

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

Investigation of Terms and Conditions of Public) Docket Nos. EL01-118-000
Utility Market-Based Rate Authorizations) and EL01-118-001
)

**INITIAL COMMENTS OF THE CALIFORNIA INDEPENDENT SYSTEM
OPERATOR CORPORATION REGARDING PROPOSED REVISIONS TO
MARKET-BASED RATE TARIFFS AND AUTHORIZATIONS**

Pursuant to the “Order Seeking Comments On Proposed Revisions To Market-Based Rate Tariffs And Authorizations” (“June 26 Order”) issued by the Federal Energy Regulatory Commission (“Commission”) on June 26, 2003 in the captioned proceeding, the California Independent System Operator Corporation (“CAISO”) hereby submits its Initial Comments regarding the proposed market behavior rules that would apply to sellers of electricity under their market-based rate tariffs.

In support hereof, the CAISO respectfully states as follows:

I. BACKGROUND

In its June 26 Order, the Commission proposes to identify transactions and practices that would be prohibited under the market-based rate tariffs and authorizations of sellers of electricity at wholesale. Specifically, the Commission proposes six specific rules applicable to the following: (1) unit operation; (2) market manipulation; (3) communication; (4) reporting; (5) record retention; and (6) related tariffs.

Under proposed Market Rule No. 1, sellers would be required to operate, bid and schedule their generating facilities in a manner that complies with the

rules and regulations of the applicable power market. Rule No. 2 prohibits actions which manipulate or attempt to manipulate the market or result in prices for products/services that do not reflect the legitimate forces of supply and demand. Market Rule No. 3 requires sellers to submit accurate and complete information to regional transmission organizations (“RTOs”) and independent system operators (“ISOs”). Market Rule No. 4 requires, *inter alia*, that sellers provide complete and accurate information to publishers of electricity and natural gas price indices. Under Market Rule No. 5, a seller must retain all data and information necessary for the reconstruction of the energy or energy products prices it charges for a period of three years. Finally, Market Rule No. 6 provides that sellers shall not violate their code of conduct or the Order No. 889 code of conduct.

If a seller is found to have engaged in transactions or behavior prohibited under the proposed market rules, it would be subject to disgorgement of unjust profits obtained in contravention of the seller’s tariff, as well as appropriate non-monetary remedies such as revocation of the seller’s market-based rate authority and revisions to the seller’s code of conduct. The Commission states that the aforementioned market behavior rules are intended to complement RTO and ISO tariff conditions or market rules that might apply to sellers in these markets. The CAISO’s comments on the proposed market behavior rules are set forth below.

II. COMMENTS

A. The Proposed Market Behavior Rules Are An Appropriate Complement To The Market Rules Of The Regional Transmission Organization Or Independent System Operator

The CAISO supports the proposed market behavior rules as a complement to the conceptual market redesign and rules of conduct that the CAISO filed on July 22, 2003 as part of its Market Design 2002 (“MD02”) proposal and Oversight and Investigation (“O & I”) program. The MD02 proposal includes a broad set of market rules that substantially reform the CAISO’s markets, including a Real-Time and Day-Ahead Must Offer Obligation designed to prevent physical withholding from the market. The O & I proposal includes, *inter alia*, a new Enforcement Protocol which sets forth (1) seven basic rules of conduct that are similar to the market rules proposed in the Commission’s Standard Market Design Notice of Proposed Rulemaking,¹ and (2) procedures for prohibiting market manipulation and other detrimental practices. The rules of conduct in the O & I proposal are consistent with the market rules proposed in the June 26 Order and should be approved by the Commission.

In the CAISO’s opinion, it is appropriate and necessary that there be comprehensive and clear market rules applicable to sellers of electricity that will (1) promote reliable operation of the transmission grid, (2) enable independent transmission providers to operate dependable, fair, efficient and competitive markets that produce just and reasonable prices, (3) allow independent transmission providers to conduct investigations and evaluate market participant behavior effectively, and (4) deter behavior by market participants that is inconsistent with such objectives. The market behavior rules proposed in the June 26 Order, as well as the rules of conduct proposed in O & I and MD02, are

¹ *Remedying Undue Discrimination Through Open Access Transmission Service and Standard Electric Market Design*, FERC Stats. & Regs. [Proposed Regulations], ¶ 32,563 at P 445 (2002) (“SMD NOPR”).

consistent with the aforementioned principles. Clearly defined market behavior rules will facilitate the development of a stable marketplace and help create an environment that will attract needed investment in new infrastructure. Further, such behavioral rules, in conjunction with specified and sufficient penalties, should deter gaming and other manipulative strategies such as those that have been employed in California in the past several years.

B. Disgorgement Of Profits Is Not Adequate Sanction

The Commission proposes that sellers which violate any of the proposed market behavior rules will be subject to disgorgement of any unjust profits obtained as a result of their inappropriate behavior. The CAISO submits that profit disgorgement is an inadequate remedy to effectively deter violations of market rules or inappropriate market behavior. Disgorgement only puts the market participant back in the position it would have been in had it not engaged in the improper behavior.² This does not serve as an adequate disincentive for sellers to engage in gaming and market manipulation because they essentially can engage in such behavior on a risk-free basis.

The CAISO submits that the Commission should take two steps that would “put more teeth” into market rules applicable to sellers of electricity. First, the Commission should not limit the monetary penalty for violations of the proposed market behavior rules to the disgorgement of unjust profits. As Commissioner Massey has recognized

² The Commission has recognized that a directive that requires a refund to be made is not properly characterized as a penalty. See, e.g., *Carolina Power & Light Company*, 87 FERC ¶ 61,083 at 61,356 (1999); *San Diego Gas & Electric Company, et al.*, 97 FERC ¶ 61,275 at 62,239 (2001)(disgorgement of profits is an equitable remedy).

[m]arket manipulation can raise the single market clearing price paid by all market participants and collected by all sellers. The Federal Power Act requires that all rates and charges be just and reasonable. Where the market has been manipulated so as to affect the market clearing price, that price is not just and reasonable and is therefore unlawful. Simply requiring that bad actors disgorge their individual profits does not make the market whole because all sellers received the unlawful price caused by the manipulation. The narrow remedy of profit disgorgement is not an adequate remedy for the adverse effect of bad behavior on the market price, and may not be an adequate deterrent to future behavior. The appropriate remedy may be that the manipulating seller makes the market whole.

American Electric Power Service Corporation, et al., 103 FERC ¶ 61,61,345 (2003)(Massey dissent).

The CAISO agrees with Commissioner Massey's statements and submits that the Commission should adopt a remedy based on market impacts and/or harm to customers, as well as a remedy based simply on the disgorgement of profits. A remedy based on market impacts and harm to customers would require the seller to make market participants harmed by the seller's improper behavior whole. Unlike mere disgorgement of profits, a market impact/customer harm remedy would serve as an actual deterrent to market manipulation and would keep market participants whole in instances where the mere disgorgement of profits does not fully compensate them for the harm suffered as a result of the seller's misconduct.

Both the Commission and the Courts have recognized that the Commission has the authority to adopt a customer harm/market impact remedy. See *Mesa Petroleum Co. v. FPC*, 441 F. 2d 182 (5th Cir. 1971); *Fact-Finding*

Investigation into Possible Manipulation of Electric and Natural Gas Prices, 102 FERC ¶ 61,108 (2203); *Jack Grynberg, et al. v. Rocky Mountain Natural Gas Company, et al.*, 93 FERC ¶ 61,180 (2000). Thus, there is no valid reason for the Commission to reject *ab initio* a customer harm/market impact remedy for violation of the proposed market behavior rules. The Commission would then have the ability to remedy fully all adverse impacts on specific customers or the market in general when the circumstances and the behavior in question make such a remedy appropriate.

Second, the Commission should authorize independent transmission providers (“ITPs”) to include market behavior rules in their tariffs, as well as specified penalties for violations of such rules. This is necessary because (1) the Commission’s penalty authority is essentially limited to equitable remedies that are intended to restore the *status quo ante*, *i.e.*, the Commission does not have civil penalty authority,³ and (2) some types of behavioral violations can be addressed more transparently, effectively and efficiently in the applicable ITP’s tariff than in the seller’s market-based rate tariff. Independent transmission providers such as the CAISO can include market behavior rules and associated penalties – some of which may be specific to that ITP’s specific market design

³ The General Accounting Office has recognized

that without a meaningful range of penalties, FERC lacks adequate enforcement “bite” to deter anticompetitive behavior or other violations of market rules. Such deterrence is an important part of an effective oversight approach, especially because FERC will likely not be able to review all the transactions in detail to identify such behavior or violations.

Energy Markets: Concerted Actions Needed by FERC to Confront Challenges That Impede Effective Oversight.

and circumstances – in their tariffs as a term or condition of service in connection with sellers’ receipt of transmission service or participation in the market. Moreover, many ITP-imposed penalties can be applied in a simple and transparent manner based on the ITP’s data, without the need for complex investigations that may be required to utilize the disgorgement of profits or customer harm/market impact remedies.

Penalties in ITP tariffs can be a more effective deterrent to market-destabilizing behavior because they can exceed the market value of the service or the market benefits received by the market participant that engaged in the improper behavior.⁴ For example, the Commission has regularly accepted penalty provisions as long as they are capped at a level of twice the standard rate for the service at issue.⁵ Further, for violations of market rules that occur during emergencies or if the market participant has shown a pattern of rules violations, the Commission has approved penalties of up to three times the normally applicable penalty.⁶ Stiff penalties, such as those proposed by the CAISO in its O & I program, will serve as a more effective deterrent of inappropriate behavior than the mere potential for the disgorgement of profits after the fact. Accordingly, the Commission should approve market behavior

⁴ See, e.g., NYISO Market Monitoring Plan (“NYISO MMP”), Sections 4.3.3-4.3.4.

⁵ See, e.g., *Alliance Companies, et al.*, 94 FERC ¶ 61,070 (2001) (penalty of twice the stated rate for unauthorized use of regulation and frequency reserve service is consistent with the Commission’s policy of allowing penalties equal to twice the stated rate); *American Transmission Company, L.L.C.*, 93 FERC ¶ 61,267 (2000) (penalty of 200 percent of the applicable charge for unauthorized use of Ancillary Services); *Wayne-White County Electric Cooperative*, 89 FERC ¶ 61,282 (1999) (twice the rate for unauthorized Ancillary Services).

⁶ See Section 13 of the ISO New England Market Rules and Procedures (“MRP 13”), Section 13.5.3.

rules and associated penalties proposed by independent transmission providers. Such market rules are a necessary complement to the market rules proposed in the June 26 Order.

III. THE COMMISSION SHOULD IMPOSE A REAL-TIME MUST OFFER OBLIGATION AS A CONDITION ON ALL MARKET-BASED RATE AUTHORIZATIONS

Proposed Market Rule No. 2 would prohibit, *inter alia*, the withholding of available capacity from the market. However, in addition to a general prohibition against physical withholding, the Commission also should impose an explicit Real-Time Must Offer Obligation – such as that currently in effect in the California market – as a permanent and fundamental condition for market-based rate authority. If a resource owner has available (*i.e.*, operable and not otherwise committed) capacity and can offer that capacity at a bid price of its choosing (up to any specified cap), there is no legitimate reason why the resource owner should not offer such capacity into the host ITP’s Real-Time market. As the Commission has recognized, “under competitive conditions, a generator that has available energy in real time should be willing to sell that energy at a price that covers its marginal costs, since it has no alternative purchaser at that time. See *San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Services into Markets Operated by the California Independent System Operator and the California Power Exchange*, 95 FERC ¶ 61,115 at 61,355-56 (2001). A Real-Time Must Offer requirement will protect consumers against physical withholding and promote stable and competitive markets. Accordingly, it should be a condition of market based rate authority.

IV. CONCLUSION

Wherefore, for the foregoing reasons, the CAISO respectfully requests that the Commission adopt the recommendations set forth in these initial comments.

Respectfully submitted,

Charles F. Robinson,
General Counsel
Anthony J. Ivancovich,
Senior Regulatory Counsel
California Independent System
Operator Corporation
151 Blue Ravine Road
Folsom, CA 95630
(916) 608-7135

Filed: August 8, 2003



August 8, 2003

The Honorable Magalie Roman Salas
Secretary
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, DC 20426

**Re: Investigation of Terms and Conditions of Public Utility Market-Based
Rate Authorizations
Docket Nos. EL01-118-00 and EL01-118-001**

Dear Secretary Salas:

Enclosed for electronic filing please find the Initial Comments of The California Independent System Operator Corporation Regarding Proposed Revisions to Market-Based Rate Tariffs and Authorizations in the above captioned dockets.

Thank you for your assistance in this matter.

Respectfully submitted,

Anthony J. Ivancovich
Counsel for The California Independent
System Operator Corporation

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 dockets.

Dated at Folsom, California, on this 8th day of August, 2003.

Anthony J. Ivancovich