

January 4, 2012

The Honorable Kimberly D. Bose
Secretary
Federal Energy Regulatory Commission
888 First Street, NE
Washington, DC 20426

**Re: California Independent System Operator Corporation
Docket No. ER12-____ - 000
Tariff Amendment Regarding Penalty Cost Allocation
Procedure**

Dear Secretary Bose:

The California Independent System Operator Corporation (ISO) submits this filing to revise its tariff to include provisions regarding penalty cost allocation procedures.¹ The proposed amendments implement guidance on penalty allocation provided by the Commission in several orders, including its Order Providing Guidance on Recovery of Reliability Penalty Costs by Regional Transmission Organizations and Independent System Operators (“Guidance Order”).² As discussed below, the amendments set forth the process the ISO will follow when seeking Commission approval, on a case-by-case basis, to allocate to one or more ISO market participants the cost of any monetary penalty that may be imposed on it by the Commission or by other regulatory bodies, including the North American Electric Reliability Corporation (NERC) and the Western Electric Coordination Council (WECC). The ISO’s proposed tariff amendments are similar to and consistent with the tariff provisions that the Commission has approved for other independent system operators and regional transmission organizations. The ISO requests that the Commission accept this filing effective as of March 5, 2012, which is 61 days from the date of this filing.

¹ The ISO submits this tariff amendment pursuant to Section 205 of the Federal Power Act, 16 U.S.C. § 824d, and Part 35 of the Commission’s regulations, 18 C.F.R. Part 35. Capitalized terms not otherwise defined herein have the meanings set forth in Appendix A to the ISO tariff.

² 122 FERC ¶ 61,247 (2008).

I. Background

The Commission has addressed concerns regarding how independent system operators and regional transmission organizations might allocate penalty costs in recent years in several orders and proceedings, beginning with Order No. 672. In that decision, which implemented various aspects of the Energy Policy Act of 2005, the Commission considered how the statute's penalty provisions relating to reliability standards violations should apply to non-profit independent system operators and regional transmission organizations that may be unable to pay substantial monetary penalties without some means of recovering the cost.³ The Commission denied requests to exempt non-profit independent system operators and regional transmission organizations from such penalties altogether or to give them blanket authority to recover the cost of such penalties in all cases.⁴ It acknowledged, however, that non-profit independent system operators and regional transmission organizations have unique characteristics that are properly considered in determining whether to impose a monetary penalty in the first instance and whether the cost of any penalty should be allocated to market participants.⁵ Rather than establishing any overarching rule, the Commission decided that it should consider and resolve penalty allocation requests on a case-by-case basis, considering the specific circumstances of each case.⁶

The Commission next convened an industry-wide technical conference in Docket No. AD07-12-000 to further consider the issue of independent system operator and regional transmission operator recovery of reliability penalty costs. The ISO participated in this technical conference and submitted comments supporting the development of procedures for independent system operators and regional transmission organizations to allocate the cost of reliability standards penalties.⁷ In written comments filed after the technical conference, NERC stated its intent to investigate the "root cause" of reliability standards violations and to

³ *Rules Concerning Certification of the Electric Reliability Organization; and Procedures for the Establishment, Approval and Enforcement of Electric Reliability Standards*, Order No. 672, 114 FERC ¶ 61,104, at PP 630-638 (2006), *on reh'g*, Order No. 672-A, 114 FERC ¶ 61,328, at PP 57-59 (2006).

⁴ Order No. 672, at PP 634-635; Order No. 672-A, at PP 57-58.

⁵ *Id.*

⁶ *Id.*

⁷ Docket No. AD07-12-000, Prepared Comments of Anthony Ivancovich, Assistant General Counsel – Regulatory, California Independent System Operator (Sept. 18, 2007 Technical Conference).

extend such investigations, where necessary, to non-registered entities that are not directly subject to such penalties.⁸ These root cause determinations, NERC suggested, should be used by the Commission in determining whether to allocate the cost of a penalty for a reliability standards violation to a particular market participant that the independent system operator or regional transmission organization contends was responsible for the violation.⁹

After the technical conference, the Commission issued its Guidance Order on penalty allocation, which broadly identifies procedures that independent system operators and regional transmission organizations should follow to obtain the Commission's case-specific review of a proposed penalty allocation involving a reliability standards violation. The Guidance Order addresses two types of allocation scenarios:

- (1) A request to the Commission to directly allocate all or part of the cost of a penalty to a particular market participant whose conduct the independent system operator or regional transmission organization contends caused or contributed to the underlying violation ("direct allocation"); and
- (2) A request to the Commission to allocate to market participants in general the cost of a penalty that is not subject to direct allocation to one or more particular market participants ("indirect allocation").¹⁰

Under both scenarios, the Guidance Order requires an independent system operator or regional transmission organization to make a filing with the Commission, under Section 205 of the Federal Power Act, that justifies and seeks approval for the proposed allocation of the penalty cost.¹¹

In addition, for a direct allocation the Guidance Order further requires that, during the enforcement entity's investigation or inquiry into the root cause of the underlying incident, the independent system operator or regional transmission organization must provide notice to any targeted market participant of its position that the market participant caused or contributed to the violation that is under

⁸ Docket No. AD07-12-000, Comments of the North American Electric Reliability Corporation, at 7-9 (Nov. 6, 2007). NERC observed that, in some instances, these root cause determinations would be made by the Regional Entities to whom it has delegated certain enforcement responsibilities, which in the case of the ISO would be WECC. *Id.*

⁹ *Id.* at 2-5, 7-10.

¹⁰ *Guidance Order*, 122 FERC ¶ 61,247, at PP 21-27.

¹¹ *Id.* at PP 21, 27.

investigation.¹² The Commission imposed this notice obligation in order to ensure, as a matter of due process, that the affected market participant has an opportunity to seek to participate in the proceeding in which the enforcement entity may establish the root cause or causes of the alleged reliability standards violation.¹³

In response to the Commission's Guidance Order, other independent system operators and regional transmission organizations have been updating their tariffs to include provisions that identify and clarify the process they will follow in seeking the Commission's approval to allocate monetary penalties to one or more market participants. To date, four independent system operators and regional transmission organizations have filed, and received the Commission's approval for, such tariff amendments.¹⁴ In approving the indirect allocation provision of the NYISO's tariff amendment, which is not limited to penalties for federal reliability standards violations and covers penalties imposed by other regulatory bodies besides FERC, NERC, and the NYISO's Regional Entity, the Commission explained that the principles set forth in its Guidance Order may be applied to monetary penalties for other violations besides federal reliability standards, including for penalties imposed by other regulatory bodies.¹⁵

II. Proposed Tariff Amendment

In this filing, the ISO proposes to implement the Commission's Guidance Order by revising its tariff to include provisions that identify and clarify the procedures the ISO intends to follow in connection with direct or indirect penalty allocation requests. These procedures are set forth in a new Section 14.7 of the tariff. The ISO has also included in Appendix A to the tariff – the Master Definitions Supplement – definitions of several new terms that are used in

¹² *Id.* at PP 23-24.

¹³ *Id.* at P 23.

¹⁴ See *Order Conditionally Accepting Proposed Tariff Revisions*, 128 FERC ¶ 61,229 (2009) (MISO); *Order Accepting Tariff Revisions*, 127 FERC ¶ 61,196 (2009) (NYISO); *Order Accepting Tariff Revisions*, 126 FERC ¶ 61,061 (2009) (SPP); *Order Accepting Tariff Revisions and Requiring Compliance Filing*, 124 FERC ¶ 61,260 (2008) (PJM).

¹⁵ 127 FERC ¶ 61,196, at PP 19, 30 (approving NYISO's proposal to apply indirect allocation process to penalties imposed by other regulators). See also *Revised Policy Statement on Penalty Guidelines*, 132 FERC ¶ 61,216, at PP 223-224 (2010) (confirming in an order addressing other types of Commission penalties that the case-by-case review process for reliability standards penalty allocation established in the Guidance Order will apply).

Section 14.7. The following provides an overview and explanation of the main provisions of the tariff amendment.

Consistent with the Guidance Order, the ISO establishes separate tariff provisions for direct and indirect allocation requests. Section 14.7.1 provides a high-level introduction to both processes and explains that the provisions will apply to penalties that are assessed and become final on or after the effective date of the amendment. The direct allocation process is set forth in detail in Section 14.7.2 (and its subsections), and the indirect allocation process is set forth in detail in Section 14.7.3 (and its subsections).

Section 14.7.2.1 sets forth the circumstances under which a direct allocation request is permitted. Following the dictates of the Guidance Order, this provision limits direct allocation requests to cases involving penalties for NERC Reliability Standards violations that the ISO contends were caused, in whole or in part, by acts or omissions of a particular ISO market participant.¹⁶ This section further provides that direct allocation will not be available unless the targeted market participant is given notice of, and an opportunity to participate in, the underlying enforcement proceeding, and the applicable enforcement entity finds that the market participant caused or contributed to any violation that is identified.

Section 14.7.2.2 details the form and substance of the notice the ISO must provide when seeking to impose a direct allocation. The provision requires the ISO to notify the affected market participant in writing of the ISO's intent to seek direct allocation, to set forth the factual basis for the ISO's position, and to inform the market participant that it may seek to participate in the underlying root cause proceeding. This provision ensures, as required by the Guidance Order, that the affected market participant receives due process. If, however, the affected market participant elects not to participate in the root cause proceeding after having been so notified, section 14.7.2.3 provides that such inaction will not prevent a direct allocation from taking place.

Section 14.7.2.4 serves two purposes. First, it requires the ISO, after the outcome of any root cause proceeding, to propose a specific direct allocation to the affected market participant based on the findings of the enforcement entity. This provides an opportunity for the parties to reach agreement, if possible, on a proposed allocation. Second, this section requires the ISO to submit any proposed allocation – whether or not agreed to by the parties – to the

¹⁶ NERC Reliability Standards are standards to ensure the reliability of the bulk power system that have been developed either by NERC or, with NERC's approval, by the Regional Entity (WECC), and that have been approved by the Commission. See Appendix A, Master Definitions Supplement (proposed definition of "NERC Reliability Standards").

Commission for review and approval pursuant to Section 205 of the Federal Power Act. This satisfies the Commission's case-by-case review requirement established in Order No. 672 and the Guidance Order.

Finally, section 14.7.2.5 addresses the mechanics of implementing any Commission-approved direct allocation through the ISO's billing process, allowing the ISO to impose any Commission-approved allocation, together with interest, if any, at the applicable Commission-approved rate, in the next available billing cycle or as soon as practicable thereafter.

Sections 14.7.3.1-14.7.3.3 set forth the process for an indirect allocation request. Section 14.7.3.1 provides that the indirect allocation process may be used for penalties involving reliability standards violations for which there is no market participant who has been found directly responsible for the violation, as well as for other monetary penalties imposed by the Commission or another regulatory body. As noted, the Commission recently approved a similar provision in the NYISO's penalty allocation tariff amendment.¹⁷ Section 14.7.3.2 provides, as required by Order No. 672 and the Guidance Order, that the ISO must seek Commission review and approval for any indirect allocation proposal. And section 14.7.3.3 provides that any Commission-approved allocation will be included in the affected market participants' invoices for the next available billing cycle or as soon thereafter as practicable.

The ISO's tariff amendment is a balanced proposal that is just and reasonable and fully complies with the Commission's guidance in Order No. 672, the Guidance Order, and in decisions approving similar tariff amendments submitted by other independent system operators and regional transmission organizations. It protects market participants by ensuring that no allocation can occur without Commission review and approval and by establishing a direct allocation procedure that enables the ISO and the Commission to ensure that the cost of a reliability standards penalty caused by a particular market participant will be borne only by that entity and not by other market participants. It protects market participants that are potentially subject to direct allocation by ensuring that they receive due process through full and fair notice of, and the opportunity to seek to participate in, any underlying root cause proceeding. And it promotes the stability and financial viability of the ISO by clarifying the process through which it may seek to recover the cost of monetary penalties that it otherwise may have no viable means to pay.

¹⁷ See 127 FERC ¶ 61,196, at PP 19, 30.

III. The Stakeholder Process for this Tariff Amendment

On November 9, 2011, the ISO initiated the stakeholder process for this tariff amendment and posted for stakeholder review the draft amendment and a paper providing background information and an overview of the proposal. The ISO requested any written stakeholder comments on the draft proposal by November 16, 2011, and hosted a stakeholder conference call to discuss the proposal on November 18, 2011. Representatives from 15 stakeholder entities attended the November 18 conference call, though only one entity (Southern California Edison Company) submitted any comments or proposed edits.

None of the stakeholders opposed the tariff amendment, either in written comments or during the stakeholder conference call. Southern California Edison offered various minor tariff wording changes, most of which were incorporated either directly or in substance in a revised draft that was posted on the ISO website on November 22, 2011.

Southern California Edison also proposed one substantive change, requesting that the ISO add language to the section addressing indirect allocation that would require the ISO, in all cases, to seek a waiver of any penalty from a regulator other than the Commission before requesting Commission approval to allocate the cost of the penalty. The ISO did not incorporate this proposal into its amendment. Although the ISO has strong incentives to take all reasonable steps in every case to avoid or reduce the magnitude of any monetary penalty, the most appropriate means for doing so will necessarily differ in each case. Because penalty review and appeal processes may differ across various regulators, a “waiver” request may not be appropriate or advisable in every context. For this reason, the ISO determined that including an express waiver requirement in the tariff would be inadvisable. No such requirement, moreover, is established in the Guidance Order, or in any of the other penalty allocation tariff amendments previously approved by the Commission.

There were no other comments or proposed edits offered by stakeholders in response to this proposed tariff amendment.

IV. Effective Date

The ISO respectfully requests that the Commission accept the tariff changes contained in this filing effective as of March 5, 2012, 61 days from the date of this filing.

V. Communications

Communications regarding this filing should be addressed to the following individuals. The individual identified with an asterisk is the person whose name

should be placed on the official service list established by the Secretary with respect to this submittal:

Nancy Saracino
General Counsel
*Burton Gross
Senior Counsel
California Independent System
Operator Corporation
250 Outcropping Way
Folsom, CA 95630
Tel: (916) 608-7268
Fax: (916) 608-7222
bgross@caiso.com

*Individual designated for service
pursuant to 18 C.F.R. § 385.203(b)(3).

VI. Service

The ISO has served copies of this transmittal letter, and all attachments, on the California Public Utilities Commission, the California Energy Commission, and all parties with effective scheduling coordinator service agreements under the ISO tariff. In addition, the ISO is posting this transmittal letter and all attachments on the ISO website.

VII. Attachments

The following documents, in addition to this transmittal letter, support the instant filing:

- | | |
|---------------------|---|
| Attachment A | Revised ISO tariff sheets – clean |
| Attachment B | Revised ISO tariff sheets – blackline |
| Attachment C | Memorandum to ISO Board of Governors and Board Resolution |

VIII. Conclusion

For all the foregoing reasons, the Commission should accept the proposed tariff revisions contained in the instant filing without modification, effective March 5, 2012. Please contact the undersigned with any questions regarding this matter.

Respectfully submitted,

By: /s/ Burton Gross

Nancy Saracino

General Counsel

Burton Gross

Senior Counsel

California Independent System

Operator Corporation

250 Outcropping Way

Folsom, CA 95630

Tel: (916) 608-7268

Fax: (916) 608-7222

bgross@caiso.com

Counsel for the California Independent
System Operator Corporation

California Independent System Operator Corporation
Fifth Replacement FERC Electric Tariff
Amendment to tariff re: Penalty Allocation Procedures
Attachment A - Clean Tariff
January 4, 2012

14. Force Majeure, Indemnity, Liabilities, and Penalties

* * *

14.7 Allocation of Costs Associated With Penalties

14.7.1 Overview of Process

Under the NERC Functional Model and the NERC Rules of Procedure, Registered Entities for a specific function, including the CAISO, may be assessed monetary penalties by FERC, NERC, and/or WECC for violations of one (1) or more NERC Reliability Standards applicable to that function. This Section 14.7 sets forth the procedure through which the CAISO may seek, with FERC approval, to directly allocate, in whole or in part, the cost of any such penalties assessed upon the CAISO to an entity or entities whose conduct or omission(s) NERC, WECC and/or FERC has determined contributed, in whole or in part, to the violation that gave rise to the penalty. This Section 14.7 also sets forth procedures through which the CAISO may seek, with FERC approval, to recover, in whole or in part, from Market Participants the cost associated with a monetary penalty for a NERC Reliability Standards violation(s) that is not subject to direct allocation, or the cost associated with other monetary penalties that may be imposed by FERC or another regulatory authority. Penalties that are assessed upon the CAISO and become final on or after the effective date of this Section 14.7 shall be subject to the procedures set forth herein regardless of the date of the underlying violation(s) for which the penalty is assessed.

14.7.2 Direct Allocation Of Reliability Standards Penalties

14.7.2.1 Conditions For Direct Allocation

If FERC, NERC, and/or WECC assess(es) one (1) or more monetary penalties against the CAISO as the Registered Entity for the violation of one or more NERC Reliability Standards, and the conduct or omission(s) of a particular Market Participant or Market Participants contributed, in whole or in part, to the violation(s) at issue, then the CAISO may seek to directly allocate, in whole or in part, such penalty costs to the Market Participant(s) whose conduct or omission(s) contributed to the violation(s), provided that each of the following conditions are met:

- (1) The Market Participant(s) subject to potential direct allocation receive notice of, and an opportunity to fully participate in, the underlying CMEP proceeding before NERC and/or WECC, or the FERC proceeding in the case of an enforcement proceeding directly instituted by FERC without a prior NERC or WECC proceeding;
- (2) The CMEP proceeding, or enforcement proceeding directly instituted by FERC, results in a finding that the conduct or omission(s) of the Market Participant(s) subject to potential direct allocation contributed, either in whole or in part, to the Reliability Standards violation(s) at issue; and
- (3) Any findings by NERC and/or WECC regarding whether the conduct or omission(s) of the Market Participant(s) contributed, either in whole or in part, to the Reliability Standards violation(s) at issue are filed with FERC.

14.7.2.2 Notice To Affected Market Participant

The CAISO will notify the Market Participant(s) it believes contributed to the Reliability Standards violation(s) during the CMEP proceeding or, if applicable, during the enforcement proceeding directly instituted by FERC. This notification shall be in writing and shall: (i) inform the Market Participant(s) that the CAISO intends to invoke the direct allocation provisions of this Section; (ii) detail the underlying factual basis for the CAISO's position; and (iii) inform the Market Participant(s) that it may seek to participate in the CMEP proceeding or, if applicable, the enforcement proceeding directly instituted by FERC.

14.7.2.3 Failure To Participate

A failure by the notified Market Participant(s) to participate in the CMEP proceeding or, if applicable, in the enforcement proceeding directly instituted by FERC, will not prevent the CAISO from directly allocating the cost associated with a monetary penalty to the Market Participant(s) provided all other conditions in Section 14.7.2 are satisfied.

14.7.2.4 Proposed Allocation And FERC Review Process

Where NERC and/or WECC, or FERC as may be applicable in an enforcement proceeding directly instituted by FERC, determines that the conduct or omission(s) of the Market Participant(s) identified by the CAISO contributed, in whole or in part, to the NERC Reliability Standard(s) violation(s) at issue, the

CAISO shall inform the involved Market Participant(s) in writing and shall initially propose an allocation of the penalty cost on a basis proportional to the parties' relative fault, consistent with the applicable regulator's analysis. Regardless of whether the involved Market Participant(s) agree or disagree over the allocation, the reasonability of such an allocation shall be determined by FERC through submission of the matter to FERC pursuant to Section 205 of the Federal Power Act.

14.7.2.5 Payment Of Allocated Amount

After FERC issues a final order regarding the CAISO's ability to directly allocate the penalty cost, the CAISO shall include any FERC-approved allocated amounts in the invoice for the appropriate Market Participant(s) for the next billing period, or as soon as practicable. The amount to be paid by the Market Participant(s) shall include the allocated portion of the penalty, as established by FERC, together with interest calculated at the FERC authorized refund rate for the period of time, if any, between the CAISO's payment of the penalty and the Market Participant(s) payment of its allocated portion of the penalty.

14.7.3 Allocation of Penalty Costs Not Subject to Direct Allocation

14.7.3.1 Procedure For Allocation

Where the conduct or omission(s) of a particular Market Participant or Market Participants has not been identified by NERC, WECC, or FERC as a contributing cause for a monetary penalty assessed against the CAISO for a NERC Reliability Standards violation, or where the CAISO is assessed a monetary penalty by FERC or another regulatory body for the CAISO's own actions or inaction in violation the CAISO Tariff, FERC rules, or rules or regulations established by other regulatory bodies, the CAISO may make a filing with FERC under Section 205 of the Federal Power Act seeking approval to recover the cost of such penalties from all Market Participants. The CAISO's Section 205 filing may include a proposed methodology for allocating the penalty across the various types of Market Participants.

14.7.3.2 Case-By-Case FERC Review

Any allocation of penalties pursuant to Section 14.7.3 must be determined by FERC on a case-by-case basis. Absent FERC approval, the CAISO will not allocate a penalty under Section 14.7.3 to Market Participants.

14.7.3.3 Payment of Allocated Amount

After FERC issues a final order regarding allocation of the monetary penalty, the CAISO shall include any FERC-approved allocated amounts in the invoices for the appropriate Market Participants for the next billing period, or as soon as practicable.

* * *

Appendix A

Master Definitions Supplement

* * *

- Compliance Monitoring and Enforcement Program (CMEP)

The program used by NERC and the Regional Entities to monitor, assess and enforce compliance with the NERC Reliability Standards. As part of this program, NERC and the Regional Entities may, among other functions, conduct investigations, determine fault and assess monetary penalties.

* * *

- NERC Functional Model

The model used by NERC to define and establish the set of functions that must be performed to ensure the reliability of the bulk power system.

* * *

- NERC Reliability Standards

The standards that have been developed by NERC and/or a Regional Entity, and have been approved by FERC, to ensure the reliability of the bulk power system. The NERC Reliability Standards set forth the specific requirements that responsible entities must perform with respect to the functions defined in NERC's Functional Model.

* * *

- NERC Rules of Procedure

A set of rules and procedures developed by NERC and approved by FERC that establish processes that NERC, NERC members, and Regional Entities must follow. The NERC Rules of Procedure include the process through which a responsible entity that is to perform a set of functions to ensure reliability of the bulk power system must register with NERC as a Registered Entity.

* * *

- Regional Entity

An entity to whom NERC has delegated certain of its electric reliability organization functions for a particular geographic region. WECC is the applicable Regional Entity for the region encompassing the CAISO.

* * *

- Registered Entity

An entity registered with NERC under the NERC Functional Model and the NERC Rules of Procedure as responsible for compliance with a designated set of requirements established by the NERC Reliability Standards.

California Independent System Operator Corporation
Fifth Replacement FERC Electric Tariff
Amendment to tariff re: Penalty Allocation Procedures
Attachment B - Marked Tariff
January 4, 2012

14. Force Majeure, Indemnification And Limitations On Liability, and Penalties

* * *

14.7 Allocation of Costs Associated With Penalties

14.7.1 Overview of Process

Under the NERC Functional Model and the NERC Rules of Procedure, Registered Entities for a specific function, including the CAISO, may be assessed monetary penalties by FERC, NERC, and/or WECC for violations of one (1) or more NERC Reliability Standards applicable to that function. This Section 14.7 sets forth the procedure through which the CAISO may seek, with FERC approval, to directly allocate, in whole or in part, the cost of any such penalties assessed upon the CAISO to an entity or entities whose conduct or omission(s) NERC, WECC and/or FERC has determined contributed, in whole or in part, to the violation that gave rise to the penalty. This Section 14.7 also sets forth procedures through which the CAISO may seek, with FERC approval, to recover, in whole or in part, from Market Participants the cost associated with a monetary penalty for a NERC Reliability Standards violation(s) that is not subject to direct allocation, or the cost associated with other monetary penalties that may be imposed by FERC or another regulatory authority. Penalties that are assessed upon the CAISO and become final on or after the effective date of this Section 14.7 shall be subject to the procedures set forth herein regardless of the date of the underlying violation(s) for which the penalty is assessed.

14.7.2 Direct Allocation Of Reliability Standards Penalties

14.7.2.1 Conditions For Direct Allocation

If FERC, NERC, and/or WECC assess(es) one (1) or more monetary penalties against the CAISO as the Registered Entity for the violation of one or more NERC Reliability Standards, and the conduct or omission(s) of a particular Market Participant or Market Participants contributed, in whole or in part, to the violation(s) at issue, then the CAISO may seek to directly allocate, in whole or in part, such penalty costs to the Market Participant(s) whose conduct or omission(s) contributed to the violation(s), provided that each of the following conditions are met:

- (1) The Market Participant(s) subject to potential direct allocation receive notice of, and an opportunity to fully participate in, the underlying CMEP proceeding before NERC

and/or WECC, or the FERC proceeding in the case of an enforcement proceeding directly instituted by FERC without a prior NERC or WECC proceeding;

(2) The CMEP proceeding, or enforcement proceeding directly instituted by FERC, results in a finding that the conduct or omission(s) of the Market Participant(s) subject to potential direct allocation contributed, either in whole or in part, to the Reliability Standards violation(s) at issue; and

(3) Any findings by NERC and/or WECC regarding whether the conduct or omission(s) of the Market Participant(s) contributed, either in whole or in part, to the Reliability Standards violation(s) at issue are filed with FERC.

14.7.2.2 Notice To Affected Market Participant

The CAISO will notify the Market Participant(s) it believes contributed to the Reliability Standards violation(s) during the CMEP proceeding or, if applicable, during the enforcement proceeding directly instituted by FERC. This notification shall be in writing and shall: (i) inform the Market Participant(s) that the CAISO intends to invoke the direct allocation provisions of this Section; (ii) detail the underlying factual basis for the CAISO's position; and (iii) inform the Market Participant(s) that it may seek to participate in the CMEP proceeding or, if applicable, the enforcement proceeding directly instituted by FERC.

14.7.2.3 Failure To Participate

A failure by the notified Market Participant(s) to participate in the CMEP proceeding or, if applicable, in the enforcement proceeding directly instituted by FERC, will not prevent the CAISO from directly allocating the cost associated with a monetary penalty to the Market Participant(s) provided all other conditions in Section 14.7.2 are satisfied.

14.7.2.4 Proposed Allocation And FERC Review Process

Where NERC and/or WECC, or FERC as may be applicable in an enforcement proceeding directly instituted by FERC, determines that the conduct or omission(s) of the Market Participant(s) identified by the CAISO contributed, in whole or in part, to the NERC Reliability Standard(s) violation(s) at issue, the CAISO shall inform the involved Market Participant(s) in writing and shall initially propose an allocation of the penalty cost on a basis proportional to the parties' relative fault, consistent with the applicable

regulator's analysis. Regardless of whether the involved Market Participant(s) agree or disagree over the allocation, the reasonability of such an allocation shall be determined by FERC through submission of the matter to FERC pursuant to Section 205 of the Federal Power Act.

14.7.2.5 Payment Of Allocated Amount

After FERC issues a final order regarding the CAISO's ability to directly allocate the penalty cost, the CAISO shall include any FERC-approved allocated amounts in the invoice for the appropriate Market Participant(s) for the next billing period, or as soon as practicable. The amount to be paid by the Market Participant(s) shall include the allocated portion of the penalty, as established by FERC, together with interest calculated at the FERC authorized refund rate for the period of time, if any, between the CAISO's payment of the penalty and the Market Participant(s) payment of its allocated portion of the penalty.

14.7.3 Allocation of Penalty Costs Not Subject to Direct Allocation

14.7.3.1 Procedure For Allocation

Where the conduct or omission(s) of a particular Market Participant or Market Participants has not been identified by NERC, WECC, or FERC as a contributing cause for a monetary penalty assessed against the CAISO for a NERC Reliability Standards violation, or where the CAISO is assessed a monetary penalty by FERC or another regulatory body for the CAISO's own actions or inaction in violation the CAISO Tariff, FERC rules, or rules or regulations established by other regulatory bodies, the CAISO may make a filing with FERC under Section 205 of the Federal Power Act seeking approval to recover the cost of such penalties from all Market Participants. The CAISO's Section 205 filing may include a proposed methodology for allocating the penalty across the various types of Market Participants.

14.7.3.2 Case-By-Case FERC Review

Any allocation of penalties pursuant to Section 14.7.3 must be determined by FERC on a case-by-case basis. Absent FERC approval, the CAISO will not allocate a penalty under Section 14.7.3 to Market Participants.

14.7.3.3 Payment of Allocated Amount

After FERC issues a final order regarding allocation of the monetary penalty, the CAISO shall include any FERC-approved allocated amounts in the invoices for the appropriate Market Participants for the next billing period, or as soon as practicable.

* * *

Appendix A

Master Definitions Supplement

* * *

- Compliance Monitoring and Enforcement Program (CMEP)

The program used by NERC and the Regional Entities to monitor, assess and enforce compliance with the NERC Reliability Standards. As part of this program, NERC and the Regional Entities may, among other functions, conduct investigations, determine fault and assess monetary penalties.

* * *

- NERC Functional Model

The model used by NERC to define and establish the set of functions that must be performed to ensure the reliability of the bulk power system.

* * *

- NERC Reliability Standards

The standards that have been developed by NERC and/or a Regional Entity, and have been approved by FERC, to ensure the reliability of the bulk power system. The NERC Reliability Standards set forth the specific requirements that responsible entities must perform with respect to the functions defined in NERC's Functional Model.

* * *

- NERC Rules of Procedure

A set of rules and procedures developed by NERC and approved by FERC that establish processes that NERC, NERC members, and Regional Entities must follow. The NERC Rules of Procedure include the process through which a responsible entity that is to perform a set of functions to ensure reliability of the bulk power system must register with NERC as a Registered Entity.

* * *

- Regional Entity

An entity to whom NERC has delegated certain of its electric reliability organization functions for a particular geographic region. WECC is the applicable Regional Entity for the region encompassing the CAISO.

* * *

- Registered Entity

An entity registered with NERC under the NERC Functional Model and the NERC Rules of Procedure as responsible for compliance with a designated set of requirements established by the NERC Reliability Standards.

California Independent System Operator Corporation
Fifth Replacement FERC Electric Tariff
Amendment to tariff re: Penalty Allocation Procedures
Attachment C – Board Memorandum and Resolution
January 4, 2012

Memorandum

To: ISO Board of Governors

From: Nancy Saracino, Vice President, General Counsel and Chief Administrative Officer

Date: December 8, 2011

Re: **Decision on Tariff Amendment Establishing Penalty Allocation Procedure**

This memorandum requires Board action.

EXECUTIVE SUMMARY

Management recommends that the ISO Board of Governors authorize an amendment to the tariff to establish a set of procedures for the ISO to follow when seeking FERC approval to allocate to one or more market participants any monetary penalty that may be imposed on the ISO by NERC, WECC, FERC or any other regulatory body. The amendment implements guidance that FERC has provided to ISOs and RTOs on this topic and is modeled after similar tariff amendments FERC has approved for other ISOs and RTOs.

Management proposes the following motion:

Moved, that the ISO Board of Governors approves the proposed tariff amendment to establish procedures for penalty allocation requests to the Federal Energy Regulatory Commission as described in the memorandum dated December 8, 2011; and

Moved, that the ISO Board of Governors authorizes Management to make all necessary and appropriate filings with the Federal Energy Regulatory Commission to implement the proposed tariff change.

DISCUSSION AND ANALYSIS

Background

In 2005, Congress enacted the Energy Policy Act of 2005, which included provisions enhancing FERC's authority to impose monetary penalties on entities subject to its jurisdiction for violations of the Federal Power Act or FERC's rules and orders implementing the Federal Power Act. The penalty provision authorizes FERC to impose penalties of up to \$1 million per violation per day for violations of the Federal Power Act, as well as for violations of FERC's rules and orders or violations of an entity's FERC-approved tariff. The

Energy Policy Act of 2005 also charged FERC with establishing mandatory reliability standards for the bulk-power system and authorized FERC, or an electric reliability organization designated by FERC, to impose monetary penalties on owners or operators of bulk-power system facilities for violations of the mandatory reliability standards. As a result of these provisions, FERC-jurisdictional entities, including the ISO, face the risk of potentially substantial monetary penalties for violations of FERC rules and orders, including for violations of mandatory reliability standards approved by FERC.

In *Order No. 672*, FERC considered how the Energy Policy Act of 2005's penalty provisions relating to reliability standards violations should apply to ISOs and RTOs that operate on a non-profit basis and thus may lack the ability to pay penalties without some means of recovering the cost. FERC denied requests to exempt these entities from such penalties or to give them blanket authority to recover such costs from their market participants. FERC instead decided that such penalty allocation requests must be considered on a case-by-case basis.

More recently, FERC issued a *Guidance Order* on penalty allocation, which broadly identifies procedures that ISOs and RTOs should follow to obtain FERC's case-specific review of a proposed penalty allocation involving a reliability standards violation. The *Guidance Order* addresses two allocation scenarios:

- (1) A request to FERC for authority to directly allocate all or part of the cost of a penalty to a particular market participant whose conduct the ISO or RTO contends caused or contributed to the underlying violation ("direct allocation"); and
- (2) A request to FERC to allocate to market participants in general the cost of a penalty that is not subject to direct allocation to one or more particular market participants ("indirect allocation").

Under both scenarios, the *Guidance Order* requires an ISO or RTO to make a filing with FERC that justifies and seeks approval for any proposed allocation of the penalty cost. In addition, for a direct allocation the *Guidance Order* requires that, during the enforcement entity's investigation of the underlying incident, the ISO or RTO must provide any affected market participant with notice of the proceeding and of its contention that the market participant may be responsible for causing the violation. FERC imposes this obligation to ensure that the affected market participant is provided an opportunity to participate in the proceeding in which the enforcement entity establishes the root cause or causes of the alleged reliability standards violation. Although FERC may directly institute and undertake

such an investigation, these proceedings more commonly take place before the North American Electric Reliability Corporation or the Western Electric Coordination Council.¹

In response to FERC's *Guidance Order*, ISOs and RTOs have been updating their tariffs to include provisions detailing the procedures they will follow in seeking FERC's approval to allocate monetary penalties to one or more market participants. To date, the New York Independent System Operator, the Midwest Independent Transmission System Operator, the Southwest Power Pool, and the PJM Interconnection have each filed, and received FERC's approval for, such tariff amendments. These tariff amendments, which are generally similar to one another, all follow the broad guidance set forth by FERC in the *Guidance Order*. In connection with approving the NYISO's tariff amendment, which is not limited to penalties for federal reliability standards violations, FERC further observed that the allocation approval process set forth in its *Guidance Order* may be applied to monetary penalties for other violations besides federal reliability standards, including for penalties imposed by other regulatory bodies.

The California ISO's proposed tariff amendments, which are generally modeled on the amendments FERC has approved for the other ISOs and RTOs, set forth the process the California ISO will follow for seeking FERC approval of any proposed penalty allocation.

Summary of the Proposed Amendment

Management proposes to add a new subsection to Section 14 of the tariff that establishes the procedures the ISO will follow for direct and indirect penalty allocation requests. The new subsection establishes procedures for allocation of all types of monetary penalties that may be imposed by FERC or by another federal or state regulatory body.

Consistent with FERC's *Guidance Order*, the direct allocation process would apply to penalties for reliability standards violations where the ISO believes that the actions or omissions of a particular market participant either caused or contributed to the violation that is the subject of the penalty. The amendment establishes four basic procedural steps.

First, during the initial proceeding before NERC, WECC, or FERC to investigate the potential violation, the ISO will provide a written notice to any market participant to whom it may later intend to seek direct allocation. The notice will: (1) inform the entity that the ISO believes it caused or contributed to the alleged violation; (2) set forth the factual basis for the ISO's position; and (3) notify the entity that it may seek to participate in the enforcement proceeding establishing the root cause or causes of the alleged violation.

¹ FERC has designated NERC as the Electric Reliability Organization and, in that capacity, NERC may undertake enforcement with respect to reliability standards violations. NERC has, in turn, delegated certain of these responsibilities to WECC as the Regional Entity for the Western interconnection.

Second, if the root cause investigation finds that the identified market participant(s) caused or contributed to the reliability standards violation, then the ISO will propose, in writing, to the involved market participant(s) an initial allocation of the penalty cost on a basis proportional to the parties' relative fault, consistent with the root cause findings made by NERC, WECC, or FERC.

Third, regardless of whether the ISO and the market participant(s) agree or disagree on the allocation, the ISO must submit the allocation proposal to FERC for its review and approval.

Fourth, after any final order from FERC approving direct allocation, the ISO will include the allocated amount in the invoice for the market participant for the next billing period, or as soon thereafter as practicable.

The indirect allocation process applies to penalties involving reliability standards violations for which there is no market participant who has been found directly responsible for the violation, as well as to other monetary penalties imposed by FERC or another regulatory body. The amendment requires, in compliance with FERC's *Guidance Order*, that before allocating the cost of any such penalty across market participants, the California ISO must file a request with FERC for approval to do so. The filing also may include a proposed methodology for allocating the penalty amount across the different types of market participants. After any final order from FERC approving an indirect allocation, the ISO will include the allocated amounts in market participants' invoices for the next billing period, or as soon thereafter as practicable.

POSITION OF THE PARTIES

The proposed tariff amendment has been circulated to stakeholders, and a stakeholder review call was held on November 18. Although representatives from 15 stakeholder entities attended the call, only one party, Southern California Edison Company, offered any comments or proposed any revisions to the draft tariff language.

SCE proposed various minor tariff wording changes, most of which were incorporated into a revised draft that was posted on the ISO website on November 22. SCE also proposed one substantive change, requesting that the ISO add language to the section discussing indirect allocation that would require the ISO to seek a waiver of the penalty from the applicable regulator in every instance before requesting an allocation of the penalty by FERC. Management does not believe such a requirement is advisable because the penalty review and appeal processes differ across various regulators and a "waiver" request may not be appropriate or advisable in every context or circumstance. Moreover, the tariff provisions that FERC approved for PJM, NYISO, MISO, and SPP do not include

such a requirement. For these reasons, we did not incorporate this suggestion into the proposed amendment.

MANAGEMENT RECOMMENDATION

The proposed tariff amendment implements FERC's guidance regarding the procedural steps a non-profit ISO or RTO should follow in order to receive approval to allocate the cost of a monetary penalty to market participants. The amendment further provides market participants with clear notice of the procedures the ISO intends to follow. For these reasons, Management recommends that the Board approve the proposed tariff amendment and authorize Management to make all necessary and appropriate filings with FERC to implement the proposed tariff change.



Board of Governors

December 15-16, 2011

**Decision on Penalty Allocation
Tariff Amendment**

General Session

Motion

Moved, that the ISO Board of Governors approves the proposed tariff amendment to establish procedures for penalty allocation requests to the Federal Energy Regulatory Commission as described in the memorandum dated December 8, 2011; and

Moved, that the ISO Board of Governors authorizes Management to make all necessary and appropriate filings with the Federal Energy Regulatory Commission to implement the proposed tariff change.

Moved: Galiteva

Second: Maullin

Board Action:	Passed	Vote Count: 4-0-0
Bhagwat	Y	
Foster	Y	
Galiteva	Y	
Maullin	Y	

Motion Number: 2011-12-G4