by energy market participants have become public. The actions of Enron, at least in part, are well known. Evidence of rampant gaming of the markets by many other companies has been publicized as well. False reporting of gas prices, skirting of price caps, disruption of natural gas supplies, and withholding of electrical capacity from the market, among many other actions, have been documented. Some — but not all — of these actions are illegal and the subject of enforcement proceedings.

Three issues limit the effectiveness of the Attorney General's investigative and enforcement tools for recovering full damages for market abuse that occurred during the energy crisis: the market-wide impacts of market power; the inefficiencies of pursuing remedies on a case-by-case basis; and preemption and preclusion of state action by federal laws and actions of the federal government.

Under the current system, market-wide abuse should be addressed by FERC, exercising its authority under the FPA to assure "just and reasonable" prices.

---

86 Cal. Const. art. V, § 13; *Camp v. Board of Supervisors*, 123 Cal.App.3d 334, 353 (1981).
87 See *People v. Cimarusti*, 81 Cal.App.3d 314, 322-24 (1978).

The Attorney General has allocated significant resources to the energy investigation and prosecutions, but there are literally millions of transactions among numerous parties that are at issue. The Attorney General must enforce market abuses selectively and on a case-by-case basis. The remedies available in individual cases may be relatively small compared to the market-wide impacts caused by an artificially inflated market clearing price. There is little doubt that some conduct will go unchecked, and remedies unsecured. This experience underscores the need for self-correcting mechanisms to be built into any new design for energy markets, and demonstrates why most electricity market enforcement should be achieved at the regulatory level, rather than after the fact.

a. Preemption and Preclusion by Federal Law and Actions of the Federal Government

The most significant limit on the ability of the Attorney General to redress fully the harm suffered by Californians in the energy crisis is the preemptive effect of federal law and federal governmental action. FERC and the electricity generators and marketers contend that only FERC has authority to provide monetary recovery to Californians. At the same time, FERC determined that it would not order refunds for any illegal prices charged before October 2, 2000. This single determination, if it stands up on appeal, will preclude recovery of billions of dollars of damages suffered by Californians. And this is but one aspect of the use of federal preemption by both FERC and energy marketers to foreclose actions by the California Attorney General and others to obtain relief.[88]

2. Cooperation Among Attorney General and Other Governmental Entities With Enforcement Authority

The number of governmental agencies with some interest, expertise, or jurisdiction relating to energy crisis matters is substantial. On the federal level, the U.S. Department of Justice, at least three U.S. Attorney's Offices, FERC, the SEC, and the Commodities Futures Trading Board, all have pursued investigations of crisis-related energy matters. Most of these agencies have both criminal and civil jurisdiction. Attorneys General in Oregon, Washington, Nevada, and other states have participated in their own investigations of conduct related to the energy crisis. In California, the PUC, the EOB, and various district attorneys, county counsel, and city attorneys have investigated market conduct leading to the crisis along with the Attorney General. The District Attorneys and the Attorney General have both criminal and civil jurisdiction. In addition, both the California Legislature and Congress have held investigatory hearings. Numerous other agencies also have roles related to the crisis, including the Department of Water Resources, the California Power Authority (created by legislation in 2001), and the Governor's Office, which has taken a lead role in many aspects of the response to the crisis. Not surprisingly, coordination is difficult.

For the most part, the California state agencies have worked well and productively together. The PUC has independent regulatory authority and has pursued some independent courses of action,

---

88 See *In re California Wholesale Electricity Antitrust Litigation*, 244 F. Supp.2d 1072 (S.D. Cal. 2003).

fully within its purview. Coordination between the Attorney General and the PUC could benefit from a specific referral process for certain limited enforcement actions. This is a modest recommendation to increase cooperation and coordination.

Coordination between California, Washington, and Oregon has been very good, based in significant part on strong working relationships between the Attorneys General and assigned attorneys from the respective states.

Cooperation and coordination between state and federal agencies has been mixed due to the absence of clear guidelines for information sharing, cooperative investigation, and joint enforcement as well as the personalities and outlooks of the individual prosecutors involved in the particular cases. Specific guidelines for cooperation would be useful. In addition, federal legislation to establish specific rules for sharing information obtained through federal criminal investigations with state civil investigators in cases involving energy industry misconduct would benefit all enforcement efforts.

Following the savings and loan scandals of the 1980s, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), enhancing civil and criminal penalties for bank fraud related offenses. FIRREA authorizes government attorneys to disclose criminal grand jury investigatory information to other government attorneys involved in civil investigations of similar violations.[89] This provision allows for a fully cooperative working relationship between criminal, civil and regulatory investigators and promotes joint criminal and civil prosecutions. A similar provision allowing coordination and information exchange in energy industry misconduct investigations would greatly benefit enforcement.

One aspect of the state-federal enforcement scheme that needs to be changed is the relationship between the California Attorney General and FERC. Early in the crisis, FERC informed the Attorney General's Office that that it was "prohibited" from conducting a joint investigation into any aspect of the crisis because the Attorney General's Office was a "party" before FERC, seeking refunds on behalf of ratepayers. FERC, therefore, refused to cooperate in any aspect of the Attorney General's investigation, and in fact forced the Attorney General to sue FERC under the Freedom of Information Act to obtain even public information. Although this case was settled, with FERC paying the Attorney General's Office its attorneys' fees and costs, this type of dispute does not serve the public well. More recently, FERC has participated with the Attorney General in a Multi-Agency Energy Working Group focusing on Enron. This cooperative effort is working well and could become a model for how state and federal agencies can work together.

3. Private Lawsuits

Resource limitations make it impossible for district attorneys and the Attorney General to redress all violations of the law. Under many state and federal laws, private parties can file lawsuits seeking to

89 18 U.S.C. § 3322.

"California's largest utility, PG&E Company, filed for 'Chapter 11' bankruptcy protection on April 6, 2001, but not before it had transferred over $4 billion of utility earnings to the parent holding company, PG&E Corporation."

enforce "public" rights on behalf of companies, individuals, or a class of individuals. The energy crisis has spawned dozens of such actions, some alleging harm to specific businesses, such as the impact of increased gas prices on dairies or wineries, and some alleging harm to individuals and the public more generally. Most of these cases pursue antitrust and unfair competition theories under state and federal law. California's legal system recognizes the important role these "private attorneys general" play, and, in some circumstances, permits the recovery of attorneys' fees if the actions are successful. Private party suits in circumstances of this kind will continue to play an important part in the enforcement of public rights.

H. The Need for Continued Regulation of Utility Holding Companies and The Failure of the Securities and Exchange Commission to Enforce the Public Utilities Holding Company Act

California's largest utility, PG&E Company, filed for "Chapter 11" bankruptcy protection on April 6, 2001, but not before it had transferred over $4 billion of utility earnings to the parent holding company, PG&E Corporation.

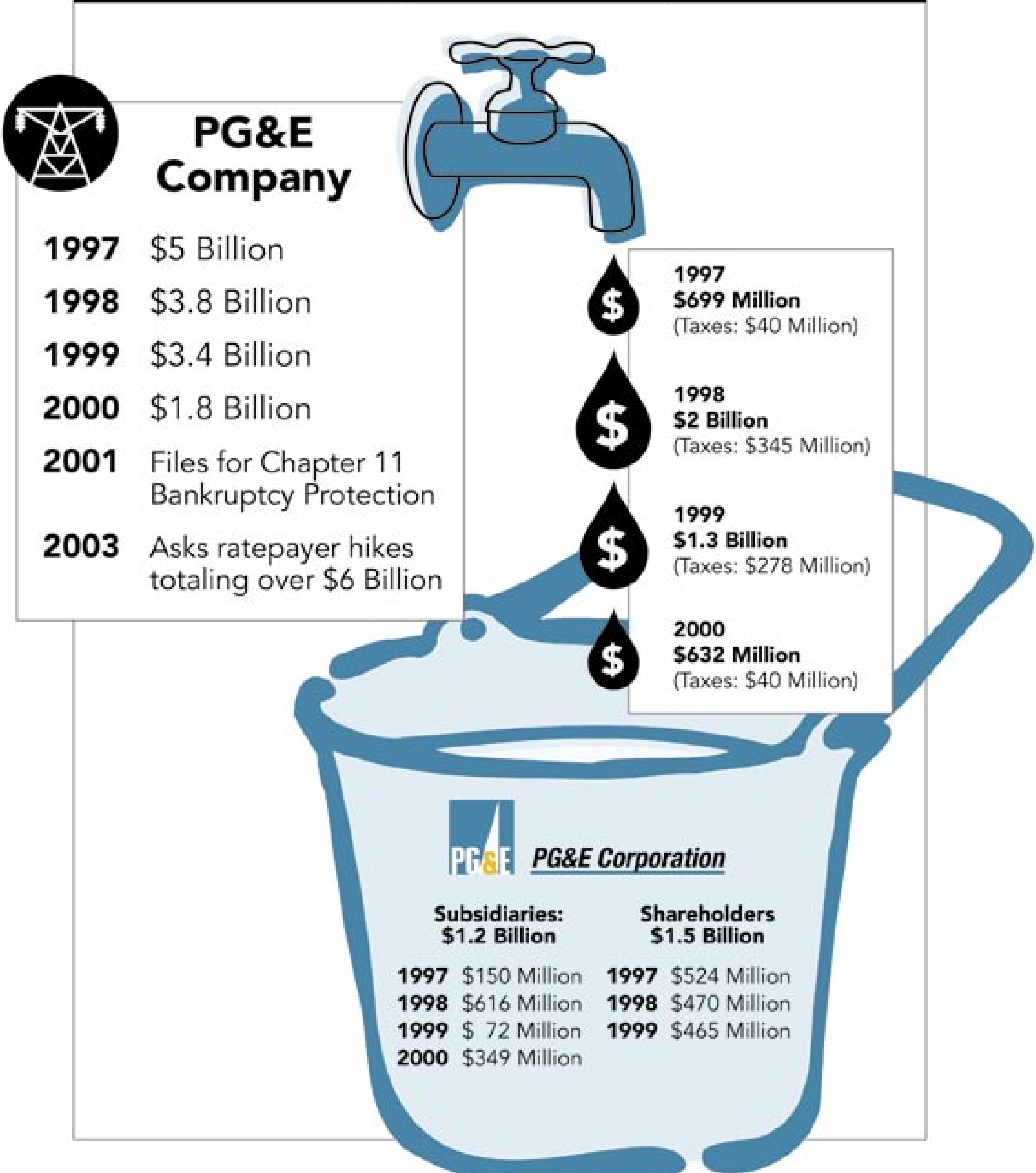
The California energy crisis and PG&E's actions are an example of why we need continued scrutiny of utility holding companies. The need for scrutiny is increased by the move to market-based rates and the climate of looser regulation of utilities. Had the billions of dollars been retained by the PG&E utility, those billions would have allowed the utility to operate as a creditworthy entity for a considerably longer time, possibly weathering the crisis and keeping the state from being thrown into the role of energy purchaser of last resort.

Under the federal Public Utility Holding Company Act (PUHCA),[90] the Securities and Exchange Commission (SEC) is obligated to scrutinize the money flow from subsidiary utility to parent holding company. The SEC, however, had granted PG&E Corporation (and the holding companies for SCE and SDG&E) an exemption, apparently in violation of the law, from the vast majority of PUHCA regulations. As a result, the SEC failed to conduct any review of the financial dealings between the utility PG&E Company and PG&E Corporation.

---

[90] 15 U.S.C. § 79 et seq.

Draining Assets from Public Utility



Due to the rapid growth of the utility industry in the 1920s, Congress directed the Federal Trade Commission (FTC) to conduct comprehensive studies of the public utility industry. These studies uncovered unprecedented industry abuses facilitated by the holding company structure. The root of these abuses was the utility holding companies' pyramidal corporate design. "The holding company structure made it virtually impossible to trace these abusive interaffiliate transactions. As a result of the abuses, investors were defrauded, subsidiary companies were forced to pay excessive prices for services, and in the end, energy prices were grossly inflated."[91] The complexity of these arrangements made monitoring almost impossible.

Holding companies often controlled numerous local utilities and engaged in multiple non-utility ventures. Congress found that some had used the holding company structure to siphon funds from the utility companies and their ratepayers in order to finance other ventures and to pay dividends to shareholders of the holding company. At its heart, PUHCA acts as a limit on holding company control. But PUHCA's provisions have not been applied to California's utility holding companies, because they are assertedly intrastate enterprises and therefore outside the purview of the act.

California's utility holding companies currently operate under this intrastate exemption to PUHCA. The exemption applies when the SEC determines that the holding company does not derive "directly or indirectly any material part of its income" from a subdivision utility, the utility and holding company are intrastate in character, and an exemption would cause no detriment to the public interest.[92]

In determining whether income from an out-of-state utility subsidiary is "material," the SEC looks at all sources of a parent holding company's income. The SEC considers various factors, including gross revenues, net operating revenues, utility assets, number of customers, and volume of gas or electricity distributed or sold.[93] According to public filings, PG&E Corporation had over $13 billion in assets outside of California.[94] With out-of-state income of at least $150 million in calendar year 2000, the company clearly derives a material part of its income from its substantial out-of-state subsidiaries.

The SEC continues to exempt the California utility holding companies, even though none of them can reasonably claim to be "predominantly intrastate" in character. In 2001, for example, the San Francisco Chronicle reported that PG&E Corporation would "begin construction of five generating facilities this year and has at least four others on the drawing board. . . in New York, New Jersey, Wisconsin, Michigan, Arizona, Illinois, Oregon, and Nevada."[95]

---

91 S. Rep. No. 107-15, at 5, 1st Sess. (2001) to accompany S. Rep. No. 206, 107th Cong., 1st Sess. (2001) to repeal the Public Utility Holding Company Act of 1935, to enact the Public Utility Holding Company Act of 2001, with an amendment in the nature of a substitute.

92 15 U.S.C. § 79c(a)(1).

93 See *In re Eastern Enterprises*, Holding Co. Act Release Nos. 35-27269, 70-9605, S.E.C. File No. 70-9605 (2000).

94 PG&E Corp., Annual Report of PG&E Corporation to the U.S. Securities and Exchange Comm'n, Form 10-K for 2000.

"'The businesses that we have outside California are designed to grow shareholder value,' PG&E Chairman Robert Glynn told shareholders. Indeed, PG&E's National Energy Group, which oversees the company's power plants, is the corporation's fastest growing division - a marked contrast to PG&E's cash-strapped utility operations."[96]

In addition, the interests of the various PG&E marketing and generating subsidiaries, and various other entities in the PG&E corporate family, are significantly different from, and occasionally contrary to, those of the utility. The utility, which delivers electricity and gas to customers, is a regulated monopoly. Its costs of operations and investments are covered by regulated rates. As a regulated monopoly, profits generally should be used for the benefit of the utility and its ratepayers. PG&E Company serves an essential function, and one that must not be compromised by adverse corporate interests within the holding company and within the extended corporate structure. It is this clarity of focus that California consumers deserve, and that PUHCA is designed to preserve. Congress should preserve these important protections. But for the PG&E Corporation's PUHCA exemption, PG&E Company's "upstreaming" of billions of dollars to the parent corporation would have been subject to SEC scrutiny. The Attorney General has requested that the SEC reconsider its PUHCA exemption decision for PG&E and other utility holding companies.[97]

I. PG&E's Bankruptcy Action Ê

Many contend that the energy crisis placed the IOUs in an economic squeeze of their own making. The IOUs supported a retail rate freeze because they believed this would guarantee recovery of their "stranded" costs.[98] As the deregulation process unfolded, however, the frozen rates prevented the IOUs from passing their soaring wholesale costs on to consumers. Irrespective of the irony of this result, bankruptcy became a serious consideration for two of California's IOUs: SCE and PG&E Company. Only PG&E Company decided to file for bankruptcy.

On April 6, 2001, after ending negotiations with the Governor to cover its costs, PG&E Company filed a voluntary "Chapter 11" bankruptcy petition in the U.S. Bankruptcy Court for the Northern District of California.[99] PG&E's *parent* company sought to restructure the debt obligations of the utility, but it also sought to exempt the utility from state laws enforced by the PUC, and as well as other laws administered by state and federal agencies.

---

95 David Lazarus, *PG&E Plans New Plants Outside California/Higher Profits From Building Elsewhere,* S.F. CHRON., May 18, 2001, at A16.

96 *Id.*

97 The Attorney General is also pursuing litigation against PG&E to recover the billions of dollars upstreamed by the holding company form the utility without SEC scrutiny.

98 Stranded costs refer to the capital investment expenditures incurred by the IOUs prior to deregulation, but not fully recovered in their rates before the passage of AB 1890.

99 *In re Pacific Gas & Electric Company,* No. 01-30923 DM.

Three days after filing for bankruptcy, PG&E filed an adversary proceeding (a lawsuit in bankruptcy) against the PUC and individual commissioners. The utility alleged a violation of a bankruptcy's "automatic stay," which halts most litigation against the debtor outside of bankruptcy court, to keep the PUC from enforcing accounting rules PG&E had objected to when they were promulgated.[100] The bankruptcy court determined that the PUC was acting within its police and regulatory authority and that the automatic stay did not apply.[101]

PG&E then sought to preclude PUC regulation through its plan of reorganization (POR), initially filed in September 2001. PG&E's plan went well beyond the typical bankruptcy plan, which centers on adjusting debtor/creditor obligations. Through the POR, PG&E sought to preempt any law that interfered with the transactions the debtor proposed in the POR. In effect, PG&E sought to "deregulate" itself.

The plan proposed to have the utility split up its assets along the utility's "lines of business" by transferring the utility's most valuable generating assets to what would become deregulated subsidiaries of the parent, PG&E Corporation. The less profitable distribution assets of the utility would be the only assets of the PG&E Company to emerge from bankruptcy, and the utility would secure gas and electricity under long-term contracts with the spun-off subsidiaries. These proposed transactions — particularly the transfer of the valuable Diablo Canyon nuclear power plant and the largest private holdings of hydroelectric generation facilities in the country — were in direct violation of state public health and welfare laws.

PG&E and its parent asserted that the federal bankruptcy code[102] is an "express preemption" statute that allows debtors to preempt all non-bankruptcy laws — state or federal, criminal or civil — to effectuate a reorganization plan.

Agreeing with the Attorney General and other state agencies, the bankruptcy court denied approval of the PG&E "express preemption" disclosure statement and POR, and required PG&E to amend the disclosure statement and POR.[103] PG&E appealed the bankruptcy court ruling to the federal district court, which determined that the Bankruptcy Code did allow a debtor to preempt laws

---

[100] *PG&E Company v. California Public Utilities Commission, et al.,* Adv. Proc. No. 01-3072.

[101] 11 U.S.C. § 362(b)(4).

[102] 11 U.S.C. § 1123(a)(5) provides: "Notwithstanding any otherwise applicable non-bankruptcy law, a plan shall — provide adequate means for the plan's implementation . . . ." The section goes on to provide examples of "adequate means" for plan implementation, "transfer of all or any part of the property of the estate to one or more entities, whether organized before or after the confirmation of such plan" and "sale of all or any part of the property of the estate, either subject to or free of any lien, or the distribution of all or any part of the property of the estate among those having an interest in such property of the estate..."

[103] *In re Pacific Gas & Electric Company*, 273 B.R. 795, 819 (Bankr. N.D. Cal. 2002) (the "Express Preemption Ruling").

which interfere with reorganization transactions in the manner advocated by PG&E.[104] On appeal, the Ninth Circuit embraced the Attorney General's position and ruled that the preemption in bankruptcy law is limited to financial transactions and remanded the matter to the bankruptcy court.[105]

While PG&E's efforts to exempt itself from state law were unsuccessful, the Bankruptcy Code needs to be amended to clarify that state and federal public health and welfare laws and criminal laws cannot by preempted by a future debtor's POR. Without such clarification, other debtors may follow PG&E's lead and argue that federal bankruptcy laws can be used to thwart state statutes of all kinds, including public utility, consumer protection, environmental and criminal laws.

PG&E Corporation pursued another avenue in its attempt to avoid or limit state regulatory authority by seeking to "remove," or transfer, from state court to bankruptcy court a state police power action brought by the California Attorney General against PG&E's parent corporation and individual officers and directors.

On January 10, 2002 in San Francisco County Superior Court, the Attorney General filed a civil law enforcement action under the California Unfair Business Practices Act[106] against PG&E Corporation and several officers and directors.[107] These non-debtor defendants filed an adversary proceeding in the bankruptcy court where the PG&E *utility* bankruptcy proceeding was pending, and removed the Attorney General's unfair business practices action to that forum.[108]

The bankruptcy court refused to accept the removal, and remanded the action back to state court.[109] The United States District Court for the Northern District of California affirmed, in part, and reversed, in part, the bankruptcy court's decision to remand the Attorney General's unfair business practices action. As a result of the district court's decision, the restitution remedy of the Attorney General's unfair business practices action is pending in the bankruptcy court. The Attorney General has an appeal pending in the Ninth Circuit Court of Appeals to review the district court' s decision to allow the restitution remedy to proceed in the bankruptcy court. However, the action is also proceeding in state court to pursue the other remedies being sought by the Attorney General against PG&E Corporation and several officer and directors. The relationship of police power actions involving restitution against debtors needs to be resolved by the appellate court.

---

104 *In re Pacific Gas & Electric Company*, 283 B.R. 41 (Bankr. N.D. Cal. 2002).

105 *In re Pacific Gas & Electric Company*, No. 02-16990.

106 California Business and Professions Code § 17200 et seq. (Unlawful, Unfair & Fraudulent Business Practices.)

107 *People of the State of California, ex rel. Bill Lockyer v. PG&E Corporation et al.*, Case No. CGC 02-403289.

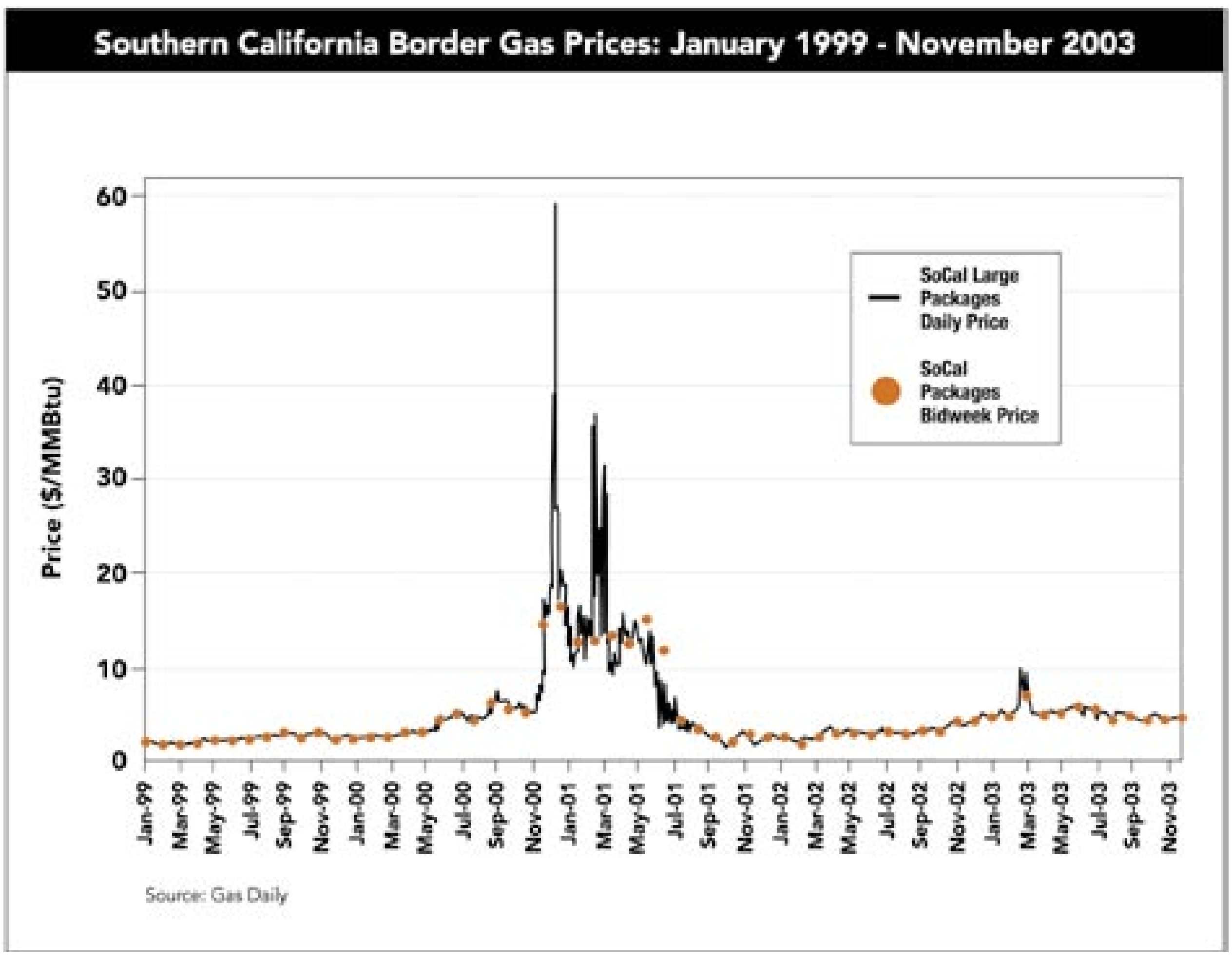
108 See Adv. Nos. 02-3026 DM, 02-3040 DM and 02-3042 DM.

109 *State of California, et al. v. PG&E Corporation, et al.*, 281 B.R. 1 (Bankr. N.D. Cal. 2002).

J. Forcing the State into Federal Court and the Issue of Sovereign Immunity Ê

Under the Eleventh Amendment to the U.S. Constitution, states — and their taxpayers — enjoy sovereign immunity and typically cannot be sued in federal court. This immunity can be waived, however, if a state chooses to participate in federal court proceedings. If state agencies wish to make claims against a bankrupt debtor's estate, the agencies must file proof of claims with the federal bankruptcy court. The question faced by state agencies with claims against PG&E was whether filing a proof of claim would be deemed a waiver of the state's sovereign immunity, exposing the agencies to lawsuits in federal court.

States should not have to face this quandary. Bankruptcy law should be clarified or amended to ensure that a state or local government can file a proof of claim without waiving sovereign immunity or subjecting its taxpayers to liability in federal court.



K. Natural Gas and Its Relation to the Electricity Crisis Ê

Electricity prices, already well above historic levels by fall 2000, rose to even higher levels when natural gas prices began to jump in November and December of that year. The immediate problem was an unprecedented increase in prices for natural gas delivered into Southern California via the El Paso pipeline.

Natural gas is the fuel for thermal generating plants that supply critical electrical generation to California. Because these plants often set the price of electricity in California, increased fuel costs at these plants have a disproportionate effect on electricity prices throughout the state.[110]

California imports 85 percent of its natural gas. This gas enters California via one of four pipelines. One of the largest pipelines is owned by El Paso Natural Gas Company (EPNG), a subsidiary of El Paso Corporation. The El Paso pipeline and another owned by Transwestern carry gas from the Southwest to the Southern California border. The PG&E and Kern River pipelines bring Canadian and Rocky Mountain gas to California. Gas transported on PG&E and Kern pipelines is fully committed under long-term contracts to customers in Northern California. Further, the intrastate pipeline capacity between Northern and Southern California is severely limited, making the shipment of gas from north to south infeasible. Therefore, short term supplies of natural gas for Southern California can only be obtained on the EPNG and Transwestern pipelines.

A federal antitrust complaint filed by the Attorney General, multiple private class action lawsuits,[111] and a decision by FERC's chief administrative law judge in a case primarily prosecuted by the PUC and Southern California Edison,[112] suggested that agreements between entities within the El Paso corporate family caused gas deliveries to California to shrink during the critical winter months of 2000 - 2001.[113] Reductions in deliveries resulted in spectacular increases in gas prices, with the gas price at California's southern border reaching roughly five times the normal price.

The effect of diminished natural gas deliveries was exacerbated by the fact that very large underground gas storage facilities, managed by a Sempra subsidiary, were far less full than in previous

---

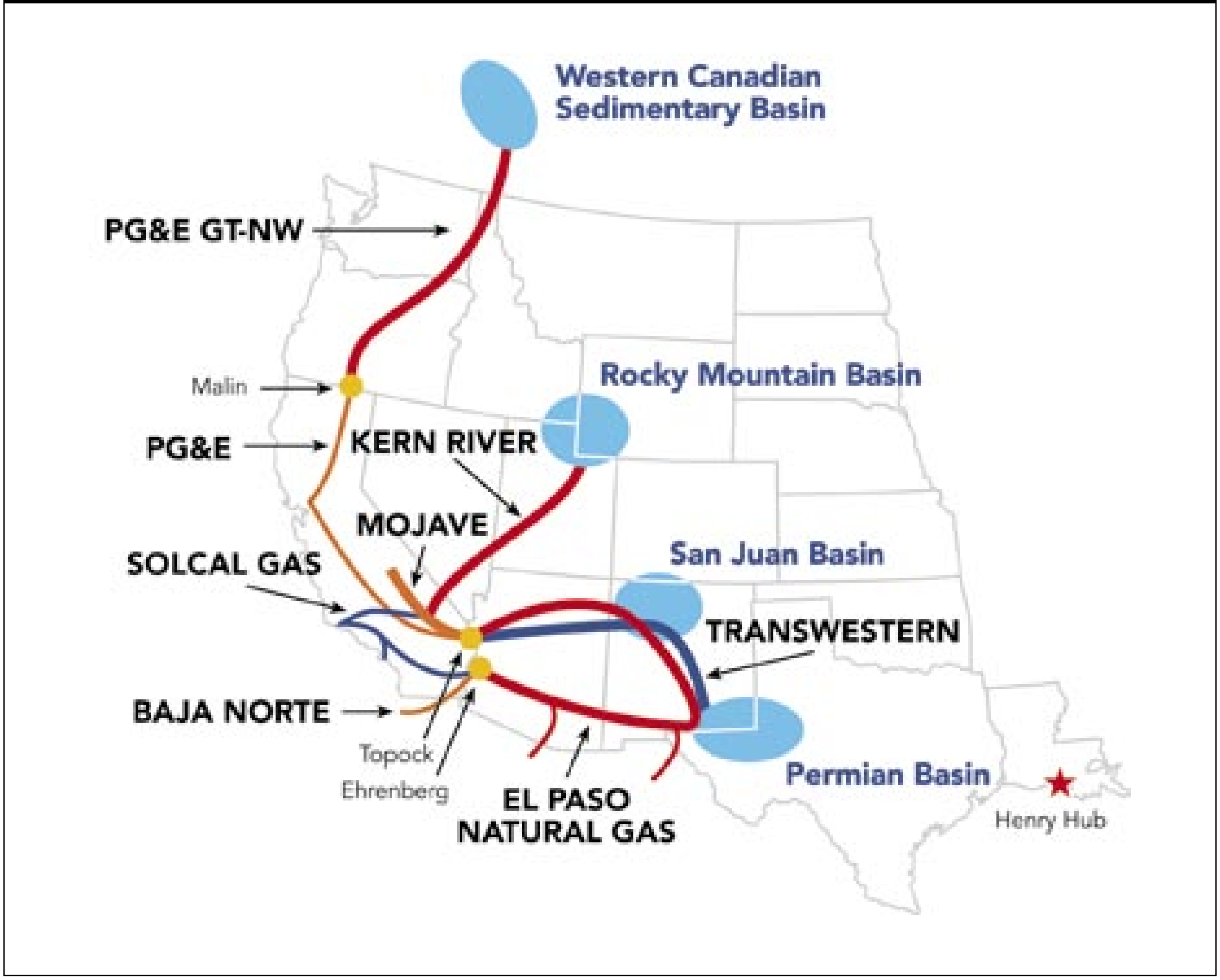
[110] Unlike much of the rest of the country, a majority of California's energy is generated from natural gas. This has significantly benefited California's air quality as compared to coal-fired plants.

[111] These actions were consolidated in San Diego County Superior Court under the caption *In re Coordinated Natural Gas Cases*, J.C.C.P. Nos. 4221, 4224, 4226 & 4228. Several complaints filed by southern California plaintiffs also allege that supply reductions were part of an antitrust conspiracy involving Sempra Corp., the holding company for Southern California Gas Co.

[112] *Public Utilities Commission of California v. El Paso Natural Gas, et al.*, 100 FERC ¶63, 041 (2002). See: http://ferris.ferc.gov/idmws/File_list.asp?document_id=4033592.

[113] Private plaintiffs have also alleged in class actions that prices were also affected by an alleged agreement between El Paso and Sempra, assertedly entered into or reaffirmed, at a meeting at a Phoenix hotel in 1996. Natural Gas Anti-Trust Cases, JCCP Case No. 4221-00000 (Super. Ct. San Diego County).

Interstate Pipeline and Supply Basins Serving California



winters. Unable to get sufficient gas from storage, and with capacity along the pipeline constrained, generators paid premium prices for gas increasing the prices consumers paid for electricity.

1. A Brief Description of the Natural Gas Industry and Legal Actions Against El Paso

The regulatory framework for the natural gas market is best understood with reference to three separate functions: (1) The production and gathering of natural gas in the field — the step at which the "wellhead price" is generally set; (2) the transmission of the gas by pipeline from the wellhead to local distribution companies or large end users; and (3) local distribution of gas to consumers.

The first of these functions, establishment of the wellhead price, was completely deregulated by the federal Natural Gas Wellhead Decontrol Act of 1989. The second function, transportation, is regulated by FERC and the reasonableness of the rates for interstate transportation falls within FERC's exclusive jurisdiction. The final function, local distribution, is not regulated by FERC, but by the PUC or public power agencies.

While FERC regulates interstate gas pipeline transportation, it does not regulate the marketing of natural gas. This incomplete regulation of the natural gas industry gives rise to the potential for a company such as El Paso to favor its own marketing subsidiaries in the allocation of transportation space on its pipelines. To avoid this potentially anti-competitive situation, FERC requires a natural gas corporation to operate its transportation affiliates at arm's length from its marketing affiliates.[114] However, El Paso failed to observe these affiliate rules, and FERC was slow to act in enforcing them, to the significant detriment of California consumers.

El Paso faced challenges to its practices in the California market on a number of fronts, including a proceeding before FERC brought by the PUC; several private class action lawsuits brought in various state courts; and intensive investigations by the Attorney General and other western states. The legal theories are varied, but the core claims are reflected in a lawsuit filed by the California Attorney General against El Paso on June 26, 2003.[115] They include:

- EPNG, El Paso's regulated subsidiary, withheld substantial amounts of transportation capacity under its physical control, in part by running its pipeline at less than its maximum approved operating pressure (MAOP) in violation of FERC rules;

- EPNG diverted substantial available pipeline capacity away from the southern California border in violation of contractual obligations, with the intent and effect of raising prices;

- El Paso Merchant Energy, El Paso's marketing arm, controlled and systematically restricted natural gas transportation capacity to the southern California border by refusing to "release" pipeline capacity for the use of other shippers seeking to move gas to the southern California border, even though it would have been profitable for El Paso Merchant Energy to do so.

- EPNG and El Paso Merchant Energy coordinated their activities under the auspices of senior El Paso management to widen the difference between the price of gas delivered at the border and the market price of gas in the producing basins (the base spread), resulting in higher prices than would have existed in a competitive situation in the absence of favoritism between two affiliated companies;

- In early 2000, El Paso purchased the All American Pipeline (now called "Line 2000"). Line 2000 was an oil pipeline providing service from Texas to Southern California, but was capable of conversion to natural gas transportation service and could compete against El Paso Natural Gas. El Paso delayed conversion of the pipeline effectively assuring that increased natural gas deliveries to the Southern California border would not occur.

By late November 2000, El Paso Merchant Energy's dominant position in the market for critical supplies of natural gas delivered at the southern California border permitted it to charge very high prices. These increases raised costs to gas-fired generators in the state and, therefore, increased the

---

114 Standards of Conduct, 18 C.F.R § 161.3.

115 *People v. El Paso Natural Gas Co.*, No. 03-4565 (C.D.Cal. filed June 26, 2003) (SVW).

price of electricity in California paid by the State of California and other consumers. The withholding of natural gas transportation capacity by El Paso Merchant Energy and EPNG also caused serious supply shortages in California electricity markets, contributing to rolling blackouts and interruptions in electricity service.

2. The El Paso Settlement

In June 2003, the Attorney General brokered an historic settlement involving multiple California parties, four states and El Paso. The settlement calls for El Paso to pay cash totaling approximately $1.69 billion. All proceeds from the settlement, other than fees, costs and money for other states, will be used for ratepayer relief, with at least $600 million paid up front with an additional $2 million from a pool for executive bonuses,[116] and another $900 million to be paid over 15 to 20 years. El Paso also agreed to extensive structural relief, ensuring that it cannot continue to manipulate natural gas supplies in California. The corporation will institute a unique antitrust compliance and training program, and will cooperate with ongoing Attorney General investigations.

Potential future problems with pipeline manipulations are addressed and foreclosed in a stipulated judgment that is part of this larger settlement. The stipulated judgment provides for the appointment of a special master to enforce El Paso's compliance with various continuing commitments to serve California's ongoing need for natural gas, which will help prevent a repeat of the 2000 - 2001 gas shortage.[117] Chief among these commitments is the requirement that El Paso make increased capacity available to its California delivery points. In addition, El Paso is obligated to construct improvements to its Line 2000 to increase its natural gas capacity, and no affiliate of EPNG is allowed to contract for new capacity on El Paso's pipeline. The Attorney General is authorized to bring action to enforce these provisions.

3. Gas Indexing Manipulation: Natural Gas Trading and the Price of Electricity

In addition to the manipulation of capacity on the El Paso pipeline, a number of energy companies also allegedly engaged in manipulation of the natural gas prices found in various natural gas price index publications.[118] These manipulations were directly related to electricity price increases in California resulting from the method used to set rates for electricity generated by gas powered plants.

---

116 El Paso executives received large bonuses as a result of high profits from California operations. The bonus pool payment reflects recovery of some of these bonuses.

117 *People v. El Paso Natural Gas Co.*, No. 03-4565 (C.D.Cal. filed June 26, 2003) (SVW).

118 The four major sources of information involved in setting the spot market prices at the critical California natural gas delivery points were Gas Daily, Inside FERC, Daily Gas Price Index, and Enron OnºLine ("EOL"). The first three sources are trade publications, which are independent from any of the energy companies and are not engaged in trading themselves. EOL, on the other hand, was a subsidiary of Enron and served as a web-based trading platform rather than a price reporting service. EOL quickly became a major source of market information for traders at different firms.

El Paso Settlement Consideration

I. Up-Front Consideration	
A. Cash – upon execution of the Escrow Agreement	$78,590,070
B. Cash – upon effective date of MSA	$2,000,000
C. Cash – 180 days after execution of MSA	$243,229,464
Total Up-Front Cash	**$323,819,534**
D. Stock – El Paso Corp.: 26,371,308 shares*	$227,584,388
Total Up-Front Consideration	**$551,403,922**
II. Deferred Consideration	
40 semiannual payments of $21,890,652 beginning July 1, 2004	**$875,626,072**
III. Contract Reduction	
Reduction in price of CDWR electricity purchases from EPME	**$125,000,000**
TOTAL CONSIDERATION	**$1,552,029,994**

** Stock value based on June 13, 2003 closing price of $8.63*

During the energy crisis, the ISO initially, and later FERC, imposed limits on what electricity generators could charge for wholesale electricity. FERC's soft cap, however, allowed suppliers to charge higher prices if the costs they incurred to generate electricity exceeded the price cap. Where the costs of generating electricity included the price of natural gas, FERC used a market-based rate formula for determining the cost of that natural gas rather than actual costs. This rate formula relied on published natural gas spot prices in California or at the California border. Energy firms with gas-powered generating facilities in California or on the California border had an incentive to increase the published price of natural gas over the actual price they paid.[119]

[119] This is not to suggest that all firms engaged in such manipulation. It is clear, however, that several firms did engage in manipulation and that all such firms had financial incentive to do so.

4. The Indexes and Methods of Manipulation

Generally speaking, the independent indices collect their gas price data in similar ways. The methods used generally involve telephone or fax communications with individual traders from different firms. In general, the indices all attempted to discover both price and volume of trades actually made and impressions of the prices available, even if the trader was not executing actual deals at those prices. Regardless of what data was requested, the information actually reported varied from trader to trader. Moreover, while the indices used some limited statistical analysis of the data collected, none of the data was verified or subject to external audit or evaluation.

In addition to the lack of verification by the independent published sources, a major problem affecting the accuracy of gas price indices was the role that Enron On-Line (EOL), an electronic trading platform, played as the source of available price information. Many traders who were surveyed for the independent indices, even when they did not intentionally misrepresent any information, based the prices they reported on the prices they saw on EOL. Without meaningful verification of the data, any errors or manipulation of the price data on EOL would be incorporated into the other indices.

There is strong evidence that the trading on EOL involved market manipulation, including "wash trades."[120] Such trades typically involve a sale of gas from a seller to a purchaser then a sale back to the same seller from the purchaser. Ultimately such transactions make the index report a much higher price, even though no actual commercial transactions take place.

Enron was in a unique position to manipulate the data on EOL. An Enron affiliate was always one of the parties to the transaction, and Enron affiliates were sometimes on both sides of a transaction. This involvement gave Enron an easy means to influence the prices posted on EOL and charged for actual trades. Investigation has shown that Enron was aware of both its ability to affect published price data (including the data published by the independent indices) and the financial incentives it had to drive up published prices. FERC should develop safeguards to prevent the manipulation of natural gas indices that are used as the basis for determining the price of electricity.

---

[120] FERC, Initial Report on Company-Specific Proceedings and Generic Reevaluations; Published Natural Gas Price Data; and Enron Trading Strategies, Docket No. PA02-2 (Aug. 1, 2002).

III. CONCLUSION AND RECOMMENDATIONS Ê

Although the state's long-term energy contracts now supply a significant portion of the state's energy needs, the real-time energy markets continue to operate, albeit on a smaller scale. The rules governing the markets have changed little. The incentives to game the market and create disruption appear, for the most, to remain in place. Market scrutiny has increased, but few additional resources have been allocated to this work. While the state has an important role in planning for energy needs, overseeing the ISO, and in promulgating retail rates, state authority is significantly constrained as a result of FERC's jurisdiction over wholesale electricity issues and prices. If wholesale markets become dysfunctional, the PUC and other state agencies have virtually no ability to control the markets; only FERC has the relevant and necessary authority. FERC has not substantially changed its market power review, nor its view that the filed rate doctrine precludes refunds. Experts continue to warn that the crisis may be repeated.

It remains essential that the incentives for market manipulation, gaming, and disruption be addressed. The recommendations that follow set forth a road map for ending some of the most significant incentives. The Attorney General is ready to work with FERC, Congress, the California Legislature, and others to consider the measures recommended here, and to take action quickly and decisively.

RECOMMENDATIONS:

The Federal Energy Regulatory Commission Ê

1. Amend the FPA and the NGA to ensure that in a market-based rate system, unjust and unreasonable rates are subject to refund, regardless of when a rate complaint is filed before FERC. Retroactive refunds could be limited to some period of time prior to the filing of a complaint at FERC.

2. Amend the FPA to prescribe that bilateral contracts entered into during a period of market dysfunction are subject to refund for that portion of the rate that exceeds a just and reasonable price.

3. Authorize FERC to issue administrative complaints for violations of the FPA, NGA, and related regulations. The penalties for proven violations must be large enough to create strong compliance incentives for regulated entities.

4. Provide sufficient funding to the FERC enforcement staff to investigate and prosecute wrongdoing.

5. Give states explicit authority to enforce compliance with the FPA and related regulations to ensure a FERC/state partnership in policing the operation of electricity and natural gas markets.

6. Establish at FERC written criteria for market monitoring, identification of gaming, and steps to be taken when markets fail to function properly.

7. Create a mechanism, similar to that in California Public Utilities Code section 1801, to encourage direct consumer participation in proceedings before FERC by entitling representatives who make a “substantial contribution” to the outcome of proceedings to recover their reasonable costs of participation.

8. Provide the ISO and other state agencies with enforcement authority so they are not entirely dependent upon FERC for market rule changes and administrative penalties.

9. Design refunds for power purchase overcharges to make all buyers who paid unjust and unreasonable rates during the entire energy crisis whole. Refunds need to encompass the market-wide impact of an individual wrongdoer’s actions and not be limited to just the profits gained by that individual.

10. Ensure that FERC orders refunds of overcharges paid by California’s Department of Water Resources after it was forced, during the spring of 2001, to become the electricity buyer of last resort and to enter into long-term contracts at a time when prices were artificially high due to market abuse.

Filed Rate Doctrine

11. Amend the FPA and the NGA to state specifically that the filed rate doctrine does not apply to market-based rates. This may be the most important action that can be taken to ensure fairness and deter future attempts to manipulate energy markets.

12. Amend the FPA and NGA to clarify that in a market-based rate system, there can be no ban on retroactive refunds.

13. Clarify the rate filing requirements under the FPA for market-based rate systems for market monitoring purposes. Revised requirements are absolutely essential if any aspect of the filed rate doctrine continues to be applied to a market-based system.

The Independent System Operator

14. If the ISO is to be relied on as an effective enforcer and market monitor, compliance and monitoring staff must be increased.

15. Create a specific and transparent market monitoring system, with specific and enforceable standards for addressing market anomalies and abuses of market power.

16. Ensure specific administrative enforcement authority. The ISO’s authority to investigate violations of the tariff, to assess penalties, and to refer cases to FERC needs to be clearly delineated.

17. Provide a specific procedure to refer the most serious matters for investigation and enforcement action, civil and criminal, to the California Attorney General. The Attorney General can then work with the ISO to ensure appropriate legal action.

State Regulators Ê

18. Further describe the EOB's oversight authority with respect to the ISO and the ISO markets by legislation or regulation. The EOB, if it is to be a viable entity, should be given sufficient resources to ensure meaningful oversight.

19. Currently, the PUC appears before FERC as a party with status similar to that of generators. The PUC can file complaints and seek redress as a party. In situations involving market dysfunction, the PUC (through federal legislation) should be given a status different from that of regulated entities to enable the PUC to work with FERC to re-establish market functionality.

20. For the most egregious violations, when discovered by the PUC, the EOB, or the ISO, provide for automatic referrals to the Attorney General for prosecution. Consider a uniform mandatory referral system for the most egregious violations. The PUC has substantial regulatory and administrative enforcement authority, which is sufficient for all but the most drastic situations, such as the energy crisis. Creating a specific referral process, whereby the PUC could request representation for specific enforcement action by the Attorney General, could benefit both the PUC and the Attorney General by linking the Attorney General's investigatory and enforcement litigation expertise with the PUC's expertise on issues concerning matters within its jurisdiction.

Enforcement of State Laws Ê

21. Amend the FPA and the NGA to clarify that a state may seek remedies under state antitrust, fraud, and unfair competition laws for conduct impacting prices of electricity and natural gas.

22. Amend State criminal law to parallel federal law by making it illegal to make material false statements to state investigators.[121] This would ensure greater cooperation and truthfulness from witnesses.

23. Make permanent the Attorney General's Energy unit to ensure sufficient resources to prosecute the most serious violations.

Promote Coordination of Federal and State Enforcement Efforts

24. Amend Federal law to allow grand jury material to be shared with state and federal criminal and civil investigators in order to promote cooperation and avoid overlapping investigations. These amendments could be modeled on similar provisions in the federal Financial Institutions Reform, Recovery, and Enforcement Act.[122]

---

[121] See 18 U.S.C. § 1001.
[122] See 18 U.S.C. § 3322.

25. Amend federal law to require FERC's full and complete cooperation with state and local investigations of fraud, antitrust violations, unfair competition and other misconduct in the energy markets.

26. Develop guidelines for all entities with enforcement authority, both at the state and federal level for information sharing and joint or cooperative investigation and enforcement.

27. Consider the creation of a multi-jurisdictional interagency energy task force. USDOJ, Attorney Generals, FERC, the Commodities Futures Trading Commission, the SEC, the state PUCs, the FBI, and other regional, state and local agencies have a strong interest in ongoing coordination of enforcement policies and actions.

Public Utilities Holding Company Act Ê

28. Eliminate the intrastate exemption from its oversight for the clearly interstate utility holding companies in California.

29. If Congress amends or rescinds PUHCA, retain the underlying concept of oversight and review of corporate activities and structure for entities that own and operate public utilities.

Federal Bankruptcy Laws Ê

30. Clarify bankruptcy law to ensure that a debtor's plan of reorganization does not automatically preempt state or federal laws, including public health and welfare and criminal laws.

31. Amend bankruptcy law to ensure that the filing by a state agency of a proof of claim does not waive the state's Eleventh Amendment sovereign immunity, thereby allowing federal court actions against the state. The filing of a proof of claim should be deemed consent only to the allowance or disallowance of the claim.

Natural Gas Ê

32. Amend the NGA to give the state concurrent jurisdiction with FERC to enforce the consumer protections built into the Act. This concurrent enforcement authority is essential because FERC primarily focuses on the smooth operation of the national markets, not necessarily on the particular impacts of the national markets on the State of California.

33. Establish safeguards at FERC to prevent manipulation of the natural gas indices that are used as the basis for determining the price of electricity and the local distribution company's cost incentive mechanism.

IV. GLOSSARY Ê

ANCILLARY SERVICES:
Various types of generating capacity that are held in reserve for use in a contingency situation, such as the loss of a critical generation or transmission facility (e.g., replacement reserves). The ISO procures these services from generators through various auction markets, and the costs are passed on to "load-serving entities," i.e., utilities that use the transmission system to serve retail customers. The generators are paid by the megawatt to reserve a certain amount of capacity. If the ISO calls on a generator to produce energy out of its capacity, the generator is also paid for the energy at the market clearing price for imbalance energy. These services are differentiated based on the amount of time it takes to deliver energy to the grid when called on by the ISO.

ANCILLARY SERVICES MARKETS:
Auction markets through which the ISO procures Ancillary services. Generators submit bids offering to sell various types of capacity at specified quantity prices. The ISO selects all the bids it needs to meet its reserve requirements, and all successful bidders are paid the market clearing price for their capacity.

AUCTION MARKETS:
The California ISO operates various centralized, bid-based auction markets to procure generating capacity and electricity needed to safely operate the high voltage transmission grid serving California. Suppliers submit bids offering to sell energy and capacity at specified prices and quantities, and the ISO selects all of the bids it needs to operate the system based on demand forecasts and "real-time" system conditions. Prior to terminating all trading in 2001, the California Power Exchange administered "day ahead" and "day of" auction markets in which most of the power needed to serve demand throughout the state was bought and sold. The ISO and PX are clearinghouses; they have no financial interest in the markets they administer. Buyers and Sellers settle their accounts through processes administered by the ISO and California Power Exchange.

BILATERAL CONTRACT:
A two-party agreement for the purchase and sale of energy products and services. These transactions are made outside of the centralized auction markets administered by the California ISO and, prior to its demise, the California Power Exchange.

BLOCK FORWARD ELECTRICITY MARKETS:
Auction markets operated by the California Power Exchange in which various mid- to long-term contracts for the purchase and sale of wholesale power were bought and sold.

CALIFORNIA INDEPENDENT SYSTEM OPERATOR:
A public benefit corporation created by AB 1890, the deregulation legislation. The California ISO, regulated by FERC, operates California's electricity transmission grid. Its responsibilities include

providing non-discriminatory access to the grid, managing congestion, maintaining the reliability and security of the grid, operating the ancillary services and imbalance energy markets, and providing billing and settlement services. The ISO has no affiliation with any market participant.

CALIFORNIA POWER AUTHORITY:
The California Consumer Power and Conservation Financing Authority, created by Senate Bill 6 in 2001, is charged with ensuring reasonably priced, long-term availability of reliable supplies of electricity and natural gas, promoting environmentally friendly supply and demand solutions, and achieving adequate capacity reserves by 2006.

CALIFORNIA POWER EXCHANGE:
An independent, non-profit corporation created by AB 1890, the deregulation legislation. The California Power Exchange was responsible for conducting centralized auction markets in which most of the power needed to serve customers in California was bought and sold. The Power Exchange filed for bankruptcy in December 2001 and is no longer operating.

CALIFORNIA PUBLIC UTILITIES COMMISSION:
A state agency created by constitutional amendment in 1911 to regulate the rates and services of more than 1,500 privately owned gas, electric, telephone, and water utilities, and 20,000 transportation companies. The Commission oversees rates charged by the major investor-owned utilities in California: Pacific Gas & Electric Co., Southern California Edison Co., and San Diego Gas & Electric Co.

COGENERATION:
Co-generation is the generation of power typically from waste heat generated by industrial processes. The generation is in conjunction with production of other products.

CONGESTION:
A condition that occurs on the high voltage transmission system when insufficient transfer capacity is available to implement all of the preferred schedules for electricity transmission simultaneously.

COST BASED RATES:
Rates for utility service that are set at a level designed to permit the recovery only of production costs plus a reasonable return on invested capital, as determined by a regulatory agency. Until the advent of "market-based rates" in the late 1980s, FERC relied primarily on cost-based ratemaking principles to ensure that utilities charged "just and reasonable" rates for wholesale power.

DAY AHEAD MARKET:
An auction market operated by the California Power Exchange in which a market price was calculated individually for each hour of the following day on the basis of participant bids for energy sales and purchases. All sellers collected, and all buyers made, the same price, known as the "market clearing price."

DOCKET:
A formal record of a Federal Energy Regulatory Commission proceeding. These records are available

for inspection and copying by the public. Each case proceeding is identified by an assigned number.

DOUBLE SELLING:
A gaming strategy whereby a wholesale power company would commit reserves, known as "Ancillary Services," to the ISO, and then produce energy out of that capacity without being called to do so by the ISO. Through this strategy, generators received payment for capacity they never kept in reserves as promised. In addition, they received payment for energy that, legally, should have been kept in reserve and was not theirs to sell.

ELECTRICITY OVERSIGHT BOARD:
A state agency charged with overseeing the operations of the California ISO and the California Power Exchange.

END USER:
A firm or individual that purchases electricity products for its own consumption and not for resale. Typically refers to retail customers.

ENRON ONLINE:
Enron's former electronic trading platform, used for trading of physical and derivative products, including natural gas and electricity.

EOB:
The Electricity Oversight Board.

EOL:
Enron Online.

FEDERAL POWER ACT:
Enacted in 1920, and amended in 1935, the Act consists of three parts. The first part incorporated the Federal Water Power Act administered by the former Federal Power Commission, whose activities were confined almost entirely to licensing non-Federal hydroelectric projects. Parts two and three extended the Act's jurisdiction to include regulating the interstate transmission and sale of wholesale electricity in interstate commerce. The Federal Energy Regulatory Commission (FERC), successor to the Federal Power Commission, is now charged with the administration of this law.

FERC:
The Federal Energy Regulatory Commission. A regulatory commission within the United States Department of Energy that has jurisdiction over energy producers that sell or transport wholesale power for resale in interstate commerce. FERC regulates oil and gas pipeline transportation rates, determines the value of oil and gas pipelines for ratemaking purposes, and has authority to regulate wholesale electric rates and hydroelectric plant licenses.

FILED RATE DOCTRINE:
The "filed rate doctrine" is based on the legal requirement that utilities file all of their rates with FERC in legal documents called tariffs or "rate schedules." Once a rate has been accepted for filing,

the “filed rate doctrine,” a principle of regulatory law, provides that a utility must adhere to those rates unless and until a new rate is established through the agency’s official rate changing procedures. The “filed rate doctrine” further provides that rates cannot be changed retroactively, either by FERC or the courts. Courts have invoked the “filed rate doctrine” to prevent consumers from suing utilities for damages on the grounds that a “filed rate” was fraudulent or the product of a price fixing conspiracy.

FPA:
The Federal Power Act.

GENERATING ASSETS:
Any combination of physically connected generators, reactors, and auxiliary equipment for converting mechanical, chemical, or nuclear energy into electric energy.

GENERATOR:
An entity that owns and operates generating plants.

GRID:
The layout of an electrical transmission and distribution system.

HOCKEY STICK BIDDING:
A gaming strategy involving the submission of bids to supply power that vary with unit output in a way that is unrelated to the known performance and/or cost characteristics of the unit(s). Occurs when a seller bids the last megawatts from its unit at an extremely high price relative to the price offered on the unit’s remaining capacity. Can also occur where a single unit in a portfolio is bid in an excessively high level compared to the remainder of the seller’s portfolio, without any apparent performance or input cost basis. The strategy provides an occasional low risk opportunity for bidders to realize huge profits.

HOLDING COMPANY:
A company that confines its activities to owing stock in and supervising management of other companies. The Securities and Exchange Commission, as administrator of the Public Utility Holding Company Act of 1935, defines a holding company as “a company which directly or indirectly owns, controls or holds 10 percent or more of the outstanding voting securities of a holding company” (15 USC 79b, par. a(7)).

HOUR-AHEAD MARKET:
An auction market operated by the California ISO in which sellers submit bids to supply electricity or capacity one hour ahead of “real-time,” i.e., the time at which electricity is produced and consumed.

ICC:
Interstate Commerce Commission

IMBALANCE ENERGY MARKET:
An auction market operated by the California ISO for the procurement of electricity needed to ensure that supply matches demand at the time power is delivered to the grid.

INTERVENOR:
An intervenor formally participates in a FERC proceeding by filing a request to intervene. Intervenors are able to file briefs, appear at hearings, and be heard by the courts if they choose to appeal a final ruling.

INVESTOR OWNED UTILITY:
A company, owned by stockholders for profit, that provides utility services. The term is used to distinguish utilities owned and operated for the benefit of shareholders from municipally owned utilities and rural electric cooperatives. In California, the three major IOUs are Pacific Gas & Electric Company, Southern California Edison Company, and San Diego Gas & Electric Company.

IOU:
Investor Owned Utility

ISO:
Independent System Operator

LOAD:
The amount of electric power delivered or required at any specific point or points on a system. The requirement originates at the energy-consuming equipment of the consumers.

MARKET-BASED RATE:
The rate determined by agreement or negotiation between buyers and sellers through market transactions. Traditionally, FERC required advance review and approval of utility rates in order to protect consumers. FERC generally required utilities to cost-justify their rates to ensure that rates were "just and reasonable," as required by the Federal Power Act. With the advent of "market-based rates," FERC began authorizing sellers to establish rates based solely on prevailing market conditions, and without prior review and approval.

MARKET CLEARING PRICE:
In the centralized auction markets operated by the ISO and the Power Exchange, all sellers collect, and all buyers pay, a single price for energy and capacity. The bid submitted by the last generating unit needed to meet demand sets the "market clearing price." All demand at or above the market clearing price is satisfied, and all supply at or below this price is purchased.

MARKETER:
An entity engaged in purchasing and selling wholesale power that owns no electricity generation or transmission facilities. FERC allows power marketers to transact at "market-based rates" if they have no market power in generation or have adequately mitigated such market power.

MARKET POWER:
The ability to exercise unilateral control over price or supply.

MARKET-BASED TARIFFS:
Tariffs or "rate schedules" are legal documents that specify the rates a utility must charge for energy

products and services. Traditionally, FERC required utilities to list their rates in tariffs, and to file their rates before they took legal effect so the agency could ensure the rates were "just and reasonable." "Market-based tariffs" contain no prices, they state only that rates will be determined "by agreement" between buyer and seller. The rates charged pursuant to "market-based tariffs" receive no advance review and approval by FERC.

MEGAWATT:
One million watts of electricity

MEGAWATT HOUR:
One million watts used for one hour, or the amount of electricity needed to light 10,000 100-watt light bulbs for a one-hour period.

MERCHANT GENERATORS:
Power plant owners that have no franchised service territories, no "native load," and no legal obligation to serve retail customers.

MUNICIPAL UTILTIY:
A provider of utility services owned and operated by a municipal government entity.

MW:
Megawatt

MWh:
The amount of electricity needed to generate one megawatt of electricity for hone hour.

NATURAL GAS ACT:
15 U.S.C. sec. 717 et seq. This law governs transport and sale of natural gas in interstate commerce.

NET SHORT:
The demand for power by load serving entities that remains to be satisfied after accounting for the output produced by resources owned or controlled by the load serving entities. During the energy crisis, the California Department of Water Resources purchased energy to meet the 'net short' requirements of PG&E and Southern California Edison, neither of which was creditworthy at the time.

NGA:
Natural Gas Act

NOMINATE:
To offer an amount of natural gas for delivery within a certain time period.

NON-CORE CUSTOMER:
The natural gas market is separated into core and non-core customer segments depending on the customer's load, end-use priority and economic ability to use alternative fuels. Core customers in-

clude all residential customers, regardless of load size, and commercial customers with annual natural gas usage levels below 250,000 therms. Non-core customers include all cogeneration, regardless of load size, and those commercial customers with annual loads above 250,000 therms.

PRICE INDEX:
An index, or average, which may be weighted, of selected prices, intended to be representative of the markets in general or a specific subset of prices.

PUBLIC UTILITY HOLDING COMPANY ACT:
This act limits the acquisition of any wholesale or retail electric business by a holding company unless the business forms part of an integrated public utility system when combined with the utility's other electrical business. The legislation also restricts ownership of an electric business by non-utility corporations.

PUC:
California Public Utilities Commission

PUHCA:
Public Utility Holding Company Act

PX:
California Power Exchange

QF:
Qualifying Facility

QUALIFYING FACILITY:
Qualifying facilities are either renewable power production or cogeneration facilities that qualify under federal law to sell their electric output to a local utility at "avoided cost rates," or the cost the utility would incur to purchase the power from traditional sources.

RELIABILITY:
Electric system reliability has two components – adequacy and security. Adequacy is the ability of the electric system to supply the aggregate electrical energy requirements of the customers at all times, taking into account scheduled and unscheduled outages of system facilities. Security is the ability of the electric system to withstand sudden disturbances such as electric short circuits or unanticipated losses of power.

RENEWABLES:
Naturally replenishing energy resources that are virtually inexhaustible in duration but limited in the amount of energy that is available per unit of time. Renewable energy resources include: biomass, hydro, geothermal, solar, wind, ocean thermal, wave action, and tidal action.

ROUND-TRIP TRADES:
Also known as "wash trades." Pre-arranged, offsetting trades of the same good (electricity or gas)

between the same parties that involve no economic risk and no net change in beneficial ownership. Such trades expose the parties to no economic risk and serve no legitimate purpose but are a manipulative device designed to artificially inflate a company's trading volumes and revenues, and/or to distort various indicators of market performance, such as price.

SCHEDULE:
Statements submitted by market participants to the California ISO which indicate: 1) the amount of power they expect their customers to consume at a given time; and 2) attendant sources of supply.

SEC:
Securities and Exchange Commission

SECURITIES AND EXCHANGE COMMISSION:
The federal agency that administers federal securities laws and regulates firms that buy and sell securities.

SHORT-TERM MARKETS:
Refers to spot, hour-ahead, and day-ahead markets collectively.

SPOT MARKETS:
Also known as "real time" markets, these are competitive energy markets controlled and coordinated by the ISO for arranging real time changes in generation output or demand necessary to maintain grid reliability.

STANDARD MARKET DESIGN:
A proposal by the Federal Energy Regulatory Commission to standardize the means by which wholesale power is bought, sold and transmitted throughout the country. Standard market design is based on several key elements, including: 1) the creation of Independent Grid Operators, known as Regional Transmission Operators or "RTOs," which will be made responsible for managing and ensuring non-discriminatory access to the high voltage transmission system within their respective geographical areas; 2) use of long-term contracting as the wholesale power industry's primary mode of buying and selling energy; 3) reliance on short-term energy and capacity markets administered by RTOs to ensure safe and reliable grid operations; and 4) adoption of resource adequacy requirements to ensure that "load serving entities," i.e., utilities that use the grid to serve customers, have sufficient generating capacity to meet peak demand.

STRANDED COSTS:
Investments in power generating facilities and contractual power purchasing obligations that were incurred by utilities prior to industry restructuring and which may not be recoverable in a competitive market.

SUNK COST:
Economic term for a cost that has already been incurred and cannot be avoided.

TARIFF:
A legal document filed with the appropriate regulatory authority specifying the rates, charges, rules, and conditions under which a utility must provide services to customers.

UTILITY RETAINED GENERATION:
Power plants retained by the major investor-owned utilities after the passage of AB 1890, primarily hydro and nuclear plants.

WHOLESALE POWER MARKET:
The purchase and sale of electricity for resale.

V. APPENDIX Ê

A Survey of Major Energy Crisis-Related Litigation

I. APPELLATE LITIGATION

UNITED STATES SUPREME COURT CASES

New York Public Services Commission v. FERC (Enron v. FERC) (Court Nos. 00-0568/00-0809) This case addressed the question of whether FERC's jurisdiction preempts state jurisdiction over intrastate retail transmission of electric energy. The Attorney General and the California Public Utilities Commission jointly filed an amicus curiae on behalf of State Of California, in support of multiple state utility commissions' challenge of FERC's assertion of jurisdiction under the Federal Power Act. The Supreme Court determined that FERC retained authority.

CALIFORNIA SUPREME COURT Ê

Southern California Edison Company v. Lynch (CA Supreme Court). Southern California Edison (SCE) sought a federal court order requiring the CPUC to raise retail utility rates by several billion dollars. The CPUC and SCE reached a settlement, which the district court approved. After an appeal by a consumer group, the Ninth Circuit requested that the CA Supreme Court clarify three issues: (1) whether, in light of the retail rate freeze, the CPUC had authority to enter into the settlement with SCE; (2) whether CPUC violated state Open Meeting laws by approving the settlement in closed session; (3) whether the $3.3 billion settlement violated the Public Utilities Code by altering utility rates without a public hearing or issuance of findings. The California Supreme Court upheld the settlement in all respects.

CIRCUIT COURTS OF APPEALS Ê

People of the State of California v. FERC (9th Cir. Court of Appeals). These appeals arise out of orders issued by FERC in the refund proceeding. Major pieces such as denial of refunds for CERS purchases, failure to put price caps into effect sooner, and issues surrounding the components of the refund methodology implemented by FERC are the subject of these consolidated appeals. The 9th Circuit retained jurisdiction over the appeals while the 100 day evidentiary proceeding is ongoing.

State of California ex rel. Bill Lockyer v. FERC (9th Circuit Court of Appeals 02-73093). In May 2002, the Attorney General filed a complaint at FERC alleging that all generators and marketers participating in California wholesale power markets had failed to file their rates with FERC in the manner required by Section 205(c) of the Federal Power Act. At stake is roughly $4 billion in additional refunds which, to date, FERC has held cannot be refunded. In its order, FERC agreed with the Attorney General that market participants failed to file transaction-specific information about their sales of energy in California during the energy crisis. Nonetheless, FERC held that the bar on retroactive refunds still applies because, even though FERC had no opportunity to review the rates for reasonableness, FERC made an advance determination that the sellers lacked market power, a finding that constitutes a filed rate. Appeal is pending in the 9th Circuit.

In re PG&E (9th Circuit Court of Appeals) - Appeal related to PG&E Bankruptcy. Judge Vaughn Walker reversed the bankruptcy court and agreed with debtor PG&E that § 1123(a) of the Bankruptcy Code "substantively empowers debtors to engage in certain transactions unfettered by otherwise applicable nonbankruptcy laws, including all the means by which the plan may be implemented specified in § 1123(a)(5). In short, § 1123(a)(5) preempts all nonbankruptcy laws 'that are obstacles to the transactions and steps necessary to effect a reorganization plan.'" The 9th Circuit reversed, finding that the provision is not an express preemption of state law.

People ex rel. Lockyer v. Dynegy et al. "Double Selling Cases" and "Failure to File/Overcharge Cases" (9th Circuit Court of Appeals). Appeal challenging federal district court's denial of Attorney General's motion to transfer to state court three cases related to the "Double Selling" of emergency generating capacity to Cal ISO and ten cases related to the failure to file rates and overcharges for power. The Attorney General appealed the ruling and the case is pending in the 9th Circuit.

Burton, Hertzberg, & City of Oakland v. FERC (9th Cir.)
On 6/15/01the AG and Gov. Davis filed an amicus curiae brief in support of Petitioners' request for rehearing en banc of their petition for writ of mandamus. In the underlying petition, Burton, Hertzberg and the City of Oakland sought a writ of mandamus from the court compelling FERC to immediately act to ensure "just and reasonable" rates for energy in California - and all western states - as mandated by 16 U.S.C. §§ 824d(a) & 824e. The 9th Circuit denied the petition for writ of mandamus.

Western Power Trading Forum v. FERC (DC Circuit)
Challenge to prior state law relating to composition of ISO. AG filed an amicus motion on 1/25/01 relating to recent state legislation (AB 5X) rendering present appeal moot and, in the event the question is not moot, seeking leave to submit argument on the preemption issue.

CALIFORNIA COURTS OF APPEAL

Carboneau v. State of CA (Court of Appeal, Third Dist.). This case challenges the validity of DWR's long-term energy contracts. The Attorney General successfully demurred to the complaint and filed a respondent's brief in the appeal. The Court issued an unpublished ruling upholding the trial court's decision to dismiss the state defendants.

PG&E v. DWR I (Court of Appeal, Third Dist.). This case challenges DWR's power purchase program. PG&E seeks to disallow $5 billion from DWR's revenue requirement. The trial court held that DWR must comply with the Administrative Procedure Act in determining its revenue requirement, and DWR appealed the ruling. The Court of Appeal reversed in part and affirmed in part the trial court's ruling. In a published decision, the Court of Appeal concluded that DWR must determine that its revenue requirement is just and reasonable, but that DWR does not have to conduct a hearing or comply with Administrative Procedure Act in doing so. In a separate, unpublished decision, the Court of Appeal reversed the trial court's award of attorneys' fees to PG&E, concluding that PG&E had a financial interest in the case that defeated its claim for fees.

PG&E Co. v. State of California (Court of Appeal, Third Dist.). PG&E sued the State for breach of contract, alleging that AB 1890 established a "regulatory contract" between the State and PG&E under which the State promised to withdraw any PUC control over PG&E's retained generation by the end of 2001. PG&E alleged that, by enacting AB6X in 2001, reasserting PUC control, the State breached AB 1890's "regulatory contract" and deprived PG&E of profits in excess of $4.1 billion. PG&E characterized this lawsuit as an alternative plea to its federal court action against the CPUC. The AGO's demurrer to PG&E's complaint was sustained without leave to amend on 1-9-03. PG&E appealed.

Sempra v. Department of Water Resources (Court of Appeal, Fourth Dist.) In an action related to DWR's $6.6 billion long-term energy contract with Sempra Energy Resources (SER), DWR filed a cross-complaint against SER on 7-2-02 for fraud, negligent misrepresentation, breach of contract, declaratory and injunctive relief in San Diego Superior Court. The court granted Sempra's motion for summary judgment both as to Sempra's complaint for a declaratory judgment that it is not in breach of the agreement, and as to DWR's cross-complaint. DWR has appealed the ruling.

II. TRIAL COURT LITIGATION Ê

FEDERAL DISTRICT COURT Ê

ISO v. Reliant (U.S.D.C. - Eastern District, Case No. CV-S-010238 FCD/JFM). Action filed on 2/6/01, and joined by AG on behalf of the Electricity Oversight Board (EOB), which oversees ISO. Purpose of suit was to compel power generators to perform under the ISO tariff and deliver energy, regardless of creditworthiness of the scheduling coordinator (i.e., utilities), when the ISO issues emergency dispatch orders because of critical energy shortages. Judge Damrell granted ISO's Preliminary Injunction against Reliant, ordering it to continue to answer emergency dispatch orders. The Court denied Reliant's motion to dismiss, finding that recent FERC orders did not impact the Court's authority to enforce a Tariff as sought by ISO and EOB. DWR's motion to dismiss Reliant's Third Party Complaint was granted, thereby exempting state funds from paying for all energy sold by the generators in California. Reliant appealed. The 9th Circuit granted a stay, finding that FERC had exclusive jurisdiction over the matter, precluding the District Court from having entered the preliminary injunction. On 4/25/01, the 9th Circuit Court of Appeals granted the jointly filed motion to dismiss the appeal.

People ex rel. Bill Lockyer v. El Paso Natural Gas Co. (U.S.D.C., Central District of California). The Attorney General is lead Plaintiff in a federal action to enforce the affirmative relief obtained in the El Paso settlement. Related actions by PG&E and SCE have been consolidated a consent decree has been negotiated with defendants.

Federal Energy Regulatory Commission v. California Independent System Operator Corp (U.S.D.C., District Court of Columbia). FERC filed suit against ISO claiming that California legislation establishing a non-generator board is illegal and preempted under the Federal Power Act. The District Court dismissed the action on jurisdictional and venue grounds, finding that the District of Columbia was the wrong court to hear the dispute.

People ex rel. Bill Lockyer v. BP Energy Co., Idaho Power Co., Merrill Lynch, Portland General Electric Co., Puget Sound, Transalta Energy, Transcanada Power LP, Transcanada Power Services, LP, Tuscon Electric Power ("failure to file/overcharge") (U.S.D.C. Northern District). On 5-30-02, the AGO filed suit against these power firms under B&P Code §17200 for failure to file market rate reports with FERC and the practice of overcharging rates at prices above those described as fair market prices by FERC from early 2000 through 2001. These cases were dismissed by Judge Walker. The matters are now on appeal to the 9th Circuit.

People ex. rel. Lockyer v. Reliant, Coral Power, Mirant California, Mirant Delta, Mirant Portrero ("Overcharging Cases") (U.S.D.C., Northern District of CA). On 4-9-02, the AGO filed complaints under Bus. & Prof. Code § 17200 for failure to file market rate reports with FERC and the practice of overcharging rates at prices above those described as fair market prices by FERC from early 2000 through 2001. Judge Walker dismissed these cases on the merits. Appeal is pending before the Ninth Circuit.

PG&E Co. v. Lynch (U.S.D.C., Northern District of CA). In this complaint, filed 11-00, PG&E Co. sought a federal court order to lift the freeze on the rates PG&E can charge its customers, and to instead mandate a pass-through of PG&E's wholesale electricity costs. In light of the proposed settlement between PG&E and the PUC, PG&E sought and obtained a stay of this appeal.

Lockyer v. Mirant and Reliant (U.S.D.C., Northern District CA). The Attorney General filed two actions in U.S. District Court alleging antitrust violations of § 7 of the federal Clayton Act, as well as unfair business practices under state law. The AGO contends that when electricity generation in the State moved from a regulated monopoly to "competition," energy companies that purchased blocks of generating capacity obtained market power in violation of the specific prohibitions of § 7. The court denied defendants' motion to dismiss the Attorney General's Section 7 claims seeking divestiture of power plants, although the court also held that the Attorney General could not seek monetary relief under the "filed rate doctrine." Trial will likely occur in late 2004 or early 2005.

People ex rel. Lockyer v. Dynegy; Reliant; Mirant (U.S.D.C., Northern District CA). ("Double Selling"). On 3-11-02 the AG filed four separate complaints under Bus. & Prof. Code § 17200 against major wholesale power companies, alleging that the companies sold emergency generating capacity to the CAISO, and then sold energy out of that capacity into the lucrative spot market for wholesale electricity. Judge Walker denied the Attorney General's claims as preempted. The case is on appeal to the 9th Circuit.

State of Ca ex rel. Bill Lockyer v. FERC (U.S.D.C., Northern District CA). On 1-25-02, the AG filed a complaint for injunctive relief against FERC under the Fed. Freedom of Information Act. The lawsuit alleged that FERC violated the Act by failing over seven months to respond to the AG's request for documents and information pertaining to FERC's order to show cause why AES Southland and Williams Energy Marketing and Trading Co. should not be found in violation of the Federal Power Act. Judge Henderson granted the Attorney General's motion for summary judgment. FERC has released all materials subject to the order.

People ex rel. Lockyer v. PG&E Corp. (U.S.D.C. Northern District). This is an appeal from the bankruptcy court's order remanding the Attorney General's § 17200 action for unfair business practices against PG&E Corporation and various individual officers and directors of the Corporation.

Pacific Gas & Electric Company v. Lynch (Northern District Cal.) In action against the PUC, PG&E sought a federal court order to lift the freeze on the rates PG&E can charge its customers, and to instead mandate a pass-through of PG&E's wholesale electricity costs.

Southern California Edison Company v. Lynch (Central District Cal.) This action tracks the PG&E v. Lynch complaint summarized above. This action was dismissed pursuant to the agreement reached between the State and SCE.

Duke Energy Trading and Marketing v. Governor Davis and CA Power Exchange (Central District Cal.) Complaint filed on 2/8/01 against the Governor and California Power Exchange (PX) seeking declaratory and injunctive relief on grounds that Governor's commandeering of contracts held by the utilities for future delivery of electricity ("block forward market contracts") violated the federal Supremacy Clause, the Federal Power Act, and the constitutional bar against impairment of contractual obligations. The District Court dismissed, but the 9th Circuit found that the Governor acted outside of his authority.

Duke Energy Trading and Marketing v. CA ISO and Director of DWR (Central District Cal.) Complaint sought declaratory and injunctive relief based on alleged violations of the ISO tariffs compelling Duke to continue to deliver power through the ISO to the utilities regardless of their creditworthiness and likely future payment. Duke alleged that because of the alleged violation by ISO/DWR of the tariff, Duke's property has been taken in violation of the Takings and Due Process Clauses of the 5th and 14th Amendments to the U.S. Constitution.

The Regents of the University of California and the Board of Trustees of the California State University v. Enron Energy Services, Inc. (Northern District Cal.) Action filed on by UC/CSU against Enron for breach of direct access contracts to provide universities with electric power, causing service default to utilities, with ultimate cost for electric power borne by DWR. UC/CSU seeking injunctive relief and specific performance. AG filed amicus curiae memorandum on 3/29 alerting the court that cost of Enron's breach of contract to be paid by state treasury. While the parties were briefing the merits of the appeal, they reached an agreement under which Enron returned the Universities to direct access status.

Qualifying Facilities Cases (U.S.D.C., Los Angeles, and various County Superior Courts). Cases in which qualifying facilities ("QF's") seek order permitting them to suspend or terminate their contracts with Edison because Edison did not pay on the contracts for a period of 4 to 5 months between 11/00 and 3/01.

UNITED STATES BANKRUPTCY COURTS Ê

Enron Bankruptcy Claims (U.S. Bankruptcy Court, S.D., N.Y.). On 10-10-02, the AG, on behalf of the People of the State of CA, filed proofs of claim against Enron and eight subsidiaries in the Enron bankruptcy cases for damages for energy market overcharges and manipulation and concurrently filed claims on behalf of the CA Energy Commission and DWR.

Pacific Gas and Electric Company (U.S. Bankruptcy Ct., N. District of California, SF Div.) Pacific Gas & Electric Company (PG&E), one of California's largest investor owned utilities, filed a Chapter 11 voluntary bankruptcy petition in April 2001. PG&E's reorganization plan, based on a settlement with the PUC, has been approved, but some parties have appealed.

CA Power Exchange Corp. (U.S. Bankruptcy Ct., Central District of California). Reorganization and confirmation of a plan for the California Power Exchange Corp. and the distribution of its bankruptcy estate. The plan has been confirmed by the Bankruptcy court. When final FERC approvals for the allocation of the Participants Committee's expenses are obtained, the CalPX plan will become effective and the transition to its new management and governance will commence.

Mirant Bankruptcy Claims (U.S. Bankruptcy Ct., Houston, TX) The AG has filed claims on behalf of state agencies as well as the People arising from the energy crisis.

NRG Bankruptcy Claims (U.S. Bankrutpcy Ct., NY, NY) The AG filed claims on behalf of the People arising from the energy crisis and reached agreement for a billion dollar carve out allowing the AG to seek redress against NRG in litigation outside of the bankruptcy forum.

CALIFORNIA SUPERIOR COURT CASES Ê

Millar v. Allegheny, et al. (San Francisco Superior Court). This is a class action case against the parties to the long term energy contracts signed by DWR, alleging that those contracts were the product of a manipulated market. The complaint seeks disgorgement and restitution from the sellers.

McClintock v. Electric Power Group & DWR (Los Angeles County Superior Court). The US Justice Foundation representing Tom McClintock and other plaintiffs filed this suit seeking declaratory and injunctive relief alleging that the long-term energy contracts and DWR's administrative contracts are void and unenforceable. The plaintiffs dismissed their suit following the ruling by the Third District Court of Appeal in *Carboneau v. State* dismissing the state defendants.

Lockyer v. PG&E Corp. (San Francisco County Superior Court). On 01-10-02 the AGO filed a civil action against PG&E Corp., the parent holding company of PG&E Co. (the utility) for unfair business practices under B&P Code § 17200. The complaint seeks injunctive relief, $500 million in monetary penalties and the return of the utility assets collected by PG&E Corp. PG&E Corp. and its board of directors removed the action to federal bankruptcy court. On July 23, 2002, Judge Montali remanded the state court action (as modified by an amended complaint) to state court. PG&E Corp. and its directors have appealed the order on remand.

Reliant Energy, et al. v. Lockyer (Los Angeles County Superior Court). In May, Reliant, Dynegy and Mirant agreed to turn over the subpoenaed documents to the AGO. In return, the AGO agreed not to share them, pending court review of the companies' confidentiality claim. On 7-9-01, Judge Wu agreed to modify the protective order to allow sharing with Washington and Oregon. Reliant and

Mirant took the issue to the Court of Appeal and lost, and the CA Supreme Court denied Reliant's petition for writ review. Dynegy dropped out of this litigation and agreed to cooperate with the AGO on document production.

Lockyer v. Enron Energy Services, Inc., & Enron Corp. (San Francisco Superior Court). In July 2001, the AGO filed suit to compel compliance with our investigative subpoenas issued to Enron Corp. and Enron Energy Services, Inc. On 8-27-01, Judge Robertson ordered that Enron and EES produce documents, including documents outside of CA, pursuant to the subpoenas.

Lockyer v. Reliant (San Francisco County Superior Court). The AGO has issued four investigatory subpoenas to Reliant since February 2001. On 5-20-02, the AGO filed a motion to compel to force Reliant to turn over electronic files, trade secret documents, and other materials. After the motion was filed, we reached agreement with Reliant that requires production of trade secret documents.

Block Forward Litigation: DWR v. ACN Energy, et. al.; PG&E v. State; CalPX v. State; Reliant v. State, Duke Energy v. State (Sacramento County Superior Court). These actions arise from Governor Davis' commandeering of the CA Power Exchange's (Cal PX), PG&E's and SCE's long-term energy supply ("block forward") electricity market contracts in February 2001. The Governor seized these contracts after the utilities defaulted on their purchase obligations and thereby became unable to maintain a reliable supply of electricity to millions of CA residents. Participants in the Cal PX market now seek damages against the State of CA under theories of inverse condemnation and compensation requirements allegedly imposed under the Emergency Services Act.

PG&E v. DWR II (Sacramento County Superior Court). PG&E again sued the DWR on 10-17-02 on the same theories asserted in PG&E v. DWR I: that DWR failed to comply with AB 1X and the Administrative Procedure Act in making its just and reasonable determination. PG&E also alleges that the regulations DWR adopted to permit public review of the 2003 revenue requirement do not comply with the APA or the Superior Court's order in PG&E v. DWR I, and that DWR did not follow its own regulations. The trial court ruled against DWR on procedural grounds, concluding that DWR did not follow its regulations in issuing additional material for public review during the course of its just and reasonable review of the revenue requirement. The court entered judgment and directed DWR to conduct further proceedings consistent with its regulations.

State of California ex rel. Lockyer v. Smutney-Jones, et al. (Sacramento County Superior Court, Case No. 01AS00440). On 1/23/01, AG filed quo warranto action seeking to obtain removal of the outgoing, voting board members of the California Independent System Operator (ISO), following enactment of AB 5X. All board members submitted resignations. Action dismissed without prejudice.

Gordon v. Reliant Energy, Inc., et al. (San Diego Superior Court Case No. GIC 758487). Pamela Gordon is class representative in this class action alleging that Williams, the Williams Companies and others engaged in unfair competition and committed antitrust violations in the California wholesale electric power markets. Sought monetary damages, injunctive relief and restitution and disgorgement to the Class and the general public.

Hendricks v. Dynegy Power Marketing, Inc., et al. (San Diego Superior Court Case No. GIC 758565). Class action alleging that the energy companies had engaged in unfair competition and committed antitrust violations in the California wholesale electric power markets. Sought monetary damages, injunctive relief, restitution and disgorgement of profits.

Sweetwater Authority v. Dynegy, et al. (San Diego Superior Court Case No. GIC 760743). Sweetwater Authority, Valley Central Municipal Water District and Padre Dam Municipal Water District filed action alleging unfair competition and commission of antitrust violations. Ramona Municipal Water District, Helix Water District, Borrego Water District, Vista Irrigation District, Yuima Municipal Water District, Fallbrook Public Utility District, Metropolitan Transit Development Board, San Diego Trolley, Inc., San Diego Transit Corporation also joined as plaintiffs. Sought monetary damages, injunctive relief, restitution and disgorgement of profits.

People v. Dynegy Power Marketing, Inc. (San Francisco Superior Court Case No. 318189). City and County of San Francisco action alleging unfair competition and antitrust violations in California wholesale electric power market. Later joined by City of Oakland, Santa Clara County and Contra Costa County. Sought monetary damages, injunctive relief and disgorgement of profits as well as civil penalties.

Pier 23 Restaurant and Oscar's Photo Lab v. PG&E Energy Trading, et al. (San Francisco Superior Court Case No. 308120). Class action alleging unfair competition in California wholesale electric power market. Oscar's Photo Lab and Mary L. Davis later joined as plaintiffs and Pier 23 later withdrew from the litigation. Sought monetary damages, injunctive relief, restitution and disgorgement of profits.

Bustamante v. Dynegy, Inc., et al. (Los Angeles Superior Court Case No. BC 249705). Lieutenant Governor Cruz Bustamante and State Assemblywoman Barbara Matthews filed action against companies, their officers and directors alleging unfair competition and antitrust violations. Sough monetary damages, injunctive relief, restitution and disgorgement of profits.

III. FEDERAL ENERGY REGULATORY COMMISSION PROCEEDINGS Ê

San Diego Gas & Electric Co., v. All Sellers et al (FERC Docket No. EL00-95-000). This is the primary FERC administrative proceeding dealing with the 2000-2001 California electricity crisis and is known as the California Refund Proceeding. As specified above in *People of the State of California v. FERC*, the Attorney General and others have objected to FERC's resolution of a wide variety of crucial issues in this proceeding and have consequently appealed many of the administrative orders issued by FERC in this matter. In general, the appeals seek to obtain millions of dollars of refunds still owed to the citizens of California by Enron Corporation and other electricity marketers who manipulated California's energy markets and greatly inflated electricity prices paid by customers during the 2000-2001 crisis.

Puget Sound Energy v. Sellers of Energy in the Pacific Northwest, Including Parties to the Western Systems Power Pool Agreement (FERC Docket No. EL01-10-000). Similar to the California Refund Proceeding, this FERC proceeding was initiated by Puget Sound Energy Company, a purchaser of electricity in the Pacific Northwest region. Puget Sound filed a complaint during the 2000-2001 crisis requesting FERC to order that electricity prices be capped in the Pacific Northwest and refunds be provided to consumers for electricity overcharges made in connection with electricity purchase transactions in that region's market. The California Attorney General and others have appealed both FERC's overall determination that no refunds would be ordered for any purchaser of Pacific Northwest electricity as well as its specific determination that purchases made by the Department of Water Resources would not qualify for refunds even if such refunds had been ordered for other parties.

American Electric Power Service Corporation, et al. (FERC Docket Nos. EL03-137 – EL03-179 (Consolidated)). In essence, this proceeding involves a subset of issues that are integral to the California Refund Proceeding. It focuses on allegations that numerous electricity marketers and generators engaged in Enron-type market manipulation games during the 2001-2001 crisis. FERC has settled with most of the entities for modest amounts.

Enron Power Marketing, Inc.; Aquila, et al. (Docket Nos. EL03-180 - EL03-203 (Consolidated)). This proceeding involves another component of the California Refund Proceeding and, as a companion to the *American Electric Power* proceeding, involves allegations that numerous electricity marketers and generators colluded in partnerships with each other to engage in Enron-type market games. FERC has also settled with many of the entities for modest amounts.

Investigation of Anomalous Bidding Behavior (FERC Docket IN03-10). As another proceeding dealing with issues that are central to the California Refund Proceeding, this closed investigation involves FERC's inquiry into patterns of suspicious bidding by participants in California's electricity markets during the 2000-2001 crisis. FERC has refused to allow the State of California or any other affected party to participate in this investigation. The Attorney General has opposed settlements arising out of this closed investigation on the basis that such settlement amounts are insufficient. The Attorney General has also argued that this investigation (as well as other FERC proceedings including *American Electric Power* and *Enron Power Marketing/Aquila* should be incorporated within the California Refund Proceeding so that a comprehensive market remedy can be fashioned.

Investigation into Physical Withholding (Undocketed) Also involving issues central to the California Refund Proceeding, this investigation involves FERC's inquiry into physical withholding of electricity supplies by participants in California's electricity markets during the 2000-2001 crisis. As with the *Anomalous Bidding Behavior* investigation, FERC has refused to allow participation by the State of California or other parties and the Attorney General has opposed FERC's treatment of this issue in a proceeding fragmented from the California Refund Proceeding and not subject to participation by affected parties.

Reliant Resources, Inc.; Reliant Coolwater; Reliant Mandalay; Reliant Ormond Beach; Reliant Elwood; Reliant Etiwanda (FERC Docket No. PA02-2-001) This action arose out of a FERC staff investigation of manipulation of electric and natural gas markets in western U.S. markets. Reliant Corporation paid $13.8 million to customers for withholding electricity supplies from California markets during the two electricity crisis days of June 20 and 21, 2000.

El Paso Electric Company/Enron (FERC Docket No. EL02-113). Also arising from the FERC staff investigation of western energy market manipulation, this proceeding focused upon investigating Electric Company for providing preferential access to its transmission facilities and, in cooperation with Enron Corporation, exported electricity out of California then imported it back at a time calculated to obtain a higher price (an Enron-type game known as a "ricochet" transaction). The Attorney General (acting also for the Public Utilities Commission and the Electricity Oversight Board) intervened in the proceeding and negotiated a settlement in which El Paso Electric has agreed to pay $15.5 million in refunds to the Department of Water Resources' Electric Power Fund.

Portland General Electric/Enron (FERC Docket No. EL02-114). This proceeding also arose out of FERC's staff investigation of manipulation of electric and natural gas markets in western U.S. markets. The Attorney General filed an uncontested offer of settlement with FERC in which Portland General Electric agreed to pay a total of $8.5 million ($6.1 million of which would be paid to the Department of Water Resources and the remainder of which would be paid to out-of-state entities) for having manipulated western energy markets.

Avista Corporation/Enron (FERC Docket No. EL02-115-000). This proceeding also arose from the FERC staff investigation of western market manipulation. The Attorney General opposed an initial settlement proposal offered for FERC certification and approval by Avista and FERC staff. FERC has not issued a final decision regarding the possible settlement.

Reliant Energy Services; BP Energy; Enron Power Marketing and Bridgeline Gas Marketing (FERC Docket Nos.EL03-59; EL03-60; and EL03-77). These three proceedings also arose out of the FERC staff investigation of western market manipulation. As a result of this investigation, FERC: (1) issued an order revoking Enron Power Marketing's market-based rate authority; (2) approved a consent agreement with BP Energy in which BP agreed to pay $3 million to the United Way to fund low-income energy assistance to customers in California and Arizona, and; (3) approved a consent agreement with Reliant Energy Services in which Reliant agreed to pay $25 million and auction an agreed amount of capacity from its facilities as a result of Reliant's high bidding and physical withholding of electricity in California markets during the crisis.

AES Southland, Inc.; Williams Energy Marketing & Trading Company (FERC Docket No. IN01-3-000) In this FERC proceeding, Williams Corporation paid $8 million for providing power from some of its expensive generation units instead of providing that power from less expensive units as it was required to do.

CPUC v. El Paso Natural Gas, El Paso Merchant (FERC Docket No. RP00-241-000). Complaint filed 4-4-00 charging that El Paso unfairly hoarded natural gas and drove up prices by awarding its affiliate, El Paso Merchant Energy 40% of the pipeline's capacity at a steeply discounted price. Matter has settled as part of the $1.69 billion agreement with El Paso.

Mirant Triennial MBR Proceeding (FERC Docket No. ER01-1265-002 *et al.*) In this proceeding, Mirant Corporation is requesting that FERC authorize Mirant to continue charging market-based rates. The Attorney General and the Public Utilities Commission filed an opposition to Mirant's request, arguing that Mirant had abused its market-based rate authority by manipulating California's electricity markets during the 2000-2001 crisis, that Mirant continues to possess market power, that its market power has not been adequately mitigated by FERC's market power mitigation mechanisms, and that FERC's reliance upon market-based "tariffs" is improper since such "tariffs" contain no ascertainable rates and therefore do not comply with Section 205 of the Federal Power Act. FERC has not as yet issued a decision on Mirant's request for continued MBR authority.

Duke Triennial MBR Proceeding (FERC Docket No. ER98-2681-005 *et al.*) Similar to the Mirant MBR proceeding, this proceeding involves Duke Energy's request that FERC authorize Duke to continue charging market-based rates. The Attorney General filed an opposition to Duke's request for continued market-base rate authority, citing reasons similar to those set forth in the *Mirant MBR* opposition. FERC has not as yet issued a decision on Duke's request for continued MBR authority.

Cal ISO Creditworthiness (FERC Docket No. ER01-889). This proceeding was initiated in order to resolve various technical issues regarding whether the Independent System Operator (the entity serving as California's electricity market clearing house during much of the crisis period) properly credited electricity transactions made by the Department of Water Resources. The Attorney General provided comments to FERC arguing that the ISO correctly treated DWR as being the de facto scheduling coordinator for Pacific Gas and Electric and Southern California Edison due to their lack of creditworthiness. This proceeding is still before FERC for resolution.

ISO, Power Exchange, & SDG&E v. Generators (FERC). In order to help protect the integrity of California's electricity markets, the Attorney General intervened in this proceeding and sought reconsideration of FERC's April 2001 order requiring that all electricity purchases made in California's markets, including those made by utilities that were facing bankruptcy as a consequence of the 2000-2001 crisis, be backed by a creditworthy purchaser. The State of California, via the Department of Water Resources, subsequently assumed the role of creditworthy purchaser and bought emergency supplies of electricity to assure its continued availability during the crisis.

California Independent System Operator Corp. (FERC Docket No. ER02-1656-000).
California Independent System Operator Corporation (ISO) has submitted Market Design amendments to its tariff. These amendments propose significant changes in the operations of power markets in California.

FERC 206 Proceeding - DWR (FERC Dockets Nos. EL02-60-000; and EL02-62-000). The Electricity Oversight Board and the CPUC filed complaints challenging the long-term contracts signed by DWR. After hearing, the ALJ (as accepted by the Commission) declined to order revision to the contracts under the Mobile-Sierra Doctrine.

Tucson Electric Power Company v. Davis and Cal PX (FERC Docket No. EL01-04)
In this proceeding, Tucson Electric Power Company seeks to invalidate Governor Davis' commandeering of block forward contracts on the basis that this action required FERC approval.

State of California v. British Columbia Power Exchange (FERC Docket No. EL02-71-000). This is a FERC proceeding in which we filed a complaint against all sellers of power in the CA market for failing to file the rates they charged as required by the Federal Power Act. FERC denied in part our complaint and our request for rehearing of the order denying the complaint in part. We have appealed FERC's order to the Ninth Circuit (State ex rel. Lockyer v. FERC).

IV. ADMINISTRATIVE HEARINGS AND ARBITRATIONS Ê

Allegheny Energy Supply Co. v. Department of Water Resources On 2-21-03, Allegheny Energy Supply Company filed a formal administrative claim against the State of CA, DWR, the CPUC and the EOB, alleging that DWR conspired with the CPUC and EOB in a "bad faith campaign" to force Allegheny to re-negotiate its $4.4 billion long-term energy supply contract with DWR. The matters have settled.