THE UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

California Independent System Operator Corporation	))	**Docket No. ER03-1102-000**

REQUEST FOR REHEARING AND MOTION FOR CLARIFICATION OF THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION

Pursuant to Rule 713 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.212, the California Independent System Operator Corporation ("ISO")[1] submits this request for rehearing and clarification in the above-captioned docket. The ISO respectfully requests that the Commission revise and/or clarify a number of items in its February 20, 2004, Order on Tariff Amendment No. 55, 106 FERC ¶ 61179 ("February 20 Order").

I. BACKGROUND

On July 22, 2003, the ISO filed Amendment No. 55 to the ISO Tariff. Amendment No. 55 proposed to modify the ISO Tariff in several respects in order to provide the ISO with an Oversight and Investigation ("O&I") program. This program was designed to build on the ISO's efforts, since start-up, to monitor its markets and report the exercise of market power. The ISO's proposed O&I program, as filed, consisted of several key features: (1) a reformation of existing Tariff prohibitions into several defined "Rules of Conduct" based in large part on the "minimum behavior rules" set forth by the

[1] Capitalized terms not otherwise defined herein are used in the sense given in the Master Definitions Supplement, Appendix A to the ISO Tariff.

Commission in the Notice of Proposed Rulemaking on Standard Market Design, in Docket No. RM01-12; (2) pre-defined penalties for the breach of these Rules of Conduct, which the ISO would have the authority to impose directly on Market Participants; (3) procedures for routine sharing of market data and other information with certain state and federal oversight and enforcement "partner" agencies; (4) procedures for measuring and publishing Market Participant performance against the Rules of Conduct; and (5) programs for regular interaction and cross-training among ISO representatives and representatives from partner agencies.

The Rules of Conduct and associated pre-defined penalties, were contained in the ISO's proposed new Enforcement Protocol ("EP") to the ISO Tariff. However, Amendment No. 55 also contained several proposed amendments to the ISO Tariff to address specific bidding and scheduling behavior, as well as to provide for the release of commercially sensitive information to federal and state partner enforcement agencies. The ISO also proposed revisions to the existing Market Monitoring and Information Protocol ("MMIP") in order to complement the EP and to update various provisions of the MMIP.

On August 18, 2003, various entities filed motions to intervene, comments, and protests concerning Amendment No. 55. The ISO filed an answer to these pleadings on August 29, 2003. On September 22, 2003, the Commission issued an order accepting Amendment No. 55 for filing, but suspending it for five months to become effective on February 21, 2004, subject to refund and subject to further order by the Commission. 104 FERC ¶ 61,308 (2003) ("September 22 Order"). The Commission explained that Amendment No. 55 included tariff changes that addressed issues that were before the

Commission in Docket No. EL01-118, in which the Commission was considering whether to condition all new and existing market-based rate tariffs and authorizations on sellers' compliance with six proposed "Market Behavior Rules."

On November 17, 2003, the Commission issued an order in Docket No. EL01-118 finding sellers' existing market-based tariffs and authorizations, without "clearly-delineated rules of the road to govern market participant conduct," to be unjust and unreasonable. *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorization*, 105 FERC ¶ 61,218 (2003) at P 3 ("MBR Tariff Order"). The Commission ordered all sellers with market-based rate authority to include six Market Behavior Rules at such time as they file any amendment to their market-based rates tariff or (if earlier) at such time as they seek continued authorization to sell at market-based rates (e.g., in their three-year update filings). The six Market Behavior Rules govern sellers' conduct with respect to: (1) unit operations; (2) market manipulation; (3) communications; (4) reporting; (5) record retention; and (6) related tariffs.

On February 20, 2004, the Commission issued a second order on Amendment No. 55. Therein, the Commission accepted, subject to Commission acceptance of a filing demonstrating that the ISO "has established an independent Governing Board in compliance with the Commission's orders," the ISO's proposal to charge pre-defined penalties for certain objectively identifiable behavior. However, the Commission directed the ISO to modify the Rules of Conduct and associated penalties proposed in Amendment No. 55 in order to be "consistent with the Commission's [MBR Tariff Order] in Docket No. EL01-118-000." February 20 Order at P 1.

II. SPECIFICATION OF ERRORS AND REQUESTS FOR CLARIFICATION

The ISO respectfully submits that the February 20 Order erred in the following respects:

- Requiring the ISO to specify that the Commission will enforce the Enforcement Protocol until such time as the ISO files and the Commission accepts the ISO's demonstration of Governing Board independence. February 20 Order at P 28.

- Requiring that the Enforcement Protocol be administered solely by the ISO's Department of Market Analysis ("DMA"), and that the DMA be independent of ISO management. February 20 Order at PP 28, 154-155.

- Directing the ISO to delete Sections 2.4 (Physical Withholding) and 2.5 (Economic Withholding) from the Enforcement Protocol. February 20 Order at P 78.

- Requiring the ISO to replace the text of proposed Section 2.9(a) of the EP with the language of Market Behavior Rule 2, from the MBR Tariff Order. February 20 Order at P 100.

- Rejecting the elimination of Usage Charges for undelivered counter-flows. February 20 Order at P 129.

The ISO also requests that the Commission clarify the following with respect to the February 20 Order:

- That a Scheduling Coordinator found in violation of a Rule of Conduct during a specific year is not eligible to receive the benefit of any proceeds collected with respect to any penalties for that year, even if that Scheduling Coordinator does not receive a monetary penalty for such violation. February 20 Order at P 40.

- That the one-year limitation on imposing penalties after discovery of a violation of the Rules of Conduct is not absolute, and can be extended by the Commission on a showing of good cause by the ISO. February 20 Order at P 32.

- That February 20 Order does not prohibit the ISO from imposing penalties that total more than $10,000 per day for violations of EP Sections 2.2 and 2.3. February 20 Order at PP 29, 58, 71.

III. REQUEST FOR REHEARING

A. The Commission Cannot Require Any Demonstration of ISO Board Independence as a Condition to Granting the ISO Authority to Enforce the Rules of Conduct Set Forth in the Enforcement Protocol

1. The Commission Has No Direct Authority to Require the ISO to Modify the Composition of its Governing Board, and Likewise, Has no Authority to Indirectly Require the ISO to do so as a Condition of Permitting the ISO to Exercise the Investigation and Enforcement Authority Approved in Amendment No. 55

In the February 20 Order, the Commission ruled that, until such time as the ISO files and the Commission accepts the ISO's demonstration of a type of independence dictated by the Commission, the Commission, rather than the ISO, will enforce the rules of conduct set forth in the Enforcement Protocol. February 20 Order at P 28. The Commission stated that concurrent with the ISO's filing "demonstrating its independence," the ISO may file an Enforcement Protocol that allows "the DMA" to administer "certain behavior-related tariff provisions and to charge penalties for certain behavior consistent with the direction provided herein." *Id.* The ISO respectfully requests rehearing of this issue.

First, and most fundamentally, this requirement is an impermissible attempt on the part of the Commission to accomplish indirectly that which it cannot do directly, namely, to dictate to the ISO the structure of its Governing Board. The governance of the ISO, as a public benefit, non-profit corporation created by state law, lies exclusively

within the jurisdiction of the State of California.[2] The ISO was created by and under the laws of the State of California in order to serve the interests of the people of California by facilitating the provision of reliable electric service. *See* Cal. Pub. Util. Code § 300, *et seq.* Because state-chartered corporations such as the ISO exist only by virtue of statutory authorization and only to serve their statutory purpose, the State has an overwhelming interest in ensuring the proper governance of such corporations and the exclusive right to do so.

Except as limited by Congress acting within its Constitutional limits, states have plenary jurisdiction over corporations, such as the ISO, that are created by state law. The governance of even *private* corporations is a matter that is definitively entrusted to the states. *See* Cort v. Ash, 422 U.S. 66 (1975). In the case of the ISO, where the corporation would not exist but for State legislation, the State's interest is even more compelling. The state enacted the laws that directed the establishment of the ISO and determine its governance. Accordingly, the State, and only the State, has the authority to change those laws. Under such circumstances, the internal workings of the ISO, such as the structure of its Governing Board, must, of necessity, rest exclusively within the jurisdiction of the State.

As noted above, the only limitations on a state's plenary jurisdiction over corporations are those imposed by Congress consistent with its constitutional boundaries. In the case of the Commission, the authority granted by Congress is spelled out in the Federal Power Act ("FPA"). Nothing in the FPA provides the Commission with authority to mandate the structure of the ISO's Governing Board. As

---

[2] *See* Request for Rehearing and Motion for Stay of the California Independent System Operator Corporation, Docket Nos. EL01-35, *et al.* (August 2, 2002).

detailed in the request for rehearing (in Docket No. EL01-35) and briefs filed by the ISO in its appeal of the Commission's July 17, 2002 order addressing the governance of the ISO, (D.C.Circuit Case No. 02-1287),[3] the ISO's governance is not, as the Commission has suggested, a "practice . . . affecting rate[s]" of the ISO's jurisdictional services.[4] *See* FPA, Section 206. The text, context, and history of Section 206 of the FPA make clear that the phrase "practice . . . affecting rate[s]" refers to a utility practice that is part of its terms of sale for wholesale power and transmissions services, *not* the composition of its governance. Congress adopted the FPA because states could not constitutionally regulate interstate sales and interstate transmission of electricity. *See* New York v. FERC, 535 U.S. 1, and therein limited the Commission's jurisdiction to "matters which are not subject to regulation by the States." FPA Section 202. Thus, Section 205 required filing of "rates and charges" and related terms of FERC-jurisdictional services, and authorized the Commission to review, and, if necessary, suspend such filings. Section 206 then authorized the Commission to review the terms of service already in place. The term "practices" must be read, like the rest of Sections 205 and 206, in this transactional context, that is, to refer to "practices" that are part of the term of sales or transmissions the Commission was expected to regulate. *See* NAACP v. FPC, 425 U.S. 662, 671 (1976) (finding that the FPC "is authorized to consider the consequences of discriminatory employment practices on the part of its regulates only insofar as such consequences are directly related to the Commission's establishment of just and reasonable rates in the public interest").

---

[3] California Independent System Operator Corporation v. FERC (D.C. Circuit Case No. 02-1287), Brief of Petitioner California Independent System Operator Corporation (October 6, 2003). The ISO herby incorporates by reference the arguments raised in its request for rehearing and appellate briefs.

The Commission itself has repeatedly defined the statutory term "practice . . . affecting rate[s]" as a "consistent and predictable course of conduct of the supplier that affects [the utility's] *financial relationship* with the consumer." Michigan-Wisconsin Pipeline Co., 34 F.P.C. 621, 626 (1965) (emphasis added). Indeed, regulations promulgated by the Commission have consistently treated "practices" as referring simply to the non-price terms and conditions of electric service. *See, e.g.*, City of San Diego v. San Diego Gas and Electric Co., 51 FERC ¶ 61,058 (1990). The Commission's appropriate power under Section 206 of the FPA is illustrated by its decision in Order No. 888. Therein, the Commission found that transmission-owning utilities have an inherent interest in providing more favorable treatment for their own or their affiliates' transmissions. Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, 61 Fed. Reg. 21,540, 21,565 (1996). However, the Commission did not order those utilities to convert their governing boards. Instead, the Commission did what Section 206 contemplates, that is, ordering transmission-owning utilities to file nondiscriminatory open-access tariffs. *Id.* at 21,541.

Even assuming, arguendo, that the ISO's governance was a "practice affecting rates" under the FPA, the Commission has made no finding that the composition of the ISO's Governing Board is in any way "unjust, unreasonable, unduly discriminatory or preferential," FPA Section 206, which is a prerequisite to the Commission's authority to order a modification to the ISO's governance structure. Specifically, the Commission has nowhere found that the ISO's Governing Board has discriminated against energy

[4] *See* Order Concerning Governance of the California Independent System Operator Corporation, 100 FERC ¶ 61,059 (2002) ("Governance Order").

suppliers or purchasers, either in California or any other state. Instead of finding a violation of Section 206, the Commission has asserted that the composition of the ISO's Board makes it not "independent" from one purchaser of power in the ISO Markets, namely the California Department of Water Resources. Governance Order at PP 52, 53, 57. However, this lack of "independence," in and of itself, does not render any of the ISO's "practices" unjust, unreasonable, or unduly discriminatory, as Section 206 requires. This is because the bar against "undue discrimination" prohibits not a lack of "*independence*" but unjustified dissimilar *treatment* of like-situated entities. *See, e.g.*, City of Gainsville v. Florida Gas Transmission Co., 55 FERC ¶ 61,486 (1991); City of Vernon v. FERC, 845 F.2d 1042 (D.C. Cir. 1998). The Commission has contended that, with the current governance structure of the ISO, it "cannot be assured that the rates, terms, or conditions of its jurisdictional service will be just, reasonable, and not unduly discriminatory or preferential. Governance Order at P 58. However, Section 206 speaks only in the present tense (e.g., "*is* unjust"). It "merely permits the Commission . . . to initiate changes to *existing* utility rates and practices." Atlantic City Electric Co. v. FERC, 295 F.3d 1, 10 (D.C. Cir. 2002) (emphasis in original). Therefore, without any finding whatsoever that the ISO's governance is somehow "unjust, unreasonable, unduly discriminatory and preferential," there is no basis under the FPA for the Commission to require the ISO to modify the composition of its Governing Board.

Moreover, when it passed the FPA, Congress included a section that specifically addressed the extent to which the Commission would be permitted to regulate utility governance. Section 305 of the FPA imposes a specific bar against individuals serving as utility officers or directors if they also serve as officers or directors of any bank,

underwriter, or supplier to the utility. Congress gave the Commission no authority to expand these categories. *See, e.g.,* Edwin I. Hatch, 2 FERC ¶ 63,023 (1978), *aff'd* 18 FERC ¶ 61,141 (1982). In fact, as part of the 1935 statute that contained the FPA, Congress gave the Securities and Exchange Commission, not FERC, various powers with respect to the selection of utility directors. *See* Public Utility Holding Company Act § 5(b)(2)(D), 15 U.S.C. § 79e(b)(2)(D); § 17(c), 15 U.S.C. § 79q(c).

It is axiomatic that if a regulatory agency such as the Commission has no authority to do something directly, it cannot attempt to do that thing indirectly by establishing it as a condition to affording some other right. *See. e,.g., Associated Gas Distributors v. FERC,* 898 F.2d 804 (D.C. Cir. 1990); *New York State Electric & Gas Corp. V. FERC,* 638 F.2d 388 (2nd Cir. 1980). However, this is precisely what the February 20 Order attempts to do. By conditioning the grant of authority to the ISO to implement the provisions of the enforcement and investigation program on the ISO's making a filing with the Commission demonstrating "ISO Board independence," the Commission attempts to indirectly coerce the ISO into modifying the structure of its Governing Board, which, as demonstrated above, the Commission has no direct authority to do. Such an approach to regulatory oversight is manifestly and obviously unreasonable. If the Commission is able to evade the limitations on its authority in the FPA by simply conditioning the approval of "rates" or "practices . . . affecting rate[s]" on a utility's compliance with matters as to which the Commission has no authority to directly regulate, then those statutory limitations are meaningless. This clearly cannot be the correct result.

2. Modification of the ISO's Governing Board is Not Necessary to Ensure that the Investigation and Enforcement Provisions of Amendment No. 55 are Exercised in a Just and Reasonable Manner

Under Section 205 of the FPA, the Commission is charged with ensuring that all rates and charges, and all rules and regulations affecting such rates and charges, "made, demanded, or received" by a public utility are just and reasonable. FPA Section 205. Thus, in evaluating Amendment No. 55, and specifically the ISO's exercise of the authority requested in that amendment, the sole question is whether the rates, and rules and regulations affecting such rates, proposed in Amendment No. 55 are just and reasonable. As such, even if the Commission has the authority to dictate the structure of the ISO's Governing Board, the issue of whether the ISO's Governing Board is "independent" is not, in and of itself, decisive as to whether the ISO's Amendment No. 55 proposal is just and reasonable, and specifically, whether it is just and reasonable for the *ISO* to exercise the investigation and enforcement authority contained therein.

Instead, in assessing the ISO's ability to administer the investigation and enforcement process, the focus must be on whether or not that process provides reasonable assurance to Market Participants that the outcomes will be just and reasonable. In its order on Tariff Amendment No. 55, the Commission has eliminated any discretion the ISO might have in administering the Rules of Conduct and penalties set forth in the EP, rendering the task of administering the EP ministerial in nature. The

Commission has specified that penalties must be formulaic, and has directed that the ISO give no consideration to whether a behavior is inadvertent, unintentional, or willful, preserving such subjective determinations to be exercised by the Commission. February 20 Order at PP 29-30. The ISO must specify exact penalty amounts, distinguished only by objective criteria limited to whether the violation occurred when a System Emergency exists or is imminent, and the duration and frequency of the violation. *Id.* These distinctions are no less objective than the determinations required in the normal course of ISO operations – determinations such as whether bids and Schedules are provided in the proper syntax, whether Dispatch Instructions are properly communicated, and whether Settlement Quality Meter Data is properly submitted – along with the ultimate settlement consequences, based on Schedules, meter values and deviations. This lack of discretion on the part of the ISO means that the ISO's alleged lack of independence can have no effect whatsoever on the enforcement process. Therefore, there is simply no valid justification for the Commission to assume the enforcement activities in the EP until such time as the ISO makes a filing with the Commission "demonstrating its independence."

Furthermore, the EP specifically requires that the ISO conduct a thorough investigation, including consideration of information provided by the Market Participant(s) that are the subject(s) of the investigation. If an investigation results in the assessment of a penalty, then the Market Participant has the explicit right to challenge that outcome through the ISO's ADR process. EP 3.10. however, most importantly is the fact that the Commission would continue to be the ultimate arbiter of any dispute concerning the ISO's exercise of the authority contained in Amendment No.

55 because a market participant would have the right to appeal any adverse decision ot the Commission. Thus, designating the Commission as the “enforcer” of the EP until such time as the ISO makes a filing demonstrating independence in its Governing Board does not change the fact that the Commission is the ultimate arbiter of the reasonableness of any ISO determination under the EP. The composition of the ISO’s Governing Board does not alter this result.

The ISO explained much of this in its answer to comments and protests on Amendment No. 55. Answer of the California Independent System Operator to Comments and Protests, Docket No. ER03-1102 at 28-29. However, in the February 20 Order, the Commission did not provide any reason or justification as to why the perceived lack of independence of the ISO’s Governing Board would cause the ISO’s exercise of the investigation and enforcement functions contained in Amendment No. 55 to be unjust and unreasonable. Instead, the Commission simply concluded that the ISO should not be permitted to administer the penalties provided for in Amendment No. 55 until such time as the ISO demonstrates to the Commission that its Governing Board is sufficiently “independent.” The failure of the Commission to provide any explanation whatsoever renders its decision on this issue arbitrary, capricious, and devoid of reasoned decision making. Such failure is all the more troubling because the Commission has permitted other independent system operators the authority to exercise the same sort of functions that the Commission withheld from the ISO in Amendment No. 55.[5]

---

[5] It is axiomatic that if a regulatory agency wishes to depart from established precedent on a particular matter, it must provide a justification for doing so. *See* Greater Boston Television Corp. v. FCC, 444 F.2d 841, 852 (D.C. Cir. 1970) (noting that “if an agency glosses over or swerves from prior precedents without discussion it may cross the line from the tolerably terse to the intolerably mute”); see

For these reasons, the Commission should grant rehearing and permit the ISO to enforce the provisions of the EP, as amended in its required compliance filing, without first submitting a filing "demonstrating Governing Board Independence."

B. The ISO's Market Monitoring Functions, Conducted by the Department of Market Analysis and the Compliance Department, Should Be Managed Through the ISO, Rather than Directly by the Commission

In the February 20 Order, the Commission required the ISO to clarify that any penalties the Commission permits the ISO to assess must be assessed by an independent Market Monitoring Unit ("MMU"). February 20 Order at P 28. Specifically, the Commission directed the ISO to revise the EP to state that the EP will be administered by the "DMA independently and not by other ISO personnel" and to replace any references to the ISO in this respect with the DMA. *Id.* The Commission noted that while it was not requiring any changes to the ISO organizational structure at this time, the DMA must be sufficiently independent to carry out enforcement activities "without interference or instruction from other ISO/RTO personnel or non-MMU supervisors." The Commission therefore directed the ISO, in its filing demonstrating Governing Board independence, to show that the DMA "possesses the ability to independently administer the behavior-related tariff provisions and assess penalty charges as discussed in this order." *Id.* at P 154. The Commission went on to explain that the ISO must identify each individual position which currently has "MMU

---

also Williston Basin Interstate Pipeline Co. v. FERC, 165 F.3d 54, 69 (D.C. Cir. 1999) ("By failing to distinguish the authority on which Williston Basin relied in support of its position, and which at least superficially contravened the Commission's ruling, the agency appeared to "gloss[ ] over or swerve[ ] from

responsibilities" and propose an "independent structure which includes all such positions based on the guidance provided in this order." *Id.* at P 155.

Currently, the functions of the "Market Monitoring Unit" envisioned by the Commission are divided between the ISO's Department of Market Analysis ("DMA") and the ISO's Compliance Department ("Compliance"). Both of these departments report to the ISO's General Counsel. The function of the DMA is to monitor activity in the ISO's markets, and to identify and report instances of manipulative or anomalous behavior in those markets. DMA would be responsible for administering any Rules of Conduct that address physical or economic withholding, detrimental behavior or gaming, and market manipulation (EP 2.4, 2.5, 2.9 and 2.10). Compliance is responsible for monitoring compliance with the ISO Tariff, and for administering any penalties that are based on objective criteria, as specified in the ISO Tariff (including the EP).

In order to implement the Commission's directives to clarify that the EP will be "administered by the DMA independently and not by other ISO personnel" and that the ISO's MMU will be "without interference or instruction from other ISO/RTO personnel or non-MMU supervisors," the ISO would need to completely re-organize its existing market monitoring structure. To the extent that this issue currently is ripe for review, the ISO respectfully requests that the Commission grant rehearing on this issue. Such rehearing is appropriate because the Commission has no authority to dictate the internal corporate/departmental structure of the ISO. Moreover, these changes are not only unnecessary to ensuring just and reasonable market monitoring on the part of the

prior precedents without discussion . . . thereby foregoing reasoned decision making.") This is precisely what the Commission has done in this instance.

ISO, but, in fact, place the ISO in legal jeopardy and undermine important rights provided regulated utilities under the Federal Power Act.

First, the arguments made above in Section III.A.1 concerning the Commission's lack of authority to direct the modification of the ISO's Governing Board apply with equal, if not greater, force to the issue of whether the Commission has the authority to dictate the internal reporting relationships within a public utility, such as the ISO. The Commission has the authority to regulate public utilities; it does not have the authority to dictate employee reporting relationships. *See NAACP v. FERC,* 425 U.S. 662 (1976) (the Commission lacks the authority to prohibit discriminatory employment practices). The internal organization of a public utility is no more a "practice . . . affecting rate[s]" than the governance of that utility. In fact, the reporting relationships within a public utility *per se* are even more removed from the Commission's oversight, because they have less bearing on the rates and terms of service of the utility. Certainly, the Commission has failed to offer any evidence specific in this case to the contrary. Because the Commission has no authority to directly dictate the internal organization of a public utility, as explained above, it has no power to modify it indirectly by establishing such a modification as a condition to affording some other right.

Moreover, conditioning the ISO's exercise of the investigation and penalty authority approved by the Commission in Amendment No. 55 on the re-organization of the ISO's market monitoring functions is not necessary to ensure that the ISO's market monitoring functions are carried out in a just and reasonable manner. In fact, requiring the ISO to reconstitute its market monitoring functions as specified in the February 20 Order would result in *unjust* and *unreasonable* outcomes. First, the structure

envisioned by the Commission, in which MMU employees would serve simultaneously as "agents" for the Commission and employees of the ISO would create an irreconcilable conflict of interest for those employees, *i.e.*, employees paid by the ISO but reporting to the ISO's regulator. The reorganization required by the Commission in the February 20 Order would also expose the ISO to an unwarranted level of legal risk by virtue of the fact that the ISO would be liable for the actions of employees without the ability to influence or impact those actions.

Additionally, both DMA and Compliance perform a number of important functions for the ISO as a corporation. DMA provides general economic advice to management and contributes to the development of ISO proposals. The ISO employees in DMA have been retained because of their expertise in economics and markets and are needed to provide broad economic advice to management, formulate proposals and assist in regulatory filings. The ISO's DMA is integral to management in providing advice regarding market design, market participant behavior and potential remedies for wrongful conduct. Similarly, Compliance staff provide internal audit services and also participate in the development of policy proposals and implementation of authorized initiatives. If DMA and Compliance employees were required to report to the Commission, rather than to ISO management, the ISO would have to go out and hire additional employees to perform services currently provided by these departments. In other words, the ISO would be compelled to hire employees to perform duplicative work. The public is better-served if the Commission retains and pays its own staff to monitor market performance to serve as a second source of information and a "check" on the analysis performed by the regulated entity, as is dictated under the Federal Power Act.

The restructuring of the ISO's market monitoring functions as set forth in the February 20 Order would also undermine the effective exercise of the ISO's Section 205 and 206 rights. This is the case because the ISO's market monitoring personnel are answerable to ISO management for purposes of receiving assignments, conducting analyses into potential market rule abuses, and assisting with developing filings with the Commission aimed at remedying those abuses. Without this reporting relationship, the ISO will be significantly hindered in evaluating legal options and filing section 206 complaints against market abusers and/or 205 filings to modify the ISO's Commission-jurisdictional Tariff, as are its rights. Separating the ISO's market monitoring functions from ISO management would cripple management's ability to independently develop such filings. Ultimately, it is ISO management that is accountable to the Commission and its Governing Board, not DMA or Compliance. Totally separating the DMA or Compliance from ISO management would severely inhibit management's ability to develop supportable Section 205 filings and 206 complaints before the Commission.

The ISO respectfully suggests that this requirement makes little sense, practically speaking, as well. The ISO's DMA has been at the forefront of the investigations of market conditions in California since the ISO began operations nearly five years ago, and throughout this entire period, the DMA has reported to ISO management. The Commission has made no findings that the monitoring functions have been conducted in any manner but in a just and reasonable fashion, and it offers no justification for conditioning the ISO's proposal on reconstituting its market monitoring and enforcement units in a completely different form.

The ISO also maintains that creating a new MMU structure that is separate and apart from the oversight of ISO management is not a necessary adjunct to a fair and effective market monitoring and enforcement scheme. The ISO's proposal as modified by the Commission will provide complete transparency through specification of all violations subject to penalty, and the schedule of penalties that will apply based on objective criteria specified by the Commission. In addition, the ISO is committed to fully documenting processes and controls to provide further assurance that the administration of the penalty authority set forth in the EP will be just and reasonable. And, as noted above in the discussion addressing the independence of the ISO governance structure, the modifications to the penalty provisions of the EP required by the Commission in the February 20 Order will result in the ISO having no discretion in the application of penalty amounts. Therefore, the fact that the ISO's DMA and Compliance departments report to ISO management will not compromise the just and reasonable administration of the EP.

Finally , the penalty authority which the Commission has granted to other independent system operators is applied directly by such independent system operators, not by a market monitoring unit independent from those entities.[6] The Commission, in the February 20 Order, did not enunciate any reasons or provide any justification as to why the ISO should be treated any differently from other independent system operators in this respect. In the absence of such justification, such disparate treatment is arbitrary, capricious, and not the product of reasoned decision making.[7]

---

[6] *See, e.g.*, NEPOOL Market Rules and Procedures, Section 13.3.1 ("The *ISO* may impose sanction on any Participant that directly engages in Sanctionable Behavior.") (emphasis added); New York Independent System Operator, FERC Electric Tariff, Attachment H.

[7] See *supra* note 2.

This is especially true given that the Commission ultimately can review any action taken by the ISO with respect to the investigation and enforcement process set forth in Amendment No. 55.

For these reasons, the ISO requests that the Commission grant rehearing and state that the ISO's current market monitoring structure, which includes both the DMA and Compliance, reporting to ISO Management, does not need to be modified in order to conduct investigations and enforcement activities under the ISO Tariff and EP.

C. The ISO's Proposed Rules on Physical and Economic Withholding (EP 2.4 and EP 2.5) are Appropriate, and Should Be Retained

The Commission, in the February 20 Order, directed the ISO to delete sections 2.4 and 2.5 from the EP, which prohibit Market Participants from engaging in physical and economic withholding. February 20 Order at P 78. The Commission stated that imposing sanctions for physical and economic withholding is redundant with measures already in place in California under the ISO's current market design. *Id.* The ISO requests rehearing on this issue. Sections 2.4 and 2.5 of the EP should be retained.

The ISO respectfully suggests that the Commission, in ordering the ISO to delete EP 2.4 and 2.5, did not sufficiently consider the usefulness of the sanctions for physical and economic withholding as a "safety net" that catches actions not addressed by the current market measures. To whatever extent the sanctions turn out to be redundant, they will not need to be employed. Their presence in the EP, however, does not detract from, and can only improve, the ability to prevent and correct for physical and economic withholding. Similarly, the existence of the Commission's Market Behavior Rule 2 from the MBR Tariff Order does not make EP 2.4 and EP 2.5 superfluous. Rather, EP 2.4 and EP 2.5 provide an additional measure to help ensure that physical and economic withholding do not occur, or if they do occur, that they will be appropriately addressed and deterred.

Both the New York ISO and ISO New England have rules in their Tariffs that prohibit physical and economic withholding.[8] These rules are *in addition to* other measures in place in those jurisdictions. For example, the Commission has approved

(albeit on a temporary basis) two tiers of local market power mitigation for ISO New England. *See Devon Power, L.L.C.*, 103 FERC ¶ 61,082, at PP 32-33 (2003); *New England Power Pool*, 100 FERC ¶ 61,287, at PP 39-46 (2002). It would be discriminatory and unfair to deny the California markets the same level of assurance against withholding practices that is granted to the markets in New York and New England. Moreover, the Commission has offered no explanation as to why it will not grant the ISO the same type of authority to prohibit physical and economic withholding as it has these other independent system operators. Stated differently, the Commission has not found such tariff prohibitions to be superfluous in the case of the New York ISO and ISO New England, but it has for the ISO. The impact of the Commission's market behavior rules apply with equal force to the ISO as they do to ISO New England and the New York ISO. Under the circumstances, there is no valid basis for the Commission to treat the ISO differently than the NYISO and ISO New England. As noted above, if the Commission wishes to depart from past precedent, it must at least articulate a reason for doing so. *See supra* note 2. In the absence of such justification, the Commission's decision to strike EP 2.4 and 2.5 is arbitrary, capricious, and not a product of reasoned decision making.

D. The ISO's Proposed Provision on Detrimental Practices (EP 2.9) Should be Retained

Addressing EP Sections 2.9 (No Detrimental Practices) and 2.10 (No Market Manipulation) in the February 20 Order, the Commission stated that although it would

[8] *See* New York Independent System Operator Tariff, Attachment H, Section 2.4(a); New England Power Pool Market Rule 1, Appendix B, Section 3.2; ISO-New England Market Rules and Procedures, Section 13.4.2.

"accept the concept underlying the general prohibitions stated under EP 2.9(a) and 2.10(a)," the ISO would be required to replace the proposed language in EP 2.9 and 2.10 with Market Behavior Rule 2 of the MBR Tariff Order.[9] February 20 Order at P 100.

The ISO requests rehearing on this issue. The proposed language in the first bullet of Section 2.9(a) should be retained because the scope of Market Behavior Rule 2 is, on its face, more limited than the scope of EP 2.9(a) with respect to practices that detrimentally affect system reliability. While EP 2.9(a) encompasses practices that detrimentally affect market efficiency, other Market Participants and system reliability, Market Behavior Rule 2 appears to cover only behavior effecting "market prices, market conditions, or market rules." The ISO believes that many manipulative and abusive practices have a direct detrimental effect on system reliability, but the impact on market conditions may be more indirect and difficult to quantify. Such practices may not be subject to sanction under Market Behavior Rule 2 by either the ISO or the Commission. Protecting the reliability of the ISO Controlled Grid is the ISO's foremost responsibility. Therefore, it is entirely reasonable that the ISO's EP provide for sanctions for behavior that directly threatens the reliability of the ISO Controlled Grid.

---

[9] Market Behavior Rule 2 in the MBR Tariff Order provides:

> Actions or transactions that are without a legitimate business purpose and that are intended to or foreseeably could manipulate market prices, market conditions, or market rules for electric energy or electricity products are prohibited. Actions or transactions undertaken by Seller that are explicitly contemplated in Commission-approved rules and regulations of an applicable power market (such as virtual supply or load bidding) or taken at the direction of an ISO or RTO are not in violation of this Market Behavior Rule.

E. The Commission Should Approve the Elimination of Usage Charges for Undelivered Counter-Flows

In the February 20 Order, the Commission rejected the ISO's proposed changes to Section 7.3.1.5.2 of the ISO Tariff to eliminate payment of Usage Charges for undelivered counter-flow Schedules. February 20 Order at P 129. The Commission erred in rejecting these proposed modifications.

The changes to Section 7.3.1.5.2 are necessary due to a market design flaw that encourages counter-flow Schedules to be cut prior to real time. As a consequence, the potential exists for reliability problems, gaming opportunities, and settlement inequalities.[10] The flaw creates the possibility for a Scheduling Coordinator to receive Congestion payments for counter-flows scheduled in the Day-Ahead and/or Hour-Ahead Congestion Management markets, even when counter-flow Schedules are reduced or cut in real time. Amendment No. 55 to the ISO Tariff, Transmittal Letter, Docket No. ER03-1102 (July 22, 2003) ("Transmittal Letter") at 64-66. This market design flaw will be corrected after the ISO implements the comprehensive market redesign ("MD02"). In the meantime, however, it needs to be remedied as the ISO has proposed.

The February 20 Order misconstrues and underestimates the potential problems associated with cut counter-flow Schedules. It frames the problems largely in terms of

---

MBR Tariff Order at P. 35.

[10] For example, undelivered counter-flows cause the scheduled flow across a constrained path to be increased over what would have been scheduled in the absence of the scheduled counter-flow, thereby increasing the risk of real-time Congestion. Amendment No. 55 Answer at 77.

adverse financial impacts to the ISO. *See* February 20 Order at P 129. However, as stated above, cut counter-flow Schedules have possible consequences in terms of increased risk of real time congestion, gaming opportunities, and settlement inequalities. Moreover, the Commission appears to consider it sufficient that, if a Scheduling Coordinator submits a counter-flow Schedule that is cut in real time, the Scheduling Coordinator must pay the ISO's cost of procuring Imbalance Energy as a result of the non-delivered Schedule. *Id.* at P 128. For undelivered counter-flows inside the control area, this consequence may be sufficient – if the real time price differential is the same as the forward price differential, then the difference in Imbalance Energy Charges will effectively eliminate the Usage Charge paid on the undelivered counter-flow. However, the Commission fails to acknowledge that for a cut counter-flow schedule over an inter-tie, a deviation results on either side of the path, but those deviations are charged and paid the same price in real time, meaning that there is no zonal price differential in real time, thereby creating a potential incentive to cut counter-flow schedules on interties. This does not give consideration to the inequity of allowing a Scheduling Coordinator to keep Usage Charge payments for Energy that was Scheduled but not delivered – which payments the changes to Section 7.3.1.5.2 would eliminate. It is appropriate to eliminate such payments; this is the case even if the Scheduling Coordinator was not engaging in gaming, because otherwise the Scheduling Coordinator would receive a windfall.[11]

[11] As the ISO has explained, the proposed Tariff changes are more analogous to the elimination of payment for services not provided, rather than a penalty. Transmittal Letter at 66.

IV. MOTION FOR CLARIFICATION

A. The Commission Should Clarify the February 20 Order With Respect to the Distribution of Penalty Amounts

In the February 20 Order, the Commission stated that "only those Scheduling Coordinators that have not been found to be in violation of the Rules of Conduct under the ISO Tariff should be allocated penalty proceeds at the end of each calendar year as a credit against their portion of the GMC." February 20 Order at P 40. With respect to this statement, the ISO requests the Commission clarify two items. First, it appears that the Commission intends that if a Scheduling Coordinator is found to be in violation of any Rule of Conduct, that Scheduling Coordinator would be ineligible to receive proceeds for *any* penalty amounts collected relating to that year, including those penalty amounts collected for violations involving other Scheduling Coordinators. So, for instance, if a Scheduling Coordinator commits one violation of a Rule of Conduct during a particular year, even if the violation were a minor first offense for which no financial penalty is levied according to the EP, then that Scheduling Coordinator is ineligible to receive a portion of the proceeds from any penalties collected by the ISO relating to that year. The ISO requests that the Commission clarify that this was the result intended in the above-quoted language from the February 20 Order.

B. The Commission Should Clarify that the One Year Limitation on Assessing Penalties After Discovery of a Violation is not an Absolute Cap

In EP 5.6 the ISO proposed that no penalties could be assessed under the EP more than three years after the discovery by the ISO of the underlying violation. In the February 20 Order, the Commission stated that this provision was unreasonable, and directed the ISO to revise this section to state that "the DMA" may assess a penalty under the EP up to a year after discovery of a violation but not later than three years after the date of a violation. February 20 Order at P 32.

The ISO requests clarification of this issue. Specifically, the ISO requests that the Commission clarify that this one year limitation is not a "hard cap," in that the Commission will entertain requests for extensions to this one year limitation upon a proper showing by the ISO that good cause exists for such an extension in a specific instance. The ISO understands and appreciates the need for certainty and finality with respect to transactions in its markets. However, it is easy to envision scenarios in which, even though the ISO exercises the utmost diligence in conducting an investigation after discovering a potential violation of the Rules of Conduct, the ISO is still unable to complete that investigation within a one-year timeframe. For instance, investigations of potential violations of the EP such as under-reported load require obtaining extensive data from the Market Participant under investigation. If that Market Participants fails to cooperate with an investigation, the ISO may not be able to conclude that investigation within a year.

C. The Commission Should Clarify that the February 20 Order Does Not Preclude Penalties that Exceed $10,000 Per Day for Violations of EP Sections 2.2 and 2.3, if an Entity Engages in Multiple Violation "Events" During the Course of a Day

In the February 20 Order, the Commission noted that while the ISO bases its Standard Penalty in EP 2.2 through 2.10 on an "event," the ISO had failed to define that term. February 20 Order at P 29. The Commission directed the ISO to identify, for each of the Rules of Conduct in the EP, "whether, for example, 'event' has the meaning of an hour or a day." February 20 Order at P 29. Later in that order, in its discussion of proposed Section 2.2 of the EP (Comply with Operating Orders), the Commission stated that it found "troublesome" the penalties proposed by the ISO for violations of EP 2.2. *Id.* at P 58. In order to "help guide the ISO in establishing appropriate penalty levels" the Commission noted that it had approved the Midwest ISO's request of "substantial sanctions and penalties of up to $10,000 per day (and not per event) as well as the ability to withhold transmission revenues until the violation ceases and any outstanding penalties have been paid." February 20 Order at P 58 (citing Midwest Independent Transmission System Operators, 84 FERC ¶ 61,231 at 62,161 (1998) ("Midwest ISO Order")). The Commission directed the ISO to re-file the penalty provisions of EP 2.2 "using the guidance provided in Section C(2) (Proposed Penalty Structure) of this order, to reflect a penalty range not to exceed $10,000 per day for violations of EP 2.2." *Id.* In its discussion of Section 2.3 of the EP (Submission of Feasible Energy and Ancillary Services Bids and Schedules), the Commission found the maximum fixed Standard

Penalty for this rule to be reasonable, "with the modification that the proposed maximum penalty be assessed per day rather than per event, as discussed above." *Id.* at P 71.

The ISO requests that the Commission, after it has received and reviewed the ISO's Amendment No. 55 compliance filing, clarify that these rulings do not necessarily prohibit penalties under EP Sections 2.2 and 2.3 that exceed $10,000 per day if an entity engages in multiple violation "events" during a day. In its general discussion of this issue, the Commission used the terms "hour" and "day" only as examples of possible definition of the term "event" in the various Rules of Conduct, suggesting that the ISO was not limited in how it defined "event," so long as the ISO could demonstrate that those definitions were reasonable. Thus, if the ISO were to define an "event" under Sections 2.2 and/or 2.3 as an activity that could occur several times in the span of one day, the ISO should not be prohibited from imposing penalties that exceed a total of $10,000 per day if an entity engaged in multiple violation "events" during a day. This approach is reasonable because it is consistent with the Midwest ISO Order cited by the Commission in paragraph 58 of the February 20 Order. In that order, the Commission approved penalties relating to violations of operating orders "of up to $ 10,000 per day *per violation*." Midwest ISO Order at 62,161. Thus, if there occurred multiple violations during one day, the Midwest ISO is authorized to fine a participant up to $10,000 per day for each of those violations, which could obviously result in a total penalty of more than $10,000 for one day. The ISO requests that the Commission clarify that the February 20 Order provides the ISO the same authority that the Commission granted the Midwest ISO in this respect. However, the ISO suggests that the Commission defer clarification on this issue until such time as the ISO files its revised penalty structure

pursuant to the February 20 Order. This way, the Commission will have the opportunity to assess this request with the benefit of the ISO's explanation as to why it believes that the specific penalty structure that it proposes is just and reasonable.

V. CONCLUSION

Wherefore, for the reasons discussed above, the ISO respectfully requests that the Commission revise and/or clarify the February 20 Order as requested above.

Respectfully submitted,

/s/ Michael Kunselman

J. Phillip Jordan
Michael Kunselman
Swidler Berlin Shereff Friedman, LLP
3000 K Street, N.W., Suite 300
Washington, DC 20007
Tel: (202) 424-7500

Charles F. Robinson
Anthony Ivancovich
The California Independent
System Operator Corporation
151 Blue Ravine Road
Folsom, CA 95630
Tel: (916) 608-7147

Dated: March 22, 2004

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in the above-captioned proceeding in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.2010.

Dated at Folsom, CA, on this 22nd day of March, 2004.

_/s/ Anthony Ivancovich________
Anthony Ivancovich