UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

California Independent System Operator Corporation	**)** **)**	**Docket No. ER03-1102-000**

ANSWER OF THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION TO MOTIONS TO INTERVENE, COMMENTS AND PROTESTS

I. INTRODUCTION AND SUMMARY

On July 22, 2003, the California Independent System Operator Corporation ("ISO" or "CAISO")[1] filed Amendment No. 55 to the ISO Tariff in the above-captioned proceeding ("Amendment No. 55")[2]. Amendment No. 55 would modify the provisions of the ISO Tariff in several important respects by establishing, *inter alia*, an Oversight & Investigation ("O & I") program that would improve upon the ISO's current market investigation and enforcement mechanisms. The O & I proposal builds upon the ISO's efforts since start-up to monitor its markets and report the exercise of market power, and is the result of a process -- the "Oversight and Investigations Activities Review" -- that the ISO initiated by market notice on June 14, 2002. The O & I Activities Review provided a forum for the evaluation of the ISO's authority, responsibilities, and

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[1] Capitalized terms not otherwise defined herein shall have the meaning set forth in the Master Definitions Supplement, Appendix A to the ISO Tariff.

[2] On August 6, 2003, the Independent Energy Producers Association ("IEPA") and various Supporting Parties filed a motion for an extension of time for the filing of comments in response to the proposed Amendment to the ISO Tariff captioned above. ("IEPA Motion") The Commission, on August 8, 2003, granted the motion and set the due date for comments on the ISO proposal to August 18, 2003.

activities in the areas of market monitoring, investigation, and enforcement. The proposals in Amendment No. 55 are the result of this process. They are designed to enhance market operations and grid reliability, reduce opportunities for gaming, more actively coordinate market investigations with the Commission and other oversight and law enforcement agencies, and increase economic efficiency in the ISO Market.

Amendment No. 55 would implement several coordinated strategies to assure Market Participants that prompt action will be taken, and effective sanctions will be promptly imposed, when the ISO identifies instances of gaming, market manipulation, and/or non-compliance with ISO Tariff obligations. The proposal is comprised of the following key features for which the ISO seeks Commission approval:

(1) proposed Rules of Conduct based largely on the "minimum behavioral rules" specified by the Commission in its Notice of Proposed Rulemaking on Standard Market Design issued in Docket No. RM01-12 ("SMD NOPR");

(2) pre-defined penalties for breach of these Rules of Conduct, which penalties the ISO would have authority to impose directly (in addition to referral to the Commission);

(3) procedures for routine sharing, subject to adequate protections, of market data and other information with certain state and federal oversight and enforcement "partner" agencies including the Commission.

The ISO requested that the provisions of Amendment No.55 be made effective September 20, 2003. Commission approval of the proposed amendment by this date would greatly facilitate maintenance of the integrity of the ISO Markets. A number of parties have moved to intervene in the present

proceeding, and many of these parties have commented on or protested Amendment No. 55.[3] Pursuant to Rules 212 and 213 of the Commission's Rules of Practice and Procedure, 18 C.F.R. §§385.212, 385.213, the ISO hereby files its answer to the comments, and requests protests.[4] The ISO does not oppose the intervention of any party. However, as explained below, the ISO believes that Amendment No.55 should be accepted by the Commission in its entirety, and the Commission therefore should reject the protests. No intervenor objects to the general concept of a more focused O & I program. Three intervenors affirmatively support the ISO's filing, and six raise no substantive issues with the proposal for the ISO Market.[5] The arguments of various intervenors who filed

[3] Motions to intervene, comments and protests were filed by the following entities: the California Electricity Oversight Board ("EOB"); Southern California Edison Company ("SCE");the Metropolitan Water District of Southern California ("MWD"); the Transmission Agency of Northern California ("TANC"); Automated Power Exchange ("APX"); City of Vernon ("Vernon"); the M-S-R Power Agency, and the Cities of Redding and Santa Clara California and Silicon Valley Power ("Cities/M-S-R");the Western Power Trading Forum ("WPTF"); Tucson Electric Power ("TEP"); Turlock Irrigation District ("Turlock"); Electric Power Supply Association ("EPSA"); the City and County of San Francisco (" San Francisco"); Northern California Power Agency ("NCPA"); Department of Water Resources-State Water Project ("State Water Project");Powerex Corporation ("Powerex"); the California Public Utilities Commission ("CPUC"); Pacific Gas and Electric Company ("PG&E"); California Municipal Utilities Association ("CMUA"); California Department of Water Resources ("CDWR"); the Cogeneration Association of California ("CAC"); the Independent Energy Producers Association ("IEPA"); FPL Energy ("FPL"); Strategic Energy L.L.C. ("Strategic"); Modesto Irrigation District ("Modesto"); Duke Energy North America LLC and Duke Energy Trading and Marketing, L.L.C.("Duke"); Calpine Corporation ("Calpine") the cities of Anaheim, Azusa, Banning, Colton, and Riverside, California (" Southern Cities"); Sempra Energy ("Sempra") Indicated Generators ("Generators"). A motion to intervene out-of-time was filed by Pinnacle West.

[4] Some of the parties that have submitted filings concerning Amendment No. 55 request affirmative relief in pleadings styled as protests. Under the Commission's Rules of Practice and Procedure, answers to protests are not generally permitted. 18 C.F.R. § 385.213 (2003). However, on August 29, 2003, the ISO filed with the Commission leave to file an answer to these protests. Therein, the ISO explained that good cause existed for accepting this answer because it would assist the Commission in understanding the issues in this proceeding and assist the Commission in its decision-making process.

[5] Interventions supportive of Amendment No. 55 were filed by San Francisco, the EOB and the CPUC. Interventions containing no substantive comments were filed by Calpine, Turlock, Tucson, Dynegy, DWR, the California Attorney General, and Pinnacle West. Interventions by these entities will not be discussed further in this Answer.

substantive protests or comments suggesting modifications to the ISO's proposal are addressed below.

II. ANSWER

A. THE RULES OF CONDUCT PROPOSED IN AMENDMENT 55 ARE SUFFICIENTLY CLEAR TO PUT MARKET PARTICIPANTS ON NOTICE AS TO THEIR OBLIGATIONS

A number of intervenors contend that the Rules of Conduct proposed by the ISO in Amendment No. 55, in particular the Rules of Conduct set forth in the Enforcement Protocol ("EP"), Section 2, are too vague, leave the ISO with too much discretion, and will subject Market Participants to substantial penalties without due process. Many of these allegations of vagueness are aimed at specific rules set forth in the EP. The ISO will address such concerns below in the sections devoted to discussion of the particular Rules of Conduct. However, several intervenors direct their comments concerning vagueness at the ISO's Rules of Conduct as a whole.[6] These arguments are unconvincing.

As a whole, the Rules of Conduct set forth in EP Section 2 are sufficient to provide Market Participants with an adequate understanding of what behavior is prohibited, and therefore subject to penalty, as well as adequately to limit the ISO's discretion in determining which Market Participant actions are subject to penalty. They describe in sufficient detail the behavior that triggers the penalties set forth in the rules. This is highlighted by the fact that the Commission recently

[6] SMUD at 9-10, SCE at 2-3.

found that the provisions of the ISO's existing MMIP concerning "gaming"[7] and "anomalous market behavior"[8] were sufficiently detailed to put Market Participants on notice that specific types of behavior are prohibited under those provisions, even though particular behaviors are not specifically described in the MMIP. In addressing whether the definitions of "gaming" and "anomalous market behavior" are sufficiently precise to operate as a prohibition against specific trading practices, the Commission concluded that they are, explaining: We agree with the Staff Final Report that one key function of the MMIP is to put market participants on notice as to the rules of the road for market participants, so that

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[7] The MMIP defines "gaming" as taking unfair advantage of the rules and procedures set forth in the PX or ISO Tariffs, Protocols or Activity Rules, or of transmission constraints in periods in which exist substantial Congestion, to the detriment of the efficiency of, and of consumers in, the ISO Markets. "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 hydropower output or seasonal limits on energy imports from out-of-state, or actions or behaviors that may otherwise render the system and the ISO Markets vulnerable to price manipulation to the detriment of their efficiency.

ISO MMIP, Section 2.1.3.

[8] The MMIP defines "anomalous market behavior" as:

> behavior that departs significantly from the normal behavior in competitive markets that do not require continuing regulation or as behavior leading to unusual or unexplained market outcomes. Evidence of such behavior may be derived from a number of circumstances, including:
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> withholding of Generation capacity under circumstances in which it would normally be offered in a competitive market;
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> unexplained or unusual redeclarations of availability by Generators; unusual trades or transactions;
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> pricing and bidding patterns that are inconsistent with prevailing supply and demand conditions, e.g., prices and bids that appear consistently excessive for otherwise inconsistent with such conditions; and
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> unusual activity or circumstances relating to imports from or exports to other markets or exchanges.

ISO MMIP, Sections 2.1.1. to 2.1.1.5.

the markets operated by the ISO are free from abusive conduct and may function as efficiently and competitively as possible. The Staff Final Report finds, and again we agree, that market participants cannot reasonably argue that they were not on notice that conduct such as the Gaming Practices discussed below would be a violation of the ISO and PX tariffs. In short, the key function of the MMIP is to put market participants on notice of what practices would be subject to monitoring and, potentially, corrective or enforcement action, by either the ISO in the first instance or by the Commission, whose role includes enforcing the terms and conditions of filed rate schedules. Accordingly, it is appropriate for us to institute this proceeding.

103 FERC 61,345 at P 23 (2003)("Show Cause Order")

The Rules of Conduct proposed in the EP are more detailed than the "gaming" and "anomalous market behavior" provisions of the MMIP, in terms of the types of behavior that trigger their prohibitions. Most of the Rules of Conduct define and proscribe a specific form of behavior. For instance, EP 2.3 requires that Market Participants must "bid and/or schedule Energy and Ancillary Services from resources that are available and capable of performing at the levels specified in the bid and/or schedule." Only EP 2.9 (No Detrimental Practices) and EP 2.10 (No Market Manipulation) are as generally phrased as the MMIP provisions which the Commission already has found to be sufficient to prohibit specific behavior. The language of these provisions is quite similar to the MMIP provisions concerning "gaming" and "anomalous market behavior." However, with respect to EP 2.9 and 2.10, the ISO has proposed a special procedure in

Section 4 of the Enforcement Protocol that will require the ISO to notify Market Participants and the Commission as to the *specific* behaviors that the ISO finds to be in violation of these two provisions. In that regard, EP 4 requires that, prior to proscribing any specific type of behavior pursuant to EP 2.9 or 2.10, the ISO first issue and file with the Commission a Preliminary Market Notice or Formal Warning, which specifies the behavior that is subject to investigation, provides an example of the behavior, and identifies the Rules of Conduct potentially violated by that behavior. Then, the ISO will conduct an investigation pursuant to procedures set forth in Section 3 of the EP in order to determine whether the specific behavior under consideration should be prohibited. Finally, if the ISO determines that the behavior should be prohibited under either EP 2.9 or EP 2.10, the ISO must post a Final Market Notice, no less than 48 hours after issuance of the Preliminary Market Notice. It is only after the issuance, and the filing with the Commission, of this Final Market Notice that the ISO can begin to assess penalties against Market Participants for violations of the specific behavior described in the market notices. Moreover, the ISO can only impose penalties for behavior that occurred subsequent to the issuance of the Final Market Notice.

Further, many of the Rules of Conduct in the Enforcement Protocol are consistent with the Commission's proposed rules governing Market Participant conduct as set forth in its SMD NOPR. Therein, the Commission states that, *at a minimum*, an Independent Transmission Provider's tariff should contain rules concerning: (1) physical withholding; (2) economic withholding; (3) availability

reporting; (4) factual accuracy; (5) information obligation;(6) cooperation; and (7) physical feasibility. SMD NOPR at P. 445. This is almost precisely the same set of rules that the ISO has proposed in the Enforcement Protocol. Moreover, the ISO's definitions closely match those set forth in the SMD NOPR. For example, one of the minimum behavior rules set forth in the SMD NOPR is entitled Availability Reporting, which the Commission defines as follows:

> **Availability Reporting:** Entities must comply with all reporting requirements governing the availability and maintenance of a Generating Unit or Transmission Facility, including proper Outage scheduling requirements. Entities must immediately notify the Independent Transmission Provider when capacity changes or resource limitations occur that affect the availability of the unit or facility or the ability to comply with dispatch instructions.

SMD NOPR P. 455. EP 2.6, entitled "Comply with Availability Reporting Requirements, is almost identical:

> **General Rule:** Market Participants must comply with all reporting requirements governing the availability and maintenance of a Generating Unit or transmission facility, including proper Outage scheduling requirements. The responsible entity (Scheduling Coordinator or Participating Transmission Owner) must immediately notify the ISO when capacity changes or resource limitations occur that affect the availability of the unit or facility or the ability to comply with Dispatch Instructions.

The ISO also notes that its proposed Rules of Conduct provide specificity comparable to, and in most instances greater specificity than, the market behavior rules that the Commission has proposed as conditions of a utility's market-based rate authorization in Docket No. EL01-118. *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 103 FERC ¶ 61,349 (2003) ("Market Behavior Rules Order"). Under these circumstances, the

Commission should find that the ISO's Rules of Conduct are sufficiently detailed and provide Market Participants with adequate notice of their obligations under such Rules.

Finally, NCPA argues that Amendment No. 55 is inconsistent with the Commission's proposal in the Market Behavior Rules Order proceeding.[9] This argument is without merit. The Commission initiated this docket separate and apart from its SMD NOPR. The separate and ongoing existence of both demonstrates the Commission's belief that a strong monitoring and enforcement plan overseen by the applicable Independent Transmission Provider, and certain rules imposed as a condition of a company's market-based tariff authority, are both important components in ensuring that wholesale electricity markets are free of the taint of detrimental behavior.

B. THE COMMISSION IS AUTHORIZED TO GRANT THE AUTHORITY REQUESTED IN AMENDMENT NO. 55

Two intervenors argue that the ISO, through EP 1.9 improperly attempts to grant the Commission more power than the Commission itself has.[10] Other intervenors argue that the Commission cannot, or should not, delegate the authority requested by the ISO in Amendment No. 55.[11] Neither of these arguments is convincing.

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9 NCPA at 3.

10 TANC at 14-15; Generators at 11-12.

11 MID at 6; Cities/M-S-R at 7-8; NCPA at 4-15; Generators at 12-13

First, with respect to the arguments that the ISO cannot grant the Commission greater authority than the Commission is itself given in the Federal Power Act ("FPA"), intervenors fail to understand that the terms of the Enforcement Protocol, as with all tariff provisions, are proposed as conditions of taking service from the ISO. Section 205 of the FPA permits regulated utilities to file proposed rates and terms and conditions of service. The terms of service of a jurisdictional utility are not limited to the powers affirmatively granted to the Commission by Congress through the FPA.[12] Indeed, if that were a prerequisite, the Commission would be unable to approve most of the provisions found in the tariffs of the companies it regulates. The only requirement is that all terms and conditions of service must be "just and reasonable." It is the Commission's duty to enforce this requirement.

Therefore, the appropriate question to ask with respect to the ISO's proposed Rules of Conduct and associated penalties is not whether the FPA explicitly grants the Commission the authority to impose the conditions of service proposed by the ISO in Amendment No. 55, but whether those conditions are just and reasonable. The ISO submits that they are. The rationale for adopting the proposed Rules of Conduct is detailed in the ISO's Transmittal Letter accompanying the Amendment No. 55 filing ("Transmittal Letter"), and to the extent individual provisions have been challenged, those challenges are addressed below. No intervenor has made a credible showing that any of the

[12] The terms and conditions of service are more akin to a contract between the utility provider (the ISO) and entities who choose to take service from that provider (ISO Market

ISO's proposed Rules of Conduct are unjust or unreasonable. Moreover, as discussed in other sections herein, the ISO's proposal is consistent with the explicit direction of the Commission, as set forth in various orders, including, *inter alia*, the SMD NOPR, the Market Behavior Rules Order and several orders approving penalty provisions for other independent system operators.

The contention that the Commission cannot delegate penalty authority to the ISO is also without merit. As the ISO explained in the Transmittal Letter, the Commission has already approved sanctions for several other ISOs, including ISO-New England, the Northern Maine Independent System Administrator, and the Midwest ISO.[13] Many of the penalty provisions approved for those entities are similar to the provisions proposed by the ISO in Amendment No. 55.[14]

Moreover, as explained above, in the SMD NOPR, the Commission has itself proposed that all Independent Transmission Providers include certain minimum behavior rules for Market Participants in their jurisdictional tariffs. These rules are very similar, to the Rules of Conduct proposed by the ISO in the Enforcement Protocol, in both subject matter covered and actual language. In the SMD NOPR, the Commission also made clear that the market monitor would need to have "adequate authority to investigate Market Participant conduct and

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Participants), with the contract being the utility's FERC-jurisdictional tariff. Of course, a utility cannot simply impose any conditions of service that it wishes.

[13] Transmittal Letter at 30-40. Indeed, over the years, the Commission has approved some type of penalty authority for virtually every regulated public utility and natural gas company. It is frivolous for intervenors to argue that the Commission lacks the ability to approve penalty authority for the ISO.

[14] *Id.*

a set of predetermined penalties to apply to conduct that is in violation of the rules of the Independent Transmission Provider's tariff."[15] This is exactly what the ISO proposes in Amendment No. 55.

Indeed, the Commission has already granted the ISO penalty authority with respect to certain behaviors. For example, the Commission has approved penalty provisions relating to Uninstructed Deviations,[16] metering errors,[17] and contributing to an outage.[18]

Finally, it is important to keep in mind that any sanctioning authority that may be approved for the ISO ultimately allows the Commission to review the use of that authority. In the ISO's proposal, as with other penalty provisions for other independent system operators, the Commission is still the "court of last resort."[19]

C. THE RULES OF CONDUCT PROPOSED IN AMENDMENT NO. 55 WILL HELP TO ENSURE A HEALTHY AND ROBUST MARKET AND A RELIABLE TRANSMISSION SYSTEM

Several intervenors claim that the ISO's Amendment No. 55 initiative, in particular the proposed Rules of Conduct, is unnecessary in light of the Commission's own efforts to condition market-based tariffs on compliance with certain market behavior rules, the various mitigation measures already in place in California, and the Commission's ongoing oversight and authority.[20] One entity claims that the ISO has not shown that any of the "alleged market abuses" that

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15 SMD NOPR at P. 454.
16 ISO Tariff, Section 11.2.4.1.2.
17 ISO Tariff, Section 2.2.9.3.
18 ISO Tariff, Section 2.3.2.9.3.
19 *See* ISO Tariff Section 13.4 (providing right of appeal to the Commission from the decision of the arbiter in the ISO's ADR process).
20 IEPA at 3; Southern Cities at 8-9; Duke at 6-7.

prompted the O & I initiative still exist today, or are likely to continue in the future.[21]

First, there is no obligation on the part of the ISO to demonstrate that the provisions of Amendment No. 55 are "necessary," *per se*. Rather, the ISO is only required to show that the proposed Rules of Conduct and tariff modifications are just and reasonable. Nevertheless, in the Amendment No. 55 Transmittal Letter, the ISO explained in significant detail the need for the various Rules of Conduct and Tariff amendments.[22] Intervenors make no effort to rebut any of the specific rationales provided therein. Instead, they merely make general unsupported allegations that the ISO's proposal is unnecessary, and the Commission should afford them no consideration. These intervenors overlook the fact that the Commission has already concluded that the types of rules which the ISO is proposing in Amendment No. 55 are necessary going forward. As discussed above, in the SMD NOPR, the Commission, explicitly concluded that Independent Transmission Providers, such as the ISO, should have a market monitoring plan that includes a clear set of rules governing Market Participant conduct, along with a set of predetermined penalties to apply to conduct that is in violation of these rules. Intervenors' argument amounts to saying that the penalty provisions called for in the SMD NOPR are not needed in the one market in the country where real, well-documented and sustained abuses have occurred.

Finally, with respect to the argument that the ISO has not shown that any of the market abuses that gave impetus to the Rules of Conduct and Tariff

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[21] Duke at 7.

modifications proposed in Amendment No. 55 still exist, or will exist in the future, it is not logical to require a showing that improper conduct is occurring or necessarily will occur before implementing measures to prevent it from happening in the first place. The proposed rules of conduct are intended to deter inappropriate behavior. As the ages old adage wisely notes, "an ounce of prevention is worth a pound of cure."

D. IT IS APPROPRIATE TO IMPLEMENT AMENDMENT NO. 55 WITHOUT WAITING FOR THE CULMINATION OF THE ISO's MARKET REDESIGN EFFORT

Several entities contend that the Commission should not consider, or at least not approve the ISO's Amendment No. 55 proposal until such time as the ISO implements its Market Redesign ("MD02") initiative.[23] The ISO addressed this argument in detail in the Transmittal Letter, and there is no previously defined need to repeat that discussion here.[24] Briefly, the provisions of Amendment No. 55 address types of behavior that are not addressed by MD02, including behavior that the Commission itself has acknowledged has harmed California -- in particular, the various "Enron games." Adopting intervenors' position would essentially endorse the position that it is permissible to engage in improper behavior before implementation of MD02, but impermissible to engage in such behavior afterwards. For example, Market Participants should be able to submit false information before MD02 but should not be able to do so after

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22 Transmittal Letter at 30-72.

23 Duke at 6-7; Generator at 9, 14; Strategic Energy at 4, 10-12.

24 *See* Transmittal Letter at 19-20.

implementation of MD02. That is an arbitrary and illogical position. There is no "magic" for waiting until MD02 to implement these basic market rules, except to delay the implementation of such rules. It would be foolhardy to wait over a year, until the implementation of MD02, to institute a system of sanctions that will operate to deter inappropriate behavior in the ISO Markets. Amendment No. 55 will provide the ISO with a much needed means of penalizing those entities that do not cooperate with the ISO's market monitoring authority. It is appropriate and necessary to implement the Amendment No. 55 proposal separately from MD02 because the rules and sanctions contained in Amendment No. 55 are designed to preempt certain categories of behavior before they escalate into market-wide problems.

E. THE ISO's PROCESS FOR INVESTIGATING VIOLATIONS AND IMPOSING PENALTIES, AND THE PENALTIES THEMSELVES, ARE FAIR TO MARKET PARTICIPANTS

Intervenors raise a number of objections to both the substance of and the process for investigating violations and imposing penalties set forth in the proposed Enforcement Protocol. First, a number of intervenors claim that the size of the penalties is exorbitant. Several argue that the ISO's penalties are in excess of those adopted by other independent system operators.[25] Except in terms of these bare comparisons to other independent system operators, none of

[25] CMUA at 10 (stating that they can find no other ISO with penalties similar to the CAISO's); Generators at 22 (arguing that in comparison to penalties approved by the Commission for other ISOs, the CAISO's proposed penalties are "draconian"); MWD at 12 (claiming that the ISO's penalties "far exceed those used by other market monitors," such as ISO-NE).

these intervenors explains why, exactly, the ISO's penalty amounts are not just and reasonable.

In the SMD NOPR, the Commission set out the basic rationale for including predetermined penalties in an Independent Transmission Provider's tariff. The Commission explained that

> Since the tariff rules are intended to ensure the fair and efficient operation of the markets, the penalties should be *designed to deter conduct that is inconsistent with the fair and efficient operation of the markets*. Specifically, the penalties should deter conduct that results in an economic benefit derived from a violation of the rules. The penalties should, at a minimum, require payment of the economic benefit derived by the violator for violating the rules. Where the violation could result in conduct that could be harmful to the reliability of the grid, it would be appropriate for the penalty to be significantly higher to serve as a deterrent for the conduct.

SMD NOPR at P. 455 (emphasis added).

Deterring conduct that is "inconsistent with the fair and efficient operation" of the ISO Markets is one of the primary goals of the Enforcement Protocol.[26] With this objective in mind, the penalty amounts set forth in the Enforcement Protocol are quite reasonable given the history and circumstances of the California energy market.

Among the various independent system operators to which intervenors cite for purposes of comparing penalty amounts, the ISO is the largest in terms of the amount of load served in its control area.[27] This means that the financial

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[26] *See* EP 1.2 (" The objectives of this Protocol are to provide . . . (b) A deterrent to Market Participants from engaging in Detrimental Practices, Market Manipulation, and other activities that are inappropriate and inconsistent with the Rules of Conduct.").

[27] Historical hourly load information is available for the New York ISO ("NYISO") at http://www.nyiso.com/markets/index.html#NYCAInfo, and for ISO-NE at http://www.iso-ne.com/market_info/forecasted_vs_actual/. Hourly load information for the CAISO is available at oasis.caiso.com under the "system load" tab.

impact of malfeasance is potentially far greater in California than in the control areas of other independent system operators. Hence, providing an opportunity to impose larger penalties is warranted.

Moreover, the California electricity markets have an unfortunate history of market abuses and failure by numerous Market Participants to conform to basic standards of conduct that are important to well-functioning wholesale electricity markets. The history of apparent manipulation and gaming behavior in the ISO Markets is related in some detail in the Transmittal Letter; there is no reason to repeat it here.[28] The bottom line is that the level of market abuses in California has far exceeded the level of market abuses in the control areas operated by other independent system operators.[29] This fact alone suggests that a stronger deterrent is needed in California than is needed in other markets. In light of the various abuses that have occurred in the California market, the potential for significant consequences is necessary to send a strong signal to Market Participants that this type of behavior will not be tolerated. The ISO's proposed penalties accomplish this end, without being unduly burdensome. As such, they are just and reasonable and should be accepted by the Commission.

Finally, it must be noted that the penalty amounts set forth in the EP constitute maximum penalties for violations of the Rules of Conduct. Section 5 of the EP makes clear that the ISO will determine the penalty to be applied in specific instances by considering a number of possible mitigating factors. EP 5.1

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[28] *See* Transmittal Letter at 5-14.

[29] In addition, certain behavior detrimental to the reliability of the grid, such as non-compliance with operating orders issued by the ISO, failure to submit feasible bids and

(listing 19 possible mitigating factors). Although some intervenors argue that the ISO's maximum penalty levels are higher than those of other independent system operators, they fail to acknowledge that the ISO's proposed tariff requires consideration of a much larger number of mitigating factors than do the tariffs of other independent system operators or the Commission in the SMD NOPR.[30]

Several intervenors contend that the ISO's penalties should be limited to the market impact of the violation at issue. For instance, MWD argues that the Commission should order the ISO to implement an approach similar to the Midwest ISO, where no penalty is imposed unless the proscribed conduct is found to have an adverse impact on prices.[31] This argument is inconsistent with the Commission's statement in the SMD NOPR that the purpose of pre-defined penalties is to *deter* future misconduct.[32] If the ISO can impose penalties only in those situations where the ISO can show that the conduct at issue has had an adverse impact on prices, then much of the deterrent value of the proposed Rules of Conduct will be lost. MWD's proposal is fatally flawed because it will provide Market Participants with a "free pass" in every instance where a violation occurs but no showing can be made that that violation has had a palpable effect on market prices. This ignores that the proposed Rules of Conduct are designed not just to protect the workability of the ISO Markets, but also to ensure the reliable operation of the ISO Controlled Grid. It also overlooks the fact that the sanctions associated with those Rules are intended to deter conduct that has the

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schedules, and physical and economic withholding, has likewise been far too commonplace in the ISO Markets.

[30] *See* SMD NOPR at P 456.

potential to negatively impact reliability and/or market operations. Violations of the Rules of Conduct should not be excused merely because, in certain instances, they did not result in actual harm to reliability or market operations. Such a position is comparable to excusing attempted robbery merely because the crime was foiled. MWD's argument should be rejected.

A number of intervenors argue that the penalty provisions of the EP provide the ISO with too much discretion to determine the actual penalty imposed in specific circumstances, and that this discretion could lead to discrimination in the treatment of suppliers.[33] Once again, the intervenors ignore or overlook the Commission's direct statement on this issue. In the SMD NOPR, the Commission explained that "it may be appropriate to build into the tariff standards for mitigating the [standard] penalty."[34] The Commission obviously envisioned that independent transmission providers would have some discretion in fixing the exact level of penalty in each specific case, so long as the maximum penalties were clearly laid out in the relevant tariff. This is further reflected in the fact that the penalty mechanisms approved for other independent system operators allow those independent system operators latitude in setting the exact penalty amount.[35] The ISO's procedure for determining the appropriate penalty amount in each case is consistent with the Commission's direction in the SMD NOPR and the authority granted to other regulated public utilities and, therefore, should be found to be just and reasonable. The ISO also expects that its O & I program

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31 MWD at 13.

32 SMD NOPR at P. 455.

33 CAC at 3-4; Sempra at 22-23; Southern Cities at 9-10.

will be scrutinized more than the oversight and enforcement programs of other independent system operators. Given this fact, the ISO has a strong incentive to assure that its discretion is exercised in a just, reasonable and transparent way. In any event, the Commission ultimately can determine whether the ISO has abused its discretion in imposing specific penalties and can undo such penalties. In other words, there will be sufficient protections in place for Market Participants.

Many intervenors take issue with the ISO's procedure for investigating potential violations, and assessing, billing, and distributing the proceeds of penalties, as set forth in the Enforcement Protocol. For the most part, these entities argue that the ISO's proposal fails to provide adequate due process to Market Participants, because they have no chance to challenge the finding of a violation or the imposition of a fine prior to being required to pay the amounts assessed. Intervenors characterize the ISO's proposal as "guilty until proven innocent."[36] These parties are in error.

First off, the notion that the ISO's process amounts to "guilty until proven innocent" is unsupported. Section 3 of the Enforcement Protocol makes clear that the ISO has no ability to impose penalties on Market Participants until it has first completed the investigation process and determined that a violation of one or more of the Rules of Conduct has occurred. During this process, the ISO must provide the Market Participant that is the subject of the investigation notice of the

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[34] SMD NOPR at P. 456.

[36] MID at 7; Southern Cities at 9; CMUA at 15-16; NCPA at 30.

investigation "in sufficient detail to allow for a meaningful response."[37] The ISO must also allow the Market Participant that is the subject of an investigation to present evidence, and the ISO must consider all such evidence presented.[38] Finally, when the ISO concludes that a Rule of Conduct has been violated, and a penalty or sanction is levied, the ISO must state its findings and conclusions in writing, and make that writing available to the Market Participant under investigation.[39]

It is only at the conclusion of this process that the ISO will actually assess the penalty against the responsible Scheduling Coordinator through the Preliminary and Final Settlement Statements. This is the normal ISO process for collecting monies due from Market Participants. As stated in the Enforcement Protocol, the Scheduling Coordinator must pay the penalty amount as invoiced, but has the right to dispute the penalty through the dispute resolution process set forth in the ISO Tariff.[40]

This ISO's proposal is hardly unique in this regard. Under the sanction mechanisms approved for ISO New-England ("ISO-NE") and the Northern Maine Independent System Administrator ("NMISA"), for example, a Market Participant must pay the penalty or post a bond equal to the amount of the penalty prior to review under the ADR process provided for therein.[41] Again, the Commission still acts as a "court of last resort" for Market Participants who feel they have been unfairly or excessively penalized.

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37 EP 3.3.
38 EP 3.4.
39 EP 3.5.

One intervenor, APX, claims that the ISO's investigation and penalty provisions unfairly penalize Scheduling Coordinators, and should instead focus on the responsible supplier, who may be different than the Scheduling Coordinator that is scheduling on behalf of that supplier.[42] APX maintains that the Commission should require the ISO to clarify that in the event the ISO initiates an investigation with regard to a transaction, the ISO must inform the Market Participant that it is the subject of the investigation, and not just its Scheduling Coordinator.[43] Section 3 of the Enforcement Protocol already requires that the ISO provide notice to the "Market Participant(s) that are the subject of the investigation." However, the ISO recognizes that a Market Participant who is acting as a Scheduling Coordinator on behalf of another Market Participant may become the subject of an investigation due to the behavior of the Market Participant on whose behalf the Scheduling Coordinator is scheduling. In such cases, the ISO will use best efforts to inform the Market Participant who is actually responsible for the improper behavior, in addition to that Market Participant's Scheduling Coordinator, and focus its investigation on the responsible Market Participant. This is evident from Section 3 of the EP, which requires that the ISO conduct a "reasonable investigation seeking available facts, data, and other information relevant to the suspected violation." However, the ISO should not be *required* to inform and pursue enforcement actions against the underlying Market Participant, in lieu of the entity acting as

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40 EP 5.4.

41 NEPOOL Market Rules & Procedures, Section 13.6.3; Northern Maine Market Rule 7.6.3.

42 APX at 14-15.

that Market Participant's Scheduling Coordinator, because it is the Scheduling Coordinator, rather than the underlying Market Participant, that is directly obligated to comply with the ISO Tariff and with whom the ISO has the contractual relationship governing the settlement of all transactions is the Scheduling Coordinator. In turn, it is the Scheduling Coordinator's responsibility to assign any such liability to the Market Participants that it represents through the agreement by which it provides services to those Market Participants. Additionally, it may be impractical to pursue enforcement against the underlying Market Participant because there will be instances, such as cases involving load data, in which the ISO does not – and cannot – know who the responsible Market Participant is. With respect to Scheduling Coordinators such as APX, the ISO may not have sufficient data to identify the individual Market Participant "behind" the Scheduling Coordinator, that caused the violation. Therefore, requiring the ISO to investigate the specific suppliers who may have actually engaged in the prohibited behavior, even though those suppliers transact through a separate Scheduling Coordinator in the ISO's Market, would hamstring the ISO's ability to efficiently monitor and deter behavior that violates the Rules of Conduct.

Southern Cities maintain that any Market Participant that the ISO proposes to penalize should have the option of a public hearing before the ISO Governing Board before the penalty is levied. Southern Cities suggests that this will provide an incentive for ISO management to investigate thoroughly and apply reasonable interpretations of its rules before initiating an enforcement

[43] APX at 19.

proceeding.[44] This suggestion is unwarranted. The incentive already exists for ISO management to investigate thoroughly and act reasonably in applying the Rules of Conduct. In fact, this behavior is *mandated* under Section 3 of the EP, which requires the ISO to conduct a "reasonable investigation, seeking available facts, data, and other information relevant to the suspected violation." The ISO has a strong incentive to comply with this mandate, lest its enforcement decisions be overturned by the Commission. The time and energies of the ISO Governing Board are already consumed with evaluating and deciding on ISO policy. Allowing for an appeal to the ISO's Governing Board will do nothing more than impose an additional step in the enforcement process, adding to the burden of efficiently concluding investigations, with no offsetting benefit. If Market Participants believe that they have been wrongly penalized, they have full recourse through the ISO's ADR process and, ultimately, an appeal to the Commission.

Several intervenors criticize the ISO's proposal to first apply the proceeds received from any penalties assessed by the ISO to cover the cost of the ISO's enforcement activities. Some of these intervenors contend that the ISO should include some sort of cost control mechanism to ensure that only "reasonable costs" are reimbursed.[45] This is unnecessary. The ISO has no incentive to incur "unreasonable" expenses because (1) it must undergo review of its GMC each year, and (2) doing so would run the risk of ultimately being overturned on an enforcement action and not collecting any amounts to offset its costs. Other

[44] Southern Cities at 15-16.

intervenors argue that by first reimbursing its own expenses, the ISO creates a perverse incentive to find improper behavior where none may exist in order to increase funding for enforcement. This argument is misguided, because it apparently assumes that the ISO operates under a traditional "for profit" regime. As is well known, the ISO is a non-profit corporation, and thus, has no need of funds beyond those required to accomplish its obligations as grid operator and market monitor. Intervenors' argument might assume that the ISO possesses the malignant intention to penalize as much behavior as possible, regardless of the impact on the markets as a whole or Market Participants individually. No such intent exists, and without any evidence of such intent, intervenors' argument should be rejected. The ISO's objective is the same as that of every other independent system operator, *i.e.*, to take all steps necessary and appropriate to maintain reliable grid operations and ensure that markets operate in a fair, efficient and effective manner. Other independent system operators have the authority to impose penalties on behavior that threatens reliable grid operations and/or market efficiency; the ISO too should have such authority.

Two entities, CMUA and Duke, raise arguments with respect to the ISO's proposed use of automated algorithms to assess penalties. CMUA argues that the process for investigation and enforcement of violations should not be "circumvented" by using automated algorithms.[46] Duke raises several more specific objections, namely that the ISO does not specify which penalties will be assessed using automated algorithms, that the ISO should be required to file any

[45] SMUD at 12; TANC at 16.

such algorithm with the Commission under Section 205 of the FPA, and that the ISO should be required to "clearly identify and describe the penalty on the ISO invoice."[47]

The ISO agrees that a better explanation of the automated algorithm process is warranted. The ISO has proposed certain penalties that are based on specific market data that is provided by Scheduling Coordinators to the ISO (Pmax, ramp rates, schedules, bids, etc) or is compiled by the ISO as the result of market performance (Generation values, submitted Load values, etc.). An automated algorithm would be a repeatable calculation that uses specific market data and performs a computation to determine if a violation has occurred. Only penalties that the Commission has specifically approved and for which explicit rules or equations have been published will be determined using automated algorithms. These automated algorithms would be subject to the same process and controls that are applied to all other established settlement calculations, including No Pay and the Uninstructed Deviation Penalty proposed in Phase 1B of the ISO's MD02 plan.[48]

The only automated algorithm that will be used for implementing penalties for violations of the Rules of Conduct are special penalties and exceptions associated with EP 2.7(c)(i) - submitting Load Schedules that are substantially in excess of metered Load. The ISO also proposes to revise EP 5.4 to provide that these specific penalties will be assessed through automated algorithms.

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46 CMUA at 14-15.

47 Duke Protest at 18.

Moreover, the ISO commits to post on its website a description of each automated algorithm and a list of the data (*i.e.*, Final Hour-Ahead Schedules, Metered Quantities, etc.) used in the computation. As with all Charge Types, the ISO will provide a description of the penalty that is being assessed on the relevant settlement statements.

Finally, several intervenors contend that the three-year time limitation from the time the ISO discovers a violation to investigate and assess appropriate penalties is too long, because it will result in a great deal of uncertainty in the market.[49] This three-year limitation is reasonable because of the enormous amount of time and effort that investigations can take, given the complexity of the ISO Markets, and the need to obtain and assess adequate data in order to ensure that an investigation is thorough. This is not to say that the ISO expects that most, if any, investigations will take anywhere near three years. Instead, the ISO will be motivated to conclude investigations in a timely manner so that harmful practices can be halted and deterred as soon as possible.

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[48] Transmittal Letter to Amendment No. 54 of the ISO Tariff, Docket No. ER03-1046-000 (filed July 8, 2003) at 6, 16-20.

[49] IEPA at 13; Generator at 24; APX at 20; MWD at 16.

F. THE COMMISSION SHOULD NOT REJECT AMENDMENT NO. 55 DUE TO THE ISO'S GOVERNANCE.

Numerous intervenors contend that the Commission should not grant the powers requested by the ISO in Amendment No. 55 because the ISO Governing Board has been found by the Commission not to be sufficiently "independent"[50]. These arguments are a red-herring, and should be treated as such. With respect to the issue of implementing an effective market monitoring and enforcement scheme, independence is not an end in and of itself, but instead a factor to be considered in assessing whether the ISO's proposal provides Market Participants with adequate assurances that the investigation and enforcement process will be conducted fairly. The ISO's proposal does so, regardless of the composition of the Governing Board. As already noted, the EP requires the ISO to conduct a thorough investigation, including consideration of information provided by the Market Participant(s) that are the subject(s) of the investigation. Additionally, if that investigation results in the assessment of a penalty, than the Market Participant has the right to challenge that outcome through the ISO's ADR process. Finally, it is clear that the Commission will continue to be the ultimate arbiter of any dispute concerning the ISO's exercise of the authority contained in Amendment No. 55. This largely blunts the concerns of intervenors that the ISO, because it is allegedly closely tied to the agenda of certain Market Participants and the State of California, will use its discretion to attempt to "punish" other classes of Market Participants (*i.e.*, suppliers). In fact, if anything, the dispute

[50] Generators at 7-8; NCPA at 5-12, 17-18; Duke at 2, 5-6; SMUD at 9; IEPA at 3, 7; Powerex at 4; Strategic at 3, 10; CMUA at 5-6; FPL at 3-4; Southern Cities at 7-8; MWD at 7.

over the independence of the ISO will ensure greater Commission scrutiny of the ISO's enforcement actions, which, in turn, will motivate the ISO to be particularly vigilant to use its enforcement authority in a cautious and deliberate manner.

What should be most troubling is that, if the Commission were to accept intervenors' arguments and not approve Amendment No. 55 until the conclusion of the governance dispute, the end result would be that the ISO Markets would be left without an effective market investigation and enforcement plan for some indeterminate period. It would be counterproductive to penalize the entire market based solely on a disagreement about the current composition of the ISO's Governing Board. The Commission should not deny to the ISO Markets the important market monitoring and enforcement tools that the Commission itself recognized are fundamental to all wholesale energy markets because of the composition of the ISO's Governing Board, given that adequate safeguards exist to ensure that the ISO will exercise the authority provided for in Amendment No. 55 in a fair and even-handed manner.[51]

Several intervenors contend that the ISO's proposal is also inconsistent with the requirement proposed in the SMD NOPR that an Independent Transmission Provider's market monitoring units should be independent of its

[51] NCPA contends that the ISO, because it is in violation of the Commission's orders with respect to independence, is engaging in price fixing under the Sherman Act, and that the members of the ISO Board can be held personally liable for damages to Market Participants. NCPA also argues that the ISO governance structure violates the Commerce and Supremacy Clauses as an attempt by the State of California to use the authority of the Commission to regulate the prices of entities that are not subject to the power of the State of California. NCPA at 15-20. While they make for fascinating reading, these arguments are far better suited for a proceeding that directly involves the issue of the independence of the ISO's governance. Suffice it to say the ISO will abide by the decision of the Commission with respect to its Amendment No. 55 proposal. Obviously, the ISO would not be acting illegally in implementing any provisions of this Amendment that are approved by the Commission.

management, because the ISO's DMA reports directly to the ISO General Counsel.[52] First, for the reasons noted in the discussion above, the ISO does not believe that a market monitoring unit that is independent of ISO management is a necessary adjunct to a fair and effective market monitoring and enforcement scheme. Moreover, it makes little sense, practically, to apply this requirement to the ISO. The ISO's DMA has been at the forefront of the investigations of market conditions in California since the ISO began operations nearly five years ago, and throughout this entire period, the DMA has reported to ISO management. It would make little sense now, and in fact cause significant harm in terms of both efficiency and effectiveness, to condition the ISO's proposal on reconstituting its market monitoring and enforcement unit in a completely different form. Therefore, the ISO believes that the unique circumstances and history of the ISO Markets make a departure from that principle warranted in this instance. Further, the ISO notes that the penalty authority which the Commission has granted to other independent system operators is applied by such independent system operators, not by a market monitoring unit.[53] The ISO should not be treated any differently, especially since the Commission ultimately can review any action taken by the ISO.

[52] NCPA at 12-13; SMUD at 4-6; Generators at 8-9.

[53] *See, e.g.*, NEPOOL Market Rules and Procedures, Section 13.3.1 ("The *ISO* may impose sanction on any Participant that directly engages in Sanctionable Behavior.") (emphasis added).

G. THE AMENDMENT NO. 55 PROPOSAL WAS DEVELOPED PURSUANT TO A SUFFICIENT STAKEHOLDER PROCESS

One intervenor, IEP, argues that the ISO has failed to honor its pledge to stakeholders during the development of the Amendment No. 55 proposal to preview the fina draft of this proposal with stakeholdersprior to filing with the Commission.[54]

This allegation is without merit. Attachment E to the Amendment No. 55 Transmittal Letter shows the extensive stakeholder process that the ISO engaged in and the numerous opportunities for stakeholder input. Given the divisiveness of the issues, the need to avoid becoming mired in disputes that clearly would not be resolved via additional stakeholder process, and in order to avoid further postponing the implementation of important mechanisms for ensuring appropriate market behavior, the ISO believes that the process that it followed in developing the O & I proposal included sufficient stakeholder input. Ironically, IEP, in its January 10, 2003, comments on the ISO's draft Enforcement Protocol, stated that "the entire O & I process has gotten overly protracted and is distracting attention from California's real electric power issues." Given its prior statements, IEP cannot now credibly assert that a more extensive stakeholder process was necessary.[55]

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[54] IEPA Motion at 4-5.

[55] IEPA took the position in its comments that the Commission does not even have the authority to grant penalty authority to the ISO, and that in no circumstance should such penalty authority be granted to the ISO due to the ISO's governance structure. It is extremely unlikely that any additional stakeholder input would have caused IEPA to modify that position. Because the ISO's Board of Governors had approved the O&I filing, and since IEPA and other market participants were firmly entrenched in their positions, the ISO decided that it was appropriate to exercise its Section 205 rights and file the O & I proposal without additional stakeholder process.

H. THE ISO WILL POST A CONFORMED COPY OF ITS TARIFF

Several intervenors maintain that the ISO should, as a condition of being granted the authority to impose sanctions on Market Participants, be required to post a current and conformed copy of its Tariff on its website, so that Market Participants can quickly and easily understand their obligations thereunder.[56] The ISO agrees, and therefore, commits to posting a current, conformed copy of the ISO Tariff on the ISO's website (www.caiso.com).

Additionally, one commentor, SWP, requests that the Commission enforce ISO compliance with a key aspect of its Standards of Conduct, the requirement that transmission providers log and post their exercise of discretion.[57] The ISO notes that EP 5.4 already provides a process under which the ISO can publish a description of a violation of the Rules of Conduct, the identity of the Market Participant that committed the violation, the amount of the penalty, and the application of any mitigating factors. This process should be sufficient to satisfy SWP's concerns.

[56] MWD at 4; SWP at 3-4.

[57] SWP at 4-6.

I. THE ISO AGREES THAT THE AMENDMENT NO. 55 PROPOSAL SHOULD INCLUDE PROTECTIONS FOR EXISTING RIGHTS

Two intervenors, TANC and SMUD, argue that the ISO's Amendment No. 55 proposal fails to make adequate provision for existing rightsholders.[58] These entities maintain that Amendment No. 55 should include provisions that exempt Market Participant behavior from the terms of Amendment No. 55, to the extent that behavior is engaged in pursuant to existing rights. The ISO agrees. Language to this effect was included in the EP during the drafting process, and was inadvertently removed. Therefore, the ISO proposes to include the following additional rule of interpretation in the Enforcement Protocol: "This EP does not modify the terms of any ISO agreements or the relationship of those agreements to the ISO Tariff."

J. COMMENTS CONCERNING SPECIFIC SECTIONS OFTHE ENFORCEMENT PROTOCOL

In this section, the ISO responds to various arguments made by intervenors concerning the specific Rules of Conduct set forth in the Enforcement Protocol. As the ISO demonstrates below, the Rules of Conduct are, with the addition of several minor clarifications made here, just and reasonable , and should be accepted by the Commission.

[58] TANC at 11-12; SMUD at 10.

1. EP 2.2 – Compliance with Operating Orders

Intervenors raise several arguments with respect to EP 2.2. First, several intervenors maintain that the effectiveness of EP 2.2 should be conditioned on the implementation of ISO software to improve real-time communication with Generating Units with respect to unit capacity and ramp rates at various operating points.[59] Such a condition is unnecessary, and intervenors' argument should therefore be rejected. The ISO intends that Market Participants will be subject to penalty under EP 2.2 *only* for failure to comply with operating orders that are directly communicated to Scheduling Coordinators by means other than the ISO's automated dispatch system. Although the ISO's implementation of the Uninstructed Deviation Penalty ("UDP") in the MD02 proceedings was conditioned on the accommodation of multiple ramp rates and the ability for suppliers to electronically communicate derates and outages, these conditions were imposed because the UDP is an automated penalty. For clarity, however, the ISO proposes to limit the applicability of EP 2.2 to operating orders that are communicated directly to the Scheduling Coordinator by the ISO, either verbally, electronically by means other than an automated dispatch instruction, or in writing SMUD argues that this rule, by requiring compliance of System Resources with ISO operating orders, would give the ISO authority over resources that are outside of the ISO's Control Area, and that this proposal goes beyond the reasonable need to rely on commitments from System Resources.[60]

SMUD urges the Commission to require the ISO to eliminate the reference

[59] CAC at 3; Duke at 9-11; SWP at 6-7.

to "System Resources" in this rule.[61] However, this provision, in particular the reference to "operating orders," is not intended to expand any of the existing obligations of Market Participants, but instead to provide consequences for failure to comply with obligations specified elsewhere in the ISO Tariff. As discussed below with respect to the specific language of Tariff Section 2.3.1.2.1, the requirement that Market Participants, including System Resources, comply with operating orders issued by the ISO does not expand the scope of authority that the ISO has to issue those operating orders in the first place, which is governed by the provisions of the ISO Tariff and agreements entered into between the ISO and Market Participants. Other than control over dynamically scheduled resources, the ISO has no authority to direct the operation of specific equipment or facilities in other Control Areas. Therefore, there is no reason to eliminate the reference to "System Resources" in this provision.

Similarly, Pacificorp contends that this rule fails to recognize that load-serving entities ("LSEs") outside the ISO's Control Area have obligations, first and foremost, to native load customers. Pacificorp maintains that EP 2.2 should be modified so that no event-driven penalty is assessed to an external LSE when it is unable to deliver Energy to the ISO due to unforeseen circumstances on its own system.[62] The ISO recognizes Pacificorp's concern. However, the ISO notes that EP 5 and Section 15 of the ISO Tariff operate to excuse a Market Participant from a violation that resulted from the occurrence of an Uncontrollable

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60 SMUD at 7.

61 *Id.*

62 Pacificorp at 3-4.

Force. These measures provide sufficient protection to accommodate Pacificorp's concern.

Several entities contend that EP 2.2 will lead to unfair results because the ISO sometimes issues operating instructions that are inconsistent with the operating characteristics of the unit dispatched, and this rule will compound the problem by empowering the ISO to impose a penalty for non-compliance with these infeasible operating instructions, leaving the burden on the Market Participant to pursue the ISO to get those funds back.[63] Under Phase 1B of MD02, the ISO is implementing several features to better enable Market Participants to specify operating constraints and report derates or outages in real time. These measures will improve the quality of information available to the ISO on which Dispatch instructions are issued.

As noted earlier, the ISO does not intend that dispatch instructions will be subject to EP 2.2 unless a directly communicated and feasible (based on information that the market participant has provided to the ISO) operating order is issued by the ISO to the Market Participant. To the extent further clarification is necessary, the ISO is willing to modify Section 2.3.1.2.1 *to make clear that an operating order* is not required to be complied with if it is physically impossible to perform, so long as the Market Participant immediately notifies the ISO of its inability to perform.

SWP argues that the approval of Amendment 55 should be conditioned upon the requirement that compliance by SWP (and any other similarly situated

[63] CAC at 3; Southern Cities at 11-12.

entity) with emergency dispatch orders or ISO emergency conditions shall not expose SWP to penalty if, in order to comply with the ISO's orders, SWP must also redispatch other facilities.[64] The ISO does not intend to penalize Market Participants for violations that arise due to compliance with an ISO operating instruction issued during an emergency. If a Market Participant demonstrates that it was acting in accordance with an ISO operating order, then the ISO would excuse the violation under EP 5.2(b).

Duke argues that the Commission should reject the special penalties, set forth in EP 2.2(c), for "any failure to comply with an operating order that contributes to or prolongs an outage as described in Section 2.3.2.9.3 of the ISO Tariff." Duke contends this provision is not consistent with the requirement in Section 2.3.2.9.3 that the ISO first file a schedule of sanctions with the Commission prior to imposing penalties, and that the provision contains no exceptions for reasons of public health, safety, or good utility practice.[65] With respect to the first point, the Enforcement Protocol is intended to operate as a "schedule of sanctions" as required under Section 2.3.2.9.3. Duke's second point is unconvincing. Section 2.3.1.2.1 of the ISO Tariff already provides for an exception to the obligation to comply with ISO operating orders when such compliance would impair public health and safety. This exception is repeated in the Enforcement Protocol. Specifically, EP 5.2(b) provides that "Failure by a Market Participant to perform its obligations may not be subject to penalty if the Market Participant is able to demonstrate that it was acting in accordance with

[64] SWP at 7-9.

Section 2.3.1.2.1 of the ISO Tariff." For these reasons, Duke's argument should be rejected.

2. EP 2.3 – Submission of Feasible Energy and Ancillary Service Bids and Schedules

Duke argues that EP 2.3 is not justified because the ISO has failed to show that a significant problem exists or is likely to occur in the future that would warrant this rule. Duke Protest at 11-12. The premise of this argument is flawed because the applicable standard is whether the proposed rule is just and reasonable, not whether a problem exists or is likely to occur. The integrity of ISO markets and the reliability of grid operations are dependent upon bids and Schedules that reflect true operational characteristics and are thus feasible and reflect resources that are available and capable of performing at the levels specified in the bid and/or schedule. This is consistent with the language in the SMD NOPR requiring feasible bids and Schedules,[66] and also is consistent with the principle enunciated by the Commission, that Market Participants submit factually accurate information to system operators.[67]

Moreover, as the ISO documented in the Amendment No. 55 Transmittal Letter, the ISO often must deal with problems caused by bids and Schedules submitted by market participants that are not feasible because they are inconsistent with the ramping and other operational information submitted by

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65 Duke at 9-11.

66 SMD NOPR at P 445.

such Market Participants. However, the ISO acknowledges that bids and Schedules may become infeasible due to malfunctions of the Market Participant's equipment and changing grid conditions (such as intrazonal congestion and line deratings) that cannot be reasonably predicted by the Market Participant in advance. The ISO does not intend that Market Participants be held to a standard that would require them to predict grid conditions or unforeseen events.[68] In recognition of this, the CAISO proposes to modify EP 2.3(a) as follows:

> "Market Participants must bid and schedule Energy and Ancillary Services from resources that are reasonably expected to be available and capable of performing at the levels specified in the bid and/or schedule, and to remain available and capable of so performing based on all information that is known to the Market Participants or should have been known at the time of bidding or scheduling."

This modification will address the concerns of intervenors that they not be held responsible for events beyond their control.

SWP requests that the ISO be required to modify EP 2.3(a) to acknowledge that a bid for contingency Operating Reserves for each hour of a trading day is not to be interpreted as a representation that it is feasible to provide energy as a result of the ISO dispatching those reserves for an entire 24-hour period.[69] SWP's concern is adequately addressed by existing Tariff language concerning Operating Reserves, and therefore no modification to EP 2.3 is necessary. A bid for contingency Operating Reserve obviously infers the expectation that it is feasible to provide the Energy behind the Operating Reserve

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67 Market Behavior Rules Order at PP 18-19.

68 *See* Duke at 11-12; Pacificorp at 6.

69 SWP at 9-11.

bid in the event of a Contingency until other resources are obtained.[70] There is nothing in the ISO Tariff that requires a resource to be capable of delivering Energy out of Operating Reserve every hour for which an Ancillary Service is scheduled in a Day Ahead Schedule. For example, if a Generating Unit can deliver Energy for 2 hours, it may still schedule Operating Reserve in all 24 hours. However, should the ISO encounter a Contingency and Dispatch that capacity, thereby rendering the resource incapable of meeting the relevant standards specified in the ISO Tariff for subsequent hours, then the Scheduling Coordinator would be expected to buy back in the Hour-Ahead Market those Spinning Reserve or Non-Spinning Reserve Schedules that could not be fulfilled. Therefore, there is no reason to read such an expectation into either the existing tariff language or EP 2.3(a).

Similarly, Pacificorp contends that the ISO should be required to stipulate a bandwidth for assessing the feasibility of bids and Schedules.[71] A provision stipulating bandwidth is unwarranted. Market Participants should be responsible for submitting bids and Schedules that contain an adequate allowance for the operational characteristics of their equipment.[72]

One intervenor, Sempra, contends that 2.3(a) will preclude bidding strategies that involve potentially infeasible Schedules but which are beneficial to

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[70] *See* ISO Tariff Section 2.5.15 (j) (Requiring that a Scheduling Coordinator bidding Spinning Reserves indicate whether the capacity reserved would be available to supply Imbalance Energy *only* in the event of the occurrence of an unplanned Outage, a Contingency, or actual System Emergency); *see also* ISO Tariff Section 2.5.16(k).

[71] Pacificorp at 5.

[72] The ISO notes that a deadband is specified for the Uninstructed Deviation Penalty in ISO Tariff Section 11.2.4.1.2.

grid operations in that they assist the CAISO in managing congestions.[73] Market participants should not be permitted to submit infeasible Schedules merely because they believe that such Schedules might be beneficial to the ISO. The ISO is responsible for determining grid reliability, and the ISO needs to be the party to determine what Schedules are appropriate and necessary to manage congestion and address operational needs. The ISO has experienced infeasible Schedules since start-up, and such Schedules have caused significant operational problems for the ISO.

3. EP 2.4 and 2.5 – Physical and Economic Withholding

Various intervenors argue that there is no need for rules against physical and economic withholding in light of other market rules already in effect that limit economic or physical withholding, such as the must-offer requirement, $250/MW bid cap, and AMP procedure for mitigation of bids.[74] These intervenors are incorrect. It is true that the conduct proscribed in the rules is also limited by the various other sections of the ISO Tariff cited in the comments of these Market Participants. In addition, such conduct is prohibited under existing general provisions of the ISO Tariff regarding gaming and market manipulation. Nevertheless, certain Market Participants have claimed that the existing proscription is not apparent from the language of the MMIP.[75] Consequently, as explained in the Amendment No. 55 Transmittal Letter, the ISO has designed

[73] Sempra at 5.

[74] Duke at 12-14; IEPA at 10; Generator at 20; Sempra at 6-8.

these two rules to make it explicitly clear to Market Participants that physical and economic withholding are prohibited behaviors in the ISO Markets.[76] The EP provides for stronger penalties for withholding than are available under the existing MMIP (*i.e.*, the mere disgorgement of profits). Thus, the provision in the EP will serve as a more effective deterrent than the ISO's existing tariff provisions. As the Commission and Market Participants are well aware, the Commission has already uncovered instances of withholding in the ISO Market, and its staff is conducting an ongoing, comprehensive investigation of withholding in the ISO Market. It is clear that a more effective deterrent is necessary under these circumstances. In any event, the penalties associated with these two rules serve as a backstop in the event that the current Tariff provisions change or an unanticipated form of physical withholding, not explicitly addressed by other Tariff provisions, is identified.

Moreover, the rules pertaining to physical and economic withholding are modeled on two of the "certain *minimum* behavioral rules" identified in the SMD NOPR. The ISO also notes that, in Docket No. EL01-118, the Commission has proposed a market behavior rule that would prohibit strategies that would raise prices by withholding available supply from the market. The ISO's proposed rules are consistent with those proposed by the Commission. Further, the proposed market rules are consistent with the market rules that the Commission

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[75] *See, e.g.,* Request of Indicated Respondents for Rehearing of Order Concerning Gaming Practices and/or Anomalous Market Behavior, Docket Nos. EL03-137, et al. (filed July 25, 2003) at 6.

[76] Transmittal Letter at 34-36.

has approved for other independent transmission providers and market operators.[77]

Several intervenors maintain that Market Participants should be subject to penalties for withholding only where there is a showing of market power abuse.[78] The Commission has not imposed such a requirement on other ISO's, nor is such a requirement proposed in the SMD NOPR or in the EL01-118 proceeding. Physical withholding can cause reliability problems, even if there is no market power abuse present. For these reasons, these rules should not require a showing of market power abuse.

Two parties, Duke and the Generators, argue that these rules create a de-facto ongoing must-offer requirement, and that such an ongoing requirement is unwarranted.[79] These parties are partially correct. In that regard, the ISO believes this type of general rule against physical withholding should be a permanent and fundamental element of the ISO Market. If a resource has available capacity in real time, there is no legitimate reason why a resource owner should not offer that capacity in the ISO Market. There is no other market into which the supplier could sell such Energy. If the supplier is being compensated for its costs, it should be required to offer such Energy into the real-time market. For this reason, the ISO has supported imposing an explicit, permanent must-offer requirement, such as that currently in effect in the ISO

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77 *See* NEPOOL Market Rules & Procedures, Section 13.4.2; NMISA Market Rule 7.4.2.

78 IEPA at 9; Duke at 12-14; Sempra at 6-7.

79 Duke at 12-13; Generators at 19-20.

Market, as a fundamental condition for market-based rate authority.[80] The Commission, by including rules against physical and economic withholding in its list of minimum behavioral rules in the SMD NOPR, evidently agrees that prohibitions against physical and economic withholding should be a fixture of functional Energy markets going forward, and not merely a temporary fix for particularly troubled markets such as California's. Accordingly, intervenors' argument should be rejected.

A number of the entities commenting on Amendment No. 55 argue that the ISO's definitions of physical and economic withholding are too vague.[81] The language of both of these rules is substantially similar to the language proposed by the Commission in the SMD NOPR. As noted above, the Commission defines physical withholding as follows:

> **Physical Withholding:** Entities may not physically withhold the output of an Electric Facility (Generating unit or Transmission Facility) by (a) falsely declaring that an Electric Facility has been forced out of service or otherwise become unavailable, or (b) failing to comply with the must-offer conditions of a participating generator agreement.

EP Section 2.4 defines physical withholding as "a failure to offer to sell or to schedule into the ISO Market the output of or services of a Generating Unit capable of serving the ISO Market, in a manner consistent with the ISO Tariff." The ISO's definition is certainly no more "vague" than the Commission's. It is, in fact, quite clear. If a Generating Unit, as defined in the ISO Tariff, has available

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[80] *See* Initial Comments of the California Independent System Operator Corporation Regarding Proposed Revisions to Market Based Rate Tariffs and Authorizations, Docket Nos. EL01-118-000 and EL01-118-001 (filed August 8, 2003) at 8.

[81] Duke at 13-14; Sempra at 5; SMUD at 11; Generators at 21.

output that is capable of serving an ISO Market, then the owner of that Unit must offer to sell or schedule that output in the ISO's Market, and must do so in a manner consistent with the terms of the ISO Tariff.

Moreover, the definition of economic withholding in EP 2.5 (a) incorporates the same definition of economic withholding already included in the ISO tariff under Appendix A of MMIP (Section 2.4.2). Given that the ISO is merely utilizing a definition already approved by Commission for use by the ISO, there is no basis to find such definition to be unjust and unreasonable. Moreover, this definition of economic withholding is more specific than that proposed by the Commission in the SMD NOPR.[82] It is also essentially identical to the definition of economic withholding which the Commission approved for NYISO.[83]

Vernon and Southern Cities argue that the rules on withholding should only apply to units that have a Participating Generator Agreement ("PGA") with the ISO.[84] From an economic and reliability perspective, there is no reason these rules should be limited to entities with PGAs. Entities without PGAs participating in the ISO Market have the ability to engage in physical and economic withholding just like units with PGAs, and the impacts of this behavior would be equal to that of entities with PGAs. It would be unduly discriminatory to limit the applicability of these market rules to only a limited set of participants in the ISO Market.

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[82] The Commission defines Economic Withholding in the SMD NOPR as "submitting high bids that are not consistent with the caps specified in the tariff or participating generator agreements." SMD NOPR at P. 445.

NCPA and Sempra argue that the ISO's proposed rules on withholding fail to recognize that there can be legitimate reasons for suppliers to bid in excess of that price indicated by the known operational characteristics and/or the known operating cost of the resource.[85] NCPA, in particular, maintains that this rule would prevent them from bidding in excess of short-run marginal costs, and that there are numerous other costs of supplying energy from a resource that are sometimes appropriate and not reflected in short-run marginal costs. The rule as written accommodates the situations NCPA describes because those additional costs beyond short-run marginal costs can be considered to be an appropriate part of the known operating cost of the resource. Moreover, as noted above, the provisions concerning economic withholding incorporate and build on language that the Commission itself recommended in the SMD NOPR, and are identical to the definitions of economic withholding already in the tariff of both the NYISO and ISO. Nevertheless, to the extent that there may be legitimate reasons for a Generating Unit to have a high bid relative to its known operating characteristics or costs, the Enforcement Protocol ensures that participants will have the opportunity to provide such justification and that the ISO will consider all such information as part of the process for investigation and enforcement specified in EP 3.

Duke and Sempra argue that the proposed rule on economic withholding should not prohibit the acceptance of bids above the applicable price cap that do

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83 *See* New York Independent System Operator Tariff, Attachment H, Section 2.4(a).

84 Vernon at 2-4; Southern Cities at 13-14.

85 NCPA at 22-27; Sempra at 7.

not set the market clearing price.[86] This argument is irrelevant, because the ISO's Commission-approved rules do not prohibit such behavior. The ISO's definition of "economic withholding" in the Enforcement Protocol is consistent with the Commission's order allowing bids above the $250/MW bid cap, which cannot set the MCP, and will only be paid if cost-justified. The first bulleted clause in the ISO's definition of economic withholding in EP 2.5, which states that economic withholding can consist of "submitting a bid for a Generating unit that is not consistent with the bid caps or thresholds specified in the ISO Tariff," would not prohibit such bids, since these bids are permitted under the terms of the ISO Tariff. Likewise, the second bulleted clause in the definition of economic withholding, which deals with submitting bids that are "unjustifiably high," would not prohibit bids over the $250/MW cap level if these could be justified based on the operational characteristics and costs of the unit. There is no conflict between current Tariff provisions allowing bids over the $250/MW cap and the proposed rule on economic withholding in the Enforcement Protocol.

Finally, Powerex and Sempra argue that the proposed rules concerning withholding fail to recognize legitimate unit limitations.[87] As noted above, these rules represent, in effect, a continuation of the Commission-imposed must-offer requirement. As such, this rule would be applied in the same manner as the must-offer requirement with respect to recognizing legitimate physical, environmental, and economic limitations.[88]

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86 Duke at 13-14; Sempra at 8-9.

87 Powerex at 4-5; Sempra at 6.

88 ISO Tariff, Section 5.11.

4. EP 2.6 - Compliance with Availability Reporting Requirements

Duke argues that the ISO has not shown EP 2.6 to be necessary, and that in Duke's experience, ISO software and logging problems are usually the problem with respect to accurate availability data.[89] Duke cites to the wrong standard for review. The applicable standard is whether this proposed provision is just and reasonable. Duke presents no argument that this rule is unjust and unreasonable. As the ISO explained in the Amendment No. 55 Transmittal Letter, one of the most common sources of operational difficulties facing the ISO is inaccurate data submitted by Market Participants regarding resource availability.[90] Although these problems will be mitigated upon implementation of Phase 1B of the ISO's MD02 proposal, this rule will make explicit Market Participants' obligation to engage in accurate availability reporting practices, promoting increased reliability to the ISO Markets. This market rule is consistent with the market behavior rules proposed by the Commission in the SMD NOPR and in Docket No. EL01-118, as well as market rules that the Commission has approved for other independent system operators.[91]

5. EP 2.7 - Provide Factually Accurate Information

Certain intervenors contend that, with respect to EP 2.7, the ISO should be required to incorporate exceptions into the rule to accommodate changes that occur that are beyond the control of the Market Participant and to define exactly

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89 Duke at 14-15.

90 Transmittal Letter at 36.

91 *See id*. at 36-37.

what constitutes a false communication.[92] The ISO maintains that EP 2.7 as written adequately addresses these concerns. The proposed rule includes the statement: "All such information submitted must be true, complete, and consistent with the operational plans of the company *to the best knowledge* of the person submitting the information." (emphasis added). This language makes it clear that the Market Participant's obligation is to submit information that it believes to be accurate at the time it is submitted, and does not give the ISO license to penalize a Market Participant for submitting information that becomes inaccurate sometime in the future, because of material changes in conditions not reasonably anticipated. Moreover, there is no need to expressly list each possible false communication under this rule. As the language in EP 2.7 makes clear, *all* communications to the ISO from Market Participants must satisfy the accuracy standard spelled out above.

Vernon and Pacificorp maintain that the ISO should clarify EP 2.7 to identify who qualifies as a "responsible company official."[93] The term "responsible company official who is knowledgeable of the facts submitted " is taken verbatim from the Commission's set of minimum behavioral rules recommended in the SMD NOPR and is intended to ensure that a Market Participant's management is responsible for the accuracy of the information submitted to the ISO. A plain reading of this language does not suggest that only persons in certain management positions are able to submit information to the ISO, but it does reasonably imply that any information submitted to the ISO

[92] SVP at 12-13, 16-17; TANC at 13.

should be completed under proper management supervision that ensures the accuracy of the information.

Two parties raise arguments with respect to EP 2.7(c)(iii), which contains a special penalty for the failure to provide complete and accurate meter data, as required by the ISO Tariff, resulting in an error discovered after the issuance of a Final Settlement Statement. Sempra maintains that, given the complexity of the meter data reporting systems, it would be unreasonable to penalize Scheduling Coordinators who discover meter errors after the issuance of Final Settlement Statements.[94] TANC contends that this penalty should only apply when an Scheduling Coordinator has repeated failures and cannot demonstrate that it is attempting to rectify the problem.[95] These arguments are unconvincing. EP 2.7(c)(ii) is important because complete and accurate Settlement Quality Meter Data is essential for an accurate settlement of the ISO Markets that avoids inequitable cost shifting between Market Participants. However, the ISO has encountered numerous instances where Market Participants have misreported meter data, including substantial amounts of underreported load. Accordingly, the ISO believes that a special penalty is appropriate to remove any incentive Market Participants may have to misreport meter data, or neglect to put into place appropriate systems and procedures to ensure meter data is complete and accurate. It is the Market Participant's responsibility under the ISO Tariff to

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93 Vernon at 6-7; Pacificorp at 6-7.
94 Sempra at 10.
95 TANC at 13.

submit accurate meter data.[96] It is incumbent on Market Participants to develop and deploy whatever procedures are necessary to enable them to detect and avoid errors. It would be inappropriate to rely on the ISO's detection of errors or wait until repeated errors occur to correct them. Market Participants have sufficient opportunity to identify and correct meter data problems: in most cases there are 70 days between the trade day and the deadline for submission of corrected meter data to be used in Final Settlement Statements.

The proposed penalty provides an incentive for Market Participants to find and correct errors on their own initiative: the proposed maximum penalty is equal to 30% of the estimated value of the Energy error if the Scheduling Coordinator reports the error, versus a maximum of 75% of the estimated value of the Energy error if the ISO discovers the error. Finally, Section 4.1 of the ISO's Meter Service Agreement, which has been approved by the Commission and entered into by numerous Market Participants, already contains a provision that the ISO can impose penalties for inaccurate, incorrect, or fraudulent meter data.

Several commenters argue that it is unjust and discriminatory to include a special penalty with respect to over-scheduled load but not under-scheduled load.[97] Obviously, it is important from a grid operations perspective that Schedules for both generation and load be accurate, and that under-scheduling and over-scheduling should be discouraged. Nevertheless, a special penalty on over-scheduled load is appropriate because under-scheduling of load is

[96] ISO Tariff, Section 2.3.2.9.3.

fundamentally different than over-scheduling. It is well-documented that certain gaming behaviors have relied on the mechanism of over-scheduling of load. These behaviors include: (1) selling undispatched energy to the ISO Market, and receiving an Imbalance Energy payment, for the amount of over-scheduled load, and (2) receiving Congestion relief payments by scheduling artificially high levels of load. These behaviors are known as “Inc’ing Load” or “Fat Boy”, and “Load Shift,” strategies, respectively, and were extensively documented in the Commission Staff’s Final Report on Price Manipulation in the Western Markets, March 2003.[98] Over-scheduling load results in an Imbalance Energy payment to the Market Participant, and when employed as part of a gaming strategy, essentially provides suppliers with a payment for the generation that corresponds to the amount of over-scheduled load, which in turn represents generation that was withheld from the normal forward-market channels and sold, unrequested, through the ISO Markets in real-time. It is not the ISO’s intent to penalize Market Participants for over-scheduling load that is a result of legitimate load forecasting error. Therefore, the ISO incorporated provisions into the Enforcement Protocol to accommodate reasonable error. First, EP 2.7(c)(i) would apply a reasonable tolerance band, established by the ISO from time to time and posted on the ISO’s website. The ISO proposes a tolerance band that can be adjusted from time-to-time, considering stakeholder input, in the event the initial value does not reasonably accommodate legitimate scheduling practices. Given the ISO’s belief

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[97] Sempra at 9; Duke at 15; IEPA at 11; Generators at 23.

[98] Final Report on Price Manipulation in Western Markets, et al., Docket No. PA02-2-000 (March, 2003) at ES-2, ES-10.

that load Schedules should be within 5 percent of actual load,[99] the proposed 10 percent tolerance band (plus an additional amount to accommodate transmission losses), which will be applied on an hourly basis, should reasonably accommodate legitimate load forecasting error. Moreover, the proposed 25 MW alternative minimum amount should accommodate Market Participants that serve a relatively small amount of load. Greater tolerances than these would potentially create an inappropriate opportunity for a Market Participant to engage in the type of gaming activities discussed above with impunity. Additionally, EP 5.1(s) provides that the CAISO will specifically consider legitimate load forecasting error in determining penalty amounts for over-scheduled load.

6. EP 2.8 - Provide Information Required by ISO Tariff

A number of intervenors argue that this rule is too broad because it allows the ISO to make unreasonable requests of Market Participants in terms of both volume of data requested and the time permitted to respond.[100] The ISO believes that, while it certainly has no intent to make unreasonable demands, it is also important to provide comfort to Market Participants. Therefore, consistent with the Commission's comments in the SMD NOPR,[101] the ISO proposes to modify the language of EP 2.8, adding the following new subsection (d), in order to make clear that a Market Participant who objects to an information request

[99] The ISO's original design expectation was that load schedules would be accurate to within 5 percent of actual load experienced in real time, based on a reasonable estimate of forecast error and contingencies.

[100] Powerex at 5; Pacificorp at 7-8; SMUD at 11-12; Duke at 15-16; CMUA at 12-13; Southern Cities at 14; MWD at 15.

[101] SMD NOPR at P. 449.

under this section will have the right to challenge that request before the Commission:

> (d) Challenge to FERC: A Market Participant who objects to a request made by the ISO under this section shall have the right to immediately appeal that request to the Commission for expedited review. For purposes of determining whether a Market Participant has made a timely response under this section, the ISO shall not count the period from the date on which a Market Participant files an appeal with the Commission until 15 days after that date.

This modification will guaranteeing that Market Participants have an opportunity for expedited review before the Commission of any objections they have to ISO information requests made under this section, while also ensuring

7. EP 2.9 and 2.10 – Detrimental Practices and Market Manipulation

a. The Market Manipulation and Detrimental Practices Tariff Provisions Are Not Vague and Overly Broad

Several intervenors claim that the ISO's definitions of "Detrimental Practices and Market Manipulation" are vague and unduly broad and, as such, provide the ISO with too much discretion to determine what constitutes "Market Manipulation" and "Detrimental Practices."[102]

There is no merit to these claims. To constitute a "Detrimental Practice" under Section EP Section 2.9, behavior must meet the following two requirements: (1) such behavior must take unfair advantage of the rules and procedures set forth in the ISO Tariff to the detriment of system reliability, other

[102] Duke at 16-17; IEPA at 12.

Market Participants, or the efficiency of the ISO Market; and (2) the specific behavior being proscribed must be identified in a Final Market Notice. To constitute "Market Manipulation" under EP Section 2.10, behavior must (1) be fraudulent, deceptive or manipulative with the intent of creating artificial or distorted prices or market outcomes, including prices or outcomes that do not reflect or are inconsistent with supply and demand conditions, and (2) be specified and proscribed in a Final Market Notice.[103] Criteria for making a determination whether behavior constitutes "Detrimental Practices" or "Market Manipulation" are set forth in EP Section 4.6.

The general definitions of "Detrimental Practices" and "Market Manipulation," and the general criteria to be applied by the ISO in determining whether specific behavior constitutes "Detrimental Practices" or "Market Manipulation," are similar to, consistent with, and contain the same level of detail as the definitions of "Anomalous Market Behavior" and "Gaming" found in sections 2.1.1 and 2.1.3 of the existing MMIP. In the Show Cause Order the Commission found that such MMIP provisions provided adequate notice to Market Participants that certain gaming behaviors (not expressly specified in the MMIP) constituted violations of the MMIP.[104] The Commission rejected arguments that the definitions of "Anomalous Market Behavior" and "Gaming" were too vague to serve as a standard by which to judge a Market Participant's behavior. Likewise, there is no valid basis to find that the similarly detailed

[103] In any Final Market Notice, the ISO also must provide an example of the behavior being proscribed. EP 4.6

[104] Show Cause Order at P 23.

definitions of “Detrimental Practices” and “Market Manipulation” are too vague. The ISO notes a standard requiring the ISO to state with precision the exact strategies that are prohibited would require a level of detail that would be impossible to achieve and would require anticipating every possible way that could be dreamed up to manipulate the market, and to spell out every one of those behaviors in the tariff. That is both unreasonable and unnecessary. The ISO’s two-notice approach produces a similar result by relying on general prohibitions and market notices proscribing specific behavior.

In any event, intervenors ignore the fact that, before the ISO can prohibit any behavior pursuant to EP Sections 2.9 and 2.10, the ISO must first issue a Preliminary Market Notice and a Final Market Notice which, *inter alia*, will identify the specific behavior being proscribed and provide an example of such behavior. Numerous parties have argued that the MMIP provisions could not be construed as prohibiting specific games because (1) the MMIP did not expressly bar any trading practices, and (2) the MMIP did not identify with precision the particular strategies subject to scrutiny. The ISO’s market notice approach addresses both of these concerns. Because the EP procedures provide for more notice and specificity than exist under the current MMIP, and the Commission found that the MMIP provides adequate notice to Market Participants, there is no legitimate basis to find that the ISO’s proposed Tariff provisions regarding “Detrimental Practices” and “Market Manipulation” are unduly vague.[105]

[105] TANC argues that no Market Participant can divine what taking “unfair advantage” of the ISO Tariff means or know when a specific action is to the detriment of “the efficiency” of the ISO market. These are terms that are already found in the definitions of “Anomalous Market Behavior”

b. EP Section 2.9 And 2.10 Do Not Constitute An Improper Delegation Of FERC Authority

Certain intervenors allege that EP Sections 2.9 and 2.10 constitute an impermissible delegation to the ISO of the Commission's authority to determine just and reasonable rates and charges.[106] They argue that the ISO should be required to make a Section 205 filing with the Commission to proscribe specific behavior that constitutes "Detrimental Practices" or "Market Manipulation." Other intervenors argue that the ISO should not be permitted to prohibit specific behaviors or impose penalties until the Commission has ruled that such behaviors are prohibited.[107]

The Commission should reject these claims. The Commission has granted virtually every regulated public utility, natural gas company and independent transmission provider, including the ISO, the right to impose penalties on parties that violate specified tariff provisions. Independent transmission providers have the right to include just and reasonable market behavior rules and associated penalties in their tariffs as a legitimate term and condition of service in connection with the receipt of transmission service or participation in the market. In previous proceedings, parties have argued that permitting public utilities to impose penalties constitutes an improper delegation of authority from the Commission to the regulated public utility to set just and reasonable rates. The Commission has

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and "Gaming" in the MMIP. Given they these provisions have already been approved by the Commission and included in the ISO Tariff, there is no basis for finding that they now are somehow unduly vague.

[106] Duke at 16-17; Vernon at 9-10.

[107] Sempra at 21.

not accepted such arguments.[108] Under these circumstances, there is no basis to find that it is unlawful for the Commission to authorize the ISO to impose penalties under EP Sections 2.9 and 2.10.

There is no need for the ISO to make a Section 205 filing every time it desires to proscribe specific behavior that constitutes a "Detrimental Practice" or "Market Manipulation." The ISO has already satisfied any Section 205 requirement by defining "Detrimental Practices" and "Market Manipulation" in the EP and specifying the criteria that it will consider in determining whether specific behavior violates EP Section 2.9 or 2.10. The Commission found that many of the Enron games constituted violations of "general" MMIP provisions even though there were no separate Section 205 filings proscribing the specific games, or precise tariff provisions expressly prohibiting the specific games. Likewise, the ISO should not be required to make a separate Section 205 filing each time it seeks to proscribe specific behavior in the future. Rather, the "general" definitions of "Detrimental Actions" and "Market Manipulation" are sufficient, especially given that the ISO will issue market notices identifying the specific behavior to be proscribed before imposing any penalties.[109]

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[108] *See, e.g.*, New York Independent System Operator Corporation, Inc., 96 FERC ¶ 61,249 (2001). In the same order, the argument was made that it was inappropriate to permit the New York ISO to impose penalties because the New York ISO would act as judge, jury and decision maker, thereby causing it to lose the appearance of impartiality. The Commission did not find this argument persuasive because it granted the New York ISO penalty authority. The Commission likewise should reject similar arguments raised by intervenors herein.

[109] Further, requiring the ISO to file separate Section 205 filings each time it seeks to proscribe specific behavior could allow behavior that has significant adverse impacts on the market to continue unabated for some period of time. In that regard, the ISO would need to draft a Section 205 filing, obtain Board approval for the filing (following minimum notification requirements), and then obtain Commission approval of the filing (as well as a waiver of the 60-day notice rule). There could be significant adverse impacts on the market during this period. On

The process the ISO is proposing is similar to the procedures that natural gas pipelines follow when issuing Operational Flow Orders ("OFOs"). Pipeline tariffs identify the general criteria that the pipeline can apply in determining whether to issue an OFO, but the pipeline issues an OFO via a market notice that directs shippers to take, or refrain from taking, specific actions. Shippers that fail to follow the OFO are subject to substantial penalties. The pipeline does not need to obtain Commission approval for each OFO it issues or to impose penalties on shippers that do not adhere to an OFO.[110] Similarly, the ISO has identified the general criteria that it will apply in determining whether specific behavior should be proscribed. The ISO will issue a market notice when it seeks to proscribe behavior. Just like natural gas pipelines do not need to make Section 4 filings to issue OFO's addressing specific behavior, the ISO should not be required to make a Section 205 filing to proscribe specific behavior. The "general" criteria set forth in the tariff – which have been approved by the Commission -- constitute a sufficient basis to issue the market notice proscribing specific behavior.

Finally, the Commission should not preclude the ISO from issuing penalties until the Commission rules that specific activities are banned. If market manipulation is occurring and adversely affecting the market, it needs to be addressed promptly. Requiring Commission approval before any penalties are imposed will only encourage Market Participants to dispute matters to the fullest

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the other hand, the market notice approach allows improper behavior to be proscribed promptly, thereby limiting any adverse impacts on the market.

[110] *See* Transmittal Letter at 51-52.

extent possible and drag out proceedings to delay paying penalties. To the best of the ISO's knowledge, and as noted above with respect to the general arguments concerning the ISO's penalty authority, every other regulated utility is permitted to impose penalties before the Commission approves such penalties. For example, as already discussed, natural gas pipelines can impose OFO penalties for violations of specific OFOs. The Commission does not need to approve the specific OFOs before the pipeline can impose a penalty. Similarly, other regulated utilities can impose penalties for certain tariff violations without the Commission first finding that the imposition of penalties on a specific Market Participant is appropriate. In that regard, if there is a factual dispute regarding imposition of a penalty, the party's recourse is to follow the dispute resolution measures in the regulated company's tariff and, ultimately, appeal the matter to the Commission. The Commission generally does not rule on the merits of the penalty before the regulated utility imposes the penalty.[111] Likewise, Commission approval should not be required before the ISO issues a penalty under Sections 2.9 and 2.10.

Market Participants are adequately protected under the ISO's proposal. The EP provides for ADR with respect to the imposition of any penalties, and the Commission ultimately retains review authority over any penalties imposed by the ISO.[112] In the past, the Commission has found such protections sufficient to

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[111] *See, e.g., United Gas Pipe Line Company*, 65 FERC ¶ 61,006, at 61,082 (1993).

[112] If the Commission ultimately finds that any penalties imposed by the ISO were improper, the ISO will refund the penalty amount plus interest. Under these circumstances, Market Participants are fully protected.

allow an independent transmission provider/market operator to impose penalties.[113]

c. EP Sections 2.9 and 2.10 Provide Adequate Notice To Market Participants

A few intervenors suggest that the proposed tariff provisions do not provide adequate notice to Market Participants.[114] The ISO believes that these general claims are unfounded. However, as discussed below, the ISO is amenable to making certain of the modifications to its notice procedures suggested by intervenors.

As discussed *supra*, the "general" market rules proscribing "Detrimental Practices" and "Market Manipulation" are sufficient, in and of themselves, to enable the ISO to impose penalties on Market Participants that violate such tariff provisions. However, the ISO has added an additional layer of protection for Market Participants by providing that the ISO cannot impose penalties until after it has completed the two-notice process. Stated differently, the EP provides more "notice" to Market Participants than does the existing MMIP, and the Commission found that the "notice" provided by the MMIP was adequate. Accordingly, there is no legitimate basis to find that the ISO is providing inadequate notice to Market Participants.

In response to the comments of certain intervenors, the ISO agrees to make several modifications to the "notice" provisions of the EP. First, the ISO agrees to modify EP 4.3 and 4.6 to expressly provide that the ISO will email the

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113 *See New England Power Pool*, 85 FERC ¶ 61,379 (1998).

114 IEPA at 12; Southern Cities at 5-6; TANC at 14.

Preliminary and Final Market Notices to Market Participants at the time such Market Notices are posted on the ISO's website.[115] Second, in response to the comments of APX that the ISO, if it prohibits behavior under these sections, should notify all Market Participants, and not just Scheduling Coordinators,[116] the ISO notes that Section 4 requires that notice be issued to "Market Participants," not just Scheduling Coordinators. In response to claims that the ISO can issue a Final Market Notice at the same time it files a Preliminary Market Notice with the Commission (*see* Southern Cities at 5-6), the ISO agrees to modify EP Section 4.6 to provide that the ISO cannot issue a Final Market Notice until at least 48 hours after it has filed the Preliminary Market Notice with the Commission. With these modifications, EP 4.3 and 4.6 will provide more than adequate market notice to Market Participants.

d. The ISO's Proposal Provides For Adequate Commission Review

A couple of intervenors claim that the notice procedures do not allow adequate time for the Commission to intervene if it determines that it is inappropriate for the ISO to proscribe certain behavior.[117]

The proposed tariff provisions provide for adequate Commission oversight and intervention. As indicated above, the penalty provisions of other regulated utilities' tariffs generally allow for Commission involvement only after the utility has imposed penalties and ADR procedures have been exhausted, and the

[115] TANC at 14. It is incumbent on Market Participants to ensure that they are on the ISO's email list.

[116] APX at 19.

Commission has found such procedures to be sufficient. The proposed EP provisions not only allow the Commission to perform the aforementioned "appellate" role, but also, because all Preliminary and Final Market Notices must be filed with the Commission within 48 hours of issuance, provide the Commission with a "heads up" as to the specific behavior the ISO proposes to penalize. This will enable the Commission to intervene at an earlier time if it believes that behavior the ISO seeks to penalize should not be penalized. Thus, the ISO is providing more protections to Market Participants and opportunities for Commission intervention than other utilities provide.

Southern Cities suggests that the Commission will only have 24 hours to act.[118] That is incorrect. With the tariff modification discussed in the prior section, the Commission will have, *at a minimum*, 72 hours to act before the ISO proscribes specific behavior. In that regard, ISO cannot issue a Final Market Notice until at least 48 hours after it files a Preliminary Market Notice with the Commission and cannot assess penalties until 24 hours after it files a Final Market Notice with the Commission. It is important to note that the issuance of a Preliminary Notice merely indicates that the ISO is initiating an investigation of specific behavior. The ISO will not issue a Final Market Notice until the ISO has completed its investigation. Thus, the actual timing of issuance of a Final Market Notice will depend, *inter alia*, on the nature and complexity of the behavior being investigated and the amount of time the ISO needs to conduct a thorough investigation. The ISO anticipates that most investigations will take significantly

[117] Southern Cities at 6; NCPA at 29-30.

longer than 48 hours. Thus, in most instances, the Commission will have more than 72 hours to intervene following issuance of a Preliminary Market Notice. Given the amount of scrutiny the ISO expects its investigations will receive, the ISO will have a strong incentive proscribe only behavior that it has been fully investigated and determined to be clearly inappropriate based on the facts presented to it.

K. COMMENTS CONCERNING THE ISO'S PROPOSED TARIFF MODIFICATIONS

In this section, the ISO responds to various arguments made by a number of intervenors concerning the amendments to the main body of the ISO Tariff proposed in Amendment No. 55. As the ISO demonstrates below, these amendments are just and reasonable as filed, and should be accepted by the Commission.

1. Section 2.2.9 – Scheduling on Zero-Rated Transmission Paths

Powerex makes several arguments with respect to this proposed Tariff modification. First, Powerex argues that Section 2.2.9 should be modified to permit the rejection of Schedules by the ISO only across out-of-service lines.[119] This modification, however, would defeat much of the purpose of this Tariff provision. The prohibition must apply not only to ties that are physically open, but also to ties that have physical capacity but for which Schedules for flow in a particular direction are not permitted due to agreements with neighboring control areas or Participating Transmission Owners. Otherwise, Market Participants

[118] Southern Cities at 6.

would still be permitted to earn Congestion revenue by scheduling counter-flows on zero-rated paths, even though no Congestion is actually relieved, because the Energy would never be permitted to flow. This practice, known as "Wheel Out," was found by the Commission to constitute gaming behavior in violation of the ISO Tariff.[120]

Powerex contends that if a Scheduling Coordinator schedules on a tie that is physically open, but rated zero due to contractual obligations, then that schedule should be set to zero by the ISO's Congestion management system, and result in a final Hour-Ahead Schedule of 0 MW on that path for that Scheduling Coordinator.[121] Powerex is mistaken. Again, the problem is that the ISO's Congestion Management system would set a Scheduling Coordinator's Schedule on a particular path to zero by exercising an Adjustment Bid, precisely the situation this Tariff change is directed at prohibiting. Moreover, the ISO cannot simply set a Schedule on a particular path to zero, because this would result in an unbalanced Schedule. It is incumbent on the Market Participant to re-submit a Balanced Schedule in the case where their Schedule is rejected due to scheduling on a zero-rated path.

Powerex states that it is unclear how this provision would be implemented prior to the elimination of the Balanced Schedule requirement.[122] The ISO would implement this prohibition by making changes to its scheduling system to prevent Scheduling Coordinators from submitting Schedules that include flows on any

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119 Powerex at 5.

120 Show Cause Order at P. 44.

121 *Id.*

path for which the Operating Transfer Capacity of the path is zero. The scheduling system would reject any such Schedules when initially submitted and notify the Scheduling Coordinator that submitted the Schedule. As Scheduling Coordinators are permitted to submit Schedules up to seven days in advance, the scheduling system would notify Scheduling Coordinators if the Operating Transfer Capacity of a path for which they have previously scheduled flow on were to be reduced to zero, and direct the Scheduling Coordinators to resubmit Balanced Schedules that do not include flow across the zero-rated path. In the event that a Scheduling Coordinator failed to resubmit a Balanced Schedule without the flow across the zero-rated path, the previously submitted Schedule would not pass the validation processes conducted prior to the close of the Day-Ahead and Hour-Ahead Markets, and the ISO would request that the Scheduling Coordinator revise the Schedule to remove the flow across the zero-rated path and balance the Schedule. If the Operating Transfer Capacity of a path were to be reduced to zero after the close of the Hour-Ahead Market, the ISO would implement its existing procedure of canceling all Schedules on the path during the final Real-Time intertie checkout conducted prior to each operating hour. In this case, affected Schedules would become effectively unbalanced and subject to any applicable Imbalance Energy charges.

Finally, Powerex maintains that 2.2.9 fails to address how a Scheduling Coordinator's debit charge will be dealt with when a Schedule is cut.[123] The ISO states that if a path is rated at zero, then the Congestion price will be set to zero

[122] Powerex at 6.

for the relevant market, and no Usage charges, including the Scheduling Coordinator debit, will be paid or assessed for that market.

2. Section 2.3.1.2.1 – Compliance with Operating Orders

Several intervenors argue that this amendment is unnecessary and/or harmful to the ISO Market. For instance, Sempra contends that Hour-Ahead Schedules have always been financially binding from the standpoint that any differences between the final Hour-Ahead Schedules and metered results are settled by the ISO as an imbalance.[124] Sempra is correct, in that Schedule deviations will still be subject to the Uninstructed Deviation Penalty, and no additional penalty under EP 2.2 will apply. However, Hour-Ahead Schedules are obviously not the only type of operating order issued by the ISO. Sempra also argues that the language in this section appears to preclude a Scheduling Coordinator from changing the Day-Ahead scheduled output of a resource without an exercised Adjustment Bid, Supplemental Energy bid, or Ancillary Services energy curve, which is unnecessary because of the incentive Market Participants already have to submit bids to the ISO.[125] The only changes to Day-Ahead Schedules that are proposed to be prohibited under Section 2.3.1.2.1 are those that would de-commit a resource that has a start-up time that would not allow Dispatch of the resource in real time. The ISO currently makes decisions on must-offer waiver revocations, and will make future decisions on Residual Unit

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123 *Id.*

124 Sempra at 13.

125 Sempra at 13.

Commitment (RUC) awards, in consideration of Day-Ahead Schedules. Allowing a long start-time unit to self-commit in the Day-Ahead Market and then to subsequently be decommitted introduces uncertainty into the waiver revocation or RUC processes that could cause reliability concerns (*i.e*., if less capacity is committed due to Schedules submitted in the Day Ahead Market that are subsequently revised) or inefficiency (*i.e*., the ISO may be required to revoke more waivers or make additional RUC awards to assure that sufficient Energy is available for the Operating Day).

IEPA argues that under the amended language, any deviation exposes the resource owner to the ISO Imbalance Energy charges and Uninstructed Deviation Penalties, and that it is unclear how this penalty will interplay with the extensive residual unit commitment mechanisms the ISO is proposing in MD02.[126] The exception in EP 2.2(d) assures that no deviation that is subject to the Uninstructed Deviation Penalty will be subject to any further action. Section 2.3.1.2.1 will need to be revised when RUC is approved to make clear that a RUC award is also a binding obligation.

Powerex maintains that this rule may have the perverse effect of eliminating market mechanisms that enable the ISO to procure as much energy as possible ahead of real time, and may result in importers being more conservative in the amount of energy they offer.[127]. There is no reason to expect the negative consequences Powerex describes. Including the reference to System Resources in this provision requiring compliance with operating orders

[126] IEPA at 15.

does not actually expand the scope of the ISO's authority to issue operating orders to System Resources. The authority of the ISO to issue operating orders to Market Participants is defined and limited by the provisions of the ISO Tariff and various agreements entered into between parties and the ISO (e.g. the Participating Generator Agreement). If there is no provision in either the ISO Tariff or these agreements that permits the ISO to control the operation of the facilities or equipment operated by a Market Participant in a particular situation, then the ISO cannot, in the first place, even issue an operating order to the Market Participant under these circumstances. With respect to System Resources, the ISO has no authority to direct the operation of System Resources except as related to bids and Schedules submitted on behalf of such Resources. Therefore, the ISO can only issue operating orders to System Resources with respect to such bids and Schedules.

Several parties suggest that portions of this amendment are unclear or lack specificity. Sempra, for instance, contends that it is unclear what the term "operating orders" means, since it is not a defined term in the ISO Tariff.[128] The ISO does not believe that a specific definition of operating order is necessary, since it clearly relates to any instruction issued in accordance with the ISO Tariff for the purpose of operating the ISO Controlled Grid and ISO Control Area in accordance with the Applicable Reliability Criteria.

Sempra also argues that it is unclear what the word "fulfilled" means, given that there is little chance that any final Hour Ahead Schedule will exactly

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[127] Powerex at 6.

match the metered results.[129] Fulfillment is determined by criteria specified under the Uninstructed Deviation Penalty provisions. The ISO does not believe that a more rigorous standard is appropriate here (*i.e.,* if the UDP is excused or doesn't apply because the deviation is within the dead band, then no further action is proposed). MWD contends that in proposed Section 2.3.1.2.1 it is not clear what the ISO means by "Day-Ahead commitment" of a resource.[130] The ISO proposes to clarify Section 2.3.1.2.1 to state that this term refers to the scheduled operation of a long-start time unit.

Powerex contends that the ISO should clarify that this provision will not prohibit an SC from changing Schedules or buying back Energy in the Hour-Ahead Market.[131] The ISO agrees, and proposes to include the following language in Section 2.3.1.2.1 to reflect this change: "This section does not prohibit a Scheduling Coordinator from modifying its Schedule or re-purchasing Energy in the Hour-Ahead Market".

3. Section 2.5.21 – Ancillary Services Buyback

With respect to the ISO's proposed modifications to Section 2.5.21, IEPA argues that these modifications are unnecessary because the ISO Tariff's existing "binding commitment" provisions, properly enforced, are sufficient to prevent any type of real or perceived gaming by sellers of Ancillary Services.[132] IEPA is incorrect. Without these modifications, the ability of the ISO and other

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128 Sempra at 12.
129 Sempra at 13.
130 MWD at 11.
131 Powerex at 7.

legal and regulatory entities to detect the practice of "Paper Trading"[133] would, as a practical matter, continue to be extremely limited and administratively burdensome. The difficulty in detecting "Paper Trading" stems, in part, from the fact that virtually all Day-Ahead Ancillary Services commitments that are canceled prior to the Hour-Ahead Market are imports to the ISO system by marketers (rather than utilities or generators directly operating physical resources).[134] For imports of Ancillary Services, suppliers only identify the Control Area rather than the actual physical resources backing these commitments. Detection of "Paper Trading" is further hindered – and sometimes even made impossible – by the fact that the actual availability of Day-Ahead Ancillary Services commitments that are reduced or cancelled in the Hour-Ahead Market cannot subsequently be tested or verified after the fact. Thus, as a practical matter, the proposed modifications represent the only reliable means of deterring the practice of "Paper Trading." Duke and the Generators argue that these proposed modifications would prevent legitimate arbitrage activity by suppliers by preventing resource-backed suppliers of Ancillary Services in the Day-Ahead Market from substituting lower cost Ancillary Services in the Hour-Ahead Market, and that this practice does not impact grid reliability because the

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[132] IEPA at 14-15.

[133] The Commission, in the Show Cause Order, found the practice of "Paper Trading" to constitute gaming behavior in violation of the ISO Tariff. Show Cause Order at P. 51.

[134] For example, all Ancillary Services that were "bought back" over the 2000-2001 period covered in the ISO's most recent report on the Enron strategies were imports, the bulk of these "buy backs" involve participants who are primarily marketers (Enron, Sempra, Coral, and Avista) rather than utilities or generators directly operating physical resources. *See* July Report, Tables 5 and 6, page 18.

ISO is receiving the Ancillary Services capacity it purchased.[135] The ISO, however, believes that current settlement provisions that permit Day-Ahead Ancillary Services commitments to be cancelled on a Hour Ahead basis have been abused in a way that negatively impacts system reliability. The ISO Tariff and Scheduling Protocols clearly indicate that sales of Ancillary Services Schedules in the Day-Ahead Market represent "binding commitments" for physical capacity and that "the ISO will require Scheduling Coordinators to honor their Day-Ahead Ancillary Services Schedules."

The rationale for this language is twofold. First, Ancillary Services 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." Second, due to various constraints and characteristics of resources that comprise the supply of Ancillary Services, Ancillary Services 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 ensure that many resources can be available to provide reserve capacity in real time, the ISO must purchase the bulk of its Ancillary Services requirements on a Day-Ahead basis in order to ensure that sufficient supply of such unloaded capacity is procured. Thus, capacity procured on the Day-Ahead and the Hour-Ahead basis are two distinct physical products, offering different degrees of system reliability. Although the ISO conducts an Hour-Ahead Market for Ancillary Services, the ISO

[135] Duke at 19-21; Generators at 14-15.

purchases the bulk of its Ancillary Services requirements in a Day-Ahead Market to ensure system reliability.

While the ISO seeks to lower its purchase costs by deferring some portion of its Ancillary Services purchases from the Day-Ahead to the Hour-Ahead Market when Hour-Ahead prices are lower, the ISO must limit the portion of Ancillary Services 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 Market Participants seek to profit from such prices 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. While this may represent a source of profit for marketers who engage in this practice, the net result of this practice is to reduce the ISO's ability to manage system reliability and costs through its Ancillary Services procurement decisions.[136]

Sempra contends that the proposed changes to Section 2.5.21 set up the possibility that in situations in which a unit supplying Ancillary Services capacity experienced problems following the close of the Day-Ahead Market but prior to the Hour-Ahead Market, the Market Participant could end up paying more in the

[136] The Commission's conclusion in the context of its Show Cause Proceedings that this is "consistent with legitimate arbitrage" is based on the erroneous premise that the ISO's Day-Ahead and Hour-Ahead Ancillary Services markets are simply "financial markets" for a single "fungible commodity," rather than separate markets for two distinct physical products. Due to the differences between capacity committed to provide Ancillary Services on a Day Ahead and Hour Ahead basis in terms of physical supply committed to operation in real time and its impact on

Hour-Ahead Market than it got paid in the Day-Ahead Market, and would likely elect not to buy back its obligation in the Hour-Ahead Market, instead opting to accept the "no pay" feature for negative real time Ancillary Services capacity imbalances.[137] Sempra is mistaken. In such cases, if the Day-Ahead price is higher than the Hour-Ahead price, then the supplier merely pays back what it was initially paid. If the Hour-Ahead price is higher than the Day-Ahead price, the supplier pays the price to replace the service that it no longer can provide. The supplier cannot profit from its misfortune, but neither is the supplier penalized for it.

4. Section 20.3.5 – Information Sharing with Regulatory Agencies

As a part of the O&I filing, the ISO has proposed to revise the confidentiality provisions in its Tariff to allow greater and more expeditious access to confidential ISO Market information by certain Oversight and Enforcement Agencies.[138] The reason for this increased and more timely access to such information is to allow other agencies with oversight authority over the ISO markets, the ISO, and ISO Market Participants, the opportunity to review market information on a near real time basis.[139] This will help create a more coordinated and coherent approach to market monitoring and investigations.

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system reliability, such "arbitrage" between these markets can ultimately have detrimental impacts on system reliability.

[137] Sempra at 14.

[138] The Oversight and Enforcement ("O&E") are defined as: the Federal Energy Regulatory Commission, the United States Department of Justice or any of its subsidiaries, the California Department of Justice or any of its subsidiaries, the California Public Utilities Commission and the California Electricity Oversight Board.

[139] Transmittal Letter at 64.

The ISO'S proposal for the sharing of confidential information under certain limited conditions with O&E Agencies is criticized by the Generators, who state that "there is no valid reason for the ISO to share information with the CPUC or EOB because these agencies have no oversight role or authority over entities engaged in wholesale electricity sales."[140] The Generator's statement is both factually and philosophically wrong. Since the passage of the electricity restructuring legislation in the state of California, the EOB has had certain unique statutory responsibilities for the supervision of the ISO. [141] In addition, as the CPUC stated in its supportive pleading on this section of Amendment No. 55, "[t]he CPUC has ongoing regulatory responsibilities, including those related to generator maintenance, which provide it with an obligation, and thus a legitimate interest, to be fully informed of market, system reliability and related conditions in the California electricity industry."[142]

At least two of the parties protesting the modifications in the confidentiality provisions appear to be confused between the O&E agencies that the ISO proposes to provide with additional access to confidential information and the California Parties, who are a group of entities acting jointly in certain ongoing litigation.[143] These two groups are distinct. The ISO does not propose to provide any confidential information to the California Parties. While the EOB, CPUC and California Attorney General are members of both groups, the ISO's proposal contains adequate safeguards in Section 20.3.5(c) to protect a Market

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[140] Generators at 25.

[141] See A.B. 1890, enacted September 23, 1996. Section 335(a) provides for oversight of the ISO by the EOB.

Participant's information. Specifically, this section obligates the agency not to disclose to any third party information provided under this section without providing written notice to the ISO and the affected Market Participant at least five business days in advance of the intended date of release.[144]

NCPA, in a sweeping misstatement of the ISO's proposal, contends that proposed Section 20.3.5 would "basically admit the EOB and CPUC to the ISO control room."[145] In fact, this proposal has nothing whatsoever to do with admission to the ISO control room by the O&E Agencies. Further, the proposal to provide access to certain otherwise confidential information on a more timely basis to O&E Agencies is clearly not a delegation of Commission authority or ISO authority to the O&E Agencies, but merely an attempt to see that investigations are coordinated and coherent in terms of recent ISO Market data.

Finally, MWD contends that such an allegedly broad dissemination of confidential information is inappropriate, and that Section 20.3.5 should be amended to limit ISO distribution of information to agencies having statutory or regulatory responsibility for enforcement of the ISO Tariff or antitrust law.[146] It is the ISO's belief that all of the O&E Agencies fall within the classification scheme that MWD finds acceptable, and thus the distribution of the information is not overbroad. The Commission, EOB and CPUC clearly have statutory regulatory responsibility that directly or indirectly impact the ISO Tariff while the state and federal departments of Justice play a role in antitrust enforcement. For these

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142 CPUC at 2-3.
143 NCPA at 20-22; Powerex at 9.
144 Transmittal Letter at 71.

reasons, the Commission should find that this proposed Tariff modification is just and reasonable.

5. Section 7.3.1.5.2 – Cut Counter-Flow Schedules

Powerex and IEPA argue that this proposal is really a market design issue, and would be better addressed in the context of the MD02 proceeding.[147] These intervenors are mistaken. As explained in the Amendment No. 55 Transmittal Letter, the proposed amendment to Section 7.3.1.5.2 of the ISO Tariff is necessary due to a market design flaw that encourages counter-flow Schedules to be cut prior to real time.[148] This flaw will be corrected under MD02. However, the proposed change is necessary until MD02 is implemented.

Sempra alleges that this amendment would interfere with legitimate business practices. [149] It is unclear how cut counter-flow Schedules represent a legitimate business practice. Undelivered counter-flows cause the scheduled flow across a constrained path to be increased over what would have been scheduled in the absence of that scheduled counter-flow, thereby increasing the risk of real time Congestion. Such an outcome does not serve to increase efficiency in the ISO Markets. Sempra also contends that counter-flow Schedules in the Day-Ahead and Hour-Ahead Markets can increase the ability of other participants to engage in commercial transactions in the direction of

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145 NCPA at 20-22.
146 MWD at 17.
147 Powerex at 7-8; IEPA at 14.
148 Transmittal Letter at 64-65.
149 Sempra at 11.

Congestion.[150] The ISO does not believe, however, that phony counter-flow Schedules are an appropriate mechanism for addressing “phantom” Congestion associated with Existing Contract rights.

6. Circular Schedules

Generators argue that the ISO’s proposed tariff amendments on Circular Schedules would prohibit legitimate business behavior. The Generators allege that this is the case because, after certain legitimate transactions were consummated, they would be given transmission tags showing the power as sourcing and sinking in the same Control Area, and thus would fall under the ISO’s definition of Circular Schedules.[151] First, the Commission concluded in the Show Cause Order that circular scheduling practices violated the MMIP because they involved the submission of false Schedules to the ISO and also because participants"fraudulently received congestion relief payments for energy that was never provided and did not relieve congestion."[152] Moreover, Circular Schedules are transactions that do not involve the flow of power from source to sink across the interconnected grid and therefore do not provide actual Congestion relief. Such Schedules cause the ISO to increase scheduled flows across a constrained path, increasing the possibility of Congestion in real time. Therefore, Circular Schedules are not legitimate transactions.

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150 *Id.*

151 Generator at 16-17.

152 Show Cause Order at P. 46.

APX states that it supports making Circular Schedules illegal, but that the ISO should revise its definition of Circular Schedules to recognize the phenomenon of one SC submitting Schedules for multiple buyers and sellers for one interval that have the appearance of a Circular Schedule simply because the Schedule is an amalgam of a number of different Market Participants' separate, but simultaneously submitted, Schedules.[153] The ISO agrees that this phenomenon should not result in a penalty to the Scheduling Coordinator. Again, the investigative process outlined in the EP provides for submission of explanatory information by parties subject to investigation for potential violations of market rules. Therefore, if a Scheduling Coordinator submits a series of Schedules that are circular, that Scheduling Coordinator will have the opportunity to show that the submission to the ISO consisted of separate Schedules, each of which has a distinct source and sink in different Control Areas.

7. MMIP 4.5.1 – Collection of Data by the DMA

Sempra and IEPA argue that if the ISO's ability to compel the production of data is approved, this authority should be limited to compelling data from entities that make jurisdictional wholesale sales in the ISO's markets and, further, to compelling from those entities only information with respect to their participation in ISO markets.[154] Such limitations are unwarranted. MMIP 4.5.1 already provides that the ISO may request ISO Participants and "other entities whose activities may affect the operation of the ISO markets" to submit "any

[153] APX at 21-22.

information or data determined [by the ISO] to be potentially relevant" to an investigation. Under the current MMIP, Section 4.5.2, failure of an ISO Market Participant to provide information requested pursuant to the MMIP or otherwise cooperate in an investigation may lead to such penalties or sanctions as are permitted under the ISO Tariff or related protocols approved by FERC. Amendment 55 simply specifies penalties that may be imposed by the ISO for failure to provide information pursuant to an investigation, as already contemplated in MMIP 4.5.2.

Additional limitations on the type of information and entities that would be subject to the ISO's authority to request and receive information would undermine the ability of the ISO to monitor market and investigate potential rule violations. For example, in some cases, entities may be involved as intermediaries in a series of transactions or otherwise engage in activity relevant and even critical to an investigation even though they do not engage in jurisdictional wholesale sales in the ISO's markets. Information from such entities may be necessary to verify the physical feasibility of resources, to determine whether any supply was withheld from the market, or otherwise to determine whether behavior that might constitute gaming or manipulation has occurred. Similarly, information regarding a participant's participation in non-ISO markets may often be directly relevant and even critical to an investigation of activity within the ISO Market. Again, such information may be necessary to verify the physical feasibility of resources, whether any supply was withheld from

[154] Sempra at 24-25; IEPA at 13-14.

the market, or other behavior that might constitute gaming or manipulation has occurred.

Sempra's suggestion that the ISO's ability to request information should be limited to cases in which the ISO is a party in a specific proceeding at the Commission[155] would also undermine the ISO's ability to monitor the market and investigate potential rule violations. Such a limitation would create a perverse "Catch-22," by dramatically limiting the ability of the ISO to assemble the initial evidence needed to refer a matter to FERC and/or initiate a case before the Commission.

Sempra also argues that the ISO's unilateral ability to compel a buyer to provide commercially sensitive data may discourage prospective sellers from engaging in meaningful contract negotiations and thereby reduce market liquidity.[156] This argument ignores the fact that Section 4.5.1 of the existing MMIP already provides that data provided to the ISO pursuant to an information request "will be subject to due safeguards to protect confidential and commercially sensitive information." In addition, the ISO believes that, on balance, the various provisions of Amendment 55 will increase market liquidity by helping to restore confidence in the integrity and stability of Western energy markets.

Finally, Sempra contends that no meaningful process is identified for objecting to an information request.[157] The ISO therefore proposes to add the

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155 Sempra at 25.
156 *Id.*
157 *Id.*

same language to MMIP 4.5.1 as with EP 2.7, providing Market Participants with the opportunity to immediately challenge ISO requests under this section before the Commission.

8. MMIP 7.3

With respect to the proposed modification to MMIP 7.3, MWD states that it is not clear whether the ISO intends to seek to apply other sanctions and penalties beyond those set forth in the Enforcement Protocol.[158] The ISO only proposed certain cosmetic changes to this provision that had nothing to do with the point raised by MWD. MWD's query is therefore irrelevant to the modifications requested with respect to this provision in Amendment No. 55.

[158] MWD at 16-17.

III. CONCLUSION

Given the complexity and importance of the issues at stake in this proceeding, the ISO respectfully requests that the Commission accept this pleading, and, for the reasons provided herein, find that the ISO's Amendment No. 55 proposal, with certain modifications indicated above, is just and reasonable.

Respectfully submitted,

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Dated: September 5, 2003

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the service list compiled by the Secretary in the above-captioned dockets.

Dated at Washington, DC, on this 5th day of September, 2003.

*/s/ Michael Kunselman*_____
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