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July 25, 2003

Hon. Magalie Roman Salas, Secretary
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, D.C. 20426

Re: *American Electric Power Service Corporation, et al.*
Docket Nos. EL03-137-000, et al.

Dear Secretary Salas:

Enclosed for filing are one original and fourteen copies of the Request for Rehearing and/or Clarification of the California Independent System Operator Corporation, submitted in the above-captioned proceeding.

Also enclosed are two extra copies of the request to be time/date stamped and returned to us by the messenger. Thank you for your assistance. Please contact the undersigned if you have any questions regarding this filing.

Respectfully submitted,

Michael Kunselman

Counsel for the California Independent System Operator Corporation

Enclosures

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UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

American Electric Power Service Corporation	)	Docket No. EL03-137-000
Aquila, Inc.	)	Docket No. EL03-138-000
Arizona Public Service Company	)	Docket No. EL03-139-000
Automated Power Exchange, Inc.	)	Docket No. EL03-140-000
Bonneville Power Administration	)	Docket No. EL03-141-000
California Department of Water Resources	)	Docket No. EL03-142-000
California Power Exchange	)	Docket No. EL03-143-000
Cargill-Alliant, LLC	)	Docket No. EL03-144-000
City of Anaheim, California	)	Docket No. EL03-145-000
City of Azusa, California	)	Docket No. EL03-146-000
City of Glendale, California	)	Docket No. EL03-147-000
City of Pasadena, California	)	Docket No. EL03-148-000
City of Redding, California	)	Docket No. EL03-149-000
City of Riverside, California	)	Docket No. EL03-150-000
Coral Power, LLC	)	Docket No. EL03-151-000
Duke Energy Trading and Marketing Company	)	Docket No. EL03-152-000
Dynegy Power Marketing, Inc.,	)	Docket No. EL03-153-000
Dynegy Power Corp., El Segundo Power	)	
LLC, Long Beach Generation LLC, Cabrillo	)	
Power I LLC, and Cabrillo Power II LLC	)	
Enron Power Marketing, Inc.	)	Docket No. EL03-154-000
and Enron Energy Services, Inc.	)	
F P & L Energy	)	Docket No. EL03-155-000
Idaho Power Company	)	Docket No. EL03-156-000
Los Angeles Department of Water and Power	)	Docket No. EL03-157-000
Mirant Americas Energy Marketing, LP, Mirant	)	Docket No. EL03-158-000
California, LLC, Mirant Delta, LLC, and	)	
Mirant Potrero, LLC	)	
Modesto Irrigation District	)	Docket No. EL03-159-000
Morgan Stanley Capital Group	)	Docket No. EL03-160-000
Northern California Power Agency	)	Docket No. EL03-161-000
Pacific Gas and Electric Company	)	Docket No. EL03-162-000
PacifiCorp	)	Docket No. EL03-163-000
PGE Energy Services	)	Docket No. EL03-164-00
Portland General Electric Company	)	Docket No. EL03-165-000
Powerex Corporation	)	Docket No. EL03-166-000
(f/k/a British Columbia Power Exchange Corp))		
Public Service Company of Colorado	)	Docket No. EL03-167-000
Public Service Company of New Mexico	)	Docket No. EL03-168-000
Puget Sound Energy, Inc.	)	Docket No. EL03-169-000
Reliant Resources, Inc.,	)	Docket No. EL03-170-000

Reliant Energy Power Generation, and Reliant Energy Services, Inc.	)	
Salt River Project Agricultural Improvement and Power District	)	Docket No. EL03-171-000
San Diego Gas & Electric Company	)	Docket No. EL03-172-000
Sempra Energy Trading Corporation	)	Docket No. EL03-173-000
Sierra Pacific Power Company	)	Docket No. EL03-174-000
Southern California Edison Company	)	Docket No. EL03-175-000
TransAlta Energy Marketing (U.S.) Inc. and TransAlta Energy Marketing (California), Inc.	)	Docket No. EL03-176-000
Tucson Electric Power Company	)	Docket No. EL03-177-000
Western Area Power Administration	)	Docket No. EL03-178-000
Williams Energy Services Corporation	)	Docket No. EL03-179-000

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

Pursuant to Rule 713 of the Commission's Rules of Practice and Procedure, 18 C.F.R.§ 385.212, the California Independent System Operator Corporation ("ISO")[1]submits this request for clarification and rehearing in the above dockets. The ISO respectfully requests that the Commission revise and/or clarify a limited number of items in its June 25, 2003, Order to Show Cause Concerning Gaming And/Or Anomalous Market Behavior (" Show Cause Order").

I. BACKGROUND

Since the inception of the ISO Markets the ISO Tariff has contained provisions that identify and prohibit "gaming" and other anomalous market behavior that has the effect of, or potential for, undermining the efficiency,

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

workability or reliability of the ISO Markets, or provide participants with an unfair competitive advantage over other Market Participants.[2] The Market Monitoring and Information Protocol ("MMIP"), an important part of the ISO Tariff from the outset, specifically defines "gaming"[3] as "taking unfair advantage of the rules and procedures set forth in the PX and ISO Tariffs, Protocols and Activity Rules, or of transmission constraints in periods in which exist substantial Congestion, to the detriment of efficiency of, and consumers in, the ISO Markets." The Tariff goes on to state that "gaming"

> may also include taking undue advantage of other conditions that may affect the availability of transmission and generation capacity, such as loop flow, facility outages, level of hydro power output or seasonal limits on energy imports from out-of-state, or action or behaviors that may otherwise render the system and the ISO Markets vulnerable to price manipulation to the detriment of market efficiency.

Since the beginning of trading in the ISO Markets, the ISO (through its Department of Market Analysis, previously called the Market Surveillance Unit) has monitored the various markets for gaming and anomalous behavior, and frequently reported to the Commission the results of its analyses. Following the release of several memoranda from Enron in May of 2002,[4] the ISO initiated an

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[2] ISO Market Monitoring & Information Protocol ("MMIP") Sections 2.1.1, 2.1.3 , 2.3.1, 2.3.2 and 2.3.3 (October 13, 2000).

[3] *Id.*

[4] The Commission released the following memoranda: (1) a December 6, 2000 memorandum from Christian Yoder (of Enron Power Marketing, Inc.) and Stephen Hall (of Stoel Rives, LLP) to Richard Sanders (of Enron) entitled "Traders' Strategies in the California Wholesale Markets/ISO Sanctions"; (2) a December 8, 2000 memorandum from Christian Yoder and Stephen Hall to Richard Sanders also entitled "Traders' Strategies in the California Wholesale Markets/ISO Sanctions"; and (3) an undated memorandum from Gary Fergus (of Brobeck, Phleger & Harrison, LLP) and Jean Frizzell (of Gibbs & Brans, LLP) to Rich Sanders entitled "Status Report on Further Investigation and Analysis of EPMI Trading Strategies," (referred to collectively as the "Enron Memos").

analysis, based on scheduling and trading data available to the ISO, to assess the extent to which the practices outlined in the Enron Memos may have been employed by Enron, as well as other entities. The results of this analysis have been summarized in a series of reports and underlying data that have been provided to FERC Staff as well as other legal and regulatory entities investigating the manipulation of Western energy markets by Enron and other entities.[5] As noted in each of these reports, the ISO's analysis of these practices was designed to be used in conjunction with other information that could be obtained by other regulatory and legal entities through various forms of investigation and discovery. On one hand, the ISO's analysis intentionally "cast a broad net" to identify all potential ISO transactions that could be associated with an abusive, manipulative or fraudulent trading practice, and therefore may warrant further investigation and/or explanation. At the same time, as noted in the ISO Reports, the ISO's analysis is by necessity limited in a variety of ways which make it impossible to detect many variations of these trading practices based only on ISO data. Given these limitations, the ISO has consistently indicated that these

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[5] Department of Market Analysis, California ISO, Analysis of Trading and Scheduling Strategies Described in Enron Memos, (October 4, 2002), publicly released on January 6, 2003, available at ttp://www.caiso.com/docs/2003/03/26/2003032613435514289.pdf; Addendum to October 4, 2002 Report on Analysis of Trading and Scheduling Strategies Described in Enron Memos: Revised Results for Analysis of Potential Circular Schedules ("Death Star" Scheduling Strategy), (January 17, 2003), available at http://www.caiso.com/docs/2003/03/26/2003032613593115924.pdf; and Supplemental Analysis of Trading and Scheduling Strategies Described in Enron Memos, (June 2003), available at http://www.caiso.com/docs/2003/06/18/2003061806053424839.pdf; Technical Supplement to Source Data Provided Pursuant to June 25 Show Cause Order (July 16, 2003), available at www2.caiso.com/docs/2003/07/17/2003071716330416 22.pdf (collectively, "ISO Reports").

reports were intended to be used as a starting point or framework for further investigation.

The Commission initiated its own investigation into these practices and other forms of market manipulation and misconduct commencing with an order issued on February 13, 2002, in Docket No. PA02-2-000, in which it directed Commission staff to begin a fact-finding investigation and analysis of physical and financial transactions that occurred both inside and outside the California energy markets. In August 2002, Commission Staff released its Initial Report on the potential manipulation of electric and natural gas prices in the California markets. In that report Staff concluded that certain conduct engaged in by Market Participants in the ISO Market constituted gaming. In its Final Report, released March 23, 2003, the same day that the Commission released its final order on the Proposed Findings On Refund Liability in Docket No. EL00-95-045 et al., Commission Staff found evidence of various types of market manipulation including economic withholding, raising market clearing prices through inflated bidding, wash trading, and gaming in violation of the MMIP. Staff also concluded that the ISO Tariff, specifically the MMIP, prohibited these types of behavior, and "authorized the imposition of sanctions and penalties by the Commission." Final Report at ES-15. Staff recommended that the Commission direct more than 30 Market Participants "to show cause why their behavior did not constitute gaming in violation of the Cal ISO and Cal PX tariffs." Final Report at ES-16.

On April 2, 2003, the Commission issued an order that provided for the submission of briefs on the extent to which parties agreed with Staff's

interpretation of the MMIP provisions that prohibit Market Participant behavior related to gaming and anomalous market behavior. The ISO submitted a brief in support of Staff's interpretation. Finally, on June 25, 2003, the Commission issued the order discussed herein, in which it found that a number of entities (the "Identified Entities") appear to have engaged in behavior, labeled as Gaming Practices, that constitute gaming and/or anomalous market behavior in violation of the ISO's Tariff during the January 1, 2000 through June 20, 2001 period. The Commission required that the Identified Entities show cause as to why the transactions that they are alleged to have engaged in do not violate the anti-gaming provisions of the ISO's MMIP, and why the profit realized from these practices should not be disgorged.

II. SPECIFICATION OF ERRORS AND REQUEST FOR CLARIFICATION

The ISO respectfully submits that the Show Cause Order erred in the following respects:

- Treating each Gaming Practice solely as a separate and individual violation of the ISO Tariff. Show Cause Order at p. 37-69.
- Limiting monetary damages to disgorgement of profits directly related to individual Gaming Practices. Show Cause Order at p. 71.
- Finding that those entities that engaged in the practice of Overscheduling of Load are not subject to monetary penalties. Show Cause Order at p. 60.

- Finding that the practice of Ancillary Services Buyback was not a Gaming Practice, but a legitimate form of arbitrage. Show Cause Order at p. 64.
- Finding that the practice of False Import is only subject to monetary penalties for the period May 2000 through October 2, 2000. Show Cause Order at p. 39 n.55.

Additionally, the ISO respectfully requests that the Commission clarify the following with respect to the Show Cause Order:

- Clarify that the practice of False Import applies to all transactions in which entities falsely reported to the ISO that their available power had been imported, in order to receive a price above the applicable price cap.

III. ARGUMENT

A. The Commission Should Not Limit Its Focus to Individual Gaming Practices, but Instead, Should Adopt a Broader, Market-Wide View of What Constitutes Gaming Practices

Under each heading for each of the individual Gaming Practices addressed in the Show Cause Order, the Commission outlined the type of behavior that constitutes each Practice, discussed the rationale as to why that Practice violates the ISO Tariff, and then identified the parties which, based on the ISO Reports or other evidence, may have engaged in the Practice. In terms of remedies, the Show Cause Order states that the Presiding ALJ will "hear

evidence and render findings and conclusions quantifying the full extent to which the Identified Entities may have been unjustly enriched as a result of their conduct." Thus, the Show Cause order effectively treats each Gaming Practice, with respect to each Identified Entity, as a separate "mini-proceeding."

This approach ignores how multiple Gaming Practices were often used together as part of an overall strategy of manipulation and market power abuse. When viewed in isolation, some of the practices engaged in by Market Participants may not appear to have constituted gaming and manipulation at all, but rather more benign forms of scheduling and profit maximization. However, when viewed in the context of other practices, the true nature and impact of these practices become evident. It is therefore important to view each of the specific practices discussed by the Commission in the Show Cause Order as part of an intertwined whole in order to understand and assess whether manipulation, abuse of market power, or other violations of the ISO Tariff occurred. This is particularly true with respect to two of these practices, Load Overscheduling and False Import (*i.e.*, "Ricochet" or "MW Laundering"), both of which are means of exercising market power by withholding capacity from the forward energy market and selling energy in the real time market, where a variety of other practices can and were employed to raise real time prices. This point was made in the submissions of both the ISO and California Parties in the 100-Day Discovery proceeding. For example, in the ISO's March 20, 2003 submission in that proceeding, the ISO's witness, Dr. Hildebrandt, recognized that the "Fat Boy" strategy (referred to in the Show Cause Order as Overscheduling of Load), when

analyzed in isolation, as the Commission did in the Show Cause Order, may not appear to have had an adverse impact on the California markets. *See* Exh. ISO-1 at 9-10.[6] In fact, as the Commission points out in the Show Cause Order, when viewed separately, the practice of overscheduling appears to have been beneficial by offsetting the need for purchasing energy in real-time to offset underscheduling. Show Cause Order at p. 60. However, as Dr. Hildebrandt went on to explain, the Fat Boy strategy was usually combined with other practices, such as Ricochet, economic and physical withholding, and bidding at high prices, in order to accomplish the end result of receiving unjust and unreasonable rates for electricity sales in the California market, rates that had little to no relation to the actual costs of production or competitive market outcomes. A similar point was also made by Dr. Fox-Penner, in his March 3, 2003 testimony on behalf of the California Parties. Therein, Dr. Fox-Penner explained that although a strategy such as Fat Boy might be more akin to efficient economic arbitrage in a workably competitive market, the nearly vertical demand curve in the ISO's real time market meant that "strategies that would ordinarily act to equalize price differences between the [Day-Ahead] or [Hour-Ahead] market can become tools to transmit some of the market power exercised in [real-time] to these other markets." Exh. CAL-1 at 165.

Therefore, it is necessary to view specific practices within the overall context of the totality of conduct of each Market Participant as well as the existing market conditions, in order to accurately determine whether manipulation,

[6] All references to exhibit numbers in this document are to exhibits filed with the Commission in the 100-Day Discovery proceeding (Docket Nos. EL00-95-069, *et al.*).

gaming, abuse of market power, or other violations of the ISO Tariff occurred. It is precisely because of this fact that the ISO's MMIP subjects a wide range of practices to scrutiny, and provides that sanctions can be recommended and imposed for practices that have the potential for undermining the "efficiency, workability, or reliability of the ISO Markets."

Given the interrelation of these various practices, the ISO believes that the Commission should not limit this proceeding to the presentation of evidence and determination of damages associated with the discrete Gaming Practices identified in the Show Cause Order. Instead, the Commission should allow the presentation of evidence that entities engaged in gaming and manipulation not only with respect to those transactions specifically associated with an individual Gaming Practice, but also through a pattern of behavior, which may have involved practices that, analyzed in a vacuum, appear benign, but actually operated as part of a larger strategy to manipulate the California electricity markets.

B. The Commission Should Allow the ALJ to Consider Additional Monetary Remedies Beyond Disgorgement

In the Show Cause Order, the Commission directs the ALJ presiding over the evidentiary hearing to quantify

> the full extent to which the entities named [in the Show Cause Order] may have been unjustly enriched by their engaging in Gaming Practices. We require that any and all such unjust profits for the period January 1, 2000 through June 20, 2001 be disgorged in their entirety. We also direct the ALJ to consider any additional, appropriate non-monetary remedies, as may be appropriate . . . .

Show Cause Order at p. 71

This approach is problematic for several reasons. Simply disgorging profits from individual transactions when gaming is detected provides no disincentive to sellers to engage in these practices. In fact, unless all of the revenues from all gaming behavior, including the interactions of gaming with other market activity, are detected and disgorged, disgorgement actually provides an economic incentive for entities to continue engaging in such behavior (since the only potential consequence is loss of profit on individual transactions, and the likelihood of such disgorgement is less than 100%). At the same time, this approach ultimately prevents consumers from being made whole for the full costs imposed by gaming.

In addition, in structuring the disgorgement penalty to focus on discrete practices, and the profits associated with those practices, the Commission ignores the overall market impacts of these behaviors. As explained in the preceding section, the manipulation and gaming engaged in by entities during the time period under investigation cannot simply be boiled down to a laundry list of discreet and unrelated activities. For the same reasons, neither can the financial impact, in terms of both profits received and damage done to the California electricity markets, be confined so neatly. For example, many of the practices clearly had the impact of raising overall market prices received by the offending parties for other sales, as well as prices received by all suppliers and paid by all buyers in the market. In such cases, the simple addition of all of the unjust profits directly associated with each of the Gaming Practices received by the

entities subject to the Show Cause Order will not result in the disgorgement of all profits received as a result of the manipulative behavior of entities during this time period. Without a more comprehensive remedy, Participants will not be fully and completely deterred from engaging in future misconduct, and buyers are not made whole. The financial impact of each of the individual Gaming Practices, as set forth in the ISO Reports and the studies provided by the California Parties, which the Commission relied on in the Show Cause Order, should therefore be treated as a reference point for determining the appropriate penalties to be imposed, rather than as a set of already determined penalties.

The ISO understands that because of the complexity of these issues and the interactions between the various gaming and manipulation behaviors, an accurate and exact quantification of the financial impact of these behaviors on the California electricity markets will most likely never be possible. However, this should not preclude the adoption of a remedy that comes closer than does the Commission's "discrete disgorgement of profits" remedy to negating the overall effects of market manipulation and gaming on the California markets during the time period at issue. One alternative would be to implement, as a baseline, a proxy mitigated price methodology of the type proposed by the California Parties, and endorsed by the ISO, in their filings made in the 100 Day Discovery proceeding. See Exh. ISO-1 at 44-46; CAL-3 at 73-92.[7] However, even if the Commission declines to adopt this approach, it should, at a minimum, find that

[7] In addition to this proxy price, the Commission should, in appropriate circumstances, still impose additional non-monetary sanctions of the type discussed in the Show Cause Order (e.g., revocation of an entity's market based rate authority).

the ALJ has the authority to recommend the adoption of monetary market remedies, applicable to all Participants, in order to make the market whole.

C. The Commission Should Find that Market Participants who Engaged in the Practice of Overscheduling Load are Subject to Penalties, Including Disgorgement of Profits, for that Behavior

In the Show Cause Order, the Commission found that the practice of Overscheduling of Load, because it involved the submission of false information to the ISO (in the form of false load schedules), constituted a violation of the MMIP. Nevertheless, the Show Cause Order declined to seek disgorgement of any profits associated with this practice due to a series of "countervailing circumstances." However, several of the Commission's conclusions with respect to these "countervailing circumstances" are in error. Therefore, the Commission should reverse its conclusion in the Show Cause Order, and require that any entities that are shown to have engaged in Overscheduling of Load disgorge any profits associated with this practice.

First, the Commission cited no convincing evidence in the record that "the market participants who engaged in Overscheduling Load did so as a direct response to the utilities practice of Underscheduling Load." *Id.* at p. 60. The only evidentiary support that the Show Cause Order provided for this finding is a single citation to unspecified statements or information supposedly contained in an August 2000 Report prepared by the ISO's Department of Market Analysis

("DMA").[8] However, that report actually reached the *opposite* conclusion, namely, that underscheduling of load by buyers was the result of underscheduling of supply by sellers and the exercise of market power in the Day-Ahead Market.[9] In fact, while the August 2000 DMA Report contains a detailed discussion of *underscheduling of load by buyers*, the report did not discuss or even mention *overscheduling of load by suppliers*. In other reports and filings prepared by DMA in which the issue of overscheduling of load by suppliers has actually been addressed, DMA has consistently found that the practice of first withholding supply from the forward markets, overscheduling load, and then bidding excessively high in the real time market does represent an exercise of market power. [10]

Another reason given in the Show Cause for not imposing monetary penalties on those entities who engaged in overscheduling is that "participants who engaged in Overscheduling Load did not set the market clearing price because, as uninstructed energy, they were price takers who were paid the ex-post price . . . set by the bid of the marginal unit dispatched." Again, the validity of this "countervailing circumstance" is not supported by the materials cited in the

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[8] *Report on California Market Issues and Performance: May-June 2000*, Special Report , by Department of Market Analysis, California ISO, August 10, 2000. ("August 2000 DMA Report")

[9] As noted in the August 2000 DMA Report, "Within the current design of California's energy markets, the ability of buyers to limit the prices they are willing to pay in the forward energy markets and shift demand into the real time imbalance market represents one of the major ways that large buyers can limit overall costs and defend against market power." August 2000 DMA Report at 25.

[10] *See, e.g.*, Supplemental Analysis of Trading and Scheduling Strategies Described in Enron Memos, (June 2003), available at http://www.caiso.com/docs/2003/06/18/2003061806053424839.pdf;b and *Responsive Filing of the California Independent System Operator*, Docket Nos. EL00-95-069, et al. (March 20, 2003) at 8, available at http://www1.caiso.com/docs/2003/03/21/2003032109052124535.pdf

Show Cause Order, and moreover, is contradicted by evidence on record in these proceedings. As noted in the ISO's March 20, 2003 rebuttal filing in the 100-Day Discovery proceeding (Docket Nos. EL00-95-069, *et al.*), the practice of Overscheduling Load by many large sellers did not represent benign "price taking" behavior; it was intended to, and did, increase overall market costs. Exh. ISO-1 at 9-12. By withholding capacity from the forward markets, and then employing a variety of other manipulative bidding and scheduling practices, certain suppliers increased the prices they were paid in the real-time market. The connection between overscheduling of load and manipulative bidding strategies aimed at spiking real-time prices is evidenced by the fact that Enron and Powerex, the two sellers who consistently overscheduled the largest amount of load, were also among those suppliers who bid at the highest levels in the real-time market. In addition, Powerex also sought to artificially inflate the real time price received for overscheduled load, through strategies such as "hockey-stick bids," in which large amounts of capacity typically offered in previous days or hours were suddenly withdrawn, and anomalous decremental energy bids were submitted to inflate the ISO target price. Exh. ISO-1 at 11-12.

Finally, it is important to recognize that overscheduling of load, because it was a key component in the overall strategy to raise real-time prices and realize profits from those increased prices, constitutes another way in which participants exercised market power during the period under investigation. This strategy began with the withholding of capacity in the forward markets run by the PX, and continued with the overscheduling of load with the ISO, with the knowledge that

the price received by the scheduled generation could then be raised through a variety of other practices, including physical and economic withholding of other available capacity. This type of behavior should not be brushed aside by the Commission. Thus, even if the Commission declines to impose penalties on entities that engaged in overscheduling in the context of the present proceeding, the ISO submits that the Commission should clarify that these practices, because they suggest a pattern of physical withholding in the forward PX markets, and were a means of profiting from both physical and economic withholding in the real-time market , will be subject to Staff's investigation of anomalous bidding practices in the IN03-10-000 docket.

D. The Commission Should Find that the Practice of Ancillary Services Buyback Constitutes a Gaming Practice Rather Than Legitimate Arbitrage

In the Show Cause Order, the Commission found that

> to the extent a market participant was merely taking advantage of the systematic differences in the day-ahead and hour-ahead market prices for ancillary services by selling ancillary services in the day-ahead market and buying them back at a lower price in the hour-ahead market, we find this practice to be consistent with legitimate arbitrage.

Show Cause Order at p. 64.

The Commission reasoned that so long as the participant actually had the generation available to provide the service, this practice was nothing more than a method to "reap a valid profit from the price differential in the day-ahead and real-time markets." *Id.*

The Show Cause order's conclusion on this issue is incorrect, and the ISO therefore respectfully requests that it be reversed. In reality, the practice of Ancillary Services "buyback" represents an abuse of the current settlement provisions for Day Ahead Ancillary Service commitments and negatively impacts system reliability. The Commission's conclusion that this practice constitutes "legitimate arbitrage" is based on the erroneous premise that the ISO's Day-Ahead and Hour-Ahead Ancillary service markets are simply "financial markets" for a single "fungible commodity," rather than separate markets for two distinct physical products.

The ISO's Tariff and Protocols clearly indicate that Ancillary Service schedules submitted in the Day Ahead market represent "binding commitments" for physical capacity and that "the ISO will require SCs to honor their Day-Ahead Ancillary Services schedules." ISO Tariff, Section 2.5.21; ISO Tariff, Schedules and Bids Protocol, Section 5.3; ISO Tariff, Scheduling Protocol, Sections 9.1, 9.3. The reason for including this language is twofold. First, Ancillary Service capacity is a physical commitment (or product) that is essential to meet the demand for system reliability, rather than simply a "financial position" for a "commodity." Secondly, due to various constraints and characteristics of resources that comprise the supply of Ancillary Services, Ancillary Service commitments procured by the ISO on a Day-Ahead basis are not directly "fungible" with commitments procured by the ISO on an Hour-Ahead basis. For instance, due to the lead times and scheduling requirements necessary to ensure that many resources can be available to provide reserve capacity in real time, the

ISO must purchase the bulk of its Ancillary Service requirements on a Day-Ahead basis in order to ensure that sufficient supply of such unloaded capacity is procured. Thus, capacity procured in the Day-Ahead and Hour-Ahead markets are two distinct physical products, offering different degrees of system reliability. Although the ISO conducts an Hour-Ahead market for Ancillary Services, the ISO purchases the bulk of its Ancillary Service requirements in the Day-Ahead market to better ensure system reliability.

While the ISO seeks to lower its purchase costs by deferring some portion of its Ancillary Service purchases from the Day-Ahead to the Hour-Ahead market when Hour-Ahead prices are lower, the ISO must limit the portion of Ancillary Service capacity purchased in the Hour-Ahead market due to uncertainty about the available supply of reserve capacity on an Hour-Ahead basis, even if the prices in the Hour-Ahead market may be systemically lower than Day-Ahead prices. When participants seek to profit from such price differences by canceling commitments made in the Day-Ahead market, the direct impact of this "arbitrage" is to require the ISO to procure a higher portion of its reliability requirements in the Hour-Ahead market. The net result of this practice is to reduce the ISO's ability to manage system reliability and costs through its Ancillary Service procurement decisions.

For example, consider a scenario in which the ISO determines that the best way to balance system reliability and costs during an hour is to procure 80% of its Ancillary Service needs in the Day-Ahead market, and to defer 20% of its requirements to the Hour-Ahead market, in which prices are expected to be

lower. If participants seeking to "arbitrage" this price difference commit to meeting 10% of the ISO's Ancillary Service needs in the Day-Ahead market, and then require the ISO to "buy back" this capacity (on behalf of Market Participants) in the Hour-Ahead market, the net result of this "arbitrage" is that the ISO ultimately procures only 70% of its Ancillary Service needs in the Day-Ahead market, and defers 30% of its requirements to the Hour-Ahead market – which significantly exceeds the volume of reserve requirements that could be deferred to the Hour-Ahead market without ultimately reducing system reliability in the judgment of the ISO Operations staff.

This example amply demonstrates that the practice of Ancillary Services buyback is not merely a benign form of economic arbitrage. By reducing the ISO's ability to reliably manage the grid, it clearly constitutes taking unfair advantage of the rules and procedures set forth in the ISO Tariff in a manner that may "have the effect of, or potential for, undermining the efficiency, workability or reliability of the ISO Markets. " ISO Tariff, MMIP 2.3.23 (description of anomalous behavior subject to sanctions including fines or suspensions). Therefore, the Commission should reverse its finding on this issue, and conclude that the practice of Ancillary Services buyback is a Gaming Practice, and therefore subject to disgorgement and other appropriate penalties, unless sellers can demonstrate that capacity they had sold in the Day-Ahead market was repurchased in the Hour-Ahead market due to unforeseeable or uncontrollable factors which made sellers unable to honor firm capacity commitments made in the Day-Ahead market.

Should the Commission fail to adopt the above approach, the ISO submits that the Commission should clarify that all participants identified as having earned significant revenues (*i.e.* greater than $10,000) from the repurchase of Ancillary Services in the Hour-Ahead market at prices lower than the Day-Ahead market should, in the context of the Show Cause proceedings, bear the burden of proof in demonstrating that capacity repurchased in the Hour-Ahead market was actually available, and that these buybacks did not constitute "Paper Trading."

E. The Commission Should Find that the Practice of False Import Is Subject to Appropriate Penalties, Including Disgorgement, for the Entire January 1, 2000 through June 20, 2001 Period

In the Show Cause Order, the Commission concluded that, with respect to the practice of False Import, the monetary remedy of disgorgement would only apply for the time period May, 2000 through October 2, 2000. The Commission based this determination on the fact that energy prices in the ISO Market, including imports, are being mitigated in the Refund Proceeding during the period subsequent to October 2, 2000. The ISO respectfully requests that the Commission reconsider this conclusion and expand the period for which monetary penalties would apply to False Import transactions to encompass the entire period covered in these proceedings, i.e., January 1, 2000 through June 21, 2001.

By restricting the beginning date to May 2000, the Show Cause Order fails to capture all of the potential False Import behavior detected by the ISO. In the

ISO's Technical Supplement to Source Data, filed with the Commission on July 16, 2003, the ISO showed that some transactions during the January 1, 2000 through May 1, 2000 period qualify as potential False Import transactions. Technical Supplement to Source Data, filed in Docket Nos. EL03-137-000, *et al.* (July 16, 2003) at 5, Figures 1-3 ("July Technical Supplement"). In the Show Cause Order, the Commission provided no rationale as to why it did not include this period in the period subject to investigation. Because there may well have been trades that qualify as False Import transactions, the Commission should set the starting date for the period that False Import transactions are subject to monetary penalty at January 1, 2000.

With respect to the end date of October 2, 2000, the Commission seems to have selected this date based on the rationale that the refund mitigation measures that apply from that date through June 20, 2001 are sufficient to remedy any False Import practices that occurred during that period. Such a conclusion is flawed. The mitigated price only operates to reset the clearing price for the intervals and hours during that period to a level found to be just and reasonable. Under the Commission's approach, profits made on a sale at a price greater than the level of the mitigated price for a particular interval or hour must be refunded. However, this does not effectively disgorge profits from Market Participants who engaged in Gaming Practices such as False Import, because it is entirely possible that Participants engaging in False Import, even if they only receive the mitigated market clearing price for these sales, would still realize a profit in the form of any difference between the cost of producing or procuring the

energy and the mitigated market clearing price. In addition, Market Participants engaging in the practice of False Import could also have made profits during intervals or hours in which the price paid to these participants is not being mitigated in the Refund Proceeding, due to the exclusion of a variety of categories of out-of-market sales from mitigation in the refund proceedings. Therefore, relying on the mitigated clearing price regime does not insure that Participants that engaged in False Import behavior actually suffer the appropriate minimum sanction of disgorgement. Clearly, this result must be the opposite of what the Commission intended to accomplish in the Show Cause Order. The Commission should, for this reason and the reason detailed in the preceding paragraph, set the date for which entities are subject to the requirement to show cause for False Import to the period January 1, 2000 through June 20, 2001.

F. The Commission Should Clarify that the Practice of False Import Applies to All Transactions in Which Entities Falsely Represented to the ISO that their Available Power Had Been Imported

In the Show Cause Order, the Commission explained the practice of False Import as

> [taking] advantage of the price differentials that existed between the day-ahead or day-of markets and out-of-market sales in the real-time market. A market participant made arrangements to export power purchased in the California day-ahead or day-of markets to an entity outside the state and to repurchase the power from the out-of-state entity, for which the out-of-state entity received a fee. The "imported" power was then sold in the California real-time market at a price above the cap.

Show Cause Order at p. 37.

The Commission stated that those entities who engaged in the False Import practice violated the MMIP by unfairly taking advantage of the rules permitting energy to be purchased at prices above the cap in OOM purchases during real-time and by deceiving the ISO by "falsely representing that their available power had been imported in order to receive a price above the cap. In fact, however, the generation was California generation, and no power had left the state in the fictional export-import parking transaction." *Id.* at p. 39.

The ISO seeks clarification that the Commission did not intend, by focusing on day-ahead or day-of purchases for export, to limit the definition of False Import to *only* those transactions that involved a day-ahead or day-of purchase of power through the California Power Exchange ("PX") markets by one entity, parking of the power with a separate out-of-state entity, and finally repurchase and sale of the power by the first entity in an OOM transaction in real time. As the California Parties pointed out in their Expedited Motion for Clarification, a generator within the ISO could have engaged in False Import behavior by selling power to an out-of-state entity through a direct bilateral arrangement, rather than purchasing the energy through the day-ahead or day-of PX markets, prior to repurchasing and selling that power in the ISO's Real-Time Market. California Parties' Expedited Motion for Clarification of Show Cause Order, filed in Docket Nos. EL03-137, et al. (July 11, 2003) at 5. Moreover, the practice of False Import could also involve entities purchasing power within California and "exporting" it to themselves in the Day-Ahead and Hour-Ahead markets and then selling it back to the ISO in real-time, rather than using a

second party to accomplish the False Import transaction. Finally, the "re-import" stage of a False Import transaction may have involved a sale other than an OOM sale to the ISO.

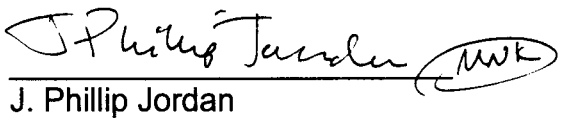
Although these transactions do not meet the narrow description of a False Import transaction in the Show Cause Order, treating them as such is consistent with the Commission's rationale for concluding that False Import transactions constitute a Gaming Practice in the first place. That is, all involve a misrepresentation to the ISO that the applicable power had been imported from out of state, when, in fact, the generation was California generation that had never left the state. Moreover, treating these types of transactions as False Imports would appear to be consistent with the Commission's intent, given that the Commission adopted as the list of entities that are required to show cause as to this issue almost exactly the list of entities that were named in the ISO Reports as possibly having engaged in Ricochet (*i.e.* false import) transactions. In fact, the Commission stated that its list of entities that might have engaged in False Import sales was based on the ISO's Report. If the definition of False Import was artificially limited to only those transactions involving two parties, a day-ahead or day-of purchase from the PX, and a sale into the real-time market through an OOM transaction, then Identified Entities would be far fewer in number than the list set forth in the Show Cause Order. Moreover, such a narrow definition is inconsistent with the definition of false import found in the ISO Reports which defines this practice as the "export of power from an SC's resource portfolio within the ISO system on a Day-Ahead or Hour-Ahead basis, and a resale of

power back into the ISO system in Real Time (through either a sale in the ISO Real Time Market or an out-of market sale)." ISO June, 2003 Report at 24. For these reasons, the most sensible approach would be to require explanation and allow further investigation, within the context of a Show Cause proceeding, of any exports scheduled on a Day-Ahead or Hour-Ahead basis that could be associated with a simultaneous sale of real time energy as an import. Such an approach would be consistent with the Commission's stated rationale for finding that False Import constituted a violation of the MMIP, as well as the ISO's own definition of false import. Therefore, the Commission should clarify that the practice of False Import is not limited to Day-Ahead or Day-Of purchases through the PX for export that are parked with an out-of-state entity and re-imported as OOM, but applies to any transaction in which an entity falsely represented that power had been imported, when, in fact, no power had left the state at all.

IV. CONCLUSION

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

Respectfully submitted,



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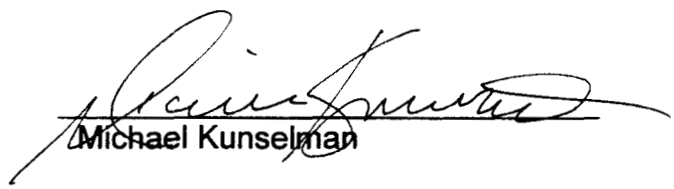
Dated: July 25, 2003

CERTIFICATE OF SERVICE

I hereby certify that I have caused the foregoing document to be served by first class mail, postage prepaid, upon each person designated on the official service list compiled by the Secretary in this proceeding.

Dated at Washington, D.C. this 25th day of July, 2003.



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