UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations	Docket No. EL06-16-000

COMMENTS OF THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION

The California Independent System Operator Corporation ("ISO") respectfully submits these comments in response to the Federal Energy Regulatory Commission's ("Commission's") Order Proposing Revisions to Market-Based Rate Tariffs and Authorizations in Docket No. EL06-16-000 ("Proposed Repeal"), in which the Commission proposes to repeal the Market Behavior Rules currently included in all public utility sellers' market-based rate tariffs and authorizations. For the reasons set forth below, the ISO believes that the Commission should retain the existing Rules of Market Behavior as a necessary adjunct to its proposed new rules prohibiting market manipulation.

The ISO appreciates the Commission's prompt action through its Notice of Proposed Rulemaking in Docket RM06-3 ("NOPR") to implement the new, broader, authority to control market manipulation granted by Congress in the Energy Policy Act of 2005. These new rules, in Part 47 of the Commission's Regulations, should make a significant contribution to the prevention of the gaming behavior that distorted California markets and deprived ratepayers of fairly priced energy during 2000 and 2001.

However, the ISO does not believe that in implementing this new authority the Commission should (or is required to) abandon the existing Market Behavior Rules, which address instances of market manipulation that are harmful to the markets but which may not constitute violations of the proposed rules in Part 47. The ISO believes that retention of the Market Behavior Rules is necessary primarily because of two concerns. First, because the Commission intends to include as an element of its Part 47 rules the *scienter* requirement applicable to violations of Securities and Exchange Commission Rule 10b-5,[1] a repeal of the Market Behavior Rules could subject rate payers to higher energy costs that are the result of foreseeable, but unintentional, market distortions. Second, it is not clear at this time that Securities and Exchange Commission precedent regarding the scope of fraudulent and manipulative behavior covered by Rule 10b-5, which the Commission intends to adopt in interpreting its Part 47 regulations,[2] encompasses the full range of activities covered by the Market Behavior Rules. The ISO believes that the Market Behavior Rules operate as an important additional protection for ratepayers – in providing the Commission with a "lesser included offense" to address behavior that does not rise to the level of a violation of the Part 47 rules – and require retention for these reasons. Specifically, retaining the Market Behavior Rules will enable the Commission to require a market participant to disgorge profits – but will not penalize a market participant – for inappropriate behavior that does not constitute a violation of the Part 47 regulations.

[1] 17 CFR 240.10b-5 (2005). *See* Proposed Repeal at P 15.
[2] *See* NOPR at P 14.

I. The Commission Should Maintain the Market Behavior Rules to Protect Ratepayers Against Unjust and Unreasonable Rates that Arise from Nonfraudulent Actions that Foreseeably Could Manipulate Market Prices, Market Conditions, or Market Rules.

In the Proposed Repeal, the Commission notes that new Section 222 of the Federal Power Act uses the term "manipulative or deceptive device or contrivance" as that term is used in Section 10b of the Securities Exchange Act, and that the term has been interpreted as used in Section 10b to require an element of *scienter*, *i.e.,* an intent to defraud. Proposed Repeal at P 15, citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976). Although, as discussed below, the ISO is not persuaded that Section 222 requires the Commission to adopt all SEC precedent regarding Rule 10b-5, the ISO does not challenge the Commission's legal conclusion that the term "manipulative or deceptive device or contrivance" – as that term is used in Section 10b – incorporates *scienter*, as that state of mind has been interpreted by the courts. Moreover, the ISO believes that such a requirement is appropriate in this context. In that regard, because the proposed Part 47 regulations declare certain manipulative and fraudulent conduct unlawful, parties that engage in such conduct would be subject to civil and criminal penalties under Section 316 and 316A of the Federal Power Act, as revised by Section 1284 of the Energy Policy Act of 2005. Such penalties should not be imposed for anything less than intentional or reckless behavior.

Whereas Congress, through Section 222, provided the Commission with the authority to impose penalties to deter fraudulent behavior, the Market Behavior Rules arise from a different authority and serve a somewhat different purpose. In particular, unlike the part 47 regulations, the Market Behavior Rules are not intended to penalize market participants for inappropriate behavior; they are merely intended to require

market participants to disgorge profits obtained from such inappropriate behavior, which violates the terms and conditions under which the rates are just and reasonable. The Commission implemented the Market Behavior Rules pursuant to its authority under Section 206 of the Federal Power Act to require that the rates charged by public utilities be just and reasonable rates. *See* Order Amending Market-Based Rate Tariffs and Authorizations, 105 FERC ¶ 61,218 at, *e.g.,* P 24 (2003), *reh'g denied*, 107 FERC ¶ 61,175 (2004). The Market Behavior Rules are conditions on market-based rate authority that ensure that such rates remain within a zone that is just and reasonable. The remedy for a violation of Market Behavior Rule 2, which prohibits market manipulation, is consistent with this purpose. *i.e.,* disgorgement of the unjust profits.

A *scienter* requirement does not make sense in light of the purpose of the Market Behavior Rules. In that regard, the justness and reasonableness of a rate does not depend upon whether the seller intended to defraud. There is no basis for allowing a seller to profit from a foreseeable, albeit unintentional, distortion of the market and there is no basis for requiring ratepayers to bear the costs of such a distortion. In light of the *scienter* requirement, the Part 47 regulations cannot replace the role of the Market Behavior Rules.

Although the Commission notes that the Part 47 regulations have been proposed in a manner to provide certainty to entities subject to the Commission's exercise of its enforcement powers, NOPR at 12, 14, and that repeal of the Market Behavior Rules will enhance clarity (Proposed Repeal at P 13), the added value of clarity does not outweigh the importance of the existing Market Behavior Rules. There is no indication that Congress, in authorizing the Commission to enforce prohibitions against and impose

penalties for fraudulent market manipulation, intended to provide clarity by lessening the Commission's exercise of its existing authority under the Federal Power Act – in particular its existing authority to require disgorgement of profits gained from the violation of the conditions of market-based rate authority – to protect ratepayers from the effects of market manipulation and the charging of unjust and unreasonable rates.

To the contrary, the little legislative history that is available makes clear that Congress's intention was to fill gaps in the Commission's authority, not to reduce the protection of ratepayers. Section 1283 of the Energy Policy Act, which added Section 222 to the Federal Power Act, derived from S.2015, introduced by Senator Cantwell.[3] In introducing the bill, Senator Cantwell quoted the Commission report in its Enron investigation:

> Enron's corporate culture fostered a disregard for the American energy customer; the success of the company's trading strategies, while temporary, demonstrates the need for explicit prohibitions on harmful and fraudulent market behavior and for aggressive market monitoring and enforcement.

150 Cong. Rec. S119 (daily ed. Jan. 21, 2004). She went on to quote a letter from Commissioner Kelliher, just prior to his confirmation:

> Markets subject to manipulation cannot operate properly and there is an urgent need to proscribe manipulation of electricity markets. You have correctly noted there is no express prohibition of market manipulation in the Federal Power Act and have proposed legislation to establish an express prohibition. This is a critical point. The Federal Energy Regulatory Commission only has the tools that Congress chooses to give it, and Congress has never given the Commission express authority to prohibit market manipulation. I believe the time has come for Congress to take that step.

[3] A previous version of the legislation had passed the Senate in 2003, but was not enacted into law. *See* 150 Cong. Rec. S119 (daily ed. Jan. 21, 2004)

Id. As the Senator explained, the purpose of the legislation was simple: "In the face of overwhelming evidence that Enron and other unscrupulous energy companies brazenly manipulated western energy markets during the crisis of 2000-2001, it would amend the Federal Power Act to put in place a blanket ban on such activities." *Id.* This understanding of the need to provide the Commission with new authority to prohibit manipulation was also shared by Senator Cantwell's colleagues. *See, e.g.,* Remarks of Senator Feingold, 151 Cong. Rec. S6877 (daily ed. Jun. 22, 2005); Remarks of Senator Feinstein, 151 Cong. Rec. S7454 (daily ed. Jun. 28, 2005).

As noted above, there is no penalty for a violation of Market Behavior Rule 2; there is merely a disgorgement of profits. Indeed, the Commission has recognized that a directive that requires a refund of the ill-gotten gains from inappropriate behavior 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 62,234 (2001) (disgorgement of profits is an equitable remedy). This view is supported by judicial case law. *See, e.g., Transcontinental Gas Pipe Line Corporation, et al., v. FERC,* 998 F.2d 1313 (5th Cir. 1993); *Coastal Oil & Gas Corp. v. FERC*, 782 F.2d 1249 (5th Cir. 1986). There is no indication whatsoever that Congress intended to eliminate the Commission's existing remedial authority under the FPA, including the Commission's authority to employ the equitable remedy of disgorgement of ill-gotten gains. There has not been an express *scienter* requirement for such disgorgement in the past, and there be none in the future.

Further, as the Supreme Court discussed in reviewing the applicability of the double jeopardy bar to forfeiture statutes, disgorgement is but a form of forfeiture:

"Forfeitures serve a variety of purposes, but are designed primarily to confiscate property used in violation of the law, and to require disgorgement of the fruits of illegal conduct." *United States v. Ursery,* 518 U.S. 267, 284 (1996). The Court stressed that forfeiture proceedings were *in rem*, civil proceedings. *Id.* One of the important factors that the Court cited as supporting the civil nature of forfeiture was the *lack of a scienter requirement for forfeiture*. *Id.* Indeed, the mental state requirement for forfeiture is virtually nonexistent. A person may constitutionally be deprived of his or her ownership in a car used in criminal activity, for example, even if the person had no knowledge of the criminal activity. *Bennis v. Michigan,* 516 U.S. 442 (1996). Even though Congress had formerly explicitly provided an exception for forfeiture of property used in drug trafficking – such as homes – when the owner lacks knowledge of the criminal activity, it eliminated that exception in 2000. Pub. L. No. 106-185, § 2(c)(2).

Maintaining the "lesser civil offense" contemplated by the Market Behavior Rules will motivate market participants to maintain the highest degree of diligence in the avoidance of market distortion. Moreover, it is consistent with the Commission's intent when it first adopted the Market Behavior Rules. In that regard, in its order establishing the existing Market Behavior Rules, the Commission stated that "if Congress grants the Commission *additional* remedial power, including the authority to levy civil penalties, the Commission will, *in addition* to the remedies set forth herein, implement such authority and utilize it when appropriate for violations of these Market Behavior Rules." 105 FERC ¶ 61,218 at n 87 (2003). Thus, the Commission expressly contemplated that, even if Congress granted it civil penalty authority – as it has in the Energy Policy Act – it would still retain its existing remedial authority to require disgorgement of profits, where

appropriate, for violations of the Market Behavior Rules. Again, Congress did not intend to eliminate any of the Commission's existing remedial authority under the FPA. In light of these considerations, the ISO believes it is incumbent upon the Commission to maintain the Market Behavior Rules to protect ratepayers against nonfraudulent actions that foreseeably could manipulate market prices, market conditions, or market rules.

II. The Commission Should Maintain the Market Behavior Rules to Ensure that the Commission Has the Authority to Police the Full Range of Gaming and Manipulative Activities.

The Commission has stated that its Part 47 rules "are intended to be interpreted consistent with analogous SEC precedent that is appropriate under the circumstances." NOPR at P 10. As noted above, the Commission believes this will provide certainty to the entities subject to the new rules. *Id.* at P 14. In comments submitted regarding the NOPR in Docket RM06-03, however, some parties have questioned the necessity, wisdom and feasibility of the Commission's proposal to accept wholesale the SEC precedent. For example, Edison Electric Institute, has explained that Section 222 of the Federal Power Act only refers to the Securities and Exchange Act to establish the meaning of "manipulative or deceptive device or contrivance." It does not follow that the Commission must employ that definition in the electric industry in the same manner that it applies in the securities industry. The regulation of the securities market is founded in disclosure and ensuring that investors have access to full and accurate information upon which to base investment decisions. In contrast, the electricity markets depend in part on private contracts, in which parties to negotiations are expected to keep information private and confidential. *See generally* Comments of Edison Electric Institute, filed November 17, 2005, in Docket No. RM06-3 at 7-10. Absent such withholding of information, agreements could rarely be reached and profits rarely made.

Even bids and other competitive information provided to the ISO as part of its market operations may not be revealed to other Market Participants. *See* ISO Tariff § 20.3. The ISO believes that the Commission's intent to apply SEC precedent leaves open many questions regarding the scope of the activities that will be subject to enforcement under the Part 47 rules.

The ISO recognizes that the Commission has stated its belief that all of the behavior prohibited by Market Behavior Rules 2 and 3 would be unlawful under the proposed Part 47 regulations and that the proposed rules do cover entities and certain transactions that are not addressed by the Market Behavior Rules. Proposed Repeal at PP 13, 16. Nonetheless, the differences between the electricity markets and securities market make it difficult to assess whether Part 47, after incorporating SEC precedent, will indeed encompass the full scope of Market Behavior Rules 2 and 3. For example, it is not at all clear that "the creation and relief of artificial congestion" would necessarily entail a misrepresentation or an omission of a material fact, which would be a required element of a violation of the proposed rules, under the precedent that establishes the elements of a violation of Rule 10b-5. *See, e.g., Southland Securities Corp. v. Inspire Insur. Solutions, Inc.,* 365 F.3d 353, 362 (5th Cir. 2004); *Adams v. Kinder-Morgan, Inc.,* 340 F.3d 1083, 1095 (10th Cir. 2003).[4]

The uncertainties regarding the scope of the proposed Part 47 regulations reinforce the ISO's concerns, discussed in Section I of these comments, regarding the wisdom of limiting regulation of market manipulation to those instances in which entities

[4] These issues are further complicated because the duty to disclose information only arises when there is a particular relationship between the parties. *See Chiarella v. United States,* 445 U.S. 222 (1980).

have an intent to defraud. For these reasons, the ISO urges the Commission to maintain its Market Behavior Rules.

III. Response to Specific Requests for Comments.

1. Are there any aspects of the Market Behavior Rules that should be retained in market-based rate sellers' tariffs and authorizations, or can all substantive provisions of the Market Behavior Rules be reflected in the proposed Part 47 regulations and other Commission rules and regulations?

The ISO's position regarding Market Behavior Rules 2 and 3 are discussed above. Market Behavior Rules 4 and 6 are discussed below.

In general, the ISO believes that much of the same discussion in Sections I and II above would be applicable to Market Behavior Rule 1, which requires sellers to follow Commission-approved rules and regulations in organized power markets. Market Participants could manipulate market rules and distort markets by violating ISO rules without necessarily engaging in fraudulent activity. Although various ISO agreements require that Market Participants abide by the terms of the ISO Tariff, they do not ensure that ratepayers will be made whole when sellers and marketers profit from violations of those terms. It is appropriate to maintain Market Behavior Rule 1 as a condition of market-based rates.

Market Behavior Rule 5 requires that sellers retain for a minimum three year period all data and information upon which they billed the prices charged under their market-based rate tariffs. The ISO believes that data retention rules are critical to the Commission's enforcement powers. Because the ISO is recommending that the Commission maintain the Market Behavior Rules, it would be reasonable to maintain Market Behavior Rule 5. However, the ISO would not have an objection to the

Commission promulgating a separate data retention rule as a replacement as long as it were equally as or more extensive than Market Rule 5.

2. Is there a need or basis for retaining existing Market Behavior Rule 2 in light of the anti-manipulation provisions set forth in the proposed Part 47 regulations?

Please see discussion above.

3. Should the Commission incorporate the qualification that no action or transaction explicitly contemplated by Commission rules, or undertaken at the direction of an ISO or RTO, is a violation of Market Behavior Rule 2 into the proposed Part 47 regulations?

Ordinarily, the *scienter* requirement would obviate the need for such an exception: neither the Commission nor an organization such as an ISO or an RTO can authorize conduct with intent to defraud. Nonetheless, the ISO is concerned because of the convergence of three factors: (1) the omission of a material fact may constitute a violation of Part 47 regulations; (2) Commission or organization rules may require that certain potentially material information be kept confidential; and (3) *scienter* can be inferred. For these reasons, the ISO supports the incorporation of the qualification that no action or transaction explicitly contemplated by Commission rules, or undertaken at the direction of an ISO or RTO, constitutes a violation of the proposed Part 47 regulations.

4. Should the affirmative defense of "legitimate business purpose" in existing Market Behavior Rule 2 be retained in any form?

There is simply no manner in which activity taken with intend to defraud can constitute a "legitimate business practice." Further, there is no such defense to violations of Rule 10b-5. Indeed, when one engages in pattern of violations of the Securities and Exchange Act in furtherance of a legitimate business, it becomes racketeering. *See* 18 U.S.C. §§ 1961-62. Nonetheless, for the reasons discussed in

connection with question 3, the ISO might have been sympathetic to such an affirmative defense. However, the ISO believes that those concerns are addressed with the qualification that no action or transaction explicitly contemplated by Commission rules, or undertaken at the direction of an ISO or RTO, is a violation of the proposed Part 47 regulations.

5. Is there any aspect of behavior forbidden by Market Behavior Rule 3 that would not act as a fraud or deceit in connection with the purchase or sale of electric energy or transmission services subject to the Commission's jurisdiction?

Market Rule 3 prohibits the submittal of any false information, while the Part 47 regulations prohibit making untrue statements of only material facts. While the ISO agrees that materiality should be required in connection with the false statements and the omission of facts that can result in severe penalties, such as under Part 47, the ISO also believes it important that public utilities remain under an obligation as a condition of market-based rates to provide accurate information in all communications. The ISO notes that, in a similar manner, many criminal codes require materiality for serious offenses such as perjury, but not for lesser offenses involving false statements to public officials. *Compare* Model Penal Code § 241.1 *with* § 241.2.

6. Is the requirement of Market Behavior Rule 4 to report transaction information accurately, to the extent a seller reports such information to price index publishers, necessary in light of the proposed Part 47 regulations?

The ISO believes that it is necessary to maintain a separate requirement in Market Behavior Rule 4 to report transaction information accurately, to the extent a seller reports such information to price index publishers. The accuracy of the information published should not depend upon whether the provider of the information had an intent to defraud.

7. Is there any aspect of Market Behavior Rule 6 that is not covered directly and explicitly by each seller's code of conduct as contained in tariff authorizations, or by the Standards of Conduct in Part 358 of our regulations, or by the proposed Part 47 regulations?

The ISO is not aware of any aspect of Market Behavior Rule 6 that is not covered directly and explicitly by each seller's code of conduct as contained in tariff authorizations, or by the Standards of Conduct in Part 358 of the Commission's regulations, or by the proposed Part 47 regulations.

Respectfully submitted,

/s/ Michael E. Ward

Charles F. Robinson – General Counsel
Anthony J. Ivancovich
Assistant General Counsel-Regulatory
The California Independent System Operator Corporation
151 Blue Ravine Road
Folsom, CA 95630
Tel: (916) 351-4400
Fax: (916) 351-4436

Sean Atkins
Michael E. Ward
Alston & Bird LLP
601 Pennsylvania Avenue, NW
North Building, 10th Floor
Washington, DC 20004-2601
Tel: (202) 756-3405
Fax: (202) 756-3333

Counsel for the California Independent System Operator Corporation

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Certificate of Service

I hereby certify that I have this day served a copy of this document upon all parties listed on the official service list compiled by the Secretary in the above-captioned proceedings, in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and Procedure (18 C.F.R. § 385.2010).

Dated this 29th day of December, 2005 at Folsom in the State of California.

/s/ Kathryn Corradetti
Kathryn Corradetti
(916) 608-7021