

122 FERC ¶ 61,161  
UNITED STATES OF AMERICA  
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Joseph T. Kelliher, Chairman;  
Sudeen G. Kelly, Marc Spitzer,  
Philip D. Moeller, and Jon Wellinghoff.

Southern California Water Company

Docket No. EL02-129-004

ORDER ON REMAND

(Issued February 21, 2008)

1. On December 30, 2005, the United States Court of Appeals for the D.C. Circuit remanded<sup>1</sup> a series of Commission orders,<sup>2</sup> requiring the Southern California Water Company (SoCal Water) to refund amounts charged in a power sale made to Mirant Americas Energy Marketing, LP (Mirant) before SoCal Water obtained market-based rate authority. On remand, the Commission modifies its prior holdings concerning how SoCal Water is to determine a cost-justified rate for the sale in question. The Commission directs SoCal Water to make a compliance filing consistent with the discussion in this order.

**I. Background**

2. SoCal Water provides electric distribution service in a franchised area in the city of Big Bear California and surrounding areas, and it is a member of the Western System Power Pool (WSPP). SoCal Water does not own any electric generating facilities. Thus, it purchases all the power it sells to its retail customers.

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<sup>1</sup> *Southern California Water Company v. FERC*, 433 F. 3d 840 (D.C. Cir. 2005) (*Southern California*).

<sup>2</sup> *Southern California Water Company*, 106 FERC ¶ 61,305 (March 2004 Order), *order denying reh'g*, 108 FERC ¶ 61,168 (August 2004 Order), *order granting late intervention and clarifying prior orders*, 109 FERC ¶ 61,121 (2004) (November 2004 Order) (collectively the prior orders).

3. On September 27, 2002, the Commission issued a letter order granting SoCal Water market-based rate authority effective September 30, 2002.<sup>3</sup> In the same order, the Commission required SoCal Water to make a compliance filing providing information about a power sale made by SoCal Water to Mirant during April 2001 pursuant to a contract executed on March 30, 2001 (March 30 contract), before it had requested market-based rate authority. Upon review of the compliance filing, the Commission determined that SoCal Water had made a market-based sale before it obtained the necessary Commission authorization and ordered SoCal Water to refund to Mirant the difference between the market-based rate it charged and a cost-justified rate.<sup>4</sup> At the time of the transaction, the Commission permitted members of the WSPP to make sales at negotiated rates pursuant to and subject to the limitations of the WSPP Agreement.<sup>5</sup>

4. The WSPP Agreement provides in relevant part:

[T]he prices shall not exceed the Seller's forecasted Incremental Cost plus up to: \$7.32/kW/month .... The hourly rate is capped at the Seller's forecasted Incremental Cost plus 33.78 cents/kW/day

Service Schedule C-3.7 of the WSPP Agreement

Thus, the WSPP Agreement contemplates that prices consist of two components: (1) the forecasted incremental cost, and (2) a fixed-cost demand charge component that may be recovered "up to" the amount permitted by the WSPP Agreement, exemplified by the 33.78 cents/kW/day stated in the WSPP Agreement. While the WSPP Agreement defines forecasted incremental cost as "[t]he forecasted expense incurred by the Seller in providing an additional increment of energy or capacity during a given hour," there is no certainty that a seller will recover any amount in excess of its forecasted Incremental Costs even though there is an opportunity to recover fixed costs up to the amount stated in the WSPP Agreement. Given this construct, the Commission first held that the rate for purposes of calculating SoCal

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<sup>3</sup> *Southern California Water Company*, 100 FERC ¶ 61,373 (2002).

<sup>4</sup> March 2004 Order, 106 FERC ¶ 61,305 at P 1.

<sup>5</sup> *Western System Power Pool*, 55 FERC ¶ 61,099 at 61,319-322, *reh'g*, 55 FERC ¶ 61,495 at 62,713-15 (1991), *aff'd*, *Environmental Action v. FERC*, 996 F.2d 401 (D.C. Cir. 1993) (*Western Systems Power Pool*); *NorthPoint Energy Solutions, Inc.*, 107 FERC ¶ 61,181 (2004).

Water's refunds should be determined based on the forecasted incremental cost of the power SoCal Water sold to Mirant.<sup>6</sup> However, the Commission subsequently granted a request for clarification by WSPP that sellers subject to the cost-based price ceiling are entitled to the fixed cost component regardless of whether they own generating plant, and the Commission accordingly permitted SoCal Water to reduce its refund by the amount of that fixed cost component.<sup>7</sup>

5. The court's remand in this case focuses on the Commission's determination of the forecasted incremental cost SoCal Water incurred in making its April 2001 sale(s) to Mirant for purposes of calculating the refunds due. The facts relevant to determining SoCal Water's forecasted incremental cost, the Commission's prior orders addressing the issue, and the court's remand are summarized below.

**A. SoCal Water's Sale to Mirant**

6. During the relevant period, the demand of SoCal Water's retail customers typically ranged from 12 to 17 megawatts. Before April 2001, SoCal Water served this load by purchasing power under two contracts: (1) a contract with Dynegy to purchase 12 megawatts of around-the-clock power at \$35.50 per megawatt hour, and (2) a contract with Illinois Energy Partners (IEP) to purchase any hourly demand in excess of those 12 megawatts at the SP15 spot price.<sup>8</sup> However, the around-the-clock contract with Dynegy was due to expire on April 30, 2001. In order to replace that contract, SoCal Water entered into a long-term contract with Mirant on March 16, 2001 to purchase 15 megawatts of around-the-clock power at a price of \$95 per megawatt hour. However, despite the fact this contract was intended to replace the Dynegy around-the-clock contract, it took effect on April 1, 2001. As a result, SoCal Water's around-the-clock power purchase contracts with Dynegy and Mirant overlapped for the month of April 2001.

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<sup>6</sup> The Commission originally held that SoCal Water was not entitled to the fixed cost component, since it does not own any generating plant. August 2004 Order, 108 FERC ¶ 61,168 at P 15.

<sup>7</sup> November 2004 Order, 109 FERC ¶ 61,121 at P 1, 12-13.

<sup>8</sup> SP15 is the name commonly used for the spot market price in the South of Path 15 zone, a relatively broad delivery zone.

7. The March 30 contract was intended to address this overlap. In the March 30 contract, SoCal Water agreed to sell Mirant 15 megawatts of around-the clock power during April 2001 at the SP15 spot market price, minus \$20 per megawatt hour. However, SoCal Water's contracts to both buy and sell 15 megawatts of around-the-clock power to Mirant were not formally tied to one another, and the prices in the two contracts differed. While SoCal Water purchased power from Mirant at a price of \$95 per megawatt hour, under the March 30 contract, SoCal Water's April 2001 sales to Mirant were priced at SP15 minus \$20 per megawatt hour. In the immediate period prior to the March 30 contract, the SP15 spot market price had fluctuated between a peak high of about \$280 and an off-peak low of about \$80.

**B. Commission orders reviewed by the court**

8. In the March 2004 Order, the Commission held that SoCal Water's forecasted incremental cost for its April 2001 sales to Mirant should be determined based on the \$95 per megawatt hour SoCal Water paid to purchase power from Mirant under the March 16, 2001 around-the-clock power purchase contract. The Commission reasoned that SoCal Water was selling back to Mirant the power that SoCal Water was required to purchase from Mirant under their March 16, 2001 contract. The Commission therefore ordered SoCal Water to make refunds to Mirant at the difference between \$95 per megawatt hour and the SP15 minus \$20 per megawatt hour price contained in the March 30 contract. The refund ordered was \$644,153.55.<sup>9</sup>

9. The Commission denied SoCal Water's request for rehearing of the March 2004 Order.<sup>10</sup> On rehearing, SoCal Water argued that the Commission erred in the March 2004 Order by finding that \$95 per megawatt hour was SoCal Water's incremental cost for its sales to Mirant. SoCal Water argued that its incremental cost was the spot market SP15 price it paid for its purchases under the IEP contract. SoCal Water argued that its "forecasted Incremental Cost" under the WSPP Agreement was the price it would pay for the last unit needed to meet the sales obligation to Mirant whenever its total sales commitments, including both its retail customers' demand of between 12 and 17 megawatts and the 15 megawatt April 2001 sale to Mirant under the March 30 contract, exceeded the 27 megawatts that it could purchase during April 2001 under its two around-the-clock purchase contracts with Dynegy and Mirant. Moreover, SoCal Water contended that it reasonably projected that its total sales commitments would almost

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<sup>9</sup> March 2004 Order, 106 FERC ¶ 61,305 at P 16.

<sup>10</sup> August 2004 Order, 108 FERC ¶ 61,168 *passim*.

always exceed 27 megawatts. Since the purchase prices under the two around-the-clock contracts were \$35.50 and \$95 per megawatt hour respectively, SoCal Water stated that it would purchase the full amount to which it was entitled under those contracts, before making the more expensive purchases at the SP15 price under the IEP spot market contract. SoCal Water further argued that the fixed cost recovery component was due to it under the terms of the WSPP Agreement and thus the refund obligation was overstated.

10. The Commission concluded that the WSPP Agreement presumes that, at the time of the contract, the seller assesses its available resources and thereby determines its “forecasted incremental cost.” Thus, a seller that owns generating resources, for example, would be able to forecast which plant would be needed to provide energy to the buyer, the cost profile of operating that plant and would estimate its incremental cost of producing additional units of power at that plant accordingly. Since in this case SoCal Water owns no generating resources, the Commission concluded it should assess the resources SoCal Water was contractually committed to purchase at the time of the sale. In doing so, the Commission held that SoCal Water’s available resources on March 30, 2001 included: (1) a contract with Dynegy for 12 megawatts of around-the-clock firm energy at \$35.50 per megawatt hour; (2) the purchase contract with Mirant for an additional 15 megawatts of firm energy at \$95 per megawatt hour; and (3) the Daily Purchasing Agreement with IEP.

11. The Commission concluded that SoCal Water’s argument regarding its incremental cost had two flaws. “First, the spot market price would only be SoCal Water’s incremental cost once the sale to Mirant is consummated. Until then, SoCal Water’s power supply portfolio is 27 megawatts (12 megawatts from Dynegy and 15 megawatts from Mirant) and it would have no need for spot market purchases. The Commission stated that its March 2004 Order required the use of SoCal Water’s incremental cost *at the time of the sale*, which SoCal Water failed to recognize.”<sup>11</sup> Second, the Commission found that SoCal Water’s position, if adopted, would effectively produce the unreasonable result of SoCal Water simultaneously selling energy to Mirant at the SP15 minus \$20 per megawatt hour price and then having to purchase IEP energy at the SP15 price. Thus, the Commission rejected SoCal Water’s arguments for using the price paid IEP to measure its forecasted incremental cost. As was previously discussed, the refund was later reduced to reflect the fixed-cost component allowed the seller under the WSPP Agreement, thereby reducing the amount of the refund the Commission had previously required.<sup>12</sup>

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<sup>11</sup> August 2004 Order, 108 FERC ¶ 61,168 at P 14 (emphasis in original).

<sup>12</sup> November 2004 Order, 109 FERC ¶ 61,121 at P 12-13.

### C. The Court Decision

12. The court concluded that the Commission had not adequately explained its interpretation of incremental cost, and reversed and remanded the Commission's orders. First, the court held that the Commission erred in rejecting SoCal Water's position on the ground that the SP15 spot price in the IEP contract would only be its "incremental cost *once the sale to Mirant is consummated.*"<sup>13</sup> The court pointed out that the WSPP Agreement defines incremental cost as the "forecasted expense incurred by the Seller *in providing* an additional increment of energy or capacity during a given hour."<sup>14</sup> The court stated that the Commission's holding that SoCal Water should not have taken the sale to Mirant into account in determining its forecasted incremental cost was inconsistent with this definition, since it required reading "in providing" as "without providing."

13. The court then stated that, more fundamentally, it would seem plain that when contemplating an extra sale, the supplier must look at the facilities actually needed to make its total sales, the new one and those already contracted. In making a sale, a seller would first use its less expensive supplies, and then as it increases its simultaneous sales, it would use progressively more costly supplies.<sup>15</sup> The court noted that under this theory SoCal Water would purchase and then sell the following supplies. For total sales of up to 12 megawatts, it would draw on Dynegy's \$35.50 per megawatt hour power first; for total sales in excess of 12 megawatts up to 27 megawatt total contract demand, it would draw on both its Dynegy and Mirant contracts, first drawing on Dynegy's power and then drawing on Mirant's \$95 per megawatt hour power. Only when total sales exceeded 27 megawatts would SoCal Water draw on the spot market IEP supplies, which SoCal Water predicted would be the average SP15 spot market price. Given its retail load of roughly 12-17 megawatts, the 15 megawatt sale to Mirant would increase SoCal Water's sales obligations to roughly 27 to 32 megawatts. The court thus found that the Mirant sale would compel SoCal Water to draw not only on its \$95 per Megawatt hour supply from Mirant, but also on its SP15 supply from IEP.

14. However, the fact SoCal Water would make its purchase decisions in this manner does not resolve the meaning of the phrase "forecasted incremental cost," which the court stated is subject to several interpretations. It could mean only the cost of the last unit

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<sup>13</sup> *Southern California*, 433 F.3d at 843 (emphasis added by the court).

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

sold, in which case the cost of the last unit would be applied to all the units sold under the contract. The court stated this would be consistent with the marginal price theory used by the Commission and regional transmission organizations in defining the wholesale price to be paid for units of the same service sold for delivery in the same time frame.

15. The court stated that the phrase “forecasted Incremental Cost” contained in the WSPP Agreement could also mean the weighted average of the total forecasted cost of all the additional units sold above some base amount, not just the cost of the last unit. For example, if the base amount is considered to be SoCal Water’s retail load of 12-17 megawatts, the additional cost would be the average cost of raising sales by the 15 megawatt amount of the Mirant sale to roughly 27-32 megawatts. The court stated that, under this view, the ceiling dictated by the WSPP Agreement would be a weighted average of the \$95 per megawatt hour Mirant contract price and the SP15 price paid for power purchased under IEP contract.<sup>16</sup>

16. The court concluded that, while there may be other linguistically possible interpretations of the term forecasted incremental costs as used in the WSPP Agreement, the interpretation contained in the Commission’s prior orders was not one of them. Accordingly, the court reversed and remanded the Commission's orders. In addition, the court stated that, if on remand the Commission should find that the incremental cost of SoCal Water’s sale to Mirant was below the SP15 minus \$20 per Megawatt hour SoCal Water charged for that sale, the Commission would have to address the issue of the appropriate remedy. The court pointed out that a number of its decisions indicate the Commission should apply equitable principles in calculating refunds in these circumstances,<sup>17</sup> and the Commission had thus far failed to do so.

## II. Discussion

17. On remand, we must determine how to apply the cost-based rate design in the WSPP Agreement to SoCal Water’s April 2001 sale to Mirant. As noted, the maximum rate (or price) a seller may charge under the WSPP Agreement is defined by two components: (1) the seller’s forecasted incremental cost and (2) a fixed cost component

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<sup>16</sup> *Id.* 844.

<sup>17</sup> *Citing Koch Gateway Pipeline Co.*, 136 F.3d 810 (D.C. Cir. 1998); *Laclede Gas Co. v. FERC*, 997 F.2d 936 (D.C. Cir. 1993); *Gulf Power Co. v. FERC*, 983 F.2d 1095 (D.C. Cir. 1993); and *Towns of Concord, Norwood & Wellesley v. FERC*, 955 F.2d 67 (D.C. Cir. 1992).

that may be “up to” the amount permitted by the WSPP Agreement. As discussed, the only issue here is the determination of the first component of the maximum price a seller is permitted to charge. However, as discussed below, we believe that the determination of how to calculate the first component must take into account the manner in which the fixed cost component is determined.<sup>18</sup>

18. The WSPP Agreement defines forecasted incremental cost as “[t]he forecasted expense incurred by the Seller in providing an additional increment of energy or capacity during a given hour.” For purposes of responding to the court’s remand, the key question is how to interpret the phrase “additional increment of energy” in the circumstances of this case. There are two possible interpretations. The “additional increment” could be the last unit of power SoCal Water sold under the March 30 contract. Under that interpretation, the forecasted expense of the last unit sold would set the incremental cost, and therefore would be applied to all the units sold to Mirant.

19. Alternatively, the “additional increment” could be the entire amount of power the March 30 contract required SoCal Water to sell to Mirant during April 2001.<sup>19</sup> Under that interpretation, forecasted incremental cost of the sale would be the average forecasted expense of all the units to be sold to Mirant during April 2001. The Commission finds that, on balance, the appropriate interpretation of “additional increment of energy” which establishes the forecasted incremental cost under the WSPP Agreement is the weighted average cost per megawatt of the entire sale to Mirant, not the cost of the last megawatt sold to Mirant. The Commission recognizes that it has held that, in an RTO regime, the cost, and price, of the last megawatt sold should establish a market-clearing price that becomes the unit price of all the megawatts sold within the relevant time frame.

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<sup>18</sup> Our decision in this case is limited to the issue of how to apply the cost-based price ceiling in the WSPP Agreement as it existed at the time of the instant sale. Since this is not a proceeding under FPA section 206, this case presents no issue concerning the continued reasonableness of that price ceiling. Moreover, this order makes no modifications to that 1991 Agreement although it is construed in light of the specific facts of this case.

<sup>19</sup> In this case, SoCal Water’s sale to Mirant was the only sale it made during April 2001 in addition to its sales to its retail customers that it was already obligated to make. Thus, we need not consider in this case the issue of how to apply the cost-based rate cap in circumstances where the utility is simultaneously making multiple sales subject to the cap.

20. However, the Commission accepted the rate cap at issue established by the WSPP Agreement in 1991 as a “cost-based price ceiling” for coordination sales in the WSPP by sellers.<sup>20</sup> The WSPP Agreement permits sellers of electric energy to charge either an uncapped market-based rate (for public utility sellers to do so, they must have obtained separate market-based rate authorization from the Commission), or a cost-based rate that is no higher than an “up to” cost-based ceiling rate. It is clear that SoCal Water did not have market-based rate authority at the time it sold power back to Mirant under the terms of its agreements with Mirant. Thus, SoCal Water was subject to the cost-constrained pricing regime of the WSPP Agreement at the time it resold power to Mirant during April 2001.

21. As described in the Appendix to the order accepting the WSPP Agreement rate, the Commission developed the fixed cost component of the ceiling price “by creating what is essentially a hypothetical ‘average’ electric utility company out of the total jurisdictional utilities participating in the WSPP and calculating the fixed costs that a utility might expect to incur supplying WSPP power (i.e., coordination sales).” Thus, the fixed costs included in the price ceiling are based on the average “investment cost per kW of the plant most likely to be available to supply a WSPP sale.”<sup>21</sup> Thus, these fixed costs are determined pursuant to a historical accounting, or book, basis.

22. On this basis, we thus find it is reasonable to determine the first component of the cost-based ceiling price -- the forecasted incremental cost -- on an accounting basis as well, i.e., the total amount of additional forecasted incremental costs (determined on an accounting basis) attributed to the sale divided by the total number of units sold. Otherwise, if forecasted incremental cost is calculated by multiplying the marginal price of the last unit sold times the total number of units, this could be significantly in excess of the average unit incremental cost based on the forecasted book incremental costs incurred by the seller. As a result, a seller could recover “costs” that exceeded those contemplated in the WSPP Agreement.<sup>22</sup> This would also permit a seller such as SoCal Water, which

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<sup>20</sup> *Western Systems Power Pool*, 55 FERC at 61,321.

<sup>21</sup> *Id.* at 61,325.

<sup>22</sup> A simple example follows. Assume that SoCal Water purchased 25 megawatts and sold 5 megawatts. The actual purchase prices were 10 megawatts at \$5 and 15 megawatts at \$10. The timing of the purchases and the sale is such that 5 megawatts sold were from the last 15 megawatts purchased. The total book incremental cost of all the megawatts is \$200 or a weighted average cost of \$8 per megawatt. Thus, under the interpretation here, the maximum revenue permitted under the WSPP Agreement is 5

(continued...)

did not have market-based rate authority at the time it entered into the March 30 contract, to effectively charge a market-based rate.<sup>23</sup> Therefore, the Commission will adopt the court's alternative approach of the weighted average cost of the incremental units sold.

23. Because the WSPP Agreement was developed at a time when almost all sales were made by vertically integrated utilities that sold power produced from their generating facilities, the WSPP Agreement does not contemplate resale transactions, such as the one at issue in the instant case. In such cases, the "cost" of the units sold must be derived from the purchase of power under a separate transaction. When the WSPP Agreement was developed, "incremental cost" generally meant the non-fixed cost portion of the price, essentially the cost of fuel and other short term variable costs required to produce the "incremental" output to be sold by a utility in excess of its own needs. In resale arrangements, the "cost" of the units sold must be derived from the purchase of power under a separate transaction. Thus, since SoCal Water has no fixed plant, this would be market-based price of the units it acquired from its various suppliers. Thus, its sale price is capped at the actual unit dollar purchase price of the power it acquired from its three sellers, plus the fixed cost component permitted by the WSPP Agreement.<sup>24</sup>

24. In this case, as SoCal Water states, its base load is the roughly the 12 to 17 megawatts it sells to its retail customers. Therefore, the incremental sales are the megawatts sold to Mirant in excess of these 12 to 17 megawatts sold to retail customers. The Commission therefore directs SoCal Water to make a compliance filing calculating the cost-based price ceiling applicable to its sale to Mirant, and comparing its actual revenues from the Mirant sale with the revenues it would have collected pursuant to the applicable rate ceiling. In order to calculate the cost-based price ceiling, SoCal Water

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times \$8 or \$40. In contrast, if incremental cost is defined as the cost of the last megawatt(s) acquired, the total revenue is 5 times \$10 or \$50. The difference is \$10 or 25 percent more revenue on the sale. Such a difference in margin above actual book or accounting cost is available only to sellers having authority to sell at market-based rates. The fixed cost component is added to the weighted average cost to all the megawatts acquired and is excluded from the weighting calculation.

<sup>23</sup> See *Western Systems Power Pool and Western Systems Power Pool Agreement*, 122 FERC ¶ 61,139 (2008).

<sup>24</sup> The fact that Mirant was authorized to make market-based sales to SoCal Water does not mean that the latter was authorized to resell at market-based prices to Mirant, or to any one else.

must determine what its reasonably forecasted incremental cost would be on March 30, 2001 by calculating the weighted average cost of the megawatts it was obligated to sell to Mirant in April 2001. This would include the cost of any amounts it could reasonably forecast it would purchase from Mirant at \$95 per megawatt hour and the cost per megawatt hour of any megawatts it could reasonably forecast it would have to purchase from IEP at the SP15 price in order to make the sales to Mirant. In both cases the per hour megawatt cost used to determine the weighted average cost must be increased thereafter by the fixed cost component allowed the seller under the terms of the WSPP Agreement. The resulting weighted average price per megawatt hour would then be multiplied by the total megawatt hours sold to Mirant during the contract term to determine the total revenues SoCal Water could have recovered from Mirant under the cost-based price ceiling. The compliance filing should include a full explanation of all calculations, including any data and documents SoCal Water asserts it would have relied upon in making the above described forecasts.

25. As previously discussed, the court held that its prior decisions required the Commission to apply equitable principles in determining a remedy and any related refunds. To the extent the compliance filing shows that SoCal Water collected revenues in excess of the ceiling price, the Commission will consider the issue of the appropriate remedy consistent with the court's decision. At this stage the Commission does not know whether SoCal Water collected revenues above the WSPP ceiling price, or if it did, by what amount. Therefore the Commission will defer determination of the remedy, and any equitable considerations, until SoCal Water makes its compliance filing.

The Commission orders:

Within 30 days after this order issues, SoCal Water shall make a compliance filing consistent with the discussion in this order.

By the Commission.

( S E A L )

Nathaniel J. Davis, Sr.,  
Deputy Secretary.