Decision 97-11-075 November 19, 1997

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the matter of the application of Southern California Edison Company (U 338-E) for authority to sell gas-fired electrical generation facilities.	Application 96-11-046 (Filed November 27, 1996)

INTERIM OPINION

Summary

Southern California Edison Company (Edison) requests authority, pursuant to Public Utilities (PU) Code Section 851, to auction and sell 12 fossil-fuel electric generation plants by the end of 1997. The second interim decision that Edison requests is that the form of Master Must-Run Agreement (MMRA) as filed at the Federal Energy Regulatory Commission (FERC) and approved by the FERC on October 30, 1997, is sufficient to ensure that six of the plants, which are required for the reliable operation of the system, remain available and operational, pursuant to PU Code Section 362 consistent with maintaining open competition.

Procedural Background

Edison filed its application on November 27, 1996. Notice appeared in the Daily Calendar on December 4, 1996. A prehearing conference was held on January 8, 1997. President Conlon, as the assigned Commissioner,[1] issued a ruling (ACR) to establish a procedural schedule on February 11, 1997. An evidentiary hearing was held on June 5-6, 1997 and the issues for the second interim opinion were submitted on the briefs and reply briefs, filed on or before June 30, 1997 and July 11, 1997, respectively. A proposed decision by the assigned administrative law judge was filed on October 20,

[1] Commissioner Bilas was subsequently co-assigned.

1997. Edison and the Office of Ratepayer Advocates (ORA) filed joint comments on November 10, 1997. No reply comments were filed.

In our first interim decision, Decision (D.) 97-09-049, we determined that Edison should be permitted to proceed with the auction while we completed review under the California Environmental Quality Act and considered the issues in this second interim opinion. In a final decision, we will consider whether to permit transfer of the plants to the successful bidder, based on the auction results.

Description of the Issues for the Second Interim Opinion

Edison wishes to offer for sale 12 electric generation plants pursuant to PU Code Section 851:

- Alamitos Generation Station
- Cool Water Generating Station
- Ellwood Energy Support Facility
- El Segundo Generating Station
- Etiwanda Generating Station
- Highgrove Generating Station
- Huntington Beach Generating Station
- Long Beach Generating Station
- Mandalay Generating Station
- Ormond Beach Generating Station
- Redondo Generating Station
- San Bernardino Generating Station

Of these, the parties agree that six are required to be kept available for the reliable operation of the transmission system pursuant to PU Code Section 362: the Alamitos, Huntington Beach, El Segundo, Etiwanda, Mandalay, and Redondo plants.

In proceedings pursuant to Section 851, we must ensure that "facilities needed to maintain the reliability of the electric supply remain available and operational, consistent with maintaining open competition and avoiding an overconcentration of market power." Edison proposes to ensure that the six "must-run" plants remain available and operational by requiring, as a condition of sale, that the purchaser of each plant enter into an MMRA with the Independent System Operator (ISO). The question thus presented is whether the means proposed ensure that "facilities needed to maintain the reliability of the electric supply remain available and operational,

consistent with maintaining open competition." (PU Code § 362.) In our first interim decision, we determined that until the outcome of the auction was known, it would not be possible to determine whether the MMRA would be consistent with "avoiding an overconcentration of market power," which is another test in PU Code Section 362, because we would need to know what other generation assets the buyer controlled.

Whether the MMRA Ensures the Continued Availability and Operation of the Six Must-Run Plants Consistent with Maintaining Open Competition

Continued Availability and Operation

Description of the MMRA

The MMRA is a bilateral contract between the owner of an electric generating facility and the ISO that permits the ISO to call upon the facility to deliver electricity into the transmission grid, at the times and in the quantities specified by the ISO, and sets out the respective rights and duties of the ISO and the owner. Its essential features are that it is governed by California law, terminable for convenience by the ISO, but not the owner, on 90 days' notice, renewable for successive terms at the option of the ISO, and permits the dispatch and payment obligations to be switched among three different regimes at the option of the ISO or the owner under various circumstances.

The three regimes, referred to as "As Called," "Full Recovery with Credit Back," and "Full Recovery with Dedicated Facility," implement three different levels of market participation by the facility.

The default regime is "As Called." Under this form of MMRA, the ISO has the right to direct that the units of a plant be dispatched on a daily, hourly or real-time basis to deliver energy or ancillary services (such as spinning reserve or voltage support). The owner has the right to receive payments for operation under ISO dispatch, at rates to be determined by the FERC. The owner is free to enter into market transactions for energy or ancillary services at all other times. The owner has the duty to maintain the units and to notify the ISO when they will be out of service for maintenance or have been taken out of service on an unscheduled basis. The ISO has

the right to dispatch the units up to a stated level. If the owner is unable to deliver required services, it has the duty to propose mitigation measures, which may include delivery from other units at the plant that are not subject to the MMRA. Payment terms are affected by any failure to deliver required services. Obligations of the parties are limited to an amount to be stated in a schedule to the MMRA. The customary types of representations, warranties, covenants, and indemnities are provided. The obligations are binding upon successor owners.

The Full Cost Recovery with Credit Back form of MMRA differs from the As Called form in several respects. Under this form of MMRA, the ISO has the right to direct that the units of a plant be dispatched to deliver energy or ancillary services on a daily, hourly, or real-time basis. The owner is free to enter into market transactions for energy or ancillary services at all other times but 90% of net payments received are credited against availability payments. The owner is subject to a revenue floor requirement. The ISO has the right to obtain temporary, preliminary and permanent injunctive relief from any court of competent jurisdiction restraining the owner from committing or continuing a breach of the agreement. In certain circumstances, the ISO has the right to the guarantee of the owner's parent company of owner's obligations.

The Full Recovery with Dedicated Facility form of MMRA differs from the Full Cost Recovery with Credit Back form in that the owner is not free to enter into market transactions for energy or ancillary services at any time.

Whether to Defer any Decision until the Specific Terms and Conditions have been Determined

The Coalition of California Utility Employees (CUE) notes in its brief that this Commission has recommended to the FERC that MMRA should be changed in this regard and sees "no rational way that the Commission could argue to FERC that these 'critical changes' to the [MMRAs] have to be made so that the plants would be 'available when called' and, at the same time, find that the [MMRA] ensure that plants will be 'available and operational' when needed."

The California Cogeneration Council (CCC) and Independent Energy Producers Association (IEP) filed a "motion for clarification." CCC/IEP purport to find

in the Commission's comments before the FERC the potential that the Commission has prejudged the issues associated with the Full Cost Recovery with Credit Back form of MMRA. Those fears are groundless. Even if the issues in the FERC proceeding were identical to the issues in this proceeding, which they are not, the Commission retains its due process obligation of deciding the issues which are before us in this proceeding based upon the record in this proceeding. That does not, however, mean that we are proscribed from reaching similar conclusions.

In addition, it is undisputed that the MMRA before the Commission has material contractual terms in blank, including unit-specific operational requirements and the ISO's payment obligations, among others. Therefore, CUE argues, we cannot determine that the MMRA is fair and reasonable to the prospective purchaser and, in the absence of knowing whether the MMRA is beneficial to the new owner, whether it will be adequately "motivated" to honor its obligations under the MMRA. Thus, CUE takes the position that a contract is no more than a scrap of paper that sovereign parties deign to observe only when it suits their interest. ORA specifically disassociates itself from the suggestion that we must know how the blank terms will be filled.

The ISO argues that because FERC has properly exercised its jurisdiction to determine the wholesale rates and terms and conditions of the MMRA, we are totally pre-empted by federal law from taking any role whatsoever in looking at the specifics of the MMRA. Edison and ORA agree that the substantive issues about the contents of the MMRA are within the exclusive jurisdiction of the FERC, and we should limit our role to ensuring that new owners of the must-run plants execute the MMRA in whatever final form is dictated by the FERC and approve or disapprove sale of the plants with such MMRA.

To unravel this particular knot may require more effort than it is worth, so perhaps it may be cut by carefully looking at our duty under Section 362:

> In proceedings pursuant to Section … 851 …, the [C]ommission shall ensure that facilities needed to maintain the reliability of the electric supply remain available and operational, consistent with maintaining open competition and avoiding an overconcentration of market power. In order to determine whether the facility needs to remain

> available and operational, the [C]ommission shall utilize standards that are no less stringent that [sic] the Western Systems Coordinating Council and North American Electric Reliability Council standards for planning reserve criteria.

As noted, this is a proceeding pursuant to Section 851, and we have determined which facilities are needed to maintain the reliability of the electric supply. The ISO has ongoing responsibility for the efficient use and reliable operation of the transmission grid. (PU Code § 345.) The ISO is to seek the authority required to give it "the ability to secure generating and transmission resources necessary to guarantee achievement of planning and operating reserve criteria no less stringent than those established by the Western Systems Coordinating Council and the North American Electric Reliability Council." (PU Code § 346.)

Because the ISO will have the ability to secure new generating and transmission resources, because the applicable criteria of the two councils may change, from time to time, because existing plants may become decrepit or obsolete, and because load characteristics evolve over time, our designation of plants as "must-run" cannot be considered permanent. It is, rather, simply complementary to the development of the ISO's ability to secure new generating and transmission resources. The Legislature was concerned that transfer of existing plants whose operation is currently necessary to maintain reliability was done in such a way that those plants would continue operating in that role as long as needed by the ISO, whose job it is to assure reliability of the electric supply going forward by securing the necessary resources.

Aside from dictating the sources of technical criteria that the ISO should apply, the Legislature afforded the ISO great scope in how it would discharge its duties. The Legislature contemplated that the "proposed restructuring of the electricity industry would transfer responsibility for ensuring short- and long-term reliability away from electric utilities and regulatory bodies to the [ISO] and various market based mechanisms." (PU Code § 334.) It is thus clear to us that our role in this area is purely transitional pending the full assumption of its authority by the ISO. In particular, as we noted in our first interim opinion, we cannot dictate to the ISO that it

enter into an MMRA for a particular plant and, if so, under what terms and conditions. What we can do is to give it the option.

Thus, if the ISO determines that any of the six plants that we have determined are needed have more attractive substitutes, it should be free, under its authority, to decline to execute an MMRA. (After all, as proposed, the ISO would have the right to terminate any MMRA on 90-days' notice, which is a provision that none of the parties have suggested is unreasonable in light of PU Code Section 362.) Thus, the ISO, subject to the requirements of the FERC, is in the position of having the final say on whether to execute a particular MMRA, regardless of what we may have to say about it.[2]

This division of responsibility renders any question of FERC preemption totally beside the point. If the ISO can decline to enter into an MMRA because it believes the plant is no longer needed, it can also decline to enter into an MMRA because it believes that it has better alternatives to it to accomplish the same purposes. In fact, a plant will be ensured to remain available and operational following the establishment of the PX only if it is either owned by the ISO (which no one contemplates) or it is subject to an MMRA or similar contractual arrangement, and it will be subject to only those MMRA terms and conditions that suit the ISO, within the range permitted by the FERC.

The same consideration renders moot the debate about the blank price terms. If we were to conclude that the MMRA fulfilled its function only if a particular blank were to be filled with the number "20" and the FERC required "10," the ISO would not execute the MMRA and, in that case, the MMRA would definitely not ensure the continued availability of a plant.

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[2] For this reason, as we noted in our first interim opinion, the condition to the transfer of the plants should be either that the buyer has executed the MMRA and delivered it to the ISO or has provided a certificate of the ISO that it waives the MMRA.

A different set of considerations also leads us to conclude that the blank price terms should not detain us. The cash flow from the MMRA is to be set in accordance with the FERC requirements to be fair and reasonable to buyer and seller. Buyers of the plants will bid taking into account either the established prices or will make allowance for any uncertainty that still exists at the time of the auction. In either event, the successful bidder will have factored the expected cash flow into its bid. That bid will be made either from the buyer's equity capital, with other people's money (debt), or with a combination of equity and debt. Thus, the proprietors or creditors, or both, of the successful bidder will have made an assessment of cash flow available from the MMRA as part of their calculation and may be presumed to have accepted the risk that the terms implemented in the MMRA are terms that they will have to observe.

What are the consequences if the successful bidder finds itself dissatisfied with the terms of the MMRA? It can attempt to have those wholesale rates changed by the FERC or it can intentionally default on its obligations under the MMRA. If the FERC adjusts the rates to the satisfaction of the successful bidder, no question arises whether rates are sufficiently motivational to ensure the continued availability and operation of the plant. If the owner intentionally defaults, the ISO looks to the remedies in the MMRA, including its right to obtain specific performance of the contract. In either case, given a legal, valid, and binding contract, there is no need to concern ourselves with the adequacy of price terms.

Consider next the case in which the FERC terms are objectively adequate, but through poor management, bad luck, or misadventure in another business, the owner becomes insolvent, unable to meet its performance obligations under the MMRA, and seeks protection in bankruptcy. In bankruptcy, two major kinds of adjustments can be made: debts can be discharged without full payment and performance obligations can be excused. So long as the bankruptcy estate discharges its performance obligations under the MMRA, the ISO is indifferent to how debts are discharged. In a bankruptcy, the debtor-in-possession or trustee has the option to affirm or avoid contractual obligations, including the MMRA. If the MMRA is affirmed, no issue arises as to the continued availability of the facility. If it is avoided, the issue

does arise. It would be avoided, however, only if the cost of performance exceeded the cash flow. That would only occur if the FERC required terms were not objectively adequate (*i.e.,* no reasonable operator would be able to perform under the MMRA).

We do not feel that the FERC is likely to badly miss the mark on what terms for the MMRA should be required. Even if we did, moreover, we are in no position to substitute our own judgment for that of an agency with superior jurisdiction over wholesale rates for all the reasons discussed above. Therefore, we look solely to the form of the MMRA.

The form of the MMRA suitably provides for a valid, legal, and binding contract between the ISO and the buyer, enforceable in accordance with its terms. The ability of the ISO to obtain specific performance in the two situations in which it relies upon the plants (the Full Cost Recovery with Credit Back form and the Full Recovery with Dedicated Facility form) and its right to require a corporate parent guarantee from any counterparty that was not the purchaser of the plant (and therefore could be thinly capitalized) are two important safeguards that provide assurance that the ISO will have the rights it requires to keep the plants in operation. Because the FERC did not modify the final form of MMRA to make it legally infirm as a binding contract or remove the right to specific performance, we will not need to revisit the form of MMRA for our final decision on the issue of whether it ensures the continued availability of the plant. We also observe that the FERC partially accepted this Commission's recommendations concerning additional remedies.

Maintaining Open Competition

Of the three forms of MMRA, only the Full Cost Recovery with Credit Back form is controversial with respect to competitive aspects. The California Manufacturers Association (CMA) and CCC/IEP contend that this form is anticompetitive and inconsistent with PU Code Section 362. Our obligation pursuant to PU Code Section 362 to ensure the continued availability of the six must-run plants is qualified by the requirement to do so "consistent with open competition." Therefore, it is possible that we could determine that the six must-run plants ought not be subject to the MMRA, if we were to find that to do so were inconsistent with maintaining open competition.

CMA/CCC/IEP sponsored testimony of witness Woodruff to show that the Full Cost Recovery with Credit Back would provide subsidies to plant purchasers, and that such subsidies would enable the owners to underbid competitors who do not have similar subsidies, resulting in lower market prices, which would harm competition by delaying or discouraging new entrants from entering the market for wholesale power.

CMA/CCC/IEP also rely on the testimony of witness Jurewitz (sponsored by Edison) that a plant that underbids can lower the PX clearing price by displacing higher bidders and that the actual or expected ability to do so would constitute a barrier to entry to the wholesale market.

If the only possible anticompetitive effect of the MMRA Full Cost Recovery with Credit Back form is that it creates difference among competitors with respect to their cash flow, we would be able to end the analysis at this point. It is not a condition of competitive market that all actors have available to them the same cash flow and capital. If it were, for example, the fledgling Microsoft Corporation would never have gained market share in the market for personal computer operating systems at the expense of the then vastly wealthier IBM. As Edison argues, the danger that the MMRA Full Cost Recovery with Credit Back form might (but which Edison argues does not) pose is one of predatory pricing.

Under federal law, a claim of predatory pricing must show that an actor sets prices below costs with the ability and intent to drive rivals out of the marketplace and that the actor has a reasonable prospect of recovering its investment in below-cost pricing by ultimately sustaining supracompetitive prices. (*See generally Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).) Below-cost pricing by itself is insufficient to "permit an inference of probable recoupment and injury to competition." (*Id.)* The Court is skeptical about the general plausibility of predatory pricing claims and approves of the summary disposition of cases in which barriers to entry are low or the actor has no excess capacity readily available to absorb the market share of discouraged rivals. (*Id.*) The Court also notes that the same mechanism by which predatory pricing is initiated, lowering prices, is also the essence of competition as a tool to increase business, and warned that the standard of proof should be not be so

low "that antitrust suits themselves become a tool for keeping prices high." We agree with the Court's formulation and caution. (*Order Instituting Rulemaking/Investigation on the Commission's Own Proposed Policies Governing Restructuring California's Electric Services Industry and Reforming Regulation,* D.95-12-063, mimeo. at 106-107.)

Given the theoretical difficulty of proving predatory pricing, it is not surprising CMA/CCC/IEP failed to do so in this proceeding. Edison urges us to assign no weight to Woodruff's testimony, because he was unable to identify any of the leading cases that address predatory pricing, has not published any scholarly papers on the subject, cannot cite any of the leading articles on predatory pricing, has no graduate education in economics, has not published any scholarly papers on the diagnosis of relevant markets and market power, and has never testified before on market power issues in any court or regulatory proceeding.

Woodruff's testimony shows that he has not carried out the kinds of studies and analyses that would permit an expert opinion. He performed no market study, did not know how much capacity would be required to affect the market-clearing price, and did not know how long it would take for an owner to recover its costs of artificially depressing the market price. Nor did he testify that the owner would be able to escape detection and prosecution from the ISO and the FERC if it were to engage in predatory pricing.

As Edison's witness, Jurewitz (who, like Woodruff, qualified as an expert economist) testified, the owner requires market-based pricing approval from the FERC to sell energy at market-based rates in the wholesale market power, and to obtain such approval must show either that it lacks market power or that it has satisfactorily mitigated market power. As a result, in Jurewitz's opinion, an owner who lacked market power, or whose market power had been mitigated, would be unable to charge supracompetitive prices. Without the ability to charge such prices, the owner would not be able to recoup its losses on below-cost sales. Without a reasonable probability of recoupment, there can be no predatory pricing.

CMA/CCC/IEP have an alternate theory of the anticompetitive effect of the MMRA Full Cost Recovery with Credit Back form other than that predatory pricing

will occur in the overall wholesale electrical market. The alternate theory is that the owner of a plant required for local reliability will be able to delay the entry into the market of a possible replacement local reliability plant because no competing source of local reliability services will "enter a market in which they must compete with subsidized participants."

CMA/CCC/IEP cite no testimony to support such a sweeping statement. The decision to enter a market, logically, reflects a variety of factors, including the potential entrant's estimates of its capital costs and operational costs in relation to the probable market price. By the logic of CMA/CCC/IEP's argument, no entrant would ever come into a market with established competitors whose investment in plant and equipment represented a sunk cost. Compared to a new investor, who must decide whether to incur substantial capital costs on the chance of being able to recover them over the projected life of the project, an existing plant owner has only to decide whether to incur the expenses necessary to keep the plant running, which may be substantially less. As the testimony of Jurewitz established, once the decision to enter or remain in the market and the initial or periodic capital investment have been made, the only remaining decision is whether the variable costs of operating the plant are exceeded by the market price of energy that can be earned.

Thus, a rational entrant who has reason to believe its projected plant will be able to achieve lower variable costs than the entrenched competitors should not be deterred by the fact that such competitors have the cash to accept costs that are below those competitors' variable costs. The reason why a rational entrant should not be deterred is that the rational incumbent will only accept costs that are below its variable costs if it believes that keeping the entrant out of the market will enable the incumbent to obtain supracompetitive prices in the future. In other words, in the absence of the conditions for successful predatory pricing, the entrant has nothing to fear. CMA/CCC/IEP have failed to show that the conditions for successful predatory pricing will exist and, accordingly, cannot show that new entrants into the market for reliability services will be deterred by the payments to the owners of plants running under the MMRA Full Cost Recovery with Credit Back form of agreement.

Avoiding an Overconcentration of Market Power

Our obligation pursuant to PU Code Section 362 to ensure the continued availability of the six must-run plants is also qualified by the requirement to do so "consistent with … avoiding an overconcentration of market power." Therefore, it is possible that we could determine that the six must-run plants ought not be subject to the MMRA, if we were to find that subjecting them to the MMRA would encourage an overconcentration of market power.

What market power arises from owning any one or more of the plants subject to the MMRA, compared to owning any one or more of the plants not subject to the MMRA, is unknown. To start, the relevant market, the PX and direct access, does not yet exist, and the number of distinct market actors is unknown. Therefore, it is premature to attempt an analysis of horizontal market power until we at least know in how many hands the plants come to rest. As we stated in our first interim opinion, we will require disclosure by the successful bidder of other generation assets held by it or related entities.

Findings of Fact

1. Edison is an electric utility subject to the jurisdiction of the Commission.

2. For purposes of PU Code Section 362, the Cool Water, Ellwood, Highgrove, Long Beach, Ormond Beach, and San Bernardino plants will be needed neither for local voltage support nor to meet applicable planning reserve criteria.

3. For purposes of PU Code Section 362, the Alamitos, El Segundo, Etiwanda, Huntington Beach, Mandalay, and Redondo plants are needed to maintain the reliability of the electric supply until the ISO determines otherwise.

4. The record in this proceeding does not show that conditions required for predatory pricing in the California wholesale electrical generation market exist.

5. The Commission may require additional information from proposed transferees concerning other generation assets to compete its review under PU Code Section 362.

Conclusions of Law

1. The Alamitos, El Segundo, Etiwanda, Huntington Beach, Mandalay, and Redondo plants will remain available and operational consistent with maintaining open competition, if, as a condition of sale, Edison requires that the successful bidder enter into an agreement with the ISO substantially in the form filed at the FERC and approved by it on October 30, 1997 or provide a certificate of the ISO to the effect that it has determined that the related plant is not required for the ISO's purposes.

2. Edison should require the successful bidder to disclose to the Commission all other generation assets in California under common ownership or control with the bidder.

INTERIM ORDER

IT IS ORDERED that:

1. Southern California Edison Company (Edison) shall require as a condition of sale of the Alamitos, El Segundo, Etiwanda, Huntington Beach, Mandalay, and Redondo plants that the successful bidder enter into an agreement with the Independent System Operator (ISO) substantially in the form filed at the Federal Energy Regulatory Commission (FERC) and approved by the FERC on October 30, 1997 or provide a certificate of the ISO to the effect that it has determined that the related plant is not required for the ISO's purposes.

2. Edison shall require the successful bidder to disclose to the Commission all other generation assets in California under common ownership or control with the bidder.

This order is effective today.

Dated November 19, 1997, at San Francisco, California.

P. GREGORY CONLON
President
JESSIE J. KNIGHT, JR.
HENRY M. DUQUE
JOSIAH L. NEEPER
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Commissioners