

**REPORT BY THE CALIFORNIA ISO BOARD OF GOVERNORS
REGARDING MATTERS RAISED BY THE SENATE
SELECT COMMITTEE TO INVESTIGATE PRICE
MANIPULATION OF THE WHOLESALE ENERGY MARKET**

June 2004

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INTRODUCTION

In spring 2002, a select committee of the California Senate was investigating manipulation of California's energy market. As part of that investigation, the Senate Committee asked the California Independent System Operator ("ISO") to respond to allegations that its employees had improperly asked the California Energy Resources Scheduling ("CERS") unit of the Department of Water Resources ("DWR") to schedule "fictitious load" during a pair of conference calls in November, 2001. The ISO investigated the allegations, and within a week reported to the Senate Committee that there had been no market manipulation and that the calls were made to insure grid reliability during upcoming scheduled maintenance that would reduce capacity on a critical transmission line in Path 26, the major interconnection between Northern and Southern California. The ISO also told the Committee that it would conduct an in-depth review of the allegations and report to the ISO Board of Governors.

The outside attorney retained by the Board to conduct its in-depth review confirmed the ISO's initial findings that there was no market manipulation and that the ISO did not ask CERS to buy unnecessary power. On these critical issues, everyone is now in agreement. The attorney's review raised additional issues, however, about the way in which ISO employees responded to a variety of Senate inquiries and in particular whether any ISO employee gave false testimony to the Senate Committee. These were grave charges, which the Board has taken very seriously. They called into question not only the integrity and reputations of the individuals involved, but of the corporation itself. They required that the employees be given an opportunity to respond and that the Board review the evidence to determine whether disciplinary or other action was warranted.

This Report describes the steps the Board has taken in response to these matters and its conclusions with respect to the major issues raised by the Senate Committee and the outside attorney. As will be evident, the Board concurs with the outside attorney on some issues

and differs with him on others. Regardless of the level of agreement, however, the Board recognizes the value of this kind of self-examination and appreciates the efforts not only of the outside attorney but of ISO officers and staff to explore and respond to the allegations in a professional and thoughtful way.

The issues addressed by the Board may be divided roughly into three topics: the “fictitious load” allegations, the allegations regarding CERS’s involvement in “out of market” transactions in 2002, and the outside attorney’s more generalized criticisms of the ISO’s “corporate culture.” This Report addresses each in turn and outlines what actions the Board has concluded are appropriate. In order to put the issues in context, the Report begins with background information about the role of the ISO and the events that preceded the calls that prompted the investigation.

I.

BACKGROUND

A. The California Independent System Operator and the Energy Crisis

The California Independent System Operator Corporation (ISO) was created as part of the restructuring of the California electric industry established by Assembly Bill 1890 in 1996. The ISO manages the energy grid that supplies electricity to three-quarters of California. It operates Day-Ahead and Hour-Ahead Markets for ancillary services and transmission, and a Real-Time Market for balancing energy supply and demand. With authorization from the Federal Energy Regulatory Commission (FERC), the ISO commenced operation in 1998.

From very early on there were disputes over the governance structure of the ISO. Additionally, there were tensions between FERC and the state, including the Legislature, California’s Electricity Oversight Board (EOB), and the Public Utilities Commission (PUC), over their respective roles and jurisdiction over the electric industry and the ISO.

The energy crisis in 2000 and 2001 exacerbated these tensions. In the summer of 2000 wholesale electricity prices skyrocketed. By 2001, California’s largest Investor Owned

Utilities (IOUs) teetered on the brink of insolvency, with PG&E finally declaring bankruptcy in April 2001.

Of necessity, the State of California stepped in.

By the end of December 2000, it had become apparent that the California Department of Water Resources (DWR) was the only entity able to step into the role of power purchaser. The Legislature and Governor took steps to authorize DWR to do that. California Energy Resources Scheduling (CERS), a newly-created division of DWR, was designated to serve as the creditworthy backer for the IOUs' purchases in transactions conducted through the ISO market. The state rapidly became the largest power buyer in the California market.

As the new system was evolving and market participants were adjusting to the changes, substantial time lags developed for generators receiving payment for purchases dependent upon CERS's creditbacking. Generators who were not being paid began to resist ISO dispatch orders and ignore must offer requirements for the generation of power. Generators also complained that the ISO was discriminating in favor of CERS in ways that gave it an advantage over other scheduling coordinators participating in the California market. The ISO complained that market participants were failing to submit bids into the real time market and failing to honor such bids when they were accepted. By the end of 2001, FERC had issued a series of orders addressing the respective obligations and complaints as well as the appropriate role of CERS, and payments from CERS as creditworthy backer were beginning to flow to the generators for 2001 transactions.

The reliability of the restructured electricity market and the ISO's ability to avoid blackouts were severely tested in 2000 and 2001. The Real-Time Market run by the ISO was only intended to acquire last-minute energy for 3-5% of the load, to accommodate fluctuations in weather and consumer demand. The vast bulk of energy needs was supposed to be met through the Power Exchange or via bilateral transactions between market participants, who submit their schedules on a forward-looking basis to the ISO. Suddenly, however, the ISO found itself

having to secure as much as one-third of all the electricity needed at any given time through its Real-Time Market.

For the most part, blackouts were averted. There were exceptions, however. For example, on June 14, 2000, rolling blackouts in San Francisco affected thousands. After this experience, state authorities, including the ISO, renewed their efforts to assure grid reliability and avoid blackouts. On August 23, 2000, FERC issued an order directing the ISO “to immediately institute a more forward approach to procuring the resources necessary to reliably operate the grid. Specifically, the ISO should anticipate the need for such additional resources based on forecasted peak periods.” (92 FERC ¶ 61,172 at 61,608.)

By 2003, the situation had changed dramatically. The crisis was behind us, and the IOUs had posted the necessary security to meet the credit requirements for ISO market participants. As a result, as of January, 2003, CERS’s role as creditworthy backer for the ISO markets terminated.

B. The Senate Select Committee to Investigate Price Manipulation of the Wholesale Energy Market

In 2001, as concerns grew that market manipulation was behind the energy crisis, the Senate Select Committee to Investigate Price Manipulation of the Wholesale Energy Market was established. In April 2001, the committee began investigating Enron. Over the next several months, the committee issued subpoenas to Enron, other market participants and the ISO, and held numerous hearings. The investigation disclosed that scheduling of false loads was a central feature of Enron market manipulations that resulted in dramatic escalation of prices and huge losses to the state. In February, 2002, the committee voted to seek criminal charges against Enron.

In early May of 2002, the Senate Committee asked participants in the California wholesale power market whether they knew of other parties that had engaged in practices similar to those of Enron. In response, CERS stated that in the course of two telephone calls on November 14, 2001, ISO employees had asked CERS to schedule “fictitious load” for the following weekend. By letter dated May 23, 2002, Senators Joseph Dunn and Bill Morrow, the

Select Committee Chair and Vice Chair respectively, asked the ISO to respond by May 30 to CERS's allegation. Chairman Kahn responded by letter the next day, stating that the Board had formed a special committee to review the matter and would be retaining an outside investigator to assist the Board. The letter further stated the Board's intent to proceed on two levels: with a prompt reply by the ISO to the committee's inquiry, to be followed by further review with the assistance of the outside investigator.

On May 30, 2002, the ISO submitted a letter to the Select Committee reviewing the situation, answering the specific questions posed in the May 23 letter from Senator Dunn, and transmitting the "Interim Report by California Independent System Operator Corporation to the Senate Select Committee to Investigate Price Manipulation of the Wholesale Energy Market Regarding the November 16-19, 2001 Partial Outage of Path 26." Both the letter and the interim report stated that the November 14, 2001 calls were not an instance of market manipulation, but an entirely legitimate effort to maintain grid reliability. The report stated that for the weekend of November 16-19, 2001 the ISO faced a major transmission outage caused by legitimate and long-delayed maintenance needs, that as a result there was a genuine threat to system reliability, and that in its conference calls with CERS the ISO was attempting to meet that very real need. Given the tenor and character of the allegations, the ISO was explicit in its response that this was not a case of Enron-like market manipulation.

In the months following, correspondence on these and other matters went back and forth between the Senate Select Committee and the ISO, and ISO officers and employees testified at several committee hearings.

C. The ISO's Continuing Investigation

Pursuant to its commitment to review the November 14, 2001 conference calls thoroughly, a committee of the ISO Board retained an outside attorney to look into the matter. As that point in time, in-depth expertise in FERC and tariff practice did not appear necessary.

On June 3, 2003, the outside attorney submitted draft findings to the Board that encompassed the facts surrounding the November 14 conference calls. In addition, he addressed

the ISO's interpretations of its tariff and FERC orders as well as events in 2002 and 2003. The outside attorney was critical of the ISO management and corporate culture and made specific and serious allegations regarding individual ISO officers and employees. The Board then provided an opportunity for the individuals involved to respond and called upon its Chief Executive Officer to address the issues pertaining to management and corporate culture. These responses raised serious concerns over the reliability and validity of various statements and allegations made by the outside attorney. The Board provided the responses to the outside attorney for his further comment.

The Board had hoped this process would be sufficient to clarify the issues and permit resolution in a manner that was comprehensive and reliable, and fair to the individuals involved. Unfortunately, further inquiry proved necessary. It had become apparent that for some of the issues, an in-depth understanding of FERC and tariff practice was helpful and, perhaps, essential. Moreover, critical aspects of the factual record required further development. The individuals' responses, while highlighting such concerns, did not provide a sufficient basis to resolve them. Nor was the outside attorney's response sufficient. This is a complex and multi-faceted area in which an intemperate tone, oversimplification and absolute characterizations cloud rather than clarify the issues. The Board was committed to a careful review of the serious issues regarding the ISO's operations and its dealings with the Legislature and, therefore, conducted further inquiry with the aid of retired California Supreme Court Justice Joseph Grodin, and the law firms of Remcho, Johansen & Purcell, and Hunton & Williams.

The Board has reviewed this matter with care and with three goals in mind: (1) assuring accountability for any past improprieties; (2) addressing concerns regarding the quality of the information provided to the Senate Select Committee; and (3) implementing steps to improve corporate management and effectively address concerns regarding corporate culture.

Specific personnel matters are necessarily confidential and, therefore, will not be addressed in this Report.¹

II.

THE NOVEMBER 14, 2001 PHONE CALLS

When questions first arose regarding the November 14, 2001 phone calls and resulting transactions, the concern was that this was an incident of market manipulation. That concern has since been laid to rest. Everyone, including the outside attorney, agrees there was no market manipulation involved. The system reliability need was quite genuine, and CERS was not being called upon to buy unnecessary power.

It is also now clear that the ISO employees involved in the calls did not improperly disclose to CERS information that was not available to other market participants. Prior to the calls, the information had, in fact, been published on the ISO's electronic bulletin board and was available to all market participants. Similarly, it has now been established that placing the first call to CERS on an unrecorded line was normal procedure and not evidence of guilty intent. What remains are questions regarding the particular mechanisms by which the ISO dealt with an authentic system reliability need and the ISO's subsequent explanations of its actions to the Senate Select Committee.

A. Asking DWR/CERS to Schedule the Necessary Power

On November 14, 2001, the ISO called CERS and asked it to schedule additional power to compensate for a planned maintenance outage on a critical north-south transmission path. There were three ISO Directors on the calls and an in-house ISO attorney. On the CERS side, there were a senior operations official and two consultants familiar with the energy market. Toward the end of the first call, they were joined by an attorney with a firm that acted as outside counsel for CERS.

¹ In California, the employee's right of privacy in certain personnel-related matters stems from the state constitutional guarantee of privacy. (Cal. Const., art. I, § 1.)

There were two calls. The first took place on an unrecorded line; the second on a recorded line by mutual consent. Thus, although there is both a recording and a transcript of the second call, the accounts of the first call are based entirely on memory. None of the participants claimed to have taken notes.

There has been considerable dispute regarding whether the November 14, 2001 calls from ISO employees to CERS were “necessary.” Our greater concern, however, is whether the calls were permissible and prudent and whether, at the time, ISO employees could reasonably have believed them to be permissible and prudent.

It is undisputed that at least two of the four ISO employees on the calls to CERS were under the impression that generators had refused the ISO’s request to provide power to cover the outage and therefore it was necessary to ask CERS’s help to schedule it. One employee could not remember, but thought that was possible. The fourth employee has raised questions regarding the sequence of events and whether he had learned prior to the calls that one of the generators had orally agreed to comply with a dispatch order. We do not find it necessary to resolve this factual dispute regarding the various employees’ information and understandings at the time the calls were placed because, while this scenario raises genuine concerns regarding confusion and/or failure in communication, it does not call into question the integrity of these employees. As a result, it is best addressed through (1) recognition that the crisis atmosphere and pressures of the situation created a risk of confusion; and (2) examination and adjustment of ISO systems to be sure they facilitate effective communication on such matters now and in any future times of crisis.

Whether the calls were permissible and prudent is a matter that bears separate consideration in retrospect as distinct from the perspective of that time. We now have had a November 20, 2001 FERC order addressing the ISO’s dealings with CERS, and months in which to analyze the question – as opposed to the need for an on-the-spot decision as to how to proceed in order to avoid a system breakdown.

At the time, crisis conditions were persisting, relations with generators over economic concerns were tense, and reliability needs were arising with frequency. The ISO has several tools to deal with reliability needs, including the BEEP stack, must-offer obligations, dispatch orders and OOM transactions.² The BEEP stack, as the only competitive tool, must be given preference when it is available. Here, however, because the need was identified days in advance, there was no BEEP stack to turn to. A too-ready willingness by the ISO to rely upon a dispatch order, which was, arguably, the most extreme mechanism, would itself open the ISO to criticism and threaten CERS's willingness to serve as the required creditworthy backer. We are cognizant that just the day before, a CERS representative appearing before the Senate Select Committee had refused to provide assurances of continued credit backing.

Much of the problem with the transaction as it evolved on November 14, 2001 seems to be that the ISO employees treated CERS's dual roles as creditworthy backer and scheduling coordinator as overlapping. It was not until November 20, 2001 that FERC issued its

² The "BEEP stack" is used by the ISO to rank on an economic merit-order basis supplemental energy bids available for balancing energy in the ISO Real-Time Market. BEEP is the acronym for Balancing Energy Ex-Post Price.

The term "Out of Market transactions" (OOM transactions) is used generally to refer to ISO transactions for the purchase or sale of energy at negotiated prices that occur outside of the BEEP stack. OOM transactions augment the BEEP stack resources, are conducted to balance the California electrical grid and assure reliability and are settled directly with the ISO. This is not a term that is defined in the tariff. Its precise definition and, particularly, the role of DWR/CERS in OOM transactions, have been the source of considerable debate.

The term "Must Offer Obligations" refers to the obligation that generators in the ISO control area offer to sell available capacity in the ISO Real-Time Market.

"Dispatch orders" are instructions to increase or decrease energy supply or demand. The orders are the result of the ISO, at its discretion, dispatching any participating generator, load and import to prevent or relieve a system emergency. Such dispatch may result from, among other things, planned and unplanned transmission facility outages, bid insufficiency in the ancillary services and Real-Time Markets, and location-specific requirements of the ISO.

order clarifying the need to keep those roles separate so that CERS did not receive preferential treatment in its functions as scheduling coordinator.

We understand that, particularly with the subsequent November 20, 2001 FERC order in hand, an argument can be made that asking CERS to schedule the necessary power was not permissible.³ In retrospect, the steps taken by ISO employees to have CERS schedule the power were not the best course. We note, however, that no one has pointed to any particular provision of the tariff that was allegedly violated. By contrast, the ISO employees have pointed to section 2.3.5.1.5 to support CERS's involvement in the transaction. This section states:

Notwithstanding the foregoing, if the ISO concludes that it may be unable to comply with the Applicable Reliability Criteria, the ISO shall, acting in accordance with Good Utility Practice, take such steps as it considers to be necessary to ensure compliance, including the negotiation of contracts through processes other than competitive solicitations.

(Tariff, § 2.3.5.1.5.)

On the one hand, if the generators had stated a willingness to supply power under particular terms, even if they demanded a dispatch order, one must question whether the ISO could reasonably consider it necessary to secure the power with the assistance of CERS. On the other hand, in those difficult and uncertain times, one could argue that additional efforts to lock

³ It has been suggested that the request on November 14 was clearly improper because the November 20, 2001 order states that the ISO acknowledges that it is the only entity with authority to make OOM calls to ensure grid reliability. (*See* 97 FERC ¶¶ 61,215, slip opn. at 10.) That begs the question, however, for it is also clear from the November 20 order that the ISO was arguing that due to its special role and responsibilities, CERS was entitled to receive confidential information and be involved in OOM transactions that side-stepped the BEEP stack and served CERS's own purposes. (*Id.* at 4-5, 9-10.) Additionally, the November 14 situation was unusual in that the future reliability need was identified before schedules had even been submitted or a BEEP stack created. Moreover, even if the ISO's litigation stance was inconsistent with staff actions on November 14, the failure of line staff to operate consistently with statements made in pleadings suggests a failure in communication rather than malfeasance.

in the power by other means as well were at least prudent, if not strictly necessary.⁴ The ISO employees involved may fairly have considered this additional assurance to be necessary, given the crisis conditions, the certainty of the need for power, and the difficult relations with generators. The FERC expert whom we consulted informed us that it would be misguided for anyone not steeped in day-to-day ISO operations and application of its tariff to attempt to give a definitive opinion as to the legality of such a specific incident.⁵ At its February 5, 2003 hearing the Senate Select Committee itself recognized that the question of CERS's proper role remained unsettled until FERC's November 20, 2001 order.⁶

While we do not fault the ISO staff for their efforts to meet a genuine reliability need in difficult and contentious times, the effectiveness of the ISO systems for clearly defining, communicating and implementing the legal complexities of the tariff *are* called into question and deserve careful scrutiny. For example, in 2001 the ISO had not adequately articulated for its operations staff or outsiders the parameters and limits of CERS's role in out-of-market transactions or for dealing with reliability needs such as those associated with maintenance projects which become apparent in advance of even the day-ahead scheduling. When called upon to explain its actions, the ISO did not, in our view, provide to the Senate Committee a clear, cogent and compelling explanation for the November 14 transaction with CERS. Instead, even

⁴ We note in this regard that, although CERS had been designated to function as creditworthy backer in January, 2001, as of November 14, 2001, for various reasons, bills still had not been paid.

⁵ The complicated nature of the legal questions involved is highlighted by the fact that the outside attorney initially mistakenly concluded that generators were within their rights in refusing to comply with a must-offer obligation. He subsequently acknowledged that mistake. Additionally, although the outside attorney raised a question regarding whether ISO employees were acting as "brokers" in the transaction, he has not found the law or circumstances sufficiently clear to answer that question.

⁶ Although the Senate Select Committee transmitted the transcript of the November 14 call to FERC, FERC has not taken a position on whether the calls were proper or not. While the absence of comment from FERC is not determinative, it is notable, given the heat of the controversy.

after the November 20, 2001 order, ISO explanations for the events of November 14 often seemed to blur CERS's roles as credit backer and scheduling coordinator.

As noted in Section IV below, the ISO has already implemented and is developing additional protocols, training, and changes to management structure designed to avoid such problems in the future.

B. The Use of the Phrase "Fictitious Load"

Questions regarding whether the ISO was proposing that a transaction be scheduled for a need that did not, in fact, exist have been put to rest. There continues, however, to be sharp disagreement (1) as to whether any ISO employee on the first November 14 call used the term "fictitious load" and (2) if so, whether anyone lied about the substance of the call to the Senate Select Committee or anyone else. And, depending upon the answers to these questions, there remains the question of what action, if any, is appropriate in response.

As to the first question, the Board agrees that, while the evidence is far from conclusive, and while some aspects of the outside attorney's reasoning in regard to this question are problematic,⁷ there is evidence to support the conclusion that someone on the ISO side of the first telephone call on November 14 used the phrase "fictitious load," and a reasonable person could conclude it is more probable than not that this was the case.

The second question is more difficult. In testimony before the Senate Committee, all four ISO employees denied using the phrase "fictitious load" on the first call, and three of the

⁷ The record clearly indicates that the CERS participants *thought* the ISO was asking them to schedule a fictitious load and were trying to confirm that with the ISO participants. The CERS participants were focused on understanding what the ISO was asking them to do. They testified that they considered the substance of the calls to be both unusual and an inappropriate request that they schedule against a non-existent load. The ISO participants have consistently maintained they did not view their request that way, however, but rather believed the load projections on which CERS relied were so inherently imprecise that the margin of error was more than enough to cover the extra 300 megawatts the ISO wanted CERS to schedule. Given the obvious misunderstanding and lack of communication that occurred on the two calls, it is certainly possible that the two sides *thought* they knew what the other was saying, but in fact did not. That state of events, in turn, could lead to different, but sincere, accounts of the conversation.

four said they could not recall whether anyone from ISO used the phrase. The recollection of the fourth was that no one from the ISO used the phrase. All four shook their heads “no” when asked whether any part of the conversation on that first call concerned a request of CERS that it schedule load that did not exist, irrespective of the use of the phrase “fictitious load.”

At this distance in time and on the available record, the Board cannot assess the veracity of any particular individual employee’s testimony before the Select Committee. It is entirely possible, given the rush of events on November 14 and the subsequent time lag, that the ISO participants would not remember the use of the phrase “fictitious load” (which, as the outside attorney observes, was in itself inconsequential) and so were telling the truth, or what they believed to be the truth, in their testimony.⁸

The Board can, however, assess the testimony as a whole, and having done that the Board concludes that the ISO and its employees appear to have been less than forthcoming with the Committee. Whether or not any of the employees lied about their recollection of the November 14th call, they and the other ISO representatives present at the hearing should have done more to place the issue in context. The ISO employees on the call should have volunteered that their recollections could be faulty, and either they or the other ISO representatives at the hearing should have reminded the Committee members that on June 18, 2002, the ISO sent a detailed letter to the Committee describing its knowledge of the circumstances under which market participants sometimes scheduled load in excess of the participants’ own forecasts.

Any lack of complete candor or failure to be forthcoming is of grave concern to the Board, as it must understandably be to the Committee, and the Board has considered carefully what response is appropriate. The problem with any individualized response is that it is impossible to determine, with the degree of confidence required for such a determination, which

⁸ The outside attorney believed that one or more of the ISO employees testified falsely, although he could not determine who or explain why. His conclusion was not based on the witnesses’ demeanors during the interviews; in fact he expressly found no significant differences among their demeanors. When interviewing the ISO employees, the outside attorney did not press them about their recollections of the call. He merely asked them for their version of the events, with very few follow-up questions.

employee or employees may have been less than candid, and which were sincere. And neither principles of law, justice, or sound personnel policy would support the imposition of discipline on a collective basis.

The Board has decided, therefore, upon the following course of action: Copies of this report will be delivered to all ISO employees who were involved in responding to the Select Committee's inquiries. Those employees,⁹ and all other ISO staff, will be instructed (1) that the Board expects complete candor and forthcoming responses from its employees in dealing with the Board, the public, and public bodies concerning matters pertaining to their work; and (2) that any future lack of candor will result in disciplinary action.

C. The Interim Report

The interim report submitted by the ISO to the Senate Select Committee on May 30, 2002 was prepared on an extremely rapid timeline (just one week) and effectively addressed the paramount concern: namely, whether market manipulation had occurred. Its conclusion that such malfeasance had not occurred has held up under all subsequent scrutiny.

The outside attorney initially faulted the ISO for using litigation counsel to prepare the report and criticized the thoroughness and accuracy of the report. Given the seven-day timeline, the ISO could only turn to in-house counsel or to outside counsel who was already familiar with the ISO to prepare the report. Litigation counsel are more accustomed to dealing with contentious factual situations and were, therefore, the likely choice in such circumstances.

In retrospect, one could argue that the interim report should have been more narrowly tailored, should have been more tentative on subsidiary matters, and/or should have explicitly noted the limits imposed by time. One could also argue that it suffered from some incomplete factfinding, overstated some conclusions and got some things wrong; similar problems led us to question aspects of the outside attorney's own draft findings. As we have

⁹ One of the participants is no longer employed by the ISO.

reviewed these matters, we have been struck by the extraordinary complexity of the issues, and the ambiguity surrounding some of the underlying legal and regulatory questions.

The outside attorney has now clarified that he does not criticize the selection of litigation counsel to prepare the interim report. Given the extremely short timeline for preparing the report, and the fact that further investigation was already planned, the approach taken to the interim report was a reasonable one. What is left is the contention that the ISO legal office should look closely at all investigatory procedures and material to be sure that independent analysis, an absence of bias, and accuracy are achieved. We agree.

In this regard, the ISO is developing general protocols to guide any future investigations of alleged wrongdoing and reorganizing its structures for responding to legislative committees. These changes will be designed to ensure complete investigation, independent analysis and provision of full and accurate information on a timely and careful basis. They will also address the need to be explicit regarding the limits that a short time for response may impose upon any investigation and report.

D. ISO's Letter to the Senate Committee Regarding the November 14, 2001 Calls

In testimony before the Senate Select Committee, an ISO attorney asserted that when the ISO contacted CERS on November 14, 2001, it was not about scheduling but about CERS functioning as a creditworthy backer. In a February 11, 2003 letter to the ISO General Counsel, Senator Dunn requested additional comment on this issue, stating that the transcript of the recorded call indicated the opposite.

In an April 9, 2003 letter the ISO counsel responded and explained why she believed the November 14, 2001 conference call was not “focused on scheduling and instead was centered upon grid reliability.” After reviewing the letter in light of the Senator’s stated inquiry and concerns, we find its submission unsatisfactory in several respects.

The letter fairly proceeds on the premise that the November 14, 2001 contacts with CERS were part of ISO concerns over grid reliability and the ISO wanted assistance in any way possible. It is also apparent, however, that whether CERS would schedule power from the

two plants in question was in fact addressed in the conversation and, at least from CERS's point of view, was an issue of significance. It is this aspect of the call that the Senator appears to have been interested in, and in our opinion, the ISO response skirts the issue rather than meeting it.

In setting out the background for the ISO calls with CERS, the April 9 letter states that the generators upon whom the ISO had called to provide power had "refused to comply with the ISO dispatch orders." Although this seems to have been what counsel reasonably believed in November 2001, and still believed at the time of the April 9, 2003 letter, by then there was evidence indicating the contrary.

In our view, it is not enough to suggest, as the April 9 letter does, that CERS could have contacted the generators to provide assurances of creditworthy backing rather than directly scheduling the power with them. That did not occur, apparently was not suggested in the November 14 phone calls, and certainly was not the issue upon which Senator Dunn asked for further response.

This inability by the ISO to "hear," appreciate and respond to the questions raised by CERS on November 14, 2001, and by Senator Dunn in his February 11, 2003 letter, causes us concern. The April 9, 2003 letter should not have been treated by the legal department as an individual response but should have been carefully scrutinized and independently evaluated by the author's supervisors as an important element in the ISO response to the Senate's concerns. This apparently did not occur.

This gap in the ISO procedures is being addressed by both the personnel office and legal department to develop procedures for assuring responsiveness, appropriate review, and close supervision in any future analogous situations.

III.

CONCERNS ABOUT CERTAIN OOM TRANSACTIONS INVOLVING DWR/CERS IN 2002 AND THE ISO'S LEGAL INTERPRETATION OF THE NOVEMBER 20, 2001 FERC ORDER

Concerns have arisen regarding the ISO's interpretation of the November 20, 2001 FERC order, various out-of-market (OOM) transactions involving ISO and CERS in May

and June, 2002, and the explanations of those transactions provided to the Senate Select Committee. We note that as of January 2003, CERS had ceased to act as a creditworthy backer to the ISO OOM transactions, and these issues are thus in a very real sense moot. Questions about them that bear on the ISO's conduct and operations nonetheless call for our review.

There is no dispute that CERS's role in OOM transactions materially changed after the November 20, 2001 FERC order. After implementation of the order, ISO no longer provided CERS with information not also provided to other scheduling coordinators, and CERS no longer engaged in OOM transactions for its own purposes as a scheduling coordinator. CERS did continue to be involved in OOM transactions to support the ISO. The Board has, therefore, undertaken a detailed review of the particular character of CERS's role in the 2002 OOM transactions, the reasonableness of the ISO's interpretation of the November 20, 2001 order, and how ISO officers and employees addressed these issues when questions were raised by the Board and the Senate Select Committee. Our findings are as follows.

A. Background

In late May and early June, 2002, the ISO encountered a series of overgeneration problems, in which energy supply exceeded demand. The overgeneration problems threatened grid reliability and the ISO implemented its standard operating procedure ("Real-Time Over-Generation" Procedure No. G-202) in accordance with section 2.3.4 of the ISO Tariff.¹⁰ As part of that procedure, the ISO sends out a Market Notice asking for additional bids for generators to reduce output, and later a follow-up Market Notice declaring over-generation.

Certain of these transactions, and the involvement of CERS, became the subject of a June 20, 2002 memorandum to the ISO Board which was addressed in public session at the June 25, 2002 Board meeting. While that memorandum to the Board reviewed and explained

¹⁰ Section 2.3.4 of the ISO tariff has the heading, "Management of Overgeneration Conditions." It reads: "The ISO's management of Overgeneration relates only to real time. Overgeneration in real time will be mitigated by the ISO as follows . . ." The tariff then lists a number of steps to be taken to mitigate the overgeneration, and sets forth a formula for sharing the costs of the ISO's mitigation efforts among all Scheduling Coordinators.

some of the transactions in considerable detail, it did not describe the full range of transactions. As we discuss below, concurrent communications with the Senate Select Committee on the same topic were even less satisfactory.¹¹

B. The November 20, 2001 FERC Order and the 2002 OOM Calls

Questions have been raised regarding the ISO's interpretation of the November 20, 2001 FERC order as permitting the involvement of CERS in the 2002 OOM transactions. There is a sharp dispute between the ISO legal department and the outside attorney regarding what constitutes a fair and reasonable interpretation of this order. We therefore designated a working group composed of a board representative, the special assistant to the board chair, and counsel from Remcho, Johansen & Purcell to look into the issue. They reviewed the order, the pleadings that led to it, the interpretations presented by the ISO legal department, and the analysis provided on behalf of one employee by a firm with particular expertise in the area. Additionally, they consulted with an independent FERC expert at Hunton & Williams, a law firm in Washington, D.C.

The November 20, 2001 FERC order clearly disapproves the conduct that is described in the complaint filed by the generators, which was the use of OOM calls to serve CERS's load in a manner that circumvented the BEEP stack and gave CERS an unfair advantage in the market.¹² The order specifically prohibits the sharing of proprietary information with

¹¹ During the February 5, 2003 Senate testimony, in response to a suggestion from Senate staff that the ISO provide additional information about these transactions, ISO staff evidenced the belief that the June 20, 2002 Board memorandum previously had been provided to the Senate Committee. In fact, the June 20, 2002 memorandum was not provided to the Senate Committee until April 2, 2003.

¹² The complaint alleged that:

[T]he ISO is providing preferential treatment to DWR/CERS. This is so, Complainants allege, because the ISO is buying energy from DWR/CERS outside of, and in preference to, the mechanisms provided in the ISO Tariff. In particular, Complainants allege that the ISO is circumventing its merit order "BEEP Stack," [fn. omitted], that ranks supplemental energy bids available for balancing energy in economic merit order, and is instead

(Continued)

CERS. It also states that the OOM process is not to be used in lieu of the BEEP stack and the market, and CERS is not to be given preferential discriminatory treatment in its role as a scheduling coordinator.

The November 20, 2001 order also finds that “the ISO is violating the terms of its own Tariff by allowing DWR to become involved in OOM calls.” (97 FERC ¶ 61,215, slip. opn. at 10.) It is this passage that has proven to be the source of controversy. The outside attorney reads the passage literally. ISO staff, and our working group, believe that the sentence cannot properly be read in isolation from the entirety of the 12-page order. There is less consensus, however, on how to read the order in the context of these transactions.

In its November 20, 2001 order, FERC is insisting that the ISO be attentive to the rules and procedures governing scheduling coordinators when it is dealing with CERS. The order does not appear to prohibit CERS from serving as a creditworthy backer in OOM transactions, since earlier FERC orders had established the requirement for a creditworthy backer for all ISO transactions.¹³ During the relevant time period CERS was acknowledging its obligation to serve as a creditworthy backer, and had received assurance from the state Attorney General that it was legal to do so. The order does not, however, clearly address the extent to which it would be permissible for CERS to participate in OOM transactions on the same terms as other scheduling coordinators.¹⁴

purchasing balancing energy from DWR/CERS through so-called out-of-market (OOM) transactions. [Fn. omitted.] The Complainants also allege that the ISO is sharing confidential information with DWR/CERS, providing it with a competitive advantage that enables DWR/CERS to facilitate the OOM transactions, in violation of its Tariff and the FPA.

(97 FERC ¶ 61,215, slip. opn. at 3.)

¹³ See, e.g., 95 FERC ¶ 61,391 (June 13, 2001); 97 FERC ¶ 61,151 (Nov. 7, 2001).

¹⁴ An underlying problem with interpreting the FERC order is that there is no set definition of “OOM,” and the various parties were not always using the term in a consistent manner.

It seems clear that in May and June of 2002, the ISO had an operational need for CERS to be involved in real-time OOM transactions to assure grid reliability. The ISO exhausted its market alternatives before moving to the OOM alternative, following its standard procedures for over-generation conditions. In some cases the ISO initiated calls to generators for an OOM transaction and called upon CERS to complete the OOM transaction. That likely was within the bounds of what CERS could do as a creditworthy backer or counterparty to the ISO OOM transactions. It is less clear that it was appropriate for the ISO to ask CERS to *initiate* OOM transactions at the ISO's request, which appears to have occurred on several occasions.¹⁵

It has become apparent during our review that the ISO staff interpreted the November 20, 2001 order as allowing CERS to be involved in a fairly wide range of conduct under the umbrella of being a creditworthy backer or counterparty to OOM transactions. In the OOM transactions at issue in 2002, CERS sometimes merely backed or "sleaved" transactions that were initiated by the ISO. Other times CERS, at the ISO's request, took a more active role in arranging for the transaction and becoming the counterparty to the transaction with the third-party generator. This is not the same conduct that was clearly prohibited by the FERC order, in that CERS was not being provided with confidential information, and OOM transactions were not being used to circumvent the BEEP stack. Nonetheless, it is not conduct clearly authorized by the November 20 order. Nor is it conduct the ordinary reader might associate with the term "creditworthy backer" as it was used in the ISO's June 18, 2002 letter.

As of January 2003, CERS no longer serves as a creditworthy backer or counterparty to ISO OOM transactions, and the legal questions raised above are essentially moot. Nonetheless, there are bound to be times in the future when the ISO staff is faced with a situation that is not clearly prohibited or approved by a particular FERC order, and where the ISO's behavior is subject to questioning from the Board, the Legislature, and the public.

¹⁵ We note that in the February 5, 2003 hearing, a representative of CERS stated that CERS had complained to FERC about the calls. As far as we have been able to determine, FERC chose not to act on those complaints.

The Board's primary concerns at this point are twofold. First, it is our duty to ensure that the ISO's actions conform to the tariff and other legal requirements. To this end, our staff is instituting procedures to formalize their interpretations of the tariff and their implementation of relevant FERC orders.¹⁶ As part of that process, we will ask them specifically to address when the ISO should seek further guidance from FERC for issues that are less than clear, and when it is sufficient instead to proceed on a course consistent with Good Utility Practice and prior tariff interpretations, knowing that market participants are likely to bring to FERC's attention issues needing further resolution. We also will ask them to review current operating procedures regarding OOM transactions now that CERS is no longer acting as the ISO's creditworthy backer.

Our second concern, addressed more fully below, is with the ISO communications on this subject with the Senate Select Committee.

C. ISO Communications with the Senate Committee about the 2002 OOM Calls

On June 6, 2002, Senator Dunn sent a letter to the ISO and CERS, in which he asked both entities to answer the following questions:

- 1) Did ISO in fact stop involving CERS in OOM transactions following the November 20, 2001, order?
- 2) Following the November 20, 2001, FERC order, did CERS begin to back OOM purchases made by ISO?
- 3) Have there been any instances in 2002 in which CERS was involved in an OOM transaction on behalf of ISO, in any capacity besides its role as creditworthy counterparty? Please make certain your examination of such transactions includes data up to the present.

The ISO responded in two letters. The first, dated June 18, 2002, just two days before the June 20, 2002 report to the Board, stated in relevant part:

With respect to inter-tie (out of state) OOM transactions, we provide the following answers to your questions:

¹⁶ See *infra* Section IV.

- 1) Following the November 20, 2001 order, based on information gathered to date, CERS participated in OOM transactions only as the credit worthy backer for the ISO. Because Scheduling Coordinators representing out of state suppliers have refused to do business with the ISO without CERS's involvement, it has been necessary to involve CERS in those transactions.
- 2) See response to Question 1.
- 3) To our knowledge, in 2002, CERS has not been involved in any out of state OOM transactions on behalf of the ISO in any capacity other than its role as a creditworthy counterparty.

A second ISO letter, dated June 21, 2002, addressed within-ISO control area OOM transactions and stated the following:

- 1) Based on information gathered to date, CERS participated in within Control Area OOM transactions following the November 20, 2001 FERC order in at least two respects. . . . On some occasions following November 20, the ISO broadly solicited OOM procurements from a number of Scheduling Coordinators, CERS among them, after available bids in the BEEP stack had been exhausted. Where CERS responded to such solicitations, the ISO consummated OOM transactions with CERS in its role as an entity that owned or controlled generation resources. . . . Additionally, on some occasions following November 20, some suppliers contacted by the ISO after bids in the BEEP stack had been exhausted declined to supply additional energy to the ISO unless CERS served as the direct counterparty to the transactions. In those instances, the ISO requested that CERS consummate the transaction with the supplier and then resell the energy to the ISO. In those instances, CERS served as the creditworthy counterparty for the transactions originally solicited by the ISO (as required under the various FERC orders on creditworthiness).
- 2) See response to Question 1.
- 3) Based on our best information to date, in 2002, CERS has not been involved in any within Control Area OOM transactions on behalf of the ISO in any capacity.

CERS had responded to Senator Dunn's June 6, 2002 letter on June 20, 2002 with a memo stating the following:

1. Did ISO in fact stop involving CERS in OOM transactions following the November 20, 2001, order?

No. As described in the enclosed ISO Market Notices dated November 30, December 5, and December 12, 2001, CAISO implemented, in stages, the [FERC] November 7, and November 20, 2001 orders to stop providing information to CERS that is not also provided to other scheduling coordinators and to stop making requests of CERS to make OOM purchases.

Also enclosed is a copy of two e-mails dated December 10, 2001 and December 11, 2001 between CERS and CAISO legal counsel in which the CAISO affirms that they would no longer use CERS for both OOM purchases and scheduling must offer unit's minimum loads starting December 13, 2001.¹⁷

The last OOM transaction CERS made in 2001 at CAISO's request was on December 7, 2001. A summary of the OOM transactions from November 20, 2001 through December 7, 2001 is enclosed. OOM calls made in 2002 are addressed in response to question number 3 below.

2. Following the November 20, 2001, FERC order, did CERS begin to back OOM purchases made by ISO?

Yes. In compliance with the November 20, 2001 FERC order, CERS as a scheduling coordinator did provide credit backing for CAISO OOM purchases. CERS also requested and received an informal opinion from the Attorney General that affirmed CERS authority under AB IX to provide credit backing to CAISO OOM purchases.

3. Have there been any instances in 2002 in which CERS was involved in an OOM transaction on behalf of ISO, in any capacity besides its role as creditworthy counterparty?

Yes. On May 26, June 2, June 3, June 4, June 6, June 7, June 8, and June 18 in 2002 CAISO instructed CERS to make OOM transactions for grid reliability. . . .

¹⁷ This reference is to an email from CERS, and a response from the ISO legal division, in which the ISO "affirm[ed] the ISO's intention to stop contacting CDWR/CERS for out-of-market ("OOM") purchases as may be needed to assure operational control and reliability of the ISO Controlled Grid, beginning at 2359 on Dec. 12, 2001."

With that letter, CERS provided Senator Dunn with a recording of 34 phone calls related to those May and June OOM transactions.

The issue appears to have languished until January and February of 2003, when the Senate Committee began further inquiries on the topic. On January 15, 2003, the Committee faxed to the ISO a copy of CERS's memo and a list of the OOM calls at issue. On January 27, 2003 Senator Dunn asked the ISO for a written explanation of the "apparent disagreement between CERS and ISO" regarding the 2002 OOM calls. The ISO responded by letter dated February 4, 2003 in which it set forth its view of the legal basis for the OOM transactions in greater detail. In addition, ISO representatives were asked to attend a February 5, 2003 Senate hearing at which they answered a series of questions about the 2002 OOM transactions with CERS and the ISO's legal interpretation of the November 20, 2001 FERC order.

After the hearing, Senator Dunn sent a letter dated February 11, 2003 asking a series of follow-up questions regarding the 2002 OOM calls. The ISO responded on April 2, 2003. With its response, the ISO provided a copy of the June 20, 2002 memorandum to the ISO Board, and the G-202 operating procedure governing real-time overgeneration conditions.

Although ISO staff ultimately provided a fuller explanation to the Senate Select Committee, we are not satisfied with our initial responses to the Senate's questions about these transactions.

We recognize that ISO staff, in addition to their usual work, were actively engaged in responding to the Senate and ISO investigations of the November 14, 2001 calls during the same time period they were responding to the Senate's initial questions regarding the 2002 OOM calls, and the former may have taken precedence. The ISO's letters to Senator Dunn of May 30, 2002 and June 18, 2002 regarding the November 14 calls are far more detailed than are the June 18 and June 21, 2002 letters on the OOM calls. The latter are by contrast inadequate and confusing.

In hindsight, it is easy to understand why the Senate Committee grew concerned about the apparently disparate answers from CERS and the ISO to Senator Dunn's June 6, 2002

letter. We have no basis on which to conclude that the ISO was deliberately misrepresenting the nature of the OOM transactions. Nonetheless, it is clear that ISO operations and legal staff had at hand detailed information regarding the 2002 OOM calls, some of which they transmitted to the ISO Board in June 2002¹⁸ but failed to share with the Senate Committee until April 2, 2003. It is also clear they had performed a legal analysis sufficient for them to give assurance to the Board on June 25, 2002 that at least some of the OOM calls were not in violation of the November 20, 2001 FERC order, but did not adequately convey that analysis to the Senate Committee until February, 2003. Especially in light of the information being gathered for the June 25, 2002 Board meeting, the letters of June 18 and June 21, 2002 appear inappropriately terse, a negative consequence of which is that they are subject to misunderstandings.

Criticism has also been leveled at ISO employees' testimony at the February 5, 2003 Senate hearing. Staff's testimony is consistent with the views they previously expressed to the Board and elsewhere to the Senate, with the possible exception of the testimony of one ISO staff counsel. That testimony, however, appears to reflect a genuine disagreement over the legal interpretation of certain aspects of the ISO tariff and the November 20, 2001 FERC order. Neither the tariff nor the FERC order covered the precise circumstances at issue in the 2002 OOM calls, and it is understandable that there might be some differing interpretations. Nonetheless, it is unfortunate that those differences were not worked out internally prior to the Senate testimony, so that the ISO could have presented a coherent and understandable view. The Board would have preferred that its general counsel clarify the record and, if necessary, disavow those portions of the staff counsel's analysis that differed from that of the corporation, either at the hearing or in subsequent correspondence to the Senate Committee.

¹⁸ The June 20, 2002 board memorandum discussed only transactions initiated by the ISO directly, and not those the ISO asked CERS to initiate on the ISO's behalf. Knowing what we now about the latter, the staff discussion appears not fully complete and accurate, although we do not know whether the staff who participated in that discussion knew at the time of those different transactions.

On February 5, 2003 the Senate Select Committee did not have the benefit of the fuller explanation provided in the April 2, 2003 ISO letter. Both the questioning and the responses would have benefited from having had that information in advance.

This Board regrets and apologizes for the unsatisfactory character of the early letters and the piecemeal character of the ISO presentations to the Senate Select Committee on this issue. As discussed in Section IV below, the ISO is committed to implementing strategies to avoid these sorts of problems, including providing greater assistance to our operations staff in formulating responses to Senate inquiries. We also are committed to implementing procedures to formalize our interpretations of the tariff and FERC orders, and timely reflect those interpretations in operating procedures and protocols and operator training.

IV.

MATTERS PERTAINING TO CORPORATE MANAGEMENT AND CULTURE

The outside attorney raised certain corporate culture issues that deserve to be addressed. Specifically, the outside attorney concluded that ISO employees failed to appreciate the concerns expressed by CERS on the November 14, 2001 calls and at other times did not successfully communicate their own positions during those interactions; that ISO has been disrespectful and arrogant in its dealing with market participants; and that ISO takes an inappropriately aggressive stance in its submissions to FERC and its interpretation of FERC orders.

The Board takes these charges seriously and has examined them carefully. Additionally, as noted above, the Board has concluded that at critical junctures in its dealings with the Senate Select Committee, the ISO's explanations were presented in a manner that was sometimes incomplete, unclear, or otherwise subject to misunderstanding. The effectiveness of ISO systems for implementing and explaining changes in the law and FERC rulings has been drawn into question. Practices, structures, and strategies that may have been necessary in the midst of the energy crisis should be reevaluated now that the situation is more stable.

In the sections that follow, we review changes that already have been implemented and steps that are planned to address concerns over ISO management and culture. We also address the criticism of the ISO's dealings with FERC.

A. Changes in Management, Operations, Training and Supervision

The Board has reviewed management's efforts to address issues of corporate culture and improve ISO management and operations as they relate to these concerns. We find a number of positive developments, as well as much work that remains to be done.

On the positive side, even prior to our review, the ISO was implementing strategies to assure that problems in the Real-Time Market, in dealings with CERS, and in implementing changes made necessary by evolving FERC orders were dealt with more effectively.

The Operations Audit for 2001 presented to the Board by PriceWaterhouseCoopers on February 7, 2002 confirmed that market stresses and changing market rules involving FERC orders and the role of CERS had contributed to an unacceptably low level of compliance (only 50%) between ISO practice and procedures. The report expressly noted that ISO operators' lack of confidence that generators would deliver needed energy through ISO Real-Time Market mechanisms adversely affected dispatch effectiveness and contributed to greater reliance on CERS. The audit report acknowledged that by the time it was presented in 2002, circumstances had changed significantly since the audit period, particularly with respect to CERS's role.¹⁹ Although several procedures addressed in the audit had already been revised to comply with then-current circumstances, the ISO, as part of its action plan, undertook a comprehensive process of reviewing and updating the Operating Procedures to keep

¹⁹ A separate independent audit commissioned by FERC similarly recognized that CERS's involvement as a creditworthy backer had resulted in various technical violations that appeared to have ceased by 2002 and were no longer a problem. That independent audit stated, "CAISO management recognized the potential problems created by CERS and appropriately initiated on its own behalf a review of CERS-related transactions." (Final Report, Operational Audit of the California Independent System Operator for the federal Energy Regulatory Commission by Vantage Consulting Company, January 25, 2002.)

them current. Systems were put in place to assure a strong coordinated effort in this process. By 2002, compliance had improved to 80%.²⁰

Now, when a FERC order that alters the tariff is issued, the Procedure Program Manager works with an interdisciplinary team of ISO employees, including operations and legal staff, to review procedures in light of the order and revise the procedures if a change in practice is called for. Thus, for example, the procedure for Must Offer Waiver (M-432) was revised in 2002, revised again twice in 2003, and was the topic of focused training in 2003. The Out-of-Market and Out-of-Sequence Control Area Generation Dispatch procedure (M-425) was revised in 2002 and 2003 and accompanied by focused training. As discussed in more detail below, the legal office is developing procedures to be certain that similar steps to revise procedures take place for all FERC orders regardless of whether actual tariff changes are involved.

In May, September, and October of 2002 the Board received updates on the ISO action plan in response to the 2001 audit. This process of developing an action plan in response to annual audits and a regular schedule for action plan updates and presentations to the Board has been institutionalized. Particularly difficult issues have been examined over sequential years to assure that issues and improvements are not lost. Thus, at management's request, real time grid operations were a particular focus of both the 2002 and 2003 operational audits.

In addition to other training, since 2002, dispatchers have had included as a standard part of their schedules an eight-hour training day for each five-week work rotation. A concerted effort to make trainings more focused, more concrete, and more effective also was instituted in 2002.

In 2002, the ISO and FERC arranged for FERC to have a local presence on the ground in the ISO Folsom offices. Since then the ISO has been working extensively with these FERC representatives to address issues as they arise and to communicate on a regular basis regarding ISO operations.

²⁰ In 2003 it was down slightly to 77%.

The ISO has instituted a number of programs specifically designed to address the concern that market participants do not feel that they are being listened to by the ISO and are not being provided useful information regarding ISO procedures, policies and practices. Greater efforts are underway to assure that stakeholder meetings create an effective forum for the exchange of information and expression of concerns. At the time of this writing the ISO is developing its action plan for addressing problems noted in the 2003 client satisfaction survey. Select officers and directors are meeting with market participants in regional forums throughout the U.S. to clarify and resolve issues. There are also additional stakeholder meetings and conference calls focused on particular issues or new developments. For example, over a six-month period in September 2003 and March 2004, the Must Offer Waiver process was the topic of conference calls, stakeholder meetings and Board updates to outline proposals, process proposals and comments, and obtain Board approval of changes to the Must Offer obligation process. Since 2002, the ISO also has increased significantly its encouragement of and participation in FERC's sponsored stakeholder events.

Pursuant to a 2003 action plan, the ISO implemented communications training for staff aimed at improving their skills in listening to clients when making operational decisions and timely providing comprehensive answers to operational questions. Interdepartmental communications are also addressed in these trainings. To help coordinate ISO internal and external communications on market participant issues, the ISO has recently hired a Director of Client Relations.

The ISO is becoming much more active in issuing market notifications regarding discussions with market participants and FERC over challenged practices. For example, on February 13, 2004, the ISO issued a market notice setting forth the status of its discussions with PG&E and FERC's Office of Market Oversight and Investigation regarding a questioned scheduling practice, its implications for congestion and reliability, and the actions that the ISO and FERC staff agreed upon pending further improvement in congestion management. This sort

of communication can help to minimize the types of problems that occurred in 2001 and 2002 in regard to CERS's role and market participants' resistance to Must Offer and dispatch orders.

Similarly, the ISO staff, and Grid Operations in particular, has a renewed commitment to self-analysis and, where appropriate, self-criticism. Recently, the ISO issued a press release acknowledging that a preliminary internal investigation found operator error had contributed to a power outage in Southern California. The release not only acknowledged the ISO's failure to ramp up output quickly enough to meet an unanticipated surge in energy demand, but also spelled out the action steps the ISO would take to prevent a similar incident from occurring in the future. Steps such as this toward greater public accountability serve to strengthen the ISO's credibility in the market and increase the public's confidence in the ISO's ability and willingness to investigate its internal policies and procedures.

Within the legal department a number of changes are already in place to address concerns raised by the outside attorney. The weekly all-attorneys meetings now include a standing item whereby the legal staff as a group discuss tariff interpretations and any ISO practices that potentially are not in compliance with the tariff. Attorneys identify the issue, formulate a plan to deal with it, and discuss it among the group so others have input and are aware of the problem. It is then tracked as part of a risk matrix.

On tariff issues, the legal department has developed a form to aid in developing the collective view of the legal department on an issue of tariff interpretation. Even before the outside attorney raised concerns, the department had initiated a procedure requiring a second legal opinion on any tariff interpretation, making sure someone at the director level in legal is informed. Placing the tariff issues as a standing item on the weekly meeting agenda enhances that review by making sure all attorneys are involved in and aware of the interpretation. In the future, the legal department will be developing an electronic, annotated tariff that would include historical cross-references and annotations of interpretations.

The legal department is also drafting a procedure for formalizing processes by which attorneys ensure compliance with FERC orders, including a checklist of requirements

arising out of any given FERC order. Regulatory filings protocols are being developed to regularize decisions regarding what to file, when to file and what position to take. These protocols will include coordination with outside counsel and review at the director level or by General Counsel. The legal department is also looking into effective ways for identifying and assuring careful consideration and high level review of situations in which the ISO may be asserting positions that break new legal ground.

A number of systems are being put in place to better coordinate between legal and other departments and avoid having either legal or operational staff stretched too thin. These include procedures to improve coordination between the market quality department and legal department on issues arising out of the settlements process, protocols for coordination with grid operations on responding to requests for information related to discovery or regulatory agency filings, procedures for maintaining a current and comprehensive litigation database to deal with the large volume of data requests, and procedures that assure on the one hand that the legal department receives sufficient notice of the needs for assistance and on the other hand that requestors (inside and outside the ISO) receive a timely response.

Besides the ethics certifications that are mandatory for all ISO personnel, the General Counsel's office has undertaken additional trainings for personnel in the General Counsel division. These trainings have included an emphasis on the need for the ISO, led by its legal division, to be the standard bearer for the industry on issues of integrity and to establish confidence in its integrity and honesty. These trainings have been supplemented by informal discussions regarding the role of the ISO attorneys in assessing legal risks versus business risks and encouraging attorneys to be vigilant in elevating potentially controversial issues up the management chain. These ethical and professional expectations are also now being converted into a formal memorandum that should improve employee understanding and enable meaningful evaluation of employees against these standards.

In August 2003, a special assistant to the Board Chair was hired to assure that there was an individual within the ISO who regularly reported directly to the Board Chair. As a

result, the Board now has a full-time individual who works for and reports directly to the Board and who has access to daily operations. This addition has improved the Board's understanding and oversight of corporate functions and issues.

The ISO has also begun a search to fill the position of Chief Operating Officer (COO), which has been empty since 1999. The intent is to have the COO oversee Market Services, Information Technology, Grid Operation and Grid Planning. This will permit greater integration and enhanced supervision of the areas under new oversight. The COO also will be able to bring particular expertise to these areas.

Finally, management is creating a new committee structure that would be specifically charged with developing ISO positions on matters that have policy implications. The particular details of this committee structure are under consideration with the goal of assuring consistent and effective coordination, articulation and implementation of policy positions.

On the less positive side, the Board notes that ISO's performance on its annual client satisfaction survey of market participants has not improved significantly over the last two years, although the trend is in the right direction. ISO's overall performance rating remains at 6.5 on a scale of 10, up just one-tenth of a point from last year. As the structural changes outlined above are implemented, the Board will be watching for improvement on this and other indicators and demanding change if they do not improve.

B. Criticisms of ISO Dealings with FERC

The outside attorney expressed concern that, as a matter of corporate culture, the ISO takes an unreasonably aggressive stance in its dealings with FERC and its interpretation of FERC orders.

Certainly there have been times when the ISO and the State of California have deliberately chosen an aggressive posture in respect to oversight of the electricity industry. In the midst of the energy crisis, the ISO – and other California energy regulators – necessarily adopted a forceful stance before FERC on a number of issues. These included (1) issues arising

from the ISO's legislatively-mandated governance structure; (2) claims that suppliers' market-based rate authority should be circumscribed and FERC should impose meaningful price controls; (3) FERC filings seeking substantial refunds of overcharges; (4) claims by the California PUC and EOB that FERC should rescind or revise the DWR's long term power contracts because they were coercively obtained at a time when the FERC-regulated wholesale markets were unjust and unreasonable; and (5) filings on a variety of issues pertaining to assuring reliability and mitigating price volatility during the energy crisis.²¹

We note that in FERC practice, multiple motions seeking clarification and rehearing on any given order are to be expected. In this context, even within a single order, FERC may uphold a point that seems contradicted by its prior order while rejecting other proposed changes or clarifications as inconsistent with prior orders. Notably, because the statutory standard under 16 U.S.C. § 824d is whether a proposal is "just and reasonable," it is not unusual to see language in which the Commission rejects a proposal as "unjust or unreasonable." We had the independent FERC expert review the language in the selected FERC orders that concerned the outside attorney. In these orders FERC sometimes agreed with the ISO proposals for deviations or modifications to prior orders and other times did not. Only two of the six orders cited by the outside attorney express frustration or any kind of reprimand. The independent expert did not find this significant, and neither do we.

Nonetheless, we agree that the ISO is best served by paying close attention to the positions it takes in proceedings before FERC and carefully evaluating how forceful a position is desirable in the current climate on any given issue. To that end, as discussed above, the legal department is implementing stricter oversight and control through a formalized regulatory filings

²¹ In the broader context in which the ISO was operating, various state officials, including members of the Legislature and the Governor, accused FERC of abdicating its responsibilities to protect California and permitting unconscionable profits for generators and power brokers with resulting losses in the billions of dollars to the state. The ISO was in many respects caught in the middle between, on the one hand, energy generators and brokers who accused it of unfairly favoring the state and consumer interests, and on the other hand media, academics and public officials who accused it of being a pawn of the power brokers and generators.

protocol. This will ensure that the General Counsel and appropriate directors sign off on decisions regarding regulatory filings with full understanding of whether the posture being taken by ISO seeks to break new ground or otherwise goes beyond prior precedents.

CONCLUSION

For everyone concerned this has been a very painful process. The responsibility for all matters discussed herein lies with the Board, which fully accepts it. Our first obligation is to the people of the State of California to run their grid with integrity and efficiency. By forcing us to introspectively address the ISO's conduct, Senator Dunn and his committee have done us and the people a significant service. This introspection will lead to a better and stronger ISO. And, this introspection has confirmed to us that during the energy crisis and since, the people have been well served by the ISO's employees who, with dedication and sincerity, if not with perfection, sought to do their duties.