UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

CALIFORNIA ELECTRICITY OVERSIGHT BOARD, PEOPLE OF THE STATE OF CALIFORNIA, ex rel. BILL LOCKYER, ATTORNEY GENERAL OF THE STATE OF CALIFORNIA, and CALIFORNIA DEPARTMENT OF WATER RESOURCES v. CALPINE ENERGY SERVICES, L.P., CALPINE CORPORATION, POWER CONTRACT FINANCING, L.L.C., and GILROY ENERGY CENTER, L.L.C.	Docket No. EL05-

PETITION FOR EMERGENCY DECLARATORY ORDER REQUIRING CONTINUING PERFORMANCE OF JURISDICTIONAL POWER PURCHASE AGREEMENT AND COMPLAINT REQUESTING FAST TRACK PROCESSING

Pursuant to Rules 206 and 207 of the Commission's Rules of Practice and Procedure, the California Electricity Oversight Board ("CEOB"), the People of the State of California, ex Rel. Bill Lockyer, Attorney General of the State of California, and the California Department of Water Resources ("CDWR") (collectively, the "California State Parties") hereby submit this Petition for Emergency Declaratory Order and Complaint Requesting Fast Track Processing

("Petition") requesting the Commission to require Calpine Energy Services, L.P., ("CES") and Calpine Corporation, as guarantor (collectively, "Calpine"), to continue to perform that certain Master Power Purchase and Sale Agreement Amended and Restated Confirmation Letter between CES and CDWR effective on May 1, 2002, under which CDWR agreed to purchase and CERS agreed to sell 1,000 MWs of 7x24 energy at $59.60 per MWh until December 31, 2009 (hereinafter the "Calpine 2 Contract"), a copy of which is attached as Exhibit A.

Based on numerous recent press reports and public statements by Calpine officials, the California State Parties believe that Calpine imminently intends to file for bankruptcy reorganization pursuant to Chapter 11 of the United States Bankruptcy Code (the "Bankruptcy Code"). The California State Parties also expect Calpine promptly (1) to seek the rejection of the Calpine 2 Contract pursuant to Bankruptcy Code section 365[1] because that long-term contract is currently priced below market and, (2) like Mirant Corporation,[2] to seek to enjoin the Commission from exercising any control over the Calpine 2 Contract, including any action by the Commission to compel Calpine's performance while

---

[1] 11 U.S.C. § 365.

[2] *See In Re Mirant Corp.*, 378 F.3d 511 (5th Cir. 2004).

the Commission reviews whether abrogation of the Calpine 2 Contract is in the public interest.[3]

As discussed below, in February 2001, the State of California, through CDWR, entered into four separate power purchase contracts with Calpine, including Calpine 2, as part of the State's emergency response to the California energy crisis and in order to assure reliability of California's transmission system and to meet the unmet demand for power of the State's millions of retail end-use customers. In April 2002, after the CEOB and the California Public Utilities Commission ("CPUC") had filed complaints at FERC seeking to modify or abrogate CDWR's long-term contracts with sellers including Calpine, the California State Parties and Calpine entered into a global settlement in which the State agreed to forgo its claims against Calpine in both the spot market "Refund Proceeding"[4] and the CEOB/CPUC Section 206 challenge to the CDWR long-term contracts in exchange for Calpine renegotiating the Calpine 2 Contract and the three other power purchase agreements. Pursuant to the terms of this settlement agreement and the resulting renegotiated contracts, Calpine committed

---

[3] Calpine has retained Kirkland & Ellis to provide bankruptcy advice to it. *See* Roddy Boyd, *Troubled Calpine Brings in Team of Bankruptcy Experts*, N.Y. POST, Oct. 18, 2005. Kirkland & Ellis represented NRG in its bankruptcy and has publicly stated that FERC should have no role in determining whether a Chapter 11 debtor may reject a power purchase agreement subject to FERC's jurisdiction. *See* Kirkland & Ellis LLP, *Rejection of Executory Contract is a Powerful Reorganization Tool* (March 7, 2005), at www.kirkland.com/clientInformation/publicationsDetail.aspx?&Type=ArticlesBy&articleH4AssetID=1126038120&pubH4ID=1467. Kirkland & Ellis undoubtedly is well aware of the tactic employed by Mirant to stymie the Commission's exercise of its jurisdiction and can be expected to follow a similar path when Calpine seeks Chapter 11 relief.

[4] *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, FERC Docket No. EL00-95.

itself to: (1) run its 6,000+ MW portfolio of Western Generation Assets when California was in need and (2) build new generation to serve California load. Both of these commitments, set forth in the Calpine 2 Contract, were intended to ensure that the conditions at the heart of the 2000-01 crisis would not recur. Rejection of the Calpine 2 Contract would, thus, undermine an important component of the consideration Calpine provided under this settlement previously filed with the Commission. In addition, rejection would cause significant economic consequences to California ratepayers, and would threaten the stability of the California spot markets and potentially undermine the near and longer term reliability of the California grid, particularly during summer 2006.

The California State Parties accordingly stand together on behalf of the ratepayers of California and file this Petition in accordance with the Commission's recent precedent in *Blumenthal v. NRG Power Marketing Inc.*,[5] requesting that the Commission order Calpine to continue to provide service to CDWR pursuant to the rates, terms and conditions of the Calpine 2 Contract, which is a contract over which the Commission has jurisdiction, unless and until the Commission determines that the contract is not in the public interest and issues an order

---

[5] *Blumenthal v. NRG Power Mktg., Inc.*, 103 FERC ¶ 61,188 (2003) (requiring compliance with the contract) [hereinafter "NRG May 16 Order"]; *Blumenthal v. NRG Power Mktg., Inc.*, 103 FERC ¶ 61,344 (2003) (addressing amended Petition, requiring compliance with the contract, and establishing hearing proceedings) [hereinafter "NRG June 25 Order"]; *Blumenthal v. NRG Power Mktg., Inc.*, 104 FERC ¶ 61,211 (2003) (denying rehearing) [hereinafter "*NRG* August 15 Order Denying Rehearing"]; *Blumenthal v. NRG Power Mktg., Inc.*, 104 FERC ¶ 61,210 (2003) (upholding contract) [hereinafter "*NRG* August 15 Order Upholding Contract"].

pursuant to Sections 205 and/or 206 of the Federal Power Act ("FPA") permitting Calpine to abrogate or modify the contract.[6]

In addition, because it is likely that Calpine, as part of its bankruptcy, will seek to enjoin the California State Parties from invoking, and the Commission itself from exercising, the Commission's jurisdiction over the Calpine 2 Contract, the California State Parties also request that the Commission order Calpine to refrain from taking any action in any other forum to seek to impede or enjoin the Commission from exercising the Commission's FPA jurisdiction over the Calpine 2 Contract, including seeking to enjoin the California State Parties' prosecution of this Petition. Only by doing so can the Commission ensure that it will not be subjected to the procedural quagmire that ensued in the Mirant case.[7]

I. SUMMARY OF ARGUMENT

In *Blumenthal v. NRG Power Marketing, Inc.*, the Commission, confronting an issue of first impression, found that, even if a public utility files for bankruptcy

[6] As discussed below, the California State Parties also seek the same relief with respect to three other power purchase agreements between CDWR and Calpine and its subsidiaries, Power Contract Financing, L.L.C. and Gilroy Energy Center, L.L.C. in the event Calpine unexpectedly seeks to reject those contracts in bankruptcy as well.

[7] It can be expected that Calpine will rely on the Fifth Circuit's decision in *Mirant* to seek a bankruptcy court order enjoining the California State Parties from invoking, and the Commission from exercising, its jurisdiction under the FPA. In that case, the court stated in *dicta* that FERC's negation of an electricity supplier's rejection of an executory power contract by ordering continued performance under the terms of the rejected contract "is certainly a legitimate basis for injunctive relief" against FERC. 378 F.3d at 523. Such an unrestricted license to interfere in the workings of the Commission "cannot be squared with the 'limited authority Congress has vested in bankruptcy courts,'" but nevertheless demonstrates why expedition is necessary here. *NRG* August 15 Order Denying Rehearing at 61,738.

and the bankruptcy court approves the rejection of an executory power purchase agreement pursuant to section 365 of the Bankruptcy Code, "the utility still must meet its obligations under the FPA."[8] Specifically, the Commission entered an emergency order that required the supplier to continue providing power under the jurisdictional contract in question "until the Commission ruled on whether the supplier's "proposed cessation of service [met] the *Mobile-Sierra* 'public interest' standard."[9]

In this case, the same emergency relief is warranted because unilateral rejection of the Calpine 2 Contract would: (1) force California consumers to bear significantly higher costs; (2) undermine the parties' 2002 global settlement entered in order to resolve the State's claims arising in its 2000-01 energy crisis; (3) jeopardize the State's efforts to put in place protections to ensure that the health, safety and welfare of California ratepayers are not adversely affected by a similar crisis in the future; and (4) threaten the stability of California electricity markets and potentially undermine the reliability of the California electricity grid, particularly during summer 2006.

The 1000 MW Calpine 2 Contract, one of CDWR's largest, provides a significant portion of the base load energy needed by Pacific Gas and Electric

---

[8] *NRG* August 15 Order Denying Rehearing at 61,733.

[9] *NRG* August 15 Order Upholding Contract at 61,721; *NRG* May 16 Order at 61,722 (entering emergency order one day after Complaint filed).

Company ("PG&E") to serve its load.[10] If Calpine ceases to deliver this energy to PG&E, then PG&E may be forced to rely on the electricity spot markets, including, in particular, the real time market of the California Independent System Operator ("CAISO"), in order to cover its load. This forced dependence on the spot markets would threaten to return PG&E, and California as a whole, back to the conditions that significantly contributed to the 2000-01 energy crisis, namely the over-reliance on the spot market during times of tight supply and high natural gas prices. In fact, based on its current forecasts, PG&E is concerned that without the stable 1,000 MW supply that the Calpine 2 Contract provides, it may have difficulty obtaining adequate supplies to cover its load, with appropriate reserve margins, during the peak hours of the 2006 summer season.

In addition, rejection of the Calpine 2 Contract also would result in the loss of two unique special conditions in the contract, discussed in detail below, that CDWR and the other California State Parties fairly bargained for during the global settlement negotiations with Calpine (and paid for through the then significantly above-market contract rates in the renegotiated contracts). These special conditions contractually obligate Calpine to: (1) deliver power from its unutilized Western Generation Assets (which amount to over 6,000 MWs) into the California market during periods of moderate or high demand, rather than sell this power to

[10] PG&E is CDWR's agent with respect to the Calpine 2 Contract and delivers the energy from this contract to serve its load in accordance with the California Water Code, sections 80000 *et seq.*, and the applicable orders of the CPUC.

out-of-state purchasers during such times, and (2) build much-needed additional generating capacity within California. Loss of these special contractual protections, negotiated against the backdrop of the California energy crisis specifically for the purpose of minimizing the prospects of a recurrence of the 2000-01 chaos, could jeopardize the stability of the California spot markets and the near and longer term reliability of the California grid, and should not be permitted unless the Commission determines, after a full review under applicable FPA standards and precedent, that the contract is not in the public interest.

Accordingly, consistent with the Commission's goal of promoting regulatory certainty, the California State Parties seek to have the Commission follow its recent and clear precedent in *NRG* and provide the same emergency relief with respect to the Calpine 2 Contract.[11] Based on numerous press reports, court filings of Calpine and statements by Calpine representatives, it appears clear that Calpine intends imminently to file bankruptcy and is likely to simultaneously, or shortly thereafter, to seek the rejection of the Calpine 2 Contract pursuant to

[11] *See Nev. Power Co.*, 99 FERC ¶ 61,047, at 61,190 (2002) ("Competitive power markets simply cannot attract the capital needed to build adequate generating infrastructure without regulatory certainty …"); *Northwest Pipeline Corp.*, 92 FERC ¶ 61,287 at 62,003 (2000) (determining that "it is appropriate for the Commission to apply precedent in cases involving similar circumstances and issues"); *see also Mich. Wisc. Pipe Line Co. v. FPC,* 520 F.2d 84, 89 (D.C. Cir. 1975) (Commission "may attach precedential and even controlling weight to principles developed in one proceeding and then apply them under appropriate circumstances in a stare decisis manner").

Bankruptcy Code section 365.[12] Because the Calpine 2 Contract is a fixed-rate contract for the purchase and sale of wholesale electricity under to the Commission's jurisdiction, Sections 205 and 206 of the FPA require Calpine to obtain an order from the Commission finding that the contract is contrary to the public interest before abrogating the contract through a section 365 rejection. Thus, the California State Parties respectfully request that the Commission enter an emergency order requiring Calpine to continue to provide service to CDWR pursuant to the rates, terms and conditions of the Calpine 2 Contract, unless and until the Commission reaches a final determination on the merits that the contract is contrary to the public interest and providing the other relief requested below.

II. SERVICE AND COMMUNICATIONS

The persons to whom correspondence, pleadings and other papers regarding this proceeding should be addressed and the persons whose names are to be placed on the Commission's official service list are designated as follows pursuant to Rule 203:

---

[12] The Calpine 2 Contract, like the contract at issue in *NRG*, does not provide that it shall automatically terminate if either party is the subject of a bankruptcy proceeding. Accordingly, the Commission's Order in *Vermont Public Power Supply* is inapplicable here. *See Vt. Pub. Power Supply Auth. v. PG&E Energy Trading*, 104 FERC ¶ 61,185 at 61,677-79 (2003) (allowing suspension of performance under a wholesale contract containing a provision specifying automatic termination upon a bankruptcy filing and distinguishing *NRG* on the basis of that contractual provision); *NRG* August 15 Order Denying Rehearing at 61,733 n. 2 (distinguishing the then recently decided *Vt. Public Power Supply* Order from the *NRG* June 25 Order on the basis that the NRG contract did not automatically terminate upon a bankruptcy filing by either of the parties to the contract).

PEGGY BERNARDY
BRUCE YONEHIRO
Office of the Chief Counsel
Department of Water Resources
P.O. Box 942836
Sacramento, CA 94236-0001
Telephone: (916) 653-6186
pbernard@water.ca.gov
yonehiro@water.ca.gov

ERIK SALTMARSH
Executive Director
California Electricity Oversight Board
770 L Street, Suite 1250
Sacramento, CA 95814
Telephone: (916) 322-8610
ens@eob.ca.gov

MARTIN GOYETTE
Supervising Deputy Attorney General
DAVID GUSTAFSON
Deputy Attorney General
1515 Clay Street, 20th Floor
P.O. Box 70550
Oakland, CA 94612-1413
Tel. (510) 622-2207
Tel. (510) 622-2232
Fax: (510) 622-2270
Fax: (510) 622-2121
martin.goyette@doj.ca.gov
david.gustafson@doj.ca.gov

IRENE TAMURA
Deputy Attorney General
1300 I Street
P.O. Box 944255
Sacramento, CA 94244-2550
Tel. (916) 322-2587
Fax: (916) 327-6833
irene.tamura@doj.ca.gov

JARED S. DES ROSIERS
CHRISTOPHER T. ROACH
Pierce Atwood LLP
One Monument Square
Portland, ME 04101
Telephone: (207) 791-1390
Fax: (207) 791-1350
jdesrosiers@pierceatwood.com
croach@pierceatwood.com

KEVIN J. MCKEON
LILLIAN S. HARRIS
Hawke McKeon Sniscak & Kennard LLP
Harrisburg Energy Center
100 North Tenth Street
P.O. Box 1778
Harrisburg, PA 17105
Telephone: (717) 236-1300
Fax: (717) 236-4841
kjmckeon@hmsk-law.com
lsharris@hmsk-law.com

The California State Parties have provided a copy of this Petition to the Respondents, CES, Calpine Corporation, Power Contract Financing, L.L.C., and Gilroy Energy Center, L.L.C., via facsimile and electronic mail. Due to the urgency of this request, it was not possible to explore alternative dispute resolution mechanisms.

III. PETITIONERS

CEOB is an agency of the State of California and was established to protect public interests concerning the restructured electricity industry. It brings this Petition under its authority to participate in proceedings "related to the wholesale market for electricity to ensure that the interests of California's citizens and consumers are served, protected, and represented in relation to the availability of electric transmission and generation and related costs."[13] The CEOB's statutory responsibilities include oversight of the CAISO, the energy and ancillary services markets administered by the CAISO, and the reliability of the CAISO-controlled electricity grid.

Bill Lockyer, the Attorney General of the State of California, is the head of the California Department of Justice,[14] and chief law officer of the State.[15] He brings this Petition on behalf of the People of the State of California in order to protect the health, safety and welfare of California citizens and ratepayers.

---

[13] Cal. Pub. Utils. Code §§ 335(e) and 341(m).

[14] Cal. Government Code § 12510.

[15] Cal. Const. Art. V, § 13.

CDWR is the California state department responsible for managing the State's dams, reservoirs and other water resources. During the height of the California energy crisis, it was authorized, under Assembly Bill 1 of the 2001-2002 First Extraordinary Session ("AB1X"), to enter into certain long-term energy contracts, including the Calpine 2 Contract, in order to assure a reliable supply of electricity for California's retail end-use consumers and to protect the safety, health and well being of the people of California.[16] It brings this Petition as a party to the four Calpine power purchase agreements discussed below, including the Calpine 2 Contract, and pursuant to its authority and jurisdiction under AB1X, regarding the Department of Water Resources Electric Power Fund separate and apart from its powers and responsibilities with respect to the State Water Resources Development System.

IV. FACTUAL BACKGROUND

A. The California energy crisis.

As the Commission is well aware, during 2000 and the first half of 2001, California and the entire western electricity grid experienced an unprecedented market meltdown. Prices in the California Power Exchange ("CAPX") and CAISO spot markets exploded to extraordinary levels. In part, because of the then-existing requirement that the investor owned utilities ("IOUs"), including PG&E, had to purchase their supply entirely in the spot market, these extraordinarily high prices, which far exceeded retail rates, led to huge financial

---

[16] *See* Cal. Water Code §§ 80000, *et seq.*

losses for the IOUs, which in turn resulted in the loss of credit and in turn significant risk premiums, and strained the reliability of the California grid on a near daily basis.[17]

During this time, the Commission instituted formal proceedings to investigate the justness and reasonableness of the rates of public utility sellers in the spot market, recognizing that dysfunction in that market could have far ranging implications.[18] In its November 1, 2000 Order as part of those proceedings, the Commission opined that the central structural flaw of the California market design was its over-reliance on the spot market.[19] The Commission outlined remedies that were to be implemented on January 1, 2001, but because the crisis was worsening, the Commission adopted those remedies earlier to "stop the current electric market hemorrhaging and restore credibility to the electric markets in the West."[20] Importantly, finding that California's flawed spot market had caused and potentially would continue to cause "unjust and unreasonable rates for short-term energy,"[21] the Commission in its December 15, 2000 Order "strongly urge[d]"

---

[17] *See San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, 93 FERC ¶ 61,121 at 61,352 & n. 25 (2000) (reporting that due to the retail rate freeze, PG&E and SoCal Edison's "cost for wholesale power exceeded the amount recovered in retail by billions of dollars.").

[18] *See San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, 92 FERC ¶ 61,172 at 61,609 (2000) (instituting consolidated hearings to investigate the rates and charges of utilities that sell energy to or through the CAISO and CAPX).

[19] *See San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, 93 FERC ¶ 61,121 at 61,359 (2000) ("[T]he market dysfunctions in California and the exposure of California consumers to high prices can be traced directly to an over-reliance on spot markets.").

[20] *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, 93 FERC ¶ 61,294 at 61,982 (2000).

[21] *Id.* at 61,984.

California market participants to enter into long-term contracts covering future deliveries of power for two years or more.[22]

Notwithstanding the Commission's orders in November and December 2000, the crisis continued unabated. It culminated with a near complete breakdown in the reliability of the California grid, as evidenced by the State suffering 32 straight days of Stage Three emergencies (*i.e.,* rolling blackouts across California) in early 2001. In addition, the financial toll of the crisis led to the bankruptcy of PG&E and the CAPX and the insolvency of Southern California Edison.

With virtually no creditworthy buyers left to purchase power, California's Governor on January 17, 2001, declared a State of Emergency and ordered that CDWR "shall enter into contracts ... for the purchase of electricity... as expeditiously as possible." The California Legislature in turn on February 1, 2001 enacted AB1X authorizing CDWR to purchase power either through the spot or forward markets until December 31, 2002.[23]

B. Calpine contracts.

Once empowered by AB1X, CDWR set out on an unprecedented procurement process over the first half of 2001.[24] These efforts led CDWR to

---

[22] *Id.* at 61,993.

[23] *See* Cal. Water Code §§ 80000, *et seq.*

[24] *See Pub. Util. Comm'n of the State of California v. Sellers of Long Term Contracts to the Cal. Dep't of Water Res.,* 103 FERC ¶ 61,354 (2003) (describing CDWR's procurement process) [hereinafter "Long Term Contract Order"].

execute 57 long-term contracts with 28 different suppliers that covered energy deliveries for periods up to 20 years. Calpine was among the suppliers, agreeing in February 2001 to four separate contracts to provide CDWR 2,000 MWs of 7x24 energy and 720 MWs of dispatchable capacity for durations lasting until 2021. Included among these contracts was the original Calpine 2 Contract that, as subsequently renegotiated, is the subject of this Petition.

Thereafter, as the facts of the market misconduct and market power abuses by numerous sellers during 2000 and 2001 became known, the California State Parties undertook a significant effort to recover refunds for spot market overcharges and to reform the CDWR power contracts to reflect just and reasonable rates and terms.[25] To its credit, Calpine was the first major supplier to reach a global settlement with the State with respect to both spot market refund issues and the CDWR long-term power contracts.

Specifically, on April 22, 2002, the California State Parties and Calpine entered a definitive global Settlement Agreement, a copy of which is attached as Exhibit B (the "Settlement Agreement"), which resolved all disputes between the parties related to the energy crisis, including Calpine's liability in the spot market "Refund Case" and the CEOB/CPUC challenge to the CDWR long-term contracts. To put the value of the Settlement Agreement to Calpine in context, for much of the life of the contract, the Calpine 2 Contract price significantly exceeded the just

---

[25] *Id.*

and reasonable market prices. In fact, under just the Calpine 2 Contract alone, during the last 4 ½ years, Calpine has reaped in excess of $400 million in profits over what it would have received for selling the power at market prices. On March 23, 2003, Calpine filed the Settlement Agreement with the Commission in support of its Motion for Partial Dismissal of the Calpine Contract and its subsidiaries from the Refund Case. In doing so, Calpine stated that the settlement "resolves all claims between Calpine and the 'California State Releasing Parties' . . . with respect to the contracts between Calpine and the CDWR.[26] The Commission then by order dated March 26, 2004, granted Calpine's Motion.[27]

Under the terms of the Settlement Agreement, CES and CDWR entered into four renegotiated power purchase agreements effective May 1, 2002, and Calpine Corporation agreed to guarantee CES's performance of these renegotiated contracts. The four renegotiated contracts are summarized as follows:

---

[26] *See San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, Docket No. EL00-95-045, Motion for Partial Dismissal of Calpine Corporation (Mar. 25, 2003).

[27] *See San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, 106 FERC ¶ 61,309 (2004).

	Product	Term	Price
Calpine 1	1000 MWs 7x24 energy	12/31/2009	$58.60 per MWh
Calpine 2	1000 MWs 7x24 energy	12/31/2009	$59.60 per MWh
Calpine 3	495 MWs Unit contingent Dispatchable Peaking Capacity from 11 units	7/31/2011	<u>Energy Price</u>: "Monthly Fuel Costs" + $4.00 per MWh <u>Capacity Charge</u>: For the period 8/1/2003 to 7/31/2006: $7.5 million per month For the period 8/1/2003 to 7/31/2011: $6.67 million per month
Calpine 4	184 MWs Unit firm Dispatchable Peaking Capacity from the Los Esteros unit	3/7/2006	<u>Energy Price</u>: "Monthly Fuel Costs" + $4.00 per MWh <u>Capacity Charge</u>: During third contract year: $16 per KW-month multiplied by the Contract Quality for that month

In the Settlement Agreement, Calpine and the California State Parties expressly acknowledged that the renegotiated contracts, including the Calpine 2 Contract, would <u>not</u> be later challenged by either party.

> 2.10. The Parties desire to resolve certain matters and to avoid any future claims relating to them, including issues relating to the effectiveness, validity or justness and reasonableness of the Renegotiated Contracts, by way of compromise rather than by litigation. The Parties have agreed to resolve such matters and to ensure the ongoing effectiveness and validity of the Renegotiated Contracts on the terms and conditions set forth in this Settlement Agreement.[28]

Calpine entered the renegotiated contracts, including the Calpine 2 Contract pursuant to the Commission's grant of market-based rate authority.[29] Calpine thereafter reported the renegotiated contracts to the Commission on their Commission 2002 second quarter quarterly report.[30]

In this stage of the proceeding, the California State Parties focus on the Calpine 2 Contract. Subsequent to their effective date, Calpine monetized the Calpine 1 and Calpine 3 Contracts, by assigning them to two different bankruptcy remote single purpose entities. Moreover, the Calpine 3 Contract is at an above-market price. It may be, therefore, that those contracts will not be subject to any attempted rejection in bankruptcy. Likewise, the dispatchable Calpine 4 Contract, which is also at an above-market price, is set to expire on March 7, 2006 and, thus, the California State Parties do not expect Calpine to seek its rejection in bankruptcy. However, in an abundance of caution in the event that Calpine and/or its subsidiaries do seek the rejection of the Calpine 1, 3 and/or 4 Contracts, the

---

[28] Exhibit B, § 2.10.

[29] *See Calpine Energy Servs., L.P.,* Docket No. ER00-3562-000, Letter Order (Sept. 21, 2000).

[30] *See Calpine Energy Servs., L.P.*, Docket No. ER02-2001, Amended Electric Quarterly Reports of Calpine Energy Services, L.P. for Second Quarter 2002 (Aug. 1, 2002).

California State Parties request that the Commission provide the same relief in this proceeding for those contracts as for the Calpine 2 Contract.[31]

C. The Calpine 2 Contract.

In the Calpine 2 Contract, CES agreed, backed by Calpine Corporation's guarantee, to deliver 1,000 MWs of 7x24 energy to CDWR through December 31, 2009 at the fixed price of $59.60 per MWh at any point or points designated by Seller on North Path 15.[32] In terms of overall energy deliveries, the Calpine 2 contract is one of the largest single power purchase agreements in CDWR's portfolio.

In addition to the large volumes of energy to be delivered, the parties agreed to several special conditions enhancing CES's performance obligations under the Calpine 2 Contract. Most notably, in Special Condition 3, Calpine agreed that for every day that the market heat rate is projected to exceed 7,000 Btu/kWh for the NP-15 congestion management zone – which benchmark was triggered in all but a handful of days during 2003 through 2005, excluding Sundays and holidays – it will deliver into the California spot markets at least the Contract Quantity of energy (*i.e.*, 1,000 MWs) for such day from its Western Generation Assets – defined to be Calpine-owned or controlled generating assets

[31] It is for this reason that the California State Parties name Power Contract Financing, L.L.C., and Gilroy Energy Center, L.L.C., as respondents here. They are respectively the single purpose entities to which Calpine assigned the Calpine 1 and 3 Contracts as part of the monetization of those contracts.

[32] On April 8, 2005, in settlement of the Seller's Choice Proceeding, CDWR and CES agreed to modify the delivery points for the Calpine 2 Contract upon LMP implementation. *See Cal. Indep. Sys. Operator Corp.*, 111 FERC ¶ 61,385 (2005).

or portions thereof located in the WSCC. Calpine further agreed that, upon the issuance of any day-ahead CAISO warning of a potential stage alert, Calpine will deliver to CDWR during the hours of any warning or stage alert occurring during the following day, the Contract Quantity from its Western Generation Assets and not from market energy purchases. Finally, Special Condition 3 also requires that, under certain specified conditions associated with day-ahead CAISO stage alerts, Calpine's unutilized Western Generation Assets, including those outside of California, must be bid into the CAISO imbalance energy market at just and reasonable rates.

CDWR mandated these requirements as part of the renegotiated Calpine 2 Contract to ensure that Calpine operated its Western Generation Assets, which include the particularly critical Delta Energy Center, Los Medanos Energy Center and Geysers units, and delivered power into the California markets during those times when the California electricity grid was most in need and, by doing so, created a contractual bar to Calpine impermissibly withholding capacity from the California market. These provisions also essentially turn a market contract into an asset-backed contract and ensure that Calpine will retain ownership of sufficient Western Generation Assets to meet its obligations under the Calpine 2 Contract. In this way, CDWR was doing what it could through the renegotiated contract terms to ensure the reliability of the California grid and to prevent a reoccurrence of the market misconduct that plagued California during the crisis.

Special Condition 4 likewise was crafted to address a major need identified during the crisis, namely the State's need for additional new and efficient generating capacity. In Special Condition 4, Calpine agreed to continue to pursue the construction of four new generation facilities within transmission-constrained areas within California, three of which remain in the development state – Otay Mesa, San Joaquin and East Altamont – which were and remain needed for the reliable operation of the California grid. Under the terms of Special Condition 4, Calpine agreed to a defined schedule to meet certain milestones towards the development of the projects. In addition, Calpine agreed that, if it did not meet these milestones, CDWR had the right to "step-in" and take over the development of these projects to ensure their completion. In short, these "step-in" rights formed an insurance policy for California's ongoing efforts to ensure that new generating steel is put in the ground within the State and thereby to avoid in the future any further instances of insufficient local supply during periods of high demand.

D. Importance of the Calpine 2 Contract to PG&E resource adequacy and avoiding reliance on the spot markets.

Electricity from CDWR contracts provided approximately 26% of the electricity delivered to PG&E's customers in Northern and Central California for the nine-month period ended September 30, 2005. As one of CDWR's largest contracts, the Calpine 2 Contract alone accounted for 11% of electricity supplied to PG&E's customers during this period and has been a key component in ensuring PG&E's ability to meet the resource needs of its five million electricity distribution customers.

Under orders and policies adopted by the State of California and the CPUC in order to avoid a repeat of the reliability problems and price shocks of the 2000-01 energy crisis, IOUs such as PG&E are required to achieve and maintain an electricity planning reserve margin of 15% to 17% in excess of peak loads by June 1, 2006, and to forward contract for at least 90% of their summer (May through September) peaking needs at least one year in advance.[33] The long-term CDWR contracts such as the Calpine 2 Contract are considered resources that meet these resource adequacy and procurement standards. To this end, the CPUC's long-term procurement plan and resource adequacy decisions assume that Calpine will continue to supply power to meet the needs of PG&E's customers through 2009 as provided under the existing CDWR contracts.

Thus, if the Calpine 2 Contract is suddenly abrogated, by rejection or otherwise, PG&E's forecast reserve margin for summer 2006 would fall to below the 15%- 17% reserve margins set by state policies. Similarly, if the Calpine 2 Contract is abrogated and Calpine is permitted to sell its output elsewhere or outside California, PG&E and its customers would not have 90 percent of their

[33] Decision 04-01-050, Cal. Pub. Utils. Comm., mimeo, p. 188, (Jan.22, 2004); Decision 04-07-037, Cal. Pub. Utils. Comm. mimeo, p. 26, (July 8, 2004); Decision 05-10-047, Cal. Pub. Utils. Comm., (Oct. 27, 2005).

summer 2006 needs contracted for in advance, and immediately would be exposed to 100% percent reliance on short-term and spot energy markets to supply the incremental energy to replace the Calpine 2 Contract – exactly the same type of circumstances that epitomized the price shocks and market dysfunction of the 2000-01 energy crisis. This reliance also could result in a significant increase in the number of MWs transacted in the CAISO imbalance energy market for NP-15[34], especially during the summer 2006 peak, which is contrary to the Commission's long-stated goal of limiting the "amount of load in the most volatile spot market – the real time imbalance energy market."[35]

In addition to the resource adequacy impacts of a loss of the Calpine 2 Contract, PG&E would be forced to replace the Calpine 2 Contract over its remaining four-year term with replacement energy currently costing hundreds of millions of dollars more in forward markets on a mark-to-market basis.[36] Since the forward wholesale prices for portions of 2006, including especially the summer peak hours, once again exceed the approved retail rates, this potentially could lead to a reprise of the financial conditions at the heart of the 2000-01 energy crisis (namely financial losses, credit concerns and higher risk premiums) and undoubtedly will result in PG&E's customers facing significantly higher

---

[34] The typical trading volume in the CAISO imbalance energy market is now approximately 600-1,200 MWs per peak hour.

[35] *San Diego Gas & Elec. Co. v. Sellers of Energy and Ancillary Servs.*, 93 FERC ¶ 61,294 at 61,995 (2000) (emphasizing that over-reliance on the CAISO imbalance market "jeopardized system operations and created a strong sellers' market and higher prices as real time approached").

[36] CDWR's authority to purchase energy under AB1X expired on December 31, 2002.

electricity costs of over the next four years to replace the Calpine 2 power. Based on current forward prices, these costs could exceed $700 million over the remaining life of the contract (and $275 million for just 2006) on a nominal basis.[37] These unexpected electric rate shocks, coming on top of already anticipated natural gas price shocks occurring during the winter of 2005-06, would cause tremendous hardship to PG&E's nine million electric and gas customers and to the California economy. It is not only in the public interest that Calpine be required to adhere to its contractual obligations which it entered into freely when it renegotiated its CDWR contracts in 2002 as part of the parties' global Settlement Agreement, it is also in the public interest that the Commission act immediately to protect California consumers and businesses from the severe hardships and harm that would ensue if the contract were terminated.

E. Expected Calpine bankruptcy and rejection of contract.

In recent days and weeks, it has become clear that Calpine will be filing for bankruptcy very soon. Numerous press accounts have detailed Calpine's shortage of cash and the major disputes it has encountered with its lenders by using the proceeds of recent assets sales for purposes not permitted by its financing agreements and other litigation casting Calpine's current liquidity in serious

[37] On a mark-to-market basis, the Calpine 2 Contract is currently estimated to be approximately $625 million below market.

doubt.[38] On December 5, 2005, the disputes culminated in a Delaware Court ruling against Calpine and ordering Calpine to pay bondholders approximately $312 million by January 22, 2006.[39] As a result of the Delaware case and other "financial challenges," Calpine's chief executive officer and chief financial officer have been relieved of duty.[40] In addition, the decision precipitated the New York Stock Exchange to suspend trading of Calpine Corporation stock[41] and prompted Company and expert statements that bankruptcy is a very real option.[42]

---

[38] *See generally* Steve Johnson, *Bankruptcy Seen Looming for Calpine*, SAN JOSE MERCURY NEWS, Dec. 7, 2005; Bernadette Tansey, *Energy Firm Tries to Avoid Bankruptcy Filing*, S.F. CHRON., Dec. 8, 2005; Rebecca Smith, *Calpine Taps Turnaround Veteran*, WALL STREET JOURNAL, p. A5, Dec. 13, 2005.

[39] *See* Press Release, Calpine Corporation, Calpine Provides Update on Delaware Litigation (Dec. 8, 2005), at http://phx.corporate-ir.net/phoenix.zhtml?c=103361&p=irol-news.

[40] Press Release, Calpine Corporation, Calpine's Board of Directors Announces Changes in Executive Management (Nov. 29, 2005), at http://phx.corporate-ir.net/phoenix.zhtml?c=103361&p=irol-news.

[41] Press Release, Calpine Corporation, Calpine's Common Stock to Cease Trading on New York Stock Exchange (Dec. 5, 2005), at http://phx.corporate-ir.net/phoenix.zhtml?c=103361&p=irol-news.

[42] For example, in a recent Company press release, Calpine informed:

> Recent developments affecting the company, including [the Delaware case], have undermined its ability to complete planned financial transactions to meet its cash-flow requirements. . . .There is a substantial risk that Calpine will not have sufficient cash to satisfy the restorative remedy ordered by the court and its ongoing debt service obligations and operating expenses. As a consequence, Calpine continues to evaluate its options, including the possibility of filing for bankruptcy.

Press Release, Calpine Corporation, Calpine Provides Update Regarding Certain Litigation Matters (Dec. 1, 2005), at http://phx.corporate-ir.net/phoenix.zhtml?c=103361&p=irol-news.

See also Steve Johnson, *Bankruptcy Seen Looming for Calpine*, SAN JOSE MERCURY NEWS, Dec. 7, 2005 (quoting Jon Kyle Carthwright, Director of Institutional Research at BOSC, which owns Calpine shares and sells its bonds: "We think [Calpine] at this point is headed toward bankruptcy."); Bernadette Tansey, *NYSE to Delist Calpine Corp. Shares*, S.F. CHRON., Dec. 6, 2005 (expressing view of senior utility analyst that a Calpine bankruptcy filing "is almost certain").

Most recently, Calpine repeated its threat of bankruptcy in court filings seeking a temporary restraining order in Delaware state court, expressly stating that it would file for bankruptcy unless it received relief from the court's prior order requiring payment of bondholders.[43] Moreover, Calpine has retained Kirkland & Ellis to provide bankruptcy advice to it and Jay Alix & Partners to provide reorganization services.[44]

Based on Calpine's public statements, the recent press reports and a review of the available public information concerning Calpine's financial condition, the California State Parties expect that Calpine's bankruptcy filing is imminent. In addition, the California State Parties believe that Calpine will seek the immediate rejection of the Calpine 2 Contract under Bankruptcy Code section 365 as part of its bankruptcy on the grounds that the contract is currently below market for Calpine. The California State Parties accordingly initiate this proceeding seeking a declaratory order requiring Calpine to continue to perform the Calpine 2 Contract, notwithstanding any bankruptcy filing, unless and until Calpine complies with its obligations under the FPA to obtain an order from the Commission permitting the abrogation of the contract.

---

[43] In its motion for the restraining order, Calpine argued that if some remedy was not offered by the court, "Calpine will be unable to calm roiled markets, address the company's continuing cash-flow demands and generate the additional cash necessary to redeposit the restoration amount." Bernadette Tansey, *Energy Firm Tries to Avoid Bankruptcy Filing*, S.F. CHRON., Dec. 8, 2005.

[44] *See* Roddy Boyd, *Troubled Calpine Brings in Team of Bankruptcy Experts*, N.Y. POST, Oct. 18, 2005.

V. LEGAL BASIS FOR PETITION

I. Calpine May Not Abrogate Or Otherwise Cease To Perform A Jurisdictional Wholesale Power Contract Without An Order From The Commission Pursuant To Sections 205 And 206 Of The FPA Determining That The Contract Is Contrary To The Public Interest.

Congress has entrusted exclusive jurisdiction over wholesale sales of electric energy to the Commission under Section 201 of the FPA.[45] "As a result, the Commission has gained experience and developed expertise in interpreting these contracts in light of the public interests in assuring adequate supply of electric energy at reasonable prices."[46]

A. The Calpine 2 Contract is a jurisdictional contract.

Calpine entered the Calpine 2 Contract pursuant to its market-based rates on file with the Commission. As such, the contract, together with Calpine's market-based rate authorization "constitutes the rates, terms, and conditions of a public utility's sale for resale in interstate commerce."[47] The Calpine 2 Contract, therefore, is clearly subject to the Commission's jurisdiction and review under

---

[45] *NRG* August 15 Order Denying Rehearing at 61,739; *see also NRG* August 15 Order at 61,736 ("Under the FPA, the Commission has jurisdiction over the wholesale sales of electric energy, . . . and has a duty to assure that such sales are performed and discontinued in compliance with the FPA.").

[46] *NRG* August 15 Order Denying Rehearing at 61,739.

[47] *NRG* June 25 Order at 62,318.

Sections 205 and 206 of the FPA.[48] Calpine itself invoked this jurisdiction in a motion it filed with the Commission on June 14, 2004, seeking approval to assign the Calpine 2 Contract, as a "jurisdictional facility" to a subsidiary as required under Section 203 of the FPA,[49] which the Commission granted on July 15, 2004.[50]

B. Sections 205 and 206 of the FPA prohibit a party to a jurisdictional contract from unilaterally modifying or abrogating that contract.

Under the FPA, the Commission's review of a proposed modification or abrogation of a jurisdictional contract is triggered in one of two ways: under Section 205, when the utility unilaterally files a rate change; and under Section 206, when third parties file a Petition in order to trigger an investigation of existing rates.[51] In the seminal *Mobile* and *Sierra* cases,[52] the Supreme Court

---

[48] *Id.* The fact that Calpine never physically filed the contract but instead reported it in Calpine's reports in no way undermines the Commission's FPA jurisdiction over it. As the Commission made clear in *NRG,* where a party "seeks to abrogate a jurisdictional agreement, . . . it must make appropriate filings under sections 205 or 206 of the FPA to change the contract, whether or not the contract itself has been physically filed." *NRG* August 15 Order Denying Rehearing at 61,741.

[49] *See Calpine Energy Servs., L.P.*, Docket No. EC04-119, Application of Calpine Energy Services, L.P. Delta Energy Center, LLC and CES Marketing III, LLC for Approval to Transfer Jurisdictional Facilities Pursuant to Section 203 of the Federal Power Act, at 7 (June 14, 2004) ("Section 203 of the FPA provides, *inter alia*, that no public utility may dispose of jurisdictional facilities prior to Commission approval. [CES] is a public utility under the FPA, and the Commission has held that wholesale power contracts such as the PSA [*i.e.*, the Calpine 2 Contract] are jurisdictional facilities. Accordingly, Commission approval of [CES's] assignment of the PSA to its affiliates is required under section 203.").

[50] *Calpine Energy Servs. L.P.,* 108 FERC ¶ 62,048 at 64,056 (2004) (instructing, among other things, that "Applicants shall make the appropriate filings under Section 205 of the FPA, as necessary, to implement the transactions").

[51] *See* 16 U.S.C. §§ 824*d* & 824*e* (FPA §§ 205 & 206).

[52] *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956); *FPC v. Sierra Pac. Power Co.,* 350 U.S. 348 (1956).

made clear that Sections 205 and 206 operate compatibly to preserve both private contractual rights and the paramount authority of the Commission to ensure that rates to the public are just and reasonable. Thus, while utilities are free to enter into private power purchase contracts, the public interest is protected by the Commission's supervision of the contracts via Section 205.[53] Likewise, when presented with a Section 206 Petition that a filed contract rate should be changed (or abrogated), the Commission's focus is not on whether the *new* rate is just or reasonable, but on whether the *existing* contract rate is contrary to the public interest.[54] Thus, the law is clear that the FPA precludes Calpine from unilaterally abrogating the Calpine 2 Contract without prior Commission approval, and the determination of the "public interest" justifying the abrogation of the contract is squarely within the Commission's statutory responsibilities under the Act.

C. A rejection under Bankruptcy Code section 365 constitutes a modification or abrogation under Sections 205 and 206 of the FPA.

In *NRG*, the Commission made clear that any breach of an agreement, including rejection of an executory contract under Bankruptcy Code section 365, is the equivalent of termination, and thus falls under the purview of the

[53] *Mobile*, 350 U.S. at 338-39; *see also Sierra*, 350 U.S. at 353 (adopting reasoning in *Mobile*).
[54] *Mobile*, 350 U.S. at 344-45; *Sierra*, 350 U.S. at 354-55.

requirements of Section 205 and/or 206 of the FPA.[55] This is certainly so in the case of the Calpine 2 Contract. If Calpine successfully rejects the Calpine 2 Contract and ceases to perform, a claim for money damages in the bankruptcy court will be a wholly inadequate substitute for the 1,000 MW of power guaranteed under the contract, and the Special Conditions described above, the purposes of which are to further ensure system reliability.

D. In order to reject or otherwise to cease to perform the Calpine 2 Contract, Calpine must provide a notice of termination pursuant to Section 205 and obtain an order from the Commission permitting the abrogation of the contract pursuant to Section 206.

The FPA and Commission precedent are clear that if a seller seeks to modify or abrogate a jurisdictional contract, the seller must make appropriate filings under FPA Sections 205 or 206 to change the contract.[56]

1. Section 205 and Commission rules require that prior notice of termination be provided to the Commission.

The Commission has determined on several occasions that termination of a FERC-jurisdictional contract is a change of service under Section 205 of the

---

[55] *See NRG* June 25 Order at 62,321 ("[A] breach is still a cessation of performance of a FERC-jurisdictional contract and has the same effect for our purposes as a termination that is unauthorized by the contract itself.").

[56] *See* U.S.C. §§ 824d, 824e; *see also NRG* June 25 Order at 62,320 ("If a seller seeks to modify or abrogate a jurisdictional contract, the seller must make appropriate filings under FPA Sections 205 or 206.").

FPA.[57] Section 205 of the FPA and Commission Regulation Part 35.15 therefore mandate that public utility sellers under jurisdictional contracts must file a notice of termination of the contract at least 60 days in advance of termination, including a statement of the reasons for the termination and identification of the purchasers under the contract who have been notified of the termination filing.[58] In *NRG*, the Commission confirmed that this notice of termination requirement applied in all situations where "a seller seeks to modify or abrogate a jurisdictional contract . . . whether or not the contract itself has been physically filed" with the Commission.[59]

The Commission's exercise of its Section 205 authority serves an important statutory purpose. Indeed, the Commission employs its review of contract terminations and other rate changes in order to determine whether such changes

---

[57] *See, e.g., Ky. Util. Co.*, 67 FERC ¶ 61,189 at 61,573 (1994) ("The Commission consistently has held that a utility may terminate service only by first making an appropriate filing of a change in service."); *La. Power & Light Co.*, 17 FERC ¶ 61,230 at 61,442 (1981) (utility could terminate its service to a municipality "only by filing a notice of termination and by the Commission's order permitting the termination). *See also* FERC Order No. 888-A, FERC Stats. & Regs. ¶ 31,048 at 30,305-06 (1997) ("Because a termination of service is clearly a change in service, public utilities must file notice of a termination.").

[58] 18 U.S.C. § 824*d*(d) ("Unless the Commission otherwise orders, no change shall be made by any public utility in any . . . rate, charge . . . or service, or in any . . . contract relating thereto, except after 60 days' notice to the Commission and to the public."); 18 C.F.R. § 35.15 ("When a rate schedule or part thereof ... is proposed to be cancelled ... each party required to file the schedule shall notify the Commission [in the manner proscribed by Commission regulation] at least sixty days ... prior to date of cancellation.").

[59] *NRG* June 25 Order at 62,320.

are consistent with the public interest.[60] As the Commission explained in *Portland General Electric Company*, notification of termination is required "to protect wholesale purchasers – and, by extension, ultimate consumers – from losing service unjustly."[61]

2. The FPA and applicable case law require that, in order to abrogate a jurisdictional contract, including by rejection, a contract party must obtain a Commission Order finding that the contract is contrary to the public interest.

In *NRG*, the Commission made clear that in order to reject a contract through section 365 of the Bankruptcy Code, a contract party "must demonstrate that its contract is contrary to the public interest."[62] Relying on *Mobile* and *Sierra*, the Commission in *NRG*, in the context of a seller in bankruptcy attempting to reject a power contract that was just and reasonable when signed, stated that this heavy burden requires the contract party to show "that its contract 'might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory.'"[63]

---

[60] *See, e.g.*, *Fla. Power & Light Co.*, 3 FERC ¶ 61,199 at 61,199 (1978) ("It is necessary and proper in the public interest . . . that the Commission enter upon a hearing concerning the lawfulness" of a utility's notice of contract cancellation.).

[61] 77 FERC ¶ 61,171 at 61,639 (1996); *see also Ford Motor Co.*, 52 FERC ¶ 61,125 at 61,145 (1990) (Commission requires notice of termination to provide it with "an opportunity to review the termination to ensure that it is just and reasonable.").

[62] *NRG* June 25 Order at 62,321.

[63] *Id.* (quoting *Sierra*, 350 U.S. at 355); *see also NRG* August 15 Order Denying Rehearing at 61,739 ("This means that we will uphold the bargain struck by the parties unless, for example, continued service under the contract would threaten the reliability of electric service to customers, cast upon other consumers an excessive burden, or be unduly discriminatory."). The pending appeals to the 9th Circuit of the Commission's Long Term Contract Order cast no doubt on the conclusion that the full public interest burden would be borne by Calpine given the absence of any basis for claiming that the contract was not just and reasonable when signed.

E. Because the Calpine 2 Contract is important to the stability of the California electricity spot markets and the reliability of the California grid, it is particularly important for the Commission to require Calpine to comply with Sections 205 and/or 206 here.

As discussed above, the Calpine 2 Contract plays an instrumental role in ensuring the stability of the California electricity markets and the reliability of the California grid. That being so, it is particularly important for the Commission to exercise its jurisdiction under the FPA to ensure that Calpine continues to perform the contract unless and until the Commission finds, pursuant to Sections 205 and/or 206, proper grounds for abrogation.

Maintaining the reliability of the nation's transmission grids and the stability of the Commission-supervised wholesale electricity markets is at the core of the Commission's responsibilities under the FPA, particularly after the Energy Policy Act of 2005.[64] Accordingly, the Commission has often used its authority under the FPA to promote a more reliable electric system by "encouraging regional coordinating and planning of the interstate grid through regional independent system operators (ISOs) and regional transmission organizations (RTOs), adopting transmission pricing policies that provide price signals for the

[64] As part of the Energy Policy Act of 2005, Congress amended the FPA by adding a new section 215, titled "Electric Reliability." Section 215 buttresses the Commission's efforts to strengthen the interstate grid by providing for a system of mandatory Reliability Standards developed by the Electric Reliability Organization ("ERO") and reviewed and approved by the Commission. *See* 16 U.S.C. § 824*o*. Importantly, the standards are mandatory, meaning that the ERO can initiate an action and impose penalties for a violation, subject to Commission review, or the Commission can initiate its own enforcement action. *Id.*

most reliable and efficient operation and expansion of the grid, and providing pricing incentives at the wholesale level for investment in grid improvements and assuring recovery of costs in wholesale transmission rates."[65] In fact, the Calpine 2 Contract itself was in a very real sense the result of the Commission's efforts to improve what was described by former Commission Chairman Hebert as the "precarious reliability of the California Power Grid" by: (1) reducing the State's reliance on the spot market to cover the IOUs' load; (2) requiring Calpine's operation of its Western Generation Assets at those times when it is most needed by the California grid; and (3) promoting the construction of new, efficient generation assets in California.[66]

Under these circumstances, even more than those in *NRG,* it is clear that the Commission should require Calpine to comply with Sections 205 and 206 of the FPA before abrogating the Calpine 2 Contract. This is particularly so since the California electricity markets remain a work in progress. While the CAISO is working on a complete and permanent redesign of the markets to remedy the flaws that resulted in the crisis, that market redesign is not set to go live until February 2007 at the earliest. Until the redesigned market is fully implemented and proves effective, the Commission should be particularly vigilant in assuring that the flaws

---

[65] Notice of Proposed Rulemaking: Rules Concerning Certification of the Electric Reliability Organization; and Procedures for the Establishment, Approval, and Enforcement of Electric Reliability Standards, FERC. Stats. & Regs. ¶ 32,587 at 32,231(2005) (detailing the role FERC has historically played in regulating the interstate energy grid).

[66] *San Diego Gas & Elec. Co v. Cal. Ind. Sys. Operator Corp.*, 93 FERC ¶ 61,294 at 62,032 (2000) (Hebert, Commissioner, concurring).

that were at the heart of the crisis, including most notably the over-reliance on the spot market, are not allowed to reoccur to once again expose California consumers to the threats of blackouts and outrageous spot market prices.[67] The Commission should be loathe to permit the unilateral abrogation of the Calpine 2 contract until it has had the opportunity, after the development of a complete record, to assess whether, on balance, the contract is contrary to the public interest, notwithstanding the threat to market stability that such an abrogation poses.

II. The Calpine 2 Contract Is Not Contrary To The Public Interest.

A. The Public Interest Standard.

In the Commission-initiated Seller's Choice Proceeding, FERC Docket No. EL04-108, Calpine expressly acknowledged that the *Mobile-Sierra* public interest standard of review applied to the Calpine 2 Contract, unequivocally asserting in its Request for Rehearing dated July 19, 2004, that "the Renegotiated Contracts are subject to the public interest standard of review under *Mobile-Sierra*."[68] As confirmed in *NRG*, the *Mobile-Sierra* public interest standard of review in the context of this case requires that Calpine demonstrate that the Calpine 2 Contract "'might impair the financial ability of the public utility to continue its service, cast

---

[67] *See San Diego Gas & Elec. Co.*, 93 FERC ¶ 61,121 at 61,367 ("Pursuant to our statutory responsibility under FPA section 206, the Commission not only must 'fix' those areas of market design that are within its jurisdiction and that are causing the potential for unjust and unreasonable rates (*i.e.*, require modifications of existing wholesale market structure and market rules that are impeding a competitive price), we must also provide measures to assure that rates remain just and reasonable until such time as the proposed longer term market remedies can be effectuated.").

[68] *See Cal. Indep. Sys. Operator Corp.*, Docket No. EL04-108, Request for Rehearing of Calpine Corporation (July 19, 2004).

upon other consumers an excessive burden, or be unduly discriminatory" before it may abrogate or otherwise cease to perform the contract.[69]

B. Calpine cannot satisfy the *Mobile-Sierra* standard here.

Calpine will be unable to demonstrate that the Calpine 2 Contract casts any excessive burden, or is unduly discriminatory to any other consumer. To the contrary, as discussed below, it is the loss of the contract that would excessively burden California consumers. Accordingly, the California State Parties expect that Calpine's only argument that the Calpine 2 Contract is contrary to the public interest will be that it currently is priced below market and, therefore, Calpine is losing money by performing. Commission precedent, however, makes clear that just because a just and reasonable contract might later become uneconomic and performed at a loss does not justify contract abrogation under the public interest standard of review.[70]

It is true that the $59.60 per MWh fixed price of Calpine 2 energy is lower than current forward prices for electricity and natural gas. This fact, however, is both transient and irrelevant in the context of a seller seeking to abrogate a power contract with an entity charged with supplying power to the public. For much of

---

[69] *NRG* June 25 Order at 62,321 (quoting *Sierra*, 350 U.S. at 355); *see also NRG* August 15 Order Denying Rehearing at 61,739 ("This means that we will uphold the bargain struck by the parties unless, for example, continued service under the contract would threaten the reliability of electric service to customers, cast upon other consumers an excessive burden, or be unduly discriminatory.")

[70] *See NRG* August 15 Order Upholding Contract at 61,730 ("The law is quite clear on that point: the fact that over time a contract becomes uneconomic does not render it contrary to the public interest."); *see also* Long Term Contract Order at 62,410 (2003).

the life of the contract, the Calpine 2 Contract price significantly exceeded the just and reasonable market prices. As mentioned above, Calpine has, in fact, over the last four and a half years profited in excess of $400 million under the Calpine 2 Contract as compared to historical market prices.

In any event, the fact that the Calpine 2 Contract is currently a financial burden to Calpine, as opposed to CDWR, is not material to the determination of whether the contract is contrary to the *public* interest. Rather, "the purpose of the power given the Commission by FPA Section 206(a) is the protection of the public interest, as distinguished from the private interest of the utilities. . . ."[71] "Thus, courts, such as the D.C. Circuit, have interpreted the *Mobile-Sierra* standard as 'contemplat[ing] abrogation of [fixed-rate] agreements only in circumstances of unequivocal public necessity.'"[72]

> Accordingly, allowing a jurisdictional sale of electricity to be abandoned merely because one party to the contract finds continued service to be burdensome does not satisfy the requirements of the FPA. In general, the public interest in cases of contract modifications revolves around preserving the contracts, which, in turn, will assure reliable supply at reasonable prices.[73]

---

[71] *Sierra*, 350 U.S. at 355; *see also Permian Basin Area Rate Cases*, 390 U.S. 747, 821 (1968) (stating that *Sierra* held "the Commission may not, absent evidence of injury to the public interest, relieve a regulated company of 'improvident bargain.'. . . It follows that the Commission [is] without authority to abrogate existing contract prices unless it first conclude[s] that they 'adversely affect the public interest.'")

[72] *NRG* August 15 Order Upholding Contract at 61,730 (quoting *Metro. Edison Co. v. FERC*, 595 F.2d 851, 858 (D.C. Cir. 1979)).

[73] *NR*G August 15 Order Denying Rehearing at 61,739.

As the Supreme Court made clear, "[b]y preserving the integrity of contracts, it permits the stability of supply arrangements which all agree is essential to the health of the . . . industry."[74]

C. Termination of the Calpine 2 Contract would harm the public interest.

The foregoing demonstrates that the continued existence and performance of the Calpine 2 Contract is not contrary to the public interest. To the contrary, the abrogation of that contract would be contrary to the public interest for the following two reasons.

1. Abrogation of the Calpine 2 Contract threatens and potentially undermines the stability of California spot markets.

If the Calpine 2 Contract is abrogated, PG&E will be forced to once again rely on the spot or short term markets to satisfy its load. This dependence would place excessive demand into the CAISO real-time market and the other California spot markets, particularly during the peak hours in the summer of 2006 when supplies are already forecast to be tight. Such forced dependence, contrary to established CPUC resource adequacy policies, would greatly erode PG&E's reserve margins during summer 2006 if it were unable to procure in advance sufficient energy to replace the large Calpine 2 Contract deliveries. PG&E's forced over-reliance on electricity spot markets and deficient reserve margins could in turn threaten to return the State to the conditions that contributed in large

---

[74] *Mobile*, 350 U.S. at 344.

part to the 2000-01 crisis, during which the over-reliance on the spot market during a period of high demand and limited supply left buyers vulnerable to huge price shocks and the market abuses that occurred then.[75] The rejection of the Calpine 2 Contract would also result in the loss of the unique and important protections provided by Special Conditions 3 and 4 discussed above thereby potentially undermining the reliability of the California grid during those times when Calpine's generation is most needed.

The Commission accordingly should not now permit Calpine to undermine the efforts of the Commission and CDWR to correct the problems that caused the crisis in the first place, particularly where Calpine's rejection would jettison the very same reliability protections that it contractually committed to provide as part of the global settlement it entered into with CDWR and the other California State Parties to resolve all of their claims against Calpine arising from the 2000-01 energy crisis.[76]

---

[75] *See San Diego Gas & Elec. Co.*, 95 FERC ¶ 61,418 at 62,546 (2001) (observing that California's "dysfunctions in the wholesale power markets operated by the ISO and PX" were caused by "California investor-owned utilities' chronic reliance on spot markets"); *Cal. Ind. Sys. Operator Corp.*, 100 FERC ¶61,060 at 61,233 (2002) (recognizing that the "the California wholesale electricity market has been dysfunctional and has experienced extremely high prices during certain periods. The causes of such dysfunction are many. Predominant among them are . . . reliance on spot markets . . . .").

[76] *See San Diego Gas & Elec. Co.*, 93 FERC ¶ 61,294 at 61,999 (2000) (stating that Commission's efforts to eliminate "reliance on the spot market represents the single most important aspect of wholesale market reform and is one of the most critical components of all the immediate market reforms necessary to correct the problems in California electricity markets and provide long-term protection of customers.").

2. Abrogation of the Calpine 2 Contract also would impose significant additional costs on California consumers.

The current mark-to-market value of the Calpine 2 Contract reflects that on a net present value basis the contract is approximately $625 million below market over the remaining four years of the contract. This means that the ratepayers of PG&E, and indirectly all ratepayers in California subject to CDWR's revenue requirement, are finally now recouping some of the losses they have sustained as a result of the energy crisis generally and because they met their contractual obligations under the Calpine 2 Contract during the past 4 ½ years when doing so was financially burdensome. Should Calpine reject, or otherwise cease to perform, the Calpine 2 Contract, these consumers will lose these savings and instead will be additionally burdened by having to pay rates in excess of what they reasonably expected to pay under the terms of the contract. Put differently, based on today's forward electricity and gas prices, the abrogation of the Calpine 2 Contract will cost the *public*, as opposed to Calpine's shareholders and creditors, hundreds of millions of dollars more over the next four years.

VI. RELIEF REQUESTED

The California State Parties respectfully request that the Commission forthwith enter an order:

(1) prohibiting Calpine from unilaterally abrogating or ceasing to perform the Calpine 2 Contract before the end of the contract term without prior Commission review and approval;

(2) requiring Calpine to continue to provide service to CDWR pursuant to the rates, terms and conditions of the Calpine 2 Contract absent

issuance of a further order of the Commission to the contrary; and

(3) requiring Calpine to refrain from taking any action in any other forum to seek to impede or enjoin the Commission from exercising the Commission's jurisdiction under the FPA over the Calpine 2 Contract, including seeking to enjoin the California State Parties' prosecution of this Petition.

In addition, the California State Parties request that, in the event Calpine seeks to reject the Calpine 2 Contract as part of its bankruptcy, the Commission immediately initiate a proceeding under Section 206 of the FPA to determine (a) whether the Calpine 2 Contract is contrary to the public interest and (b) whether the rejection of the Calpine 2 Contract would be consistent with the public interest. Finally, the California State Parties also request, out of an abundance of caution, that the Commission provide the same relief with respect to the Calpine 1, 3 and/or 4 Contracts in the unexpected event that Calpine and/or its subsidiaries seek to reject one or more of them as well in its bankruptcy.

VII. CONCLUSION

For the foregoing reasons, the California State Parties respectfully request that the Commission grant the relief prayed for in the body of this Petition and such other relief as the Commission in its discretion may find to be appropriate under the circumstances. Due to the substantial harm that will occur as a result of Calpine's immediate rejection of the Calpine 2 Contract, the California State Parties request immediate processing of this pleading pursuant to the Commission's rules.

Respectfully submitted this 19th day of December 2005.

CALIFORNIA ELECTRICITY OVERSIGHT BOARD

JARED S. DES ROSIERS
CHRISTOPHER T. ROACH
Pierce Atwood LLP
One Monument Square
Portland, ME 04101
Telephone: (207) 791-1390
Fax: (207) 791-1350
jdesrosiers@pierceatwood.com
croach@pierceatwood.com

and

ERIK SALTMARSH
Executive Director
California Electricity Oversight Board
770 L Street, Suite 1250
Sacramento, CA 95814
Telephone: (916) 322-8610
ens@eob.ca.gov

PEOPLE OF THE STATE OF CALIFORNIA, ex rel. BILL LOCKYER, ATTORNEY GENERAL OF THE STATE OF CALIFORNIA

MARTIN GOYETTE
Supervising Deputy Attorney General
DAVID GUSTAFSON
Deputy Attorney General
1515 Clay Street, 20th Floor
P.O. Box 70550
Oakland, CA 94612-1413
Tel. (510) 622-2232
Tel. (510) 622-2207
Fax: (510) 622-2270
Fax: (510) 622-2121
martin.goyette@doj.ca.gov
david.gustafson@doj.ca.gov

IRENE TAMURA
Deputy Attorney General
1300 I Street
P.O. Box 944255
Sacramento, CA 94244-2550
Tel. (916) 322-2587
Fax: (916) 327-6833
irene.tamura@doj.ca.gov

and

KEVIN J. MCKEON
LILLIAN S. HARRIS
Hawke McKeon Sniscak & Kennard LLP
Harrisburg Energy Center
100 North Tenth Street,
P.O. Box 1778
Harrisburg, PA 17105
Telephone: (717) 236-1300
Fax: (717) 236-4841
kjmckeon@hmsk-law.com
lsharris@hmsk-law.com

CALIFORNIA DEPARTMENT OF WATER RESOURCES

JARED S. DES ROSIERS
CHRISTOPHER T. ROACH
Pierce Atwood LLP
One Monument Square
Portland, ME 04101
Telephone: (207) 791-1390
Fax: (207) 791-1350
jdesrosiers@pierceatwood.com
croach@pierceatwood.com

and

PEGGY BERNARDY
BRUCE YONEHIRO
Office of the Chief Counsel
Department of Water Resources
P.O. Box 942836
Sacramento, CA 94236-0001
Telephone: (916) 653-6186
pbernard@water.ca.gov

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

CALIFORNIA ELECTRICITY OVERSIGHT BOARD, PEOPLE OF THE STATE OF CALIFORNIA, ex rel. BILL LOCKYER, ATTORNEY GENERAL OF THE STATE OF CALIFORNIA, and CALIFORNIA DEPARTMENT OF WATER RESOURCES, v. CALPINE ENERGY SERVICES, L.P., CALPINE CORPORATION, POWER CONTRACT FINANCING, L.L.C., and GILROY ENERGY CENTER, L.L.C.	Docket No. EL05-

NOTICE OF FILING
(December ____, 2005)

Take notice that, on December ____, 2005, the California Electricity Oversight Board, the People of the State Of California, ex Rel. Bill Lockyer, Attorney General of the State of California and the California Department of Water Resources filed a Petition against Calpine Energy Services, L.P., Calpine Corporation, Power Contract Financing, L.L.C. and Gilroy Energy Center, L.L.C. in the above-referenced docket.

Any person desiring to intervene or to protest this filing must file in accordance with Rules 211 and 214 of the Commission's Rules of Practice and Procedure (18 C.F.R. 385.211, 385.214). Protests will be considered by the Commission in determining the appropriate action to be taken, but will not serve to make protestants parties to the proceeding. Any person wishing to become a party must file a notice of intervention or motion to intervene, as appropriate. Such notices, motions, or protests must be filed on or before the comment date.

Anyone filing a motion to intervene or protest must serve a copy of that document on the Applicant and all the parties in this proceeding.

The Commission encourages electronic submission of protests and interventions in lieu of paper using the "eFiling" link at *http://www.ferc.gov*. Persons unable to file electronically should submit an original and 14 copies of the protest or intervention to the Federal Energy Regulatory Commission, 888 First Street, N.E., Washington, D.C. 20426.

This filing is accessible on-line at *http://www.ferc.gov*, using the "eLibrary" link and is available for review in the Commission's Public Reference Room in Washington, D.C. There is an "eSubscription" link on the web site that enables subscribers to receive email notification when a document is added to a subscribed docket(s). For assistance with any FERC Online service, please email *FERCOnlineSupport@ferc.gov*, or call (866) 208-3676 (toll free). For TTY, call (202) 502-8659.