ORAL ARGUMENT IS NOT YET SCHEDULED

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

No. 06-1178

COGENERATION ASSOCIATION OF CALIFORNIA AND THE ENERGY PRODUCERS AND USERS COALITION,
PETITIONERS,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
RESPONDENT.

ON PETITION FOR REVIEW OF ORDERS OF THE FEDERAL ENERGY REGULATORY COMMISSION

BRIEF OF RESPONDENT FEDERAL ENERGY REGULATORY COMMISSION

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FINAL BRIEF: June 4, 2007

CIRCUIT RULE 28(a)(1) CERTIFICATE

A. Parties:

All parties and intervenors appearing below and in this Court are listed in Petitioner's brief. There are no amici.

B. Rulings Under Review:

1. *Pacific Gas & Elec. Co.*, Opinion No. 482, 113 FERC ¶ 61,084 (2005), R.155, JA 245 ("Approval Order").

2. *Pacific Gas & Elec. Co.*, Opinion No. 482-A, 114 FERC ¶ 61,324 (2006), R.159, JA 295 ("Rehearing Order").

C. Related Cases:

This case has not previously been before this Court or any other court. Counsel is not aware of any other related cases pending before this or any other court.

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June 4, 2007

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GLOSSARY

12-CP	12 Coincident Peak Method
ALJ Order	*Pacific Gas and Elec. Co.*, 110 FERC ¶ 63,026 (2005), R.151, JA 149
Approval Order	*Pacific Gas & Elec. Co.*, Opinion No. 482, 113 FERC ¶ 61,084 (2005), R.155, JA 245
Commission or FERC	Federal Energy Regulatory Commission
FPA	Federal Power Act
PG&E	Pacific Gas & Electric Company
Rehearing Order	*Pacific Gas & Elec. Co.*, Opinion No. 482-A, 114 FERC ¶ 61,324 (2006), R.159, JA 295 ("Rehearing Order")
Standby Customers	Petitioners Cogeneration Association of California and Energy Producers and Users Coalition

IN THE UNITED STATES COURT OF APPEALS
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FEDERAL ENERGY REGULATORY COMMISSION,
RESPONDENT.

ON PETITION FOR REVIEW OF ORDERS OF THE FEDERAL ENERGY REGULATORY COMMISSION

BRIEF OF RESPONDENT FEDERAL ENERGY REGULATORY COMMISSION

STATEMENT OF THE ISSUE

Whether the Federal Energy Regulatory Commission ("Commission" or "FERC") reasonably determined, based on substantial evidence in the record and consistent with cost causation principles, that Pacific Gas & Electric Company's ("PG&E") proposed rates for standby transmission service are just and reasonable.

STATUTES AND REGULATIONS

The relevant statutes and regulations are contained in the Addendum to this brief.

STATEMENT OF THE CASE

This case concerns the Commission's acceptance of PG&E's filing of rates for electric transmission service. The issue raised here is whether PG&E may, consistent with cost causation principles, use a particular cost allocation method to develop rates for transmission service to a particular class of customers -- standby customers -- which have their own electric generation facilities and take service from PG&E only when their facilities are out of service.

Specifically, PG&E proposed in its filing to develop rates for standby transmission service using a "probabilistic" method, which assesses the amount of contracted service that standby customers are likely to require during hours of peak demand on the transmission system. PG&E has used this method since 1993 to account for the markedly different characteristics of standby transmission customers, whose use of the transmission system is dependent on random outages of their on-site generators, and thus cannot be predicted with any certainty. For all other rate classes, PG&E proposed to use the more common 12 coincident peak (12-CP) cost allocation method.

Following a hearing, an administrative law judge concluded that, while PG&E had proven that standby transmission customers are sufficiently different from other transmission customers to warrant different rate treatment, PG&E had not shown that the specific components used in the probabilistic analysis were just and reasonable and supported by substantial evidence. Instead, the judge required PG&E to use the 12-CP method to develop its standby transmission rates. *See Pacific Gas and Elec. Co.*, 110 FERC ¶ 63,026 (2005), R.151, JA 149 ("ALJ Order").[1]

In the orders under review, the Commission agreed with the judge that PG&E had proven that standby customers are not similarly situated to other customers, but disagreed with the judge's conclusion that PG&E had not supported the components of its probabilistic method as just and reasonable. The Commission concluded that substantial evidence in the record supported the components of PG&E's probabilistic analysis, that the probabilistic method satisfied cost causation principles, and that use of the 12-CP method to set standby rates would be inappropriate given the record evidence regarding the significantly different characteristics of the standby class. *See Pacific Gas & Elec. Co.*, Opinion No. 482, 113 FERC ¶ 61,084 (2005), R.155, JA 245 ("Approval Order"), *order on*

[1] "R." refers to a record item. "JA" refers to the Joint Appendix page number. "P" refers to the internal paragraph number within a FERC order.

reh'g, Opinion No. 482-A, 114 FERC ¶ 61,324 (2006), R.159, JA 295 ("Rehearing Order").

STATEMENT OF FACTS

I. Statutory and Regulatory Background

Under Section 201(b) of the Federal Power Act ("FPA"), 16 U.S.C. § 824(b), the Commission has exclusive jurisdiction to regulate the transmission and sale at wholesale of electric energy in interstate commerce. *See, e.g., New York v. FERC*, 535 U.S. 1 (2002) (discussing statutory framework and Commission jurisdiction under the FPA).

Section 205(c) of the FPA, 16 U.S.C. § 824d(c), requires public utilities to file tariff schedules with the Commission showing their rates and terms of service, along with related contracts, for service subject to FERC jurisdiction. When those tariff schedules are filed, Sections 205(a)-(b) of the FPA, 16 U.S.C. §§ 824d(a)-(b), obligate the Commission to assure that the rates and services described in the tariff are just and reasonable and not unduly discriminatory. Under FPA § 205d(e), 16 U.S.C. § 824d(e), the Commission may suspend newly-filed rates or terms of service and set them for hearing procedures concerning their lawfulness.

II. PG&E's Transmission Rates Filing

On January 13, 2003, PG&E filed with the Commission, under FPA § 205, a proposed increase in its electric transmission rates under its Transmission Owner

Tariff ("TO Tariff"). R.1. PG&E's filing reflected a revenue requirement of $545 million, a proposed increase of $166 million as compared to its rates then in effect. *Id.* PG&E did not propose any changes to the non-rate terms and conditions of its tariff. *Id.*

PG&E's filing set forth a proposed allocation of its revenue requirements to various classes of customers, and the resulting rates for those customers. As relevant to this appeal, PG&E proposed to increase its rates for transmission service to "standby" customers, from $0.26 per kilowatt of contract demand to $0.35 per kilowatt of contract demand. *See* Approval Order at P 2, JA 248-49. Standby transmission service is provided to entities that have their own generating units on site to supply some or all of their own electricity requirements, but use the PG&E transmission system to draw electric power from the grid in the event of planned or unplanned outages of their on-site generators. *See* Brief on Exceptions of PG&E at 5-6, JA 210-11. Standby customers enter into a contract with PG&E entitling them to standby service up to a set amount when needed. *Id.*

A. The "Probabilistic" Method

PG&E has, since 1993, developed its standby transmission service rate using a "probabilistic" method, which assigns costs to the standby class based on the amount of standby customer generating capacity likely to be out of service, and therefore the amount of contracted service likely to be used by standby customers

during times of peak use of the transmission system. *See* Approval Order at P 8, JA 250. PG&E's 2003 filing, employing this method, assigned transmission system costs to standby customers to reflect 27.1 percent of the 600 MW of total contracted demand for the standby class. Exh. PGE-45 at 2-3, R. 172, JA 347-48. The 27.1 percent allocation factor was developed as a weighted average of a 12 percent allocation factor for the regional transmission share of PG&E's revenue requirement, and a 38 percent allocation factor for the local transmission share. *Id.*

For all other customer classes, PG&E used the 12-coincident peak ("12-CP") rate method, which assigns costs to the various classes based on the peak demand on the system during each month of the test year, and the percentage contribution of each class to that peak demand. *See, e.g., Second Taxing Dist. of Norwalk v. FERC*, 683 F.2d 477, 480-81 (D.C. Cir. 1982) (describing the 12-CP rate method).

III. Commission Proceedings and Orders

After providing notice and an opportunity for comment, on March 13, 2003, the Commission issued an order setting PG&E's filing for a hearing before an administrative law judge, concluding that parties intervening in the case had raised "factual matters that are best resolved at hearing." *See Pacific Gas and Elec. Co.*, 102 FERC ¶ 61,270 (2003), R.27, JA 137.

During the hearing procedures, the presiding administrative law judge granted summary disposition as to one issue raised by PG&E's filing, and two

uncontested partial settlements were reached by the parties on all but one of the remaining issues. The grant of summary disposition and the settlements were affirmed by the Commission, and are not challenged in this appeal. *See* ALJ Order at PP 2-5, JA 151 (describing summary disposition and uncontested partial settlements, and Commission approvals).

The one issue remaining for hearing and decision was PG&E's use of the probabilistic method to develop rates for standby transmission service. A hearing was held on this issue on August 31, 2004, and the administrative law judge issued an Initial Decision on February 9, 2005.

A. Positions of the Parties at Hearing

At hearing, Petitioners Cogeneration Association of California and Energy Producers and Users Coalition (collectively, "Standby Customers") challenged PG&E's use of the probabilistic method, instead of the 12-CP method, to design rates for the standby customer class. They argued that the standby class is not sufficiently different from other rate classes as to justify different rate treatment. *See* ALJ Order at PP 21-26, JA 155-56. Further, they asserted that PG&E plans its transmission system and incurs costs to serve the standby class in the same manner it incurs costs to serve other classes, and thus the standby class should receive identical rate treatment. *Id.* As a result, Standby Customers argued that costs should be allocated to the standby class based on the same 12-CP method used for

PG&E's other rate classes. Their preferred cost allocation method, they contended, better reflected PG&E's assessment of transmission adequacy and the factors it used in its transmission planning process. *Id.* at P 24-25, JA 156.

PG&E responded that the unique characteristics of standby transmission service customers and their use of the system warrant different rate treatment from other classes of service. *Id.* at PP 12-20, JA 152-55. They argued that use of the transmission system by standby customers is subject to extreme and unpredictable variations (particularly during summer peak hours), different from the ordinary variations in use by other customers classes, and therefore justifying different rate treatment. *Id.* at P 12, JA 152. Accordingly, PG&E contended that its modification of the 12-CP method to employ a probabilistic analysis based on contract demand was reasonable and consistent with the use characteristics of the standby class, and fairly assigned cost responsibility to standby customers. *Id.* at P 13, JA 153. PG&E also asserted that the unadjusted application of the 12-CP method to standby customer rates, advocated by Standby Customers, would be inappropriate, because it could not meet its obligation to provide standby service if it planned the system based only on the average peak-period demand of those customers. *Id.* at P 18, JA 154.

The Commission Trial Staff supported PG&E's proposed rate design. Staff argued that PG&E adequately supported the probabilistic method as just and

reasonable, and that this method was not unduly discriminatory, given that standby customers are not similarly situated to other customer classes. *Id.* at P 27-28, JA 156-57.

B. ALJ Order

Based on the positions advanced at hearing, the administrative law judge divided the cost allocation issue into two sub-issues: (1) whether the standby class is sufficiently different from other classes of transmission customers, such that PG&E could allocate costs based on a probabilistic analysis of contract demand, rather than the contribution to system peak (or 12-CP) method; and (2) whether PG&E's probabilistic method was flawed because it did not appropriately reflect the differences between the standby class and other classes. ALJ Order at P 32, JA 158.

On the first sub-issue, the judge began by noting that while the 12-CP method has been commonly used for cost allocation, the Commission has allowed the use of other methods on a case-by-case basis. *Id.* at P 35, JA 159-60 (citing *Central Power and Light Co.*, 47 FERC ¶ 61,339 at 62,165 (1989)). The judge went on to find that PG&E had met its burden of proving that the standby class is not "similarly situated" to other rate classes, noting witness testimony regarding the "fundamental randomness" of the demand of standby customers as compared to customers relying on PG&E for all of their service. *Id.* at P 36, JA 160. Given this

fundamental randomness, the judge further found that PG&E must "stand ready" to serve standby loads, and that it incurs a cost to reserve capacity and be prepared to serve standby customers up to their contracted demand level when needed. *Id.* at PP 39-40, JA 161. As a result, the judge concluded that basing rates for this "valuable service" on a probabilistic method based on contract demand as opposed to the 12-CP method is not *per se* unreasonable. *Id.* at P 41-43, JA 161-62.

While finding that a probabilistic method based on contract demand was not precluded, the judge noted that the method must still be supported by PG&E as just and reasonable under FPA § 205. *Id.* at P 44, JA 162. Reviewing the evidence presented by PG&E and its witness, Mr. Bell, the judge held that PG&E had not supported its proposed rate design for standby service. *Id.* at PP 45-60, JA 162-67. In particular, the judge was critical of the regional and local components used to develop the 27.1 percent allocation factor on which the standby rates were based, finding that they were "noticeably undersupported" and had not been updated to reflect more recent load data since they were first used in a 1993 rate case. *Id.* at PP 45-50, JA 162-64. The judge instead relied on the testimony of Standby Customers' witness, Mr. Ross, which she found reflected "the more recent data and behavior of the standby class." *Id.* at P 52, JA 165.

Additionally, the judge reasoned that "PG&E's proposal confronts the Commission preference for 12-CP methodology for rate design purposes." *Id.* at P

53, JA 165 (citing *Union Elec. Co. v. FERC*, 890 F.2d 1193, 1199 n. 7 (D.C. Cir. 1989)). She also found that PG&E had not shown that its method follows "the general principle . . . that 'cost responsibility should track cost causation.'" ALJ Order at PP 53-54, JA 165 (citation omitted).

Concluding her consideration of the second sub-issue, the judge found that in contrast to PG&E's proposed rate design, the 12-CP method advanced by Standby Customers would result in the standby class properly paying for their actual use of the system, and would better align cost responsibility with cost causation. *Id.* at P 60, JA 167. The judge also noted that the relatively small size of the standby class (about 3.2 percent of PG&E's revenue requirement) would mitigate any difficulty created by the unpredictability of standby demand. *Id.*

C. Challenged Orders

1. Approval Order

Both PG&E and FERC Trial Staff filed exceptions to the ALJ Order, and Standby Customers filed a brief opposing those exceptions, pursuant to 18 C.F.R. § 385.711 (2006).

In Opinion No. 482, the Commission addressed these submissions and affirmed in part and reversed in part the ALJ Order. The Commission identified specific issues raised by the ALJ Order and submissions of the parties, three of which are relevant to this appeal: (1) whether PG&E's proposed probabilistic

method properly determined the cost responsibility of the standby class; (2) whether there was substantial evidence in the record to support PG&E's proposed standby transmission service rates; and (3) whether, in contrast, the 12-CP method proposed by Standby Customers properly allocated costs to standby customers. Approval Order at P 21, JA 254-55.

With regard to the first issue, the Commission noted that no exceptions were filed to the following findings of the administrative law judge:

> (1) PG&E has an obligation to provide standby service when it is called upon; (2) PG&E's proposed standby rate is not *per se* unreasonable or discriminatory merely because PG&E uses a 12 coincident peak methodology for other rate classes; (3) the standby customer class is not similarly situated to other customer classes; (4) a rate based on contract demand may be appropriate; and (5) PG&E standing ready to provide transmission service to standby customers on demand is a valuable service and rates based on this potential use of transmission, rather than actual use, are not *per se* unreasonable and may be reasonable if they are based on reasonable extrapolations from historical data on operating demand.

Id. at P 22, 24, JA 255, 256. The Commission expressly affirmed these findings, and concurred "with the [judge's] view that PG&E's rate proposal need not be perfect but need only be reasonable." *Id.* at P 24, JA 256.

With regard to the second issue (the sufficiency of PG&E's evidence), the Commission reversed the judge's findings and found that "substantial and persuasive evidence" in the record supported PG&E's probabilistic method and resulting rate design for standby transmission service. *Id.* at P 41, JA 261. The

Commission stated that PG&E's probabilistic method of designing standby rates, while originally developed in 1993, had been carried forward through five rate cases and, more importantly, was supported by more recent data in the record. *Id.* at P 42, JA 261-62. In particular, the agency observed that for both the regional and local allocation factors, PG&E witness Bell confirmed the continued appropriateness of those components based on 2001 data in the record. *Id.* at PP 43-44, JA 262-63. The Commission also noted that PG&E's proposed rates for standby service were substantially less than the rates charged to full requirements customers that do not have their own generation and rely entirely on PG&E's transmission system to support their needs. *Id.* at P 48, JA 263-64. Further, the Commission stated that the probabilistic analysis was supported by its policy on rates to cogeneration facilities (which represent the bulk of standby transmission service customers) announced in a 1980 rulemaking. *Id.* (citing *Small Power Production and Cogeneration Facilities; Regulations Implementing Section 210 of the Public Utility Regulatory Policies Act of 1978*, Order No. 69, FERC Stats. & Regs. ¶ 30,128 at 30,887, 30,889 (1980)).

The Commission reversed the judge's findings with regard to the third issue (whether the 12-CP method is appropriate in this case). The Commission granted exceptions to the judge's reliance on earlier Commission rulings to support application of the 12-CP method to PG&E's standby rates, Approval Order at PP

53-57, JA 265-67, and also held that the probabilistic method satisfied the principles of cost causation because it reasonably reflected the costs imposed by standby customers. *Id.* at PP 63, 65, JA 268, 269. The Commission also concluded that, on the basis of the record in this case, the 12-CP method did not fairly allocate costs to standby customers because they are not similarly situated with other classes of customers due to the unpredictability of their demand. *Id.* at P 64, JA 268-69.

2. Rehearing Order

In Opinion No. 482-A, the Commission denied rehearing. With regard to cost causation, the Commission rejected Standby Customers' arguments that the evidence failed to show the particular incremental costs actually incurred by PG&E to serve standby load. Rehearing Order at PP 10-12, JA 298-99. Further, the Commission reaffirmed its conclusion that the probabilistic method proposed by PG&E more fairly allocated costs to standby transmission service customers than the application of the 12-CP method. *Id.* at PP 13-14, JA 299-300. Additionally, the Commission rejected Standby Customers' arguments that the probabilistic method was neither supported by the evidence, nor produced a reasonable result. *Id.* at PP 17-21, JA 301-304.

SUMMARY OF ARGUMENT

The Commission reasonably concluded that PG&E's continued use of a probabilistic analysis to develop standby transmission rates, in contrast to the 12-CP method used for its other rates, is supported by substantial evidence, is consistent with cost causation principles, and produces rates that are just and reasonable.

First and foremost, under the relevant standard of review, the Commission's decision is supported by substantial evidence in the record. That evidence demonstrated that standby transmission customers are not similarly situated to other transmission customers due to the unpredictable nature of their use of the transmission system, and that PG&E incurs a cost to serve those customers. The specific components used in PG&E's probabilistic analysis were also supported by substantial record evidence, particularly the more recent data showing the use of standby transmission customers at or near the system peak.

The Commission's conclusion is also supported by cost causation principles. As the record evidence showed, PG&E incurs costs (in the nature of a capacity requirement) to meet its obligations to serve standby customers. As a result, it was reasonable to allocate a share of the costs of PG&E's transmission system to the standby class according to the likelihood that they will use the system during peak periods.

Finally, the probabilistic method used by PG&E results in just and reasonable rates to standby customers. The rates reflect an 80 MW share of PG&E's transmission system, substantially less than the 600 MW of total demand contracted for by standby customers and that PG&E is obligated to provide when needed. Those rates are also, appropriately, significantly less than the rates paid by customers who rely on PG&E for all of their service needs.

ARGUMENT

I. Standard of Review

The Commission's orders are reviewed under the arbitrary and capricious standard of the Administrative Procedure Act. *See, e.g., Sithe/Independence Power Partners v. FERC*, 165 F.3d 944, 948 (D.C. Cir. 1999). Under this standard, the court "will affirm the Commission's orders so long as FERC 'examined the relevant data and articulated a . . . rational connection between the facts found and the choice made.'" *Midwest ISO Transmission Owners v. FERC*, 373 F.3d 1361, 1368 (D.C. Cir. 2004) (quoting *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 26, 43 (1983)). "Further, in light of the technical nature of rate design, involving policy judgments at the core of the regulatory function, the court's review of challenges to rate design is highly deferential." *Entergy Servs., Inc. v. FERC*, 319 F.3d 536, 541 (D.C. Cir. 2003) (citing *Sithe/Independence Power Partners*, 165 F.3d at 948).

The Court upholds the Commission's factual findings if supported by substantial evidence. *See Florida Municipal Power Agency v. FERC*, 315 F.3d 362, 365 (D.C. Cir. 2003); FPA § 313(b), 16 U.S.C. § 825*l*(b). Substantial evidence is "such 'relevant evidence as a reasonable mind might accept as adequate to support [a] conclusion.'" *Consolidated Oil & Gas, Inc. v. FERC*, 806 F.2d 275, 279 (D.C. Cir. 1986) (quoting *Universal Camera Corp. v. NLRB*, 340 U.S. 474, 477 (1951)). "The 'substantial evidence' standard requires more than a scintilla, but can be satisfied by something less than a preponderance of the evidence." *FPL Energy Maine Hydro LLC v. FERC*, 287 F.3d 1151, 1160 (D.C. Cir. 2002). Where the evidence might support more than one rational interpretation, the Court upholds the Commission's findings: "'the question we must answer . . . is not whether record evidence supports [the petitioner's] version of events, but whether it supports FERC's.'" *B&J Oil and Gas v. FERC*, 353 F.3d 71, 78 (D.C. Cir. 2004) (quoting *Florida Municipal*, 315 F.3d at 368).

II. The Commission's Acceptance of the Probabilistic Method is Based On Substantial Evidence In The Record

In this case, the Commission was faced with a choice between two competing methods (and the evidence supporting those methods) for designing PG&E's standby transmission service rates: the probabilistic method proposed by PG&E in its FPA § 205 rate filing, or the 12-CP method advanced by Standby Customers at hearing. The Commission's conclusion in the challenged orders that

the probabilistic method is just and reasonable is based on several pieces of relevant record evidence, as discussed below. The Commission's conclusions, therefore, satisfy the substantial evidence standard. *See B&J Oil and Gas*, 353 F.3d at 78 (quoting *Florida Municipal*, 315 F.3d at 368) ("'the question we must answer . . . is not whether record evidence supports [the petitioner's] version of events, but whether it supports FERC's'").

A. Substantial Record Evidence Supports The Conclusion That Standby Transmission Customers Are Not Similarly Situated to Other Customers, And That PG&E Incurs Costs to Stand Ready to Serve Standby Customers.

As noted above, the presiding judge concluded that PG&E had demonstrated that standby transmission customers are not similarly situated to other classes of customers due to the unpredictability of their use of the transmission system, and thus a standby rate design based on contract demand instead of the 12-CP method is not *per se* unreasonable. ALJ Order at PP 36-43, JA 160-62. The presiding judge also found that PG&E incurs costs (in the nature of a "capacity requirement") to stand ready to serve standby transmission customers up to their contracted demand level when required. *Id.* at PP 39-40, JA 161.

The judge's findings in this regard were based on testimony in the record from witnesses for both PG&E and Standby Customers. *See id.* at PP 33, 36, 39-41, JA 158-59, 160, 161-62. With regard to the unique nature of standby service, the judge relied on PG&E witness Bell's testimony at hearing that the demand of

the standby class is "fundamentally random" and can vary significantly compared to other rate classes, since it depends on the combination of customer generators that are out of service on particular days. *Id.* at P 33, 36, JA 158-59, 160 (citing Tr. at 187-90, JA 11-14). Additionally, the judge noted that Standby Customers' witness Ross agreed that standby service differs from other classes of service "'because it is typically a function of random outages associated with the customer generation equipment failure.'" *Id.* at P 36, JA 160 (quoting Exh. CAC/EPUC 1R at 3-4, R. 160, JA 311-12).

The judge also relied on testimony in the record to find that PG&E incurs costs to stand ready to provide service to standby transmission service customers when needed. ALJ Order at PP 39-40, JA 161. For example, the judge referenced Mr. Bell's testimony regarding PG&E's obligation to have capacity available at all times to serve standby load when needed. *Id.* at P 39, JA 161. Mr. Bell stated that standby customers are entitled under their contracts to receive service up to the contracted demand level when their generators are out of service. *See* Tr. at 188, JA 12. Because the amount or timing of their need for service cannot be predicted with certainty, there is a capacity requirement that PG&E must maintain to meet its obligation, and thus a cost responsibility that should attach to standby customers' entitlement to take service up to their contracted demand. ALJ Order at P 39, JA 161. The judge concluded that this testimony showed that PG&E incurs a cost to

be prepared to meet standby customer needs when called upon. *Id.* at P 40, JA 161. She also noted the agreement of Mr. Ross, testifying for Standby Customers, that PG&E "must be ready 'to serve the standby load at all times.'" *Id.* (quoting Tr. at 286, R.133, JA 110).

No party filed exceptions to these findings and conclusions, and, as discussed above, the Commission explicitly affirmed them. Approval Order at PP 22-24, JA 255-56.

B. Substantial Record Evidence Supports the Commission's Determination That The Specific Probabilistic Method Proposed By PG&E is Reasonable.

The presiding judge ultimately rejected PG&E's probabilistic method, however, because she found that the local and regional components of the contract demand allocation factor (27.1 percent) used to allocate costs to the standby class were not supported by the evidence. ALJ Order at PP 48-52, JA 163-65. In addition, the judge found that the probabilistic method was at odds with the Commission's general preference for the 12-CP method. *Id.* at P 53, JA 165. Rather than require changes to the components of the probabilistic method, the judge chose to adopt the 12-CP method urged by Standby Customers and used for PG&E's other rate classes, concluding that it better accounted for standby customers' actual use of the transmission system at peak times, and more properly aligned cost responsibility with cost causation. *Id.* at P 60, JA 167.

The Commission reversed the judge's conclusion that PG&E's probabilistic method was not supported as just and reasonable, finding that substantial evidence supported the method and the resulting rates. Approval Order at P 41, JA 261. In particular, the Commission disagreed with the judge's primary conclusion that PG&E's regional and local allocation factors (forming the basis of the 27.1 percent of contract demand figure), based on a 1993 analysis, were outdated. *Id.* at PP 42-45, JA 261-63.

First, with regard to the 12 percent allocation factor for the regional share of the standby rates, the Commission relied on record evidence showing that while the average of 12 monthly coincident peaks (used if 12-CP were applied) would allocate a 40 MW share to the standby class, their actual use at or near the coincident peak in certain months of 2001 was 70-100 MW, significantly higher and consistent with the 12 percent regional allocation factor. Approval Order at P 43, JA 262 (citing Exh. PGE-45 at 5-6, JA 350-51). The Commission relied on testimony from PG&E witness Bell, which confirmed the continued appropriateness of the 12 percent regional allocation factor through an analysis of 2001 data. Approval Order at P 43, JA 262; *see also id.* at P 60 n. 65, JA 267 (reviewing 2001 data provided in Exh. PGE-51, R.173, JA 354).

Standby Customers argue only that this evidence relates to "*non-coincident* demands," and since such demands do not require enlargement of the transmission

system, they do not drive PG&E's costs. Pet. Br. at 18-19. As discussed above (*see supra* pages 19-20), and below (*see infra* pages 24-26), the presiding judge and the Commission concluded that PG&E incurs costs to stand ready to provide standby service, and such costs are reflected in its revenue requirements (*i.e.* the cost of maintaining and operating the transmission system) and not in particular incremental expansion costs. *See* Rehearing Order at P 11, JA 298.

The Commission also found that the evidence supported PG&E's 38 percent allocation factor for the local transmission component of the overall 27.1 percent allocation factor. Approval Order at P 44, JA 262-63. The Commission relied in part on Mr. Bell's analysis of the 2001 data, which showed that, for each of six areas, the single largest individual standby transmission customer accounted for between 29 and 48 percent of the total contracted standby load in that area, consistent with the 38 percent allocation factor. *Id.* (citing Exh. PGE-45 at 6-7, JA 351-52). The Commission also found FERC Staff's analysis of the 2001 data persuasive. That evidence showed that average standby load for all six areas in 2001 was 37 percent, comparable to the 38 percent allocation proposed by PG&E. Approval Order at P 44, JA 262-63 (citing Tr. at 204-05, JA 28-29).

Standby Customers' dismiss the correlation between Mr. Bell's evidence and the 38 percent local component as "merely coincidence," and contend that the performance of the single largest generator does not correlate to the probable

demand of standby customers in an area. Pet. Br. at 19. However, it is unclear why a contingency analysis of actual 2001 data for the single largest generator in each area is not probative of the likely demand of the standby class, especially since Mr. Bell went on to state that "[w]ere a 'two largest units' contingency analysis developed that would only serve to increase" the 38 percent local component, and the resulting rates. *See* Exh. PGE-45 at 7, JA 352 (responding to testimony of Mr. Ross discussing proper contingency evaluation of the transmission system).

Moreover, Standby Customers' argument holds the evidence that the Commission may rely on to a much more exacting standard than is required under the arbitrary and capricious standard or the substantial evidence standard. Mr. Bell's analysis of the 2001 data, along with FERC Staff's further explanation of that data, is relevant evidence relating to standby customers use of the transmission system, and supports the conclusion that a 38 percent local allocation component meets the just and reasonable standard of the FPA. *See Midwest ISO Transmission Owners*, 373 F.3d at 1368 (FERC must "examine[] the relevant data and articulate[] . . . a rational connection between the facts found and the choice made"); *FPL Energy Maine Hydro*, 287 F.3d at 1160 ("substantial evidence" is "more than a scintilla, but . . . something less than a preponderance of the evidence").

III. The Commission Reasonably Concluded, Based On Substantial Evidence In The Record, That The Probabilistic Method Satisfies Cost Causation Principles

Standby Customers broadly assert that the Commission's acceptance of the probabilistic method, underlying PG&E's proposed rates, fails to reflect cost causation. Pet. Br. at 2-13.

As Standby Customers note (*id.* at 3), to "add flesh" to the just and reasonable standard of the FPA, the Commission and the Courts have "traditionally required that all approved rates reflect to some degree the costs actually caused by the customer that must pay them." *K N Energy, Inc. v. FERC*, 968 F.2d 1295, 1300 (D.C. Cir. 1992). The Court "evaluate[s] compliance with this . . . principle by comparing the costs assessed against a party to the burdens imposed or benefits drawn by that party." *Midwest ISO Transmission Owners*, 373 F.3d at 1368. The Court does not require that costs be allocated "with exacting precision," and, under the standard of review of the Administrative Procedure Act, "[i]t is enough . . . that the cost allocation mechanism not be 'arbitrary or capricious' in light of the burdens imposed or benefits received." *Id.* (citing *Sithe/Independence Power Partners*, 285 F.3d at 5 ("FERC is not bound to reject any rate mechanism that tracks the cost-causation principle less than perfectly")).

The Commission's acceptance of the probabilistic method, continued in PG&E's 2003 rate filing, fully comports with these principles. While Standby

Customers assert that no record evidence supports the Commission's view that PG&E incurs costs to stand ready to serve standby customers, their argument ignores substantial evidence (discussed above) showing that PG&E is obligated under the terms of its contracts with standby customers to provide service up to their contracted demand when their generators are out of service. *See* ALJ Order at P 39, JA 161 (citing Tr. at 188:6-10, JA 12). Because standby customers take service at irregular intervals that cannot be predicted with certainty ("when needed, but only when needed,") PG&E essentially maintains a capacity requirement to meet its obligations to those customers. ALJ Order at P 39, JA 161 (citing Tr. at 193-94, JA 17-18).

As the presiding judge found, and as the Commission expressly affirmed, PG&E incurs costs to maintain that capacity and stand ready to provide standby transmission service when needed, even at system peak. *See* ALJ Order at PP 39-41, 48, JA 161-62, 163-64; affirmed in Approval Order at PP 22-24, 63, JA 255-56, 268; *see also* Rehearing Order at P 14, JA 300. Although they now dispute this finding, Standby Customers did not file any exception to the judge's finding in this regard, as required by 18 C.F.R. § 385.711(d). *See* Rehearing Order at P 12, JA 299.

Given the finding that PG&E incurs costs to stand ready to provide standby service, and the substantial evidence regarding the fundamental difference between

the standby class and other classes of customers, *see supra* pages 18-19, the Commission reasonably concluded that the probabilistic method properly allocated a share of the costs of PG&E's transmission system to standby customers commensurate with their use of the transmission system. *See* Approval Order at P 63, JA 268 (holding that PG&E's choice of rate design "provides the necessary nexus between costs incurred and rate responsibility").

This holding was not groundbreaking. The Commission has long recognized that standby transmission service is unique, and that a probabilistic analysis can be an appropriate method to allocate costs to standby customers. In its 1980 regulations implementing the Public Utility Regulatory Policies Act of 1978, for example, the Commission stated that rates for standby service should reflect the probability that the customer will need to take service and use the utility's capacity. *See* Approval Order at P 48, JA 264 (citing *Small Power Production and Cogeneration Facilities; Regulations Implementing Section 210 of the Public Utility Regulatory Policies Act of 1978*, Order No. 69, FERC Stats. & Regs. ¶ 30,128 at 30,887, 30,889 (1980)). Since that time, the Commission has recognized that the randomness associated with the demands of standby transmission service customers makes the use of a probabilistic analysis to assess cost responsibility appropriate. *See* ALJ Order at P 38, JA 160-61; *see also, e.g., Industrial Cogenerators v. Fla. Pub. Serv. Comm'n*, 43 FERC ¶ 61,545 at 62,351 (1988).

Further, as the judge noted in her decision, in *Central Power and Light Co.*, 47 FERC ¶ 61,339 (1989), a case Standby Customers attempt to distinguish (*see* Pet. Br. at 6), the Commission permitted the utility to charge a partial requirements transmission customer a rate based on contract demand (like the probabilistic method) rather than the 4-CP method it used for other classes. *See* ALJ Order at PP 35, 37-38, JA 159-60, 160-61. While the customer in that case was receiving a different service from the standby customers at issue here, both sets of customers "share the same element of fundamental randomness" that the Commission found justified use of a contract demand-based analysis in *Central*. *Id.* at P 38, JA 160-61.[2]

Standby Customers' entire argument proceeds from the notion that because PG&E plans its system to ensure that it can meet peak system loads, costs are incurred by PG&E only when it must expand the transmission system to meet peaks. Pet. Br. at 3-6. According to Standby Customers, the need to build

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[2] Standby Customers, in addition to failing to take exception to the ALJ Order regarding this conclusion, *see* Rehearing Order at P 12, JA 299, now argue for the first time that *Central* is distinguishable because the utility there took the contract demand of the partial requirements customer into account in its planning. Pet. Br. at 6. While that may be true, it does not make the Commission's ultimate holding in that case – that a utility may reasonably allocate costs to customers based on contract demand where the evidence shows that it incurs costs to stand ready to provide the contracted service – any less applicable here. As discussed above, substantial evidence in this case demonstrates that PG&E incurs costs to stand ready to provide service to standby customers up to their contracted demand levels; thus, consistent with *Central*, it is reasonable for PG&E to allocate costs using a probabilistic analysis of contract demand. *See supra* at pages 19-20, 24-26.

additional facilities to meet demand at system peak is the primary cost driver, rather than contract demand, and thus the probabilistic analysis based on contract demand does not satisfy cost causation principles. *Id.*

The Commission properly rejected this reasoning, explaining that rates for all classes of customers were developed based on PG&E's annual transmission revenue requirement (*i.e.*, its total cost to maintain and operate the transmission system, not just incremental costs). Rehearing Order at P 11, JA 298. As the Commission reasoned, "[t]hat the transmission system may have been built to meet the annual system peak does not mean that the rates to the standby class must be set using a [12-CP] methodology." *Id.* at P 11 n. 16, JA 298-99. Given the significant differences in the timing and quantity of the demand of the standby class, as compared to other classes, standby rates "can, and should, be developed differently." *Id.*

The Commission's view is in line with the view of this Court regarding cost causation. As noted above, the Court assesses compliance with cost causation principles "by comparing the costs assessed against a party to the burdens imposed or benefits drawn by that party." *Midwest ISO Transmission Owners*, 373 F.3d at 1369. Standby customers benefit from the right to take up to 600 MW of contracted service from PG&E whenever their generators are out of service, even during system peaks, and PG&E has the burden of maintaining capacity to stand

ready to provide service to the standby customers. Accordingly, allowing PG&E to assign a share of the costs of its system to standby customers based on a probabilistic analysis of the likely amount of standby service likely to be required during peak hours does not violate cost causation principles. *See also id.* at 1369 ("[i]t is enough, given the standard of review under the [Administrative Procedure Act], that the cost allocation mechanism not be 'arbitrary or capricious' in light of the burdens imposed or benefits received").

Standby Customers' assert that their preferred 12-CP method "better" tracks cost causation. Pet. Br. at 5. The Commission disagreed, concluding that applying the 12-CP method would not fairly allocate system costs to the standby class, given the record evidence that it is not similarly situated to other classes of service given the unpredictability of its use of the transmission system. Approval Order at P 64, JA 268-69; Rehearing Order at P 13, JA 299-300; *see also Second Taxing District*, 683 F.3d at 480-81 (noting that the 12-CP method best reflects real costs for customer classes that use consistent amounts of power throughout the year, but generally fails to reflect actual costs when a class imposes irregular demands (such as heavy seasonal demand)).

The evidence fully supports this conclusion. Importantly, PG&E and FERC Staff showed that the 12-CP method (under which the 12 monthly coincident peaks are averaged) would not fairly reflect the wide fluctuations in demand of standby

customers. They demonstrated that if the 12-CP method were used, standby customers would be assigned costs representing only a 40 MW share of the costs of the transmission system, even though their demand in many months far exceeded that amount. *See* Approval Order at P 60, JA 267 (citing Exh. PGE-45 at 4-5, JA 349-50, and Exh. PGE-51, JA 354). Further, despite paying for only a 40 MW share of the system, standby customers would continue to have the right to receive transmission service for up to 600 MW of contract demand. *Id.*

Moreover, Standby Customers' reliance on Mr. Morris' testimony as "the most probative" regarding the appropriate cost allocation method is unconvincing. Pet. Br. at 3. As the Commission explained on rehearing, Mr. Morris' testimony was not relevant to the cost causation determination, as it simply described the assessment of the transmission system conducted by PG&E each year to identify problems and propose facility expansions to correct those problems. Rehearing Order at P 11, JA 298. He did not identify incremental costs related to those plans, nor did he seek to assign any incremental expansion costs to particular customers or classes of customers. *Id.* In fact, as the Commission explained, he could not have done so, as PG&E's rates are based on its total annual revenue requirement, not just the costs of incremental expansion. *Id.*

In any event, the question the Commission had to answer in this case is not whether the 12-CP method advanced by Standby Customers "better" or more

perfectly tracks cost causation, but whether PG&E's proposed method is just and reasonable and consistent with cost causation principles. Cost causation principles do not "require[] a ratemaking agency to allocate costs with exacting precision." *See Midwest ISO Transmission Owners*, 373 F.3d at 1369 (citing *Sithe/Independence Power Partners*, 285 F.3d at 5). Similarly, under the FPA's "just and reasonable" standard, rate proposals "need not be perfect but need only be reasonable." Approval Order at P 24, JA 265; *see also, e.g.*, ALJ Order at P 31, JA 157-58 (citing FERC orders); *Belco Petroleum Corp. v. FERC*, 589 F.2d 680, 689 (D.C. Cir. 1979) (citing *Permian Basin Area Rate Cases*, 390 U.S. 747, 767 (1968)) ("[a] just and reasonable rate is not a product of any single formula, but is instead a rate within a broad ambit of various rates which may be just and reasonable").

IV. The Probabilistic Method Results In Just And Reasonable Rates For Standby Transmission Service

Standby Customers also broadly contend that the probabilistic method produces an unreasonable result. Pet. Br. at 13-21. To the contrary, as the Commission found in its orders, PG&E's method results in just and reasonable rates for standby customers.

A. The Evidence Demonstrates That PG&E's Proposed Standby Rates are Just and Reasonable

In addition to the substantial evidence in the record relied on by the Commission (particularly the 2001 data), the Commission noted other facts in evidence to conclude that the rates produced by the probabilistic method are just and reasonable. Contrary to Standby Customers' contention, then, the Commission did not "dismiss the [judge's] findings as being based solely" on the lack of more recent data, *see* Pet. Br. at 17, although the Commission's review of that data was certainly central to its decision to overturn the judge.

For example, the Commission reasoned that an allocation of costs to the standby class based on 27.1 percent of total contracted demand for the class is not unreasonable on its face, given that PG&E must be prepared to provide the entire 600 MW of standby customer demand at any time, including at peak. Approval Order at P 48, JA 263-64. The Commission also noted that the 12 percent regional transmission component of the overall 27.1 percent allocation factor is "fairly conservative," given the unpredictable nature of standby transmission service demand. Rehearing Order at P 20, JA 303. This characterization is borne out by the evidence, which showed that while the 12 percent regional transmission component provides cost recovery for somewhat less than an 80 MW share of regional transmission facilities, the use of the standby class exceeded that level

during five of the 12 months of 2001, twice during peak times. Approval Order at P 36, JA 259-60 (citing Exh. PGE-45 at 5-6, JA 350-51).

Further, while standby rates are higher under the probabilistic analysis than the 12-CP analysis advanced by Standby Customers, that fact alone does not render the rates unreasonable. Approval Order at P 46, JA 263. In fact, the standby rates produced by the probabilistic method, quite appropriately, are "substantially less than the rate charged to full requirements customers who do not have their own generating capacity, and must rely entirely on PG&E's transmission system." *Id.* at P 48, JA 263-64 (citing Tr. at 248-49, JA 72-73). By only allocating costs to standby customers based on 27.1 percent of their full contractual entitlement, "the probabilistic methodology provides a substantial discount" when compared to a full 100 percent allocation. Rehearing Order at P 20 n. 39, JA 303.

B. Standby Customers' Arguments To The Contrary Lack Merit

Standby Customers argue that the Commission, by pointing out on rehearing that they had not taken exception to the judge's conclusion that cost causation principles do not require the use of a 12-CP method, held that they could not "object to the cost allocation resulting from the [probabilistic] methodology." Pet. Br. at 14 (citing Rehearing Order at P 12, JA 299). This was not the Commission's holding. As discussed above, the Commission's conclusion was simply that by failing to object to the judge's conclusion, Standby Customers could not argue on

rehearing that cost causation principles *require* the use of a 12-CP method and *preclude* the use of a probabilistic method. *See* Rehearing Order at P 12, JA 299. Standby Customers were still able to (and did) advance other arguments regarding the probabilistic method, including the reasonableness of the precise rates it produced, and the Commission addressed and ultimately rejected those arguments in the challenged orders.

Additionally, while Standby Customers may be correct in stating that the Commission's 1980 rulemaking regarding pricing of standby service to cogeneration customers "does not require use of [a] probabilistic methodology," Pet. Br. at 17-18, that rulemaking provides support for the use of such a method, when justified, to assign costs to standby customers. *See* Approval Order at P 48, JA 263-64 (citing FERC Stats. & Regs. ¶ 30,128 at 30,887, 30,889). Whether a 12-CP method can ever be used to develop standby transmission rates consistent with the Commission's guidance in its 1980 rulemaking is irrelevant to the question the Commission was faced with here, which is whether PG&E's standby rates developed with a probabilistic method were just and reasonable. The Commission simply noted that its 1980 rulemaking supported PG&E's proposal, not that it required it or precluded the use of a 12-CP method.

Finally, Standby Customers characterize the Commission's acknowledgement that PG&E has used the probabilistic method in several prior

rate cases as holding that the method has the protection of collateral estoppel and cannot be challenged in later rate cases. Pet. Br. at 20-21. The Commission reached no such holding. As the Commission stated on rehearing, while it noted that PG&E had used its proposed method in previous cases, it "never concluded that that fact was the deciding fact." Rehearing Order at P 18, JA 302. Quite the opposite of precluding Standby Customers from challenging PG&E's choice of a probabilistic method, a hearing was held before an administrative law judge concerning their objections, and the Commission ultimately accepted the proposed method based on the substantial evidence developed at hearing. *Id.* The Commission merely noted PG&E's prior use of the probabilistic method, consistent with prior Commission guidance and without earlier challenge from Standby Customers, as one relevant fact in its deliberations. *Id.*

CONCLUSION

For the reasons stated, the petition for review should be denied and the Commission's orders should be upheld in all respects.

Respectfully submitted,

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FINAL BRIEF: June 4, 2007

Cogeneration Association of Calif., et al. v. FERC **Docket No. ER03-409**
D.C. Cir. No. 06-1178

CERTIFICATE OF COMPLIANCE

In accordance with Fed. R. App. P. 32(a)(7)(C)(i), I certify that the Brief of Respondent Federal Energy Regulatory Commission contains 8,126 words, not including the tables of contents and authorities, the certificates of counsel, or the addendum.

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