UNITED STATES OF AMERICA 102 FERC ¶ 63,030
FEDERAL ENERGY REGULATORY COMMISSION

PacifiCorp,
Complainant,

v. **Docket Nos. EL02-80-002**
EL02-81-002
Reliant Energy Services, Inc., **EL02-82-002**
Morgan Stanley Capital Group Inc. **EL02-83-002**
Williams Energy Marketing & Trading
Company and
El Paso Merchant Energy, L.P.,
Respondents.

INITIAL DECISION DISMISSING COMPLAINTS
(Issued February 26, 2003)

APPEARANCES

Paul E. Nordstrom, J. Cathy Fogel and Kellie A. Donnelly for PacifiCorp.

Edward J. Twomey, Kenneth W. Irwin and Bruce J. Barnard for El Paso Merchant Energy, L.P.

Kurt W. Bilas, Randolph Q. McManus, and Melissa E. Maxwell for Reliant Energy Services, Inc.

Excetral K. Caldwell and Tim W. Muller for Williams Energy Marketing & Trading Company.

Gregory K. Lawrence, Michael A. Yuffee and Mark H. Churchill for Morgan Stanley Capital Group Inc.

Janet Kay Jones and Daniel Simon for the Trial Staff of the Federal Energy Regulatory Commission.

ISAAC D. BENKIN, Presiding Administrative Law Judge:

1. This proceeding is one of a series of cases in which the Commission must decide whether to order the abrogation or modification of contracts for the purchase of electricity made during the so-called California Energy Crisis of the years 2000-2001. [1]

2. The 12 contracts were entered into by PacifiCorp, as buyer, and four different marketer-sellers during April, May and June 2001. Each of the contracts called for the delivery of electrical energy to PacifiCorp during the period between July 1, 2002 and September 30, 2002 at a stated price. The prices ranged from $126.00 per MWh to $262.000 per MWh, with a weighted average price of $181.00 per MWh. [2] These amounts reflected generally prevailing market prices at the time the contracts were executed.[3] In all, PacifiCorp purchased 369,600 MWh of energy from the Respondents for a total of $66,943,800. See Ex. PAC-41 at 2; Ex. EPME-24 at 11.

3. The contracts were brokered transactions, i.e., a broker matched bids and offers between parties who did not negotiate with each other on a face-to-face basis. PacifiCorp

[1] In addition to this case, the Commission has before it Nevada Power Co. and Sierra Pacific Power Co., Docket Nos. EL02-26-000 et al. and Public Utilities Comm'n of California v. Sellers of Long Term Contracts to the Cal. Dept. of Water Resources, Docket Nos. EL02-60-000 et al., which involve similar issues arising out of complaints by purchasers of forward contracts.

[2] Pricing information was received into the record under the terms of a Protective Order. In light of the fact that most of this information is now almost two years old and because the public has a legitimate interest in knowing the facts on which the Commission is basing its decisions concerning the energy emergencies on the West Coast during the 2000-2001 period, I am dissolving the confidentiality restrictions that attached to such information, to the extent that it is now quoted in this initial decision and may be reflected in briefs to be publicly filed in this proceeding hereafter.

[3] In its complaints, PacifiCorp said that "[t]he prices in the Summer 90-Day Contracts were well below the projected spot market prices for the summer of 2001 and were within the range of forward prices suppliers were offering (prior to June 19, 2001) for the summer of 2002." This quotation is from p. 27 n.38 of the complaint against El Paso Power Marketing, Inc. filed on May 2, 2002 Essentially the same language appears in paragraph 16 of the declaration (affidavit) of Dr. Robert Klein, PacifiCorp's Vice President for Commercial and Trading, which was attached to each of the complaints.

did not issue a Request for Proposals. PacifiCorp contacted the brokers, advising that it had a desire to enter into so-called "six-by-sixteen" contracts for the sale of 25 MW apiece for delivery at the switchyard of the Palo Verde nuclear plant during the months of June, July and August of 2002, some 12 to 14 months in the future. The "six-by-sixteen" contract was a standard product offered for sale in the forward market place at that time. It provided for delivery of electricity during the sixteen "heavy load" hours of the day (i.e., the daylight hours), six days per week, Sundays and holidays excepted. The product was commonly purchased by load-serving utilities with a need to secure additional supplies of energy to serve peak periods. Load-serving entities, as well as other participants in the marketplace, had become signatories to standardized master contracts, the terms of which were developed by Edison Electric Institute (a trade association of investor-owned electric utilities) and the Western Systems Power Pool, successor to the Western Systems Coordinating Council. See Ex. PAC-13 at 13. See generally A.S. Katz, Using the EEI-NEM Master Contract to Manage Power Marketing Risks, 21 Energy L.J. 269 (2000). The Palo Verde switchyard was (and still is) a common delivery point, probably the most frequently designated location in the Western United States for the delivery of power pursuant to electricity futures contracts. See Tr. 866.

4. When PacifiCorp went to the brokers to find acceptable counterparties, it was engaging in a strategy that it had been following for a while. Believing that it would be "short" of sufficient energy to serve its peak summer load, PacifiCorp had followed a practice of purchasing six-by-sixteen packages for delivery during the summer months for some time, varying the number of packages to reflect the prices being offered in the futures marketplace. In short, it appears that PacifiCorp was engaged in a policy of "dollar averaging." [4] It was no novice to the futures marketplace. Indeed, PacifiCorp was an

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[4] An internal PacifiCorp report, prepared for a meeting of its "Risk Forum" on June 6, 2001 (Ex. RES-33) reads, in part, as follows:

> Why is $220/MWh a good deal for next year?
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> We continue to execute the low-risk strategy of purchasing slowly to fill the CQ3 2002 short (i.e., dollar-cost averaging). Purchases are made at the market. The market has fallen substantially from the inception of executing this strategy from $260 through $220 to $125/MWh. In response to this weaker market we have increased our rate of purchases from 25 aMW [sic] per week to 50 aMW [sic] per week. Our view is this is a dip and that California will experience days of rotating outages that will firm prices out the curve, at which time we intend to suspend purchases.

experienced player, albeit with a limited repertoire. The six-by-sixteen contracts provided more energy than it actually needed to serve its loads; the electricity supplied during the so-called "shoulder hours" was surplus. PacifiCorp typically sold the shoulder-hour supplies on the futures market in an effort to recoup some of its expenditures.

5. The brokers with which PacifiCorp did business eventually located several counterparties who quoted prices that PacifiCorp found acceptable and were willing to do business with the utility under one or the other of the master contracts to which PacifiCorp had agreed to adhere. They, too, did not attempt to negotiate any variations in the terms of the master contract. In all, twelve contracts were entered into with the Respondents, four with El Paso, three with Morgan Stanley, two with Reliant and three with Williams. The contracts take the form of one-page confirmations that incorporate by reference the terms of one of the two master contracts. Four of the agreements with El Paso and two of the contracts with Williams were based on the WSPP Master Agreement. The two contracts with Reliant, the three with Morgan Stanley and one of the Williams deals were made under the EEI Master Agreement. In one instance, the counterparty that the broker located was not on PacifiCorp's list of creditworthy counterparties with which it would do business in the futures market. In that case, Williams (which was on PacifiCorp's approved list) agreed to step into the transaction as a "sleeve," acting as the nominal counterparty so that the deal could be consummated. It is clear that Williams was not the real party in interest in these transactions and performed its "sleeve" function largely as an accommodation. It received no compensation for being the sleeve on two of the contracts and earned only 50 cents per MWh on the third (the May 7, 2001 contract). See Ex. WIL-1 at 10. With the possible exception of the Williams arrangement, PacifiCorp had no idea of who its counterparties were until the confirmations arrived in its mailbox.

6. None of the contracts went to physical delivery. When the summer of 2002 arrived, PacifiCorp found it financially advantageous to "book out" the deals, either by the payment of money or by the delivery of energy at Palo Verde to some other party who had participated in the forward market. By doing so, PacifiCorp and its counterparties were spared the expense of transmitting the contracted-for energy from Palo Verde to a delivery point on the PacifiCorp system.

7. Shortly after the confirmation on the last of the contracts was signed, however, the Commission issued its June 19, 2001 order in San Diego Gas & Elec. Co. v. Sellers of Energy and Ancillary Services, 95 FERC ¶ 61,418 (2001). That order put in place a set of maximum just and reasonable "mitigated" prices for wholesale sales of electricity in spot

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Id. at 2 (Bates 0044998).

markets in the Western United States. In general, the "mitigated" prices were lower than the prices PacifiCorp had agreed to pay. By the time the summer of 2002 was on the horizon, it was clear that the contract prices were considerably higher than the market prices PacifiCorp was experiencing or was likely to experience for the foreseeable future. In hindsight, PacifiCorp had made a very bad deal.

8. PacifiCorp's reaction was to file a complaint under section 206 of the Federal Power Act, 16 U.S.C. §824e, and Rule 206 of the Commission's Procedural Rules, 18 C.F.R. §385.206 (2001) against each of the sellers. [5] The complaints, filed on May 2, 2002, sought alternative remedies; they asked the Commission either to reduce the contract prices to the maximum level authorized for spot sales in its June 19, 2001 order or, alternatively, to set for hearing the question of the appropriate "reformed" rate level. The four sellers responded by asking the Commission to reject PacifiCorp's complaints, principally on the grounds that the contracts were not subject to modification or abrogation under the so-called Sierra-Mobile doctrine and that, to the extent Sierra-Mobile authorized the Commission to prescribe a change in the contracts, the Complainant (PacifiCorp) had not established the existence of grounds for requiring such a change.

9. The Commission on June 28, 2002, issued an order, consolidating the cases and setting the complaints for an evidentiary hearing. PacifiCorp v. Reliant Energy Services, Inc., 99 FERC ¶ 61,381 (2002). In its June 28, 2002 hearing order, the Commission posed a series of questions that it wished to have litigated in the hearing, including the "issue of whether the complainant must bear the burden of showing that a challenged contract is contrary to the public interest, or whether PacifiCorp will bear the burden of showing that the contract is not just and reasonable." 99 FERC at 62,614. A second principal question raised in the hearing order was identical to a question that had been posed in other, similar proceedings: Did the "dysfunctional" ISO and PX spot markets in California have an adverse effect on the forward markets for bilateral transactions in which PacifiCorp made the deals that its complaints addressed? Id. at 62,615.

10. The hearing order directed that the hearing would be held in abeyance until the parties had had the opportunity to settle their disputes in a proceeding before a settlement judge. A settlement conference was held before the Chief Administrative Law Judge on

[5] A complaint was also filed against a fifth seller, Enron Power Marketing, Inc. (Enron). Enron, which had by then become bankrupt, did not file an answer and, on June 21, 2002, PacifiCorp withdrew the complaint against it. The withdrawal became effective 15 days later.

July 9, 2002. Settlement discussions took place at that conference and thereafter among the parties independently. The negotiations, however, did not succeed in achieving a settlement. Upon receiving the parties' report that they were at loggerheads, the Chief Judge, in an order issued August 7, 2002, terminated the formal settlement process and assigned the case to me for the conduct of the hearing and the preparation of an initial decision.

11 In due course, prepared testimony was filed, discovery took place, and the hearing was held. It began on December 13, 2002 and concluded on January 3, 2003.

The Parties

12. PacifiCorp is an investor-owned public utility serving approximately 1.5 million retail customers in widely dispersed service territories in the states of Oregon, Washington, Utah, California, Wyoming and Idaho. See Ex. PAC-1 at 7. It is a wholly-owned indirect subsidiary of Scottish Power plc. PacifiCorp sells electricity at retail and at wholesale.[6]

13. The four Respondents are Reliant Energy Services, Inc. (Reliant), Morgan Stanley Capital Group Inc. (Morgan Stanley), Williams Energy Marketing & Trading Company (Williams) and El Paso Merchant Energy, L.P. (El Paso). Each of the Respondents is a power marketer, authorized by the Commission to sell electricity at wholesale in interstate commerce at market-based rates. [7] Only one of the Respondents, El Paso, owns generating facilities; however, El Paso's facilities are not located near PacifiCorp's service territory and were not used to generate the electricity that El Paso sold under the contracts at issue here. In sum, none of the electricity sold under the contracts at issue was generated by, or could have been generated by, facilities owned or controlled by any of the Respondents. They

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[6] PacifiCorp was very active as a seller at wholesale during the period when it entered into the contracts in question. In fact, from May 2000 until June 19, 2001, PacifiCorp purchased power from 80 different sellers and sold power at wholesale to 98 different buyers. See Ex. EPME-44 at response (k) to Data Request EPME-PAC-6. It made more than 250 forward contracts for delivery more than a month in advance at prices that ranged from $100 to $570 per MWh. See Exs. EPME-28 at 36; EPME-45.

[7] See Morgan Stanley Capital Group, Inc., 69 FERC ¶ 61,175 (1994), modified, Morgan Stanley Capital Group Inc., 72 FERC ¶ 61,082 (1995); Letter Order (unpub.) dated January 2, 1998, Docket No. ER94-1348-017; Letter Order (unpub.) dated June 26, 2001, Docket No. ER94-1384-029: Letter Order (unpub.) dated December 17, 2002, Docket No. ER03-168-000; Nor-Am Energy Services, Inc., Letter Order Approving Market-Based Rates, Docket No. ER94-1247 (July 25, 1994) (unpublished); Ex. EPME-26 at 3; Ex. WIL-1 at 2.

were strictly sellers of hedges who were willing to assume the risk that future prices would be above the level specified in the contracts they signed with PacifiCorp.

Sierra-Mobile Issues

14. The Sierra-Mobile doctrine had its genesis in two Supreme Court cases decided the same day. In United Gas Pipe Line Co. v. Mobile Gas Service Corp., 350 U.S. 332 (1956), the Supreme Court ruled that the Natural Gas Act does not permit the Commission to allow a jurisdictional natural-gas company which had executed a contract to charge specified rates to a local distribution company to increase its rates above the levels specified in the contract. Once a contractual rate is established, the Court held, the statute requires adherence to the contract; a utility may not file, and the Commission may not accept, a rate that differs from the rate specified in the contract. In F.P.C. v. Sierra Pacific Power Co., 350 U.S. 348 (1956), the Court gave the same reading to contractual rates agreed to by public utilities subject to the Commission's jurisdiction under the Federal Power Act. Once again, the Court held that the Commission could not validly entertain a unilateral rate filing under section 205 of the Act in contravention of the contractual rate. In the Sierra case, however, the Court went further to spell out the limited conditions under which a contractual rate could be set aside under section 206 of the Act. When faced with a contractual rate, the Court wrote, "the sole concern of the Commission would seem to be whether the rate is so low as to adversely affect the public interest -- as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory." Id. at 355.

15. The Sierra-Mobile doctrine that emerged from these cases was more than simply a restriction on the Commission's discretion or a method of preserving "the benefit of the bargain" for customers who had signed low-rate contracts during the industry's salad days. It represented a fundamental shift in the locus of power to make rates -- from rates prescribed by governmental action to rates derived from private ordering. As one commentator has said, "the chief concern of the Mobile and Sierra decision was the preservation of the integrity of contracts and the limitations on the Congressional delegation of authority to the FPC to encroach on private contractual arrangements." C. Gentile, The Mobile-Sierra Rule: Its Illustrious Past and Uncertain Future, 21 Energy L.J. 353, 362 (2000). Parties seeking to avoid the application of the Sierra-Mobile rule frequently argue, as PacifiCorp does here, that the Supreme Court did not purport to dispense with the statutory requirement that "all rates must be just and reasonable." That is indeed true, but it misses the point. Under Sierra-Mobile, a contractual rate is by its nature just and reasonable; as the same commentator quoted above has said, "the existence of a contract has a dispositive effect on the public interest analysis used to determine justness and reasonableness . . . the existence of a contract infuses the rate with the attribute of reasonableness." Id. at 357.

16. The heart of the Sierra-Mobile doctrine is the supremacy of private ordering.[8] That was made clear in two subsequent cases, United Gas Pipe Line Co v. Memphis Light, Gas & Water Div., 358 U.S. 103 (1958) and Papago Tribal Utility Auth. v. FERC, 723 F.2d 950 (D.C. Cir. 1983), in which the courts held that the Commission must honor a contractual provision that selected a middle ground for agency review of rate changes. In Memphis, the parties had agreed that review of rate changes by the utility could take place only under the aegis of section 206 of the Federal Power Act, rather than the normal forum for utility rate filings, section 205 of the Act. What difference did it make? Both sections of the statute employed the "just and reasonable" standard for judging the validity of the utility's rate change. Unlike a section 205 filing, however, in a proceeding under section 206 there was in that day no provision allowing the Commission to provide retroactive relief to a customer who had been paying rates that the Commission determined were unjust or unreasonable -- the Commission's order could be effective prospectively only. See Boston Edison Co. v. FERC, 856 F.2d 361, 372-73 (1st Cir. 1988); Kansas Cities v. FERC, 723 F.2d 82,87 (D.C. Cir. 1983).[9] In Papago, decided the same day as Kansas Cities, the Court of Appeals, in an opinion by then-Judge Scalia, said that the parties could agree upon, and the Commission could employ, a just-and-reasonable standard for review of rate change filings. The Commission, according to Papago, was not obliged to adhere to the draconian "public-interest" test, a standard that the court characterized as "practically insurmountable." 723 F.2d at 954. In large measure, the Papago court adopted this middle ground in recognition of the fact that "rate changes would be a dim prospect, hardly worthy of recognition, if the parties did not intend the just-and-reasonable standard to govern." Id.

17. In the present case, however, neither the text of the contracts nor the circumstances surrounding their creation address the criteria for changing the rates agreed-to by the parties. This is the case, undoubtedly, for two reasons. First, the parties did not expect the rates to change; in a competitive marketplace, the obligations of the parties to commodity futures

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[8] See Atlantic City Electric Co. v. FERC, 295 F.3d 1, 14 (D.C. Cir. 2002) (the purpose of the Mobile-Sierra doctrine is to "preserve the benefits of the parties' bargain as reflected in the contract . . . ".).

[9] In 1988, Congress enacted the Regulatory Fairness Act, P.L. No. 100-473, 102 Stat. 2299 (1988), which amended section 206 to permit the Commission to order refund relief in a proceeding under that section. This change took place a decade after the Memphis decision was issued. Another difference, of course, is that in a §205 case, the utility has the burden of proof, while in a §206 proceeding, the burden rests on the complaining customer.

contracts are "firm," at least in the absence of some catastrophic occurrence in the nature of a world war. Second, the contracts are short-term arrangements calling for deliveries of electricity and payment of the prices during a period of only 90 days. In that context, it could hardly have occurred to either PacifiCorp or any of the Respondents that it, or its counterparty, might apply to the Commission for a change in the contract prices. So the contracts say nothing about the mechanism for making that kind of application or the standard that the Commission should employ to determine whether a change in the prices would be warranted.

18. It is well-established that, under the Sierra-Mobile doctrine, the absence of an express contractual manifestation of the parties' intentions with respect to the method of changing their agreement means that the rate provided in the contract may not be altered unless the Commission correctly determines that the public-interest standard laid down in the Sierra case has been satisfied. As the United States Court of Appeals for the District of Columbia Circuit said in said in Texaco, Inc. v. FERC, 148 F.3d 1091, 1096 (D.C. Cir. 1998), "[t]he law is quite clear: absent contractual language 'susceptible to the construction that the rate may be altered while the contract subsists,' the Mobile-Sierra doctrine applies." (Quoting Appalachian Power Co. v. FPC, 529 F.2d 342, 348 (D.C. Cir. 1976).) Contractual silence on this subject speaks volumes: "specification of a rate or formula by itself implicates Mobile-Sierra (unless the parties negate the implication.)" Boston Edison Co. v. FERC, 233 F.3d 60, 67 (1st Cir. 2000). In San Diego Gas & Electric Co. v. Public Serv. Co. of New Mexico, 91 FERC ¶ 61,233 (2000), the Commission held that it could not change a contract rate at the behest of a purchaser of electricity unless the purchaser could satisfy the public-interest standard. In that case, as here, the contract contained no language about the buyer's rights under §206 of the FPA, and "the evidence introduced at the hearing similarly reflected that the parties did not ever discuss either Section 206 or the applicable standard of review were a Section 206 complaint to be filed." Id. at 61,852.

19. Both the Complainant and the Respondents agree that there is no language in any of the contracts that is susceptible of the construction that the rates set forth therein may be altered in any manner except by mutual consent of the parties. The EEI Master contract and the confirmations are all totally silent on the subject. Section 6.1 of the WSPP Agreement provides as follows:

> Nothing contained herein shall be construed as affecting in any way the rights of the Parties to jointly make application to FERC for a change in the rates and charges, classification, service, terms, or conditions affecting WSPP transactions under Section 205 of the Federal Power Act and pursuant to FERC rules and regulations promulgated thereunder.

This provision seems to say only that the parties to the contract may jointly apply to the Commission for a change in rates, terms or conditions agreed upon by them. It is silent, however, on the ability of a party to apply unilaterally to the Commission for such a change. See Ex. S-6 at 15. In addition, Exhibit D to the WSSP Agreement includes a dispute-resolution clause, which provides for informal mediation and formal arbitration. In its June 28, 2002 hearing order, however, the Commission expressly declined to require the parties to exercise their rights under the mediation and arbitration provision, asserting that the issue of the rate to be charged PacifiCorp "is clearly within the Commission's exclusive jurisdiction under the [Federal Power Act]." 99 FERC at 62,614. [10] As the record stands, therefore, the parties' silence on the subject of the methodology for changing the rates, terms and conditions of their bargains means that the Sierra-Mobile doctrine applies to the 12 contracts at issue in this proceeding and prohibits the Commission from changing the contract rates in the absence of a finding that the public-interest standard has been satisfied.

20. PacifiCorp's primary argument to the contrary is twofold. First, it says that the Sierra-Mobile doctrine does not apply to contracts made under market-based rate authority. Second, PacifiCorp points out that although both the EEI Master Contract and the WSPP Master Agreement may have been filed with the Commission in other proceedings,[11] the specific 12 confirmation agreements at issue here "have never been filed, reviewed, or accepted by the Commission." PacifiCorp Initial Brief at 25. PacifiCorp next points out that in several cases, e.g., Florida Power & Light Co., 67 FERC ¶ 61,141 (1994) and Northeast Utilities Service Co., 66 FERC ¶ 61,332 (1994), the Commission has ruled that the Sierra-Mobile doctrine applies only to contracts that have been filed with the Commission and

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[10] It is less clear than may appear on the surface, particularly if the Sierra-Mobile rule is read as a limitation on the Commission's jurisdiction (as the Supreme Court seemed to think it was). If parties may, by contract, restrict the Commission from setting aside their rate agreement, it is at least conceivable that the parties' contract may also prohibit the Commission from disregarding their agreement to settle disputes by commercial arbitration. This is, however, an issue that is not before me and one on which I express no opinion.

[11] As Staff witness Poffenberger pointed out (Ex. S-6 at 16), the Commission approved the WSPP Agreement, with modifications not here relevant, in Western Systems Power Pool, 55 FERC ¶ 61,099 (1991).

accepted for filing. The necessity for filing and acceptance was also noted in the Boston Edison case, supra, adds PacifiCorp. [12]

21. PacifiCorp's argument is in its essence an attack on the validity of market-based rates. If PacifiCorp were correct, no reasonable seller of electricity at wholesale in interstate commerce would seek or use market-based rate authority. The Sierra-Mobile doctrine, or something very much like it, is an essential element of a program in which buyers and sellers come together in an open competitive market and trade electricity. If neither party to those deals could be assured that the transactions could be legally enforced without first going through the sometimes-painful process of securing Commission approval of their agreement, no one except a vertically-integrated electric utility with the legal right and ability to pass through its costs to ratepayers would bother to participate in the marketplace or would risk the capital to do so. In addition, section 205's requirement that filed rates must be "open in a convenient form and place for public inspection" would inhibit the development of robust competitive markets. If PacifiCorp were correct, its attempts to meet its need for power and energy for delivery during the summer of 2002 would have been unavailing; when it sought to find counterparties with the assistance of brokers, no one would have answered the telephone.

22. The trouble with PacifiCorp's argument, therefore, is that it proves too much. If it is correct, no contract made under market-based authority is valid. The Commission expressly and definitively rejected that proposition within the past year. State of California ex rel. Lockyer v. British Columbia Power Exchange Corp., 99 FERC ¶ 61,247, reh'g denied, 100 FERC ¶ 61,295 (2002), appeal filed sub nom. State of California v. FERC, No. 02-73093, 9th Cir. This may explain why, in its hearing order, the Commission expressly excluded from the subjects set for hearing "issues concerning the Commission's policies on granting market-based rate authority or on regulation of sellers with such authority." 99 FERC at 62,615.

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[12] In Order No. 2001, Revised Public Utility Filing Requirements, FERC Stats. & Regs. ¶ 31,127, 30,125 n.30 (2002), the Commission said: "Any provisions in agreements that purport to bind the Commission to a standard other than the just and reasonable standard of FPA section 206, and that are not explicitly ruled upon and accepted by the Commission, will not be binding on the Commission." In its order on rehearing, however, the Commission withdrew this footnote stating that it would address Mobile-Sierra issues generically in a future proceeding. Order No. 2001-A, 100 FERC ¶ 61,074 at 61,285 (2002).

23. The rules for sellers in Respondents' category holding market-based authority do not require them to file contracts for Commission review before the contracts may be placed into effect. All that is required is periodic transaction reports. See Order No. 2001 Revised Public Utility Filing Requirements, FERC Stats. & Regs. ¶ 31,127 (2002). See also PacifiCorp Power Marketing, Inc., 74 FERC ¶ 61,139 (1996). While the Commission has issued a Notice proposing to adopt a policy statement that would require specific language invoking Sierra-Mobile coverage to appear in contracts by sellers holding market-based rate authority (see Standard of Review for Proposed Changes to Market-Based Rate Contracts for Wholesale Sales of Electric Energy by Public Utilities, FERC Stats. & Regs. ¶ 32,562 (2002)), that remains only a proposal which, by its terms, would not apply retroactively to the contracts at issue here. The proposal, nevertheless, reflects the Commission's belief that contracts made under market-based rate authority are not incompatible with the application of the Sierra-Mobile doctrine; all that the Commission is seeking under the proposed policy statement is fair notice of what species of Sierra-Mobile protection the parties to the contract intended.

24. In Lockyer, the Commission pointed out that it does not grant authority to make sales at market-based rates without first assuring itself that the applicant lacks market power; this investigation, the Commission ruled, satisfies the requirements in section 205 that rates must be just and reasonable and must be subject to review by the Commission. 99 FERC at 62,064 (2002).[13] If that is correct, there is no valid reason to treat a contractual rate resulting from the valid exercise of market-based rate authority any differently for purposes of the Sierra-Mobile doctrine than any other contractual rate.

25. As we have seen, the public-interest standard permits contractual rates to be modified only if the Commission determines that it is necessary to do so in order the safeguard the public interest. In Sierra, The term "public interest" was narrowly defined. Only if the Commission finds the presence of one of three factors -- (1) impairment of the financial ability of the public utility to continue its service; (2) casting upon other consumers an excessive burden; or (3) creating undue discrimination -- can the Commission alter the parties' contract rates. Later cases, casting a wary eye on Judge Scalia's view that the original version of the public-interest standard was far too restrictive, seem to have adopted a much more flexible reading of the public-interest standard. In Northeast Utilities Serv. Co.

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[13] It is ironic that the case cited by the Lockyer order for this proposition was PacifiCorp Power Marketing, Inc. 98 FERC ¶ 61,108 (2002). In that case, PacifiCorp's power marketing affiliate successfully fought off a challenge by the California Public Utilities Commission to the validity of its market-based rate transactions.

v. FERC, 55 F.3d 686, 691 (1st Cir. 1995), the Court of Appeals listed other circumstances that might justify modification of a contract under the public interest standard. A contract may be changed in the public interest, said the court, when it is unduly discriminatory or preferential to the detriment of parties that are not parties to the contract, when it is not the result of arm's-length bargaining (e.g., when the parties are affiliates) or when "it reflects circumstances where the seller has exercised market power over the purchaser." (quoting Northeast Utilities Serv. Co., 50 FERC ¶ 61,266 at 61,839 (1990)). The critical factor, in all of these cases, is that the Commission is acting to protect outside parties (i.e., parties who did not participate in the making of the contract) from undue discrimination or an excessive burden. See Northeast Utilities Serv. Co. v. FERC, 993 F.2d 937, 961 (1st Cir. 1993).

26. So the critical question is whether PacifiCorp has established on this record that it should be granted relief under the public-interest standard. In my judgment, it has not, regardless of which version of that standard is applied.

27. The historic public-interest test enunciated in Sierra focused principally on the impact of the contract on the financial health of the utility. It was concerned with the question whether performance of the contract in accordance with its terms might result in bankruptcy or insolvency of the utility, so that its retail customers might suffer an interruption in their service. PacifiCorp's evidence on this point includes the direct testimony of Roger Weaver, PacifiCorp's Director, Regulatory Strategy and Planning, and the rebuttal testimony of Bruce N. Williams, the company's Treasurer. According to Dr. Weaver, "[t]he out-of-market cost of these contracts is approximately $53 million on a total company basis." Ex. PAC-41, at 3.[14] Mr. Williams testified that the negative cash flow impact of the contracts was $61.9 million, i.e., PacifiCorp had purchased-power costs in excess of the amounts being recovered in rates during the third quarter of 2002 amounting to almost $62 million. See Ex. 73 at 2-3. Both of these witnesses said that PacifiCorp's debt had been down-graded in November 2001, with both Moody's and Standard & Poor's citing PacifiCorp's above-market fuel and purchased power costs. They both conceded, however, that the Western power crisis in general played a large part in the down-grading. In addition, these witnesses noted, PacifiCorp had suspended dividend payments to its shareholder and put off several capital improvement projects.

28. It is difficult to say whether PacifiCorp's troubles have been more extensive than those of the electric power industry as a whole or worse than those of the segment of the

[14] "The out-of-market cost," Dr. Weaver explained, "was calculated by multiplying the difference between the contract price per MWh and PacifiCorp's February 2002 Official Forward Price Curve." Id. at 11.

industry that serves the Western states. The Commission can, and should, take administrative notice of the fact that many public utilities in those categories have suffered financially during the 2000-2002 period, and that the largest of them filed for bankruptcy protection. In general, PacifiCorp's financial fortunes have been no worse than average and, by some lights, have held up fairly well. Little or none of this gloom can be directly connected to the transactions at issue in this proceeding. In August 2001, at least nine months before entering into those transactions, Mr. Williams, on behalf of PacifiCorp, filed prepared testimony with the Wyoming Public Service Commission, stating that PacifiCorp was "experiencing a financial emergency" and that PacifiCorp's "cash flow is, has been, and is expected to continue to be impaired." Ex. S-9, at 1, 3. He attributed the difficulty to "extremely high purchased power costs." Id. By contrast, the company's reports to its ultimate stockholders filed after PacifiCorp "booked out" the contracts in question were upbeat. Scottish Power issued a report of its financial and operating results for the six-month period ending September 30, 2002 which boasted that the operating cash flow of the company had increased from £ 353 million to £ 621 million and noting that:

> PacifiCorp reported an operating profit of £ 141 million for the quarter, bringing operating profit for the half year to £ 275 million, an increase of £ 249 million compared to the equivalent period last year. The improved financial performance for the half year was a result of regulatory rate increases and recoveries of excess power costs of £ 55 million, significantly lower net power costs and other gross margin movements of £ 235 million and continued progress with the Transition Plan which increased benefits in the half year by £ 31 million.

Ex. S-10, at 2-3. Not exactly the lament of a utility that is feeling the pinch of financial adversity. More recent data tell us the same thing. Scottish Power has stated that PacifiCorp is on track to double its operating profit to £1 billion or more over the next three years. Ex. MSC-43 at 1; Ex. EPME-37 at 4. PacifiCorp has received authorization to issue new common stock to Scottish Power. PacifiCorp's current debt ratings, both for long-term and short-term debt, are average-to-above-average. Tr. 587-88. In short, PacifiCorp should have no more difficulty raising new capital than other utilities in the same sector of the country.

29. PacifiCorp may be able to pass through a significant share of the cost of the contracts to its retail ratepayers. It has already received regulatory authorization to do so in Oregon. See Ex. PAC-41 at 6. Applications for pass-through authority are pending in California and Wyoming. Id. at 7. In Washington, PacifiCorp is subject to a five-year plan adopted in August 2000; the plan prevents the utility from filing for a rate increase until 2005, with the increase to be effective in 2006 at the earliest. PacifiCorp has, however, asked the Washington Commission for authority to "defer" its excess purchased power costs, i.e., to capitalize the costs as a regulatory asset and amortize them over a period of time. Id. As of

the date of the hearing PacifiCorp had not even asked for authority to pass through the additional expense to its Oregon and Idaho ratepayers; it retains that option in the future. The only jurisdiction in which PacifiCorp is prevented from recovering the costs from its ratepayers is Utah, where PacifiCorp agreed to a rate-case settlement that precludes it from filing for a rate increase until May 2003, with the increase becoming effective not earlier than January 2004. Id.

30. Dr. Weaver's estimate that PacifiCorp will be liable for $53 million of "out-of-market" costs attributable to the contracts at issue represents a worst-case forecast. It is based on the assumption that, if markets had been "normal," PacifiCorp would have been able to fulfill its need for Summer 2002 forward contracts at the prices predicted by its February 2002 price curve. It is not entirely clear why those predicted prices should constitute the starting point for calculating the downside risk that PacifiCorp assumed. Dr. Weaver says that the prices set forth in PacifiCorp's February 2000 Official Forward Price Curve were used as the benchmark in the Oregon retail rate proceeding. See Ex. PAC-41, at 3 n.1. But, like Staff witness Daniel L. Poffenberger (See Ex. S-6 at 20), I find it difficult to discern the relevance of that statement. [15] In its Reply Brief (at p. 45) PacifiCorp says that post-February 2002 price curves "could be relevant." But PacifiCorp, not anyone else, chose to use the February 2002 data. It is, moreover, likely that most, if not all, of the power-purchase costs PacifiCorp incurred under the contracts at issue will be recovered from retail rate payers. But even if we assume that the $53 million figure is an accurate representation of PacifiCorp's loss stemming from its agreement to these transactions, it does not amount to enough to warrant regulatory intervention under the public-interest standard. As Mr. Poffenberger pointed out, $53 million spread over PacifiCorp's 2001 net system load would result in a rate increase of less than one dollar per MWh. See Ex. S-6 at 21. It would increase residential, commercial and industrial rates during the year by only 1.5%, 1.8% and 2.7% respectively. Id. The total amount of power involved in the 12 contracts represents only about one-half of one percent of PacifiCorp's portfolio. See Ex. EPME-24 at 12. These figures are too close to the de minimis level to satisfy the Sierra test.

31. Even if we assume that the just-and-reasonable test should be applied here in lieu of the public-interest standard, the evidence that PacifiCorp has adduced does not persuade one that the prices set forth in the contracts at issue exceeded a just and reasonable level at the time the contracts were made. In fact, PacifiCorp did not squarely allege that the prices it

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[15] The prices predicted by the February 2000 curve, $37.48/MWh for July 2002, $42.68/MWh for August 2002 and $32.67/MWh for September 2002, are all significantly below the $92.00/MWh west-wide spot market price cap the Commission imposed in its June 19, 2002 order.

agreed to pay were not just and reasonable. Instead, it has claimed that the "market" was "dysfunctional" and that the Respondents exercised "market power." PacifiCorp witness Klein [16]defined a "dysfunctional market" as one in which:

> (1) the prices of electricity generally offered for sale differ significantly from prices representing the cost of production plus a reasonable margin; (2) such prices continue to be offered for an extended period of time; and (3) such prices are accepted by buyers because the buyers have no alternatives (such as increasing their own generation, turning to another sources of supply or not buying).

Ex. PAC-1 at 21. "Market power" according to PacifiCorp's evidence consisted of the ability to sell electricity above the short-run marginal cost of production. See Ex. PAC-17 at. 8.

32. While it is possible to support these concepts with selected excerpts from Commission issuances, [17] they do not amount to a credible case that the Respondents were exercising market power or sold electricity to PacifiCorp at prices that were above a just and reasonable level. To begin with, Professor Kalt was quite correct in pointing out that, as a matter of first principles, "market power is the ability to profitably sustain elevated prices *through the unilateral restriction of supply by a dominant firm or by the restriction of supply arising from the coordinated (e.g., collusive) restriction of supply decisions by multiple firms acting in a coordinated fashion.*" [18] The Commission, too, has recognized that "[m]arket power derives from the ability to withhold energy." California Independent System Operator Corp., 100 FERC ¶ 61,060 at 61,241, modified, 101 FERC ¶ 61061 (2002). The ineluctable fact of the matter is that the record in this case contains not a shred of evidence that the Respondents or any of them colluded or otherwise acted in concert with

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[16] PacifiCorp's Senior Vice President for Commercial and Trading.

[17] E.g., Dr. Klein quotes the Commission as saying "market power is defined as prices above short-run marginal costs." Ex. PAC-17, p. 8. A look at the source of that statement shows that the Commission was merely quoting a Staff Report that said "sellers had the potential to exercise market power (where market power is defined as prices above short-run marginal costs) this summer . . ." San Diego Gas & Electric Co. v. Sellers of Energy and Ancillary Servs., 93 FERC ¶ 61,121 at 61,355 (2000).

[18] Ex. EPME-1 at 39 (emphasis in original). Professor Joseph P. Kalt, who testified as a witness on behalf of El Paso, is on the faculty of the Kennedy School of Government at Harvard University.

respect to prices or terms and conditions of service in the forward markets for electricity in the Western United States at or about the time that the contracts at issue were entered into. Nor is there any credible basis for concluding that the prices at which they sold electricity to PacifiCorp were unjust and unreasonable. True, those prices were higher than historic prices that had prevailed in the same market during earlier periods. But high prices can result from scarcity rents as well as the exercise of market power or profiteering. See Ex. EPME-1 at 39-40; Ex. S-11 at 19-20.[19] In this instance, it is clear that the Respondents were price-takers rather than primary producers in a position to withhold production from the market place. As Staff witness Ogur pointed out, prices can become elevated simply because demand has outpaced supply.[20] Indeed, the increase in prices is what tends to encourage new supply, thus righting the demand-supply balance. See Ex. EPME 20 at 38-40.

33. The marketplace in which these transactions took place was a busy place. Although PacifiCorp had only 13 suppliers that it deemed creditworthy (see Ex. EPME at RES-PAC 6(a), MSCG-PAC-12(b)), it had during the May 2000-June 2001 purchased power from 80 different sellers and sold power to 98 different buyers. See Ex. EPME-44 at EPME-PAC6(j), EPME-PAC-8(a). It seems clear that none of the Respondents could have dominated the market, as there were plenty of competitors ready, willing and able to do business with PacifiCorp. It is understandable that none of the parties offering electric energy for delivery during the three summer months of 2002 was willing to sell to PacifiCorp for less than it cost to buy the energy. That tends to be the rule, and market participants who violate the rule soon find themselves out of the marketplace, watching their erstwhile competitors and customers from the vantage point of a bankruptcy court. (To PacifiCorp witness Pechman, being forced out of business because a regulatory agency compels a marketer to sell power for less than it cost to acquire it is simply "not FERC's problem." Tr. 670) [21] There simply is no principled basis on which to assess penalties or impose refund obligations on these

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[19] It is astonishing to find PacifiCorp claiming, as late as its Reply Brief (at p. 30) that "California spot markets could have never allowed the existence of scarcity rents." For this interesting proposition, PacifiCorp cites testimony by Dr. Bidwell who, it turns out, was talking about so-called "perfect competition." Tr. 370.

[20] Ex. S-11, p. 19. Dr. Jonathan D. Ogur is an economist in the Commission's Office of Administrative Litigation.

[21] Dr. Carl Pechman, an economic consultant, was PacifiCorp's principal witness on the question whether granting the relief PacifiCorp seeks would adversely affect investor confidence. He spent most of his career on the staff of the New York Public Service Commission. See Ex. PAC-71.

Respondents for declining to sell electricity for less than the prices they thought they would have to pay to acquire it. Their unwillingness to do so is inherent in the concept of a seller of electricity who has been authorized to make sales at market-based rates.

34. PacifiCorp's case, in substance, is that the Respondents were duty-bound to offer themselves for martyrdom. They should have sold power at a below-market rate (Tr. 136) or, perhaps, when PacifiCorp's broker called seeking to purchase power for delivery 14 months hence, they should not have answered the phone. Accord Dr. Pechman at Tr. 670. According to PacifiCorp's witness Miles Bidwell, marketers and their owners should have simply absorbed the difference between the market price of electricity and the price that PacifiCorp, after the fact, deemed just and reasonable. Tr. 387-391. Dr. Oren, who testified for PacifiCorp, [22] said that Respondents should be deemed to have accepted the risk that the prices arrived at by arm's-length bargaining would, several years later, be found to be excessive. See Tr. 668.

35. With all due respect to PacifiCorp's learned counsel and equally learned witnesses, the hypotheses upon which PacifiCorp has sought relief from this Commission are simply absurd. No responsible regulatory agency could embrace them. The Respondents had authority to charge market-based rates. Market-based rates are rates that the market will bear. The rates they charged under their contracts with PacifiCorp were exactly what the authorization for market-based rates would have predicted. They did not collaborate to produce the rates that the market bore at the time PacifiCorp entered the market seeking counterparties who would promise it the delivery of power at Palo Verde in the summer of 2002. They did not mislead PacifiCorp. They did not hide material facts from PacifiCorp. PacifiCorp was a knowledgeable and sophisticated player in the market, and its marketing affiliate was, at or about the same time, busy extracting maximum profits from its own sales.

36. Here again, we see that PacifiCorp's case is essentially an assault on the Commission's policy of granting marketers and others the authority to make wholesale sales at market-based rates. That is, as we have explained above, something the Commission does not wish to consider in this case. For the foregoing reasons, I conclude that PacifiCorp has not sustained it burden of proving that the rates the Respondents charged under the contracts at issue were unjust or unreasonable.

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[22] Prof. Shmuel S. Oren, a Professor of Industrial Engineering and Operations Research at the University of California at Berkeley, testified as a witness on behalf of PacifiCorp.

The Relationship, If Any, Between the "Dysfunctional" Spot Market and the Forward Market

37. The Commission's June 28, 2002 hearing order called for an inquiry into "the question of whether the dysfunctional California spot market adversely affected the forward bilateral markets, and, if so, whether modification of any individual contract at issue is warranted." 99 FERC at 62,615 (footnote omitted). A great deal of the hearing record has been devoted to this issue. The evidence falls into three categories. First, there is the testimony of actual players in both the spot and forward markets about their experiences during the relevant period. Second, there is expert testimony by economists about whether there exists, as a theoretical matter, a connection between spot and forward markets for the same commodity. Third, there is a debate about whether the Complainant has successfully demonstrated that a meaningful statistical correlation exists between prices in the spot and forward markets.

38. The Commission has used the term "dysfunctional" to describe the California spot market in its November 1, 2000 and December 15, 2000 orders preempting California's efforts to require its investor-owned load-serving utilities to purchase all of their power needs on the spot market. San Diego Gas & Elec. Co., 93 FERC ¶ 61,121 (2000); San Diego Gas & Elec. Co. v. Sellers of Energy and Ancillary Servs. 93 FERC ¶ 61,294 (2000). The symptoms of the dysfunction were twofold. First, wholesale prices for electricity increased precipitously to levels that had not previously been seen, or even imagined, by experienced members of the utility community. Second, a significant shortage of supply existed; as a result, the California Independent System Operator was compelled to direct electric utilities to cut service to end-users, a phenomenon known as "rolling blackouts." The immediate causes of the dysfunction included an ill-conceived market design, under which load-serving utilities were prohibited from purchasing power under forward contracts and, at the same time, were legally constrained from raising their retail rates to pass through to customers the sharply escalating cost of purchased power. Also contributing to the disarray were various market "fundamentals." These fundamentals included unprecedented demand for electricity, rising natural gas prices (gas is the fuel that produces most of California's electricity), a sharp reduction in the availability of hydroelectric power owing to drought conditions in California and the Pacific Northwest, delays in the construction of new power plants owing to lengthy environmental and other siting reviews required by California law, the lack of sufficient emission credits to allow existing plants to run for longer periods and the lack of any mechanism to allow "price signals" to be discerned by end-users who might be thus induced to conserve their use of electricity.

39. The dysfunction in the California spot market soon spread to other Western states. As we shall have occasion to consider later on, events in the California economy tended to

become very influential in determining what happens throughout the Western Electric Coordinating Council (now the Western Systems Power Pool) region. Data contained in the testimony of several witnesses show graphically the enormous fluctuations in spot wholesale electricity prices throughout the region following soon after the destabilization of the California spot market. There really is no dispute about this. The question that remains, however, is whether there was a linkage between the spot market and the forward market, on which the transactions at issue took place.

40. To Dr. Robert Klein, PacifiCorp's Senior Vice President for Commercial and Trading, the proof of the connection between spot market prices and forward market prices is the fact that both sets of prices moved in tandem: When spot prices rose, so did forward prices. And when spot prices fell immediately after the Commission's "price-cap" order, so did forward market prices. See generally Ex. PAC-44 at 3-4. Stan K. Watters, PacifiCorp's Vice President of Trading and Origination, testified that during the Spring of 2001, prices in the WECC (presumably forward-market prices) were "3 to 6 times higher than historical prices in the WECC market for comparable electricity purchases." Ex. PAC-20, at 15-16. Prof. Oren graphed what he describes as "Q3 Average Forward Price - Palo Verde" in Figure 7 of his testimony (Ex. PAC-11). The graph shows that forward prices, which had reached the neighborhood of $280 per MWh in April 2001, dropped precipitously in May 2001, then rebounded somewhat in June, before falling below $50 per MWh in the December 2001-January 2002 period. The temporal correlation between price trends in the spot market and price trends in the forward market, PacifiCorp says, demonstrates that the answer to the Commission's question must be affirmative: the dysfunctional spot market triggered an effect on the forward market in which it traded.

41. The Respondents answer that PacifiCorp's hypothesis is a classic example of post hoc reasoning. [23] Their mantra is that "correlation does not establish causation." Resp. Initial Brief at 35. The Respondents' principal hypothesis is that, in the words of their witness Harvey, [24] "forward or long-term bilateral market prices are determined by expected future market fundamentals while current spot market prices are determined by current market fundamentals." Ex. MSC-1 at 8 (emphasis Dr. Harvey's). "Fundamentals," according to the Respondents, include such things as electricity demand, the cost and availability of natural gas, availability of hydroelectric supplies, weather, outages of generating and transmission

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[23] Post hoc ergo propter hoc reasoning postulates that if two events always occur in sequence, the earlier event must have caused the later one. On this basis, one can determine that the crowing of cocks causes the sun to rise every morning.

[24] Scott M. Harvey, an economic consultant, testified on behalf of three of the Respondents -- Morgan Stanley, Reliant and Williams.

facilities, availability of generating capacity and emission allowance costs and availability. Id. These things determine spot market prices. The fundamentals that affect forward prices include expected future electricity demand, expected drought conditions, expected weather and expected future additions to generating capacity. "Current spot prices do not determine forward prices," Dr. Harvey testified, "but both spot and forward prices may be affected by similar market fundamentals, or they may be impacted by divergent market fundamentals." Id. at 10. Prof. Kalt agreed. He testified that "a correlation between current spot and forward prices would not tell us that current spot prices are affecting or driving forward prices. Rather, it might tell us that market fundamentals existing today (e.g., tight supply) are expected to persist into the future." Ex. EPME-28 at 13 (emphasis in original).

42. The Respondents' poster child for the lack of causal connection between spot and forward markets is the fact that "on[-] and off-peak prices declined materially prior to the effective date of the Commission's April 16, 2001 order, briefly spiked in early June after the effective date of the April 16, 2001 Order, and then fell well before the Commission's June 19, 2001 Order." Ex. MSC-1 at 99. The Respondents place a great deal of weight on the decline in prices that took place before the Commission issued its "hard-cap" price mitigation order. This demonstrates, they say, that "the evidence does not support the conclusion that it was the June 19 Order which ended the dysfunctions in the spot market and therefore caused forward prices to decline, since both markets were declining prior to that Commission order." Resp. Initial Brief at 35.

43. Respondents also claim that, to a large extent, PacifiCorp has been aiming its arrows at the wrong target. They emphasize the fact that the Commission's hearing order did not ask whether the dysfunctions in the spot market had a causal effect on the forward market. Rather, the Commission asked whether the dysfunctional spot market "adversely affected" the forward bilateral market. The Respondents' point here is that even if there was a connection between the two markets, PacifiCorp has not demonstrated that the spot market's impact on the forward market was "adverse." For this reasoning, they rely on Prof. Kalt, who testified that when spot markets are dysfunctional, forward markets provide the therapy to cure the dysfunction.

> forward prices provide precisely the price signals that buyers and suppliers need to adjust to that prospect of continued spot market dysfunction. Such signals provide buyers with incentives to reduce demand through electricity conservation and to adjust their supply portfolios so as to dampen the impacts of higher prices that could arise in the future. On the supply side, such signals provide sellers with motivation and means for seeking out additional sources of supply and making new investments.

Ex. EPME-28 at 53. Dr. Ogur, testifying on behalf of the Commission's Trial Staff, agreed. See Ex. S-11 at 14.

44. In addition to its reliance upon empirical evidence, PacifiCorp also argues that economic theory supports its view that there is a linkage between spot and forward prices. Prof. Oren, one of its economic witnesses, pointed out that the underlying premise of forward contract pricing is that the buyers and sellers can, in lieu of transacting business on the forward market, wait and conclude the same transaction on the spot market at a later date. In a market where spot prices are high and supplies are scarce, therefore, forward prices will have built into them "an insurance premium reflecting the buyers' willingness to pay to avoid the risk of high future spot prices." Ex. PAC-11 at 38. Such a premium is especially likely when the spot market is dysfunctional, Oren concluded. Id. at 39, 41. Dr. Bidwell saw three economic links between spot and forward markets. First, there is arbitrage, i.e., buying in a spot market and buying in a forward market may represent equivalent means of obtaining supplies. See Ex. PAC-17 at 47. This may be the case with some commodities, but it is difficult to imagine how one would arbitrage between current and future prices for a commodity which cannot be stored. Dr. Bidwell's second "principle" is that there is an "uncertainty" link. An increase in uncertainty about future spot prices will cause an increase in the price of futures contracts, he claims. This is true only to the extent that prospective buyers are adverse to uncertainty, per se. In that event, they may be willing to purchase forward simply to obtain price certainty. We must remember, however, that the uncertainty that is of concern to buyers is limited to uncertainty about possible upward price movements. If buyers believe that prices will move downward, uncertainty about the extent of the movement may have no effect on their willingness to purchase forward. Finally, Dr. Bidwell says that there is a "bargaining outcomes" link. When spot market prices are high and volatile, he suggests, buyers have to buy but sellers do not have to sell; thus, a buyer will agree to pay excessive prices in order to secure supplies. This is a very tendentious analysis, which seems to assume a number of highly debatable conclusions. Among them is the assumption that PacifiCorp was under an overwhelming compulsion to purchase some 14 months forward or more and had no alternative except to purchase the products that it did. He also assumes that forward prices are excessive, which is the very thing he is attempting to prove. The appeal to fundamental economic theory does not appear to provide very much support for PacifiCorp's view.

45. Econometric analysis was the third leg on PacifiCorp's tripod. Prof. Timothy D. Mount, a Professor of Applied Economics and Management at Cornell University, presented a standard Vector Auto Regressive ("VAR") model of spot prices at four different locations in the West at which electricity is normally traded, including the Palo Verde switchyard. Using reported data from the New York Mercantile Exchange ("NYMEX"), Prof. Mount said he had conducted a statistical analysis which showed that "the spot price for electricity at Palo Verde is a statistically significant determinant of the forward price of electricity for two fixed delivery dates, August 2001 and August 2002." Ex. PAC-14 at 4. According to Prof. Mount, his analysis showed that "90% of the variability of the forward price ratio (of

electricity to natural gas) for delivery at Palo Verde in August 2002 can be explained by changes in the spot price of electricity." Id.

46. After this brave beginning, things rapidly got more murky. Prof. Mount examined the daily observed on-peak prices at the trading hubs commonly known as SP-15, COB, Mid-C and Palo Verde for the period January 1,1999 to August 31, 2002. Id. at 5. After some adjustments to get rid of the impact of seasonal factors and the Commission's "soft-cap" order of December 2000, Prof. Mount placed the four price series into a VAR model as dependent variables. After further manipulation of the data, he arrived at the not-too-surprising conclusion that "there is strong statistical evidence that the four price series share a common dynamic structure and are highly interrelated. . . In other words, unexpected price shocks in the California spot market affected the spot prices at Palo Verde as well as the other two spot markets." Id. at 10. He then undertook to examine how current market conditions during the period of market dysfunction affected forward prices, using NYMEX data at Palo Verde for delivery of electricity in August 2001 and August 2002. To do so, Prof. Mount first looked at the relationship between the current spot price for electricity and the forward price of natural gas at Henry Hub on the same dates as the delivery dates of the forward sales of electricity. Id. at 11. His conclusion:

> Both regression models, fitted for the delivery dates of August, 2001 and August, 2002, show that most of the changes in the forward price ratio can be predicted by changes in the spot price. The null hypothesis that spot prices do not affect the forward price ratio can be rejected in both cases. Over 80% of the variability of the forward price ratio for delivery in August, 2001, and over 90% of the variability of the forward price ratio for delivery in August, 2002 can be explained by changes in the spot price of electricity.

Id. at 14-15.

> the spot markets for electricity in the Western Interconnection were interrelated, across the separate market locations and across time, in a meaningful and statistically significant way . . . most of the changes in the long-run relationship between the forward prices of electricity and natural gas at Palo Verde for delivery in August 2001 and August 2002 can be attributed to changes in the spot prices for electricity