

# 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**

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***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.<sup>1</sup>

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.

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<sup>1</sup> 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.