

Letter of Support for Amendment 55 Filing by California ISO
by
Market Surveillance Committee of California ISO
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We strongly encourage the Federal Energy Regulatory Commission (FERC) to approve the mechanism for monitoring, investigating, and penalizing market rule violations in the California ISO's Amendment 55 filing. In July 2002, we issued a detailed opinion on California ISO oversight and investigation review process. In this letter, we reiterate the importance of a transparent market oversight and investigations process to ensure that market participants obey market rules, fulfill their contract obligations to other market participants (including the California ISO), and have strong incentives not to engage in behavior that degrades market efficiency and system reliability. Clear market rules with swift and transparent enforcement will reduce the considerable uncertainty that market participants currently face. If all participants, including the ISO operators, are confident that market rules will be obeyed and contractual obligations honored regardless of system conditions, this will reduce the both the cost of operating system and of participating in the California electricity market.

All formal markets for commodities, stocks, bonds, and other financial instruments have rules governing the behavior of market participants and the ability to both penalize and sanction market participants for violations of market rules. Voluntary participation in these formal markets amounts to a contract between the participant and the market administrator. Participants in these formal markets agree to abide by the rules of the market; if participants violate these rules, they are subject to penalties and sanctions.

Well-functioning financial markets have clear rules governing the markets, which if violated result in penalties that serve as a deterrent to activities that are potentially damaging to market efficiency. Without such authority, the violation of a market rule can be extremely profitable for an individual market participant. Thus, the penalties associated with any rule violation must be greater than the additional profits a market participant expects to earn from violating the market rule.¹ Energy markets should have similar protections.

The time lag between the finding of a market rule violation and the imposition of the appropriate penalty for this violation must be as short possible. Moreover, the

¹ The now infamous December 2000 Enron memos provide an interesting case study of how a market participant explicitly evaluated whether its actions were a violation of the ISO market tariff and whether their actions would result in ISO action. Clearly, Enron decided the prospects of penalties were sufficiently small and therefore failed to deter Enron traders from engaging most of the trading practices outlined in those memos.

uncertainty surrounding the magnitude of the penalty associated with a violation should also be as small as possible. The less uncertainty market participants have about what constitutes a violation, the time lag between detection and punishment for a market rule violation, and finally the magnitude of the financial penalty associated with the violation, the less likely they are to find violating market rules profitable, and the more efficiently the market will operate.

In Amendment 55, the California ISO has proposed a reasonable set of rules and an enforcement protocol that would provide energy markets with important protections against behavior that is detrimental to system reliability and market efficiency. Currently, the ISO has very limited authority to impose penalties or sanctions on market participants that violate market rules. This is a glaring weakness in the current California energy market. To deter market participants from engaging in activity that is detrimental to system reliability or market efficiency, the penalties and sanctions for engaging in these activities must be greater than the potential profits from engaging in them. Absent such penalties and sanctions, market participants have strong incentives to engage in detrimental behavior.

Another key component of Amendment 55 is the provision that grants the ISO authority to obtain accurate and timely data from market participants. The ISO's ability to monitor market operations depends critically on its ability to acquire accurate information from market participants. The need to request and receive potentially highly confidential data from market participants cannot be overemphasized. The success of FERC's investigations of the western electricity and natural gas markets was crucially dependent on its ability to request and receive confidential data from market participants. The "Enron memos" are one such example. If the ISO needs access to this sort of information from participants in the California electricity to carry out an investigation, it should have the authority to request and receive this information. This authority will speed the oversight and investigation process and limit the size of potential damages from market rule violations. Rather than having to wait until the market rule violations occur and cause enormous harm to market participants and consumers, which then triggers a FERC investigation that allows this information to be collected, a superior strategy would be grant the ISO the authority to request and receive this information in order to correct the market design flaw or other source of market inefficiency before a small problem becomes a major disaster. This is entirely consistent with the Standard Market Design proposals in this area.

While the enforcement protocol contains several specific rules (e.g., EP 2.3: The submission of feasible energy and ancillary service bids and schedules), it is impossible for the ISO to foresee all possible actions of market participants that might be detrimental to system reliability or market efficiency. Thus, there is a clear need for a general provision prohibiting such activity (i.e., E.P. 2.9., No detrimental practices).

With such a general provision, it is important that the ISO provides a reasonable process to investigate and, ultimately, penalize rule violations. The proposed enforcement protocol provides such a process. If the ISO identifies a market participant

who has violated its market rules, it first issues a general *Preliminary Market Notice* and a specific *Formal Warning* to the affected market participant. The issuance of a *Preliminary Market Notice* and a *Formal Warning* obligates the ISO to issue a *Final Market Notice*, which specifies the behavior under investigation, provides examples of the behavior, and identifies the specific market rules violated (if any). If a market rule has been violated, the *Final Market Notice* must also state the possible consequences of the violation (including applicable penalties). The ISO can only impose penalties for violations occurring **after** the issuance of the Final Market Notice. Though not explicitly outlined in the enforcement protocol, a penalized market participant can contest a penalty imposed by the ISO. As set forth in the ISO tariff, the penalized market participant has the right to arbitration proceedings and can appeal any adverse decision to FERC (and to the U.S. Court of Appeals if necessary). In short, market participants are given ample warning regarding alleged rule violations, face penalties only if they engage in practices explicitly outlined in a Final Market Notice, and have a reasonable opportunity to appeal any ISO-imposed penalties.

The proposed enforcement protocol provides a reasonable process for the investigation of rule violations and the imposition of penalties and sanctions associated with rule violations. Similar procedures have been adopted in other markets. Two examples are noteworthy.

First, FERC has long authorized provisions in pipeline tariffs that permit pipelines to collect scheduling, imbalance, and overrun penalties, if the pipelines show that they are necessary to deter shipper behavior which threatens the integrity of the pipeline system or which imposes unjustified costs on other shippers or the pipeline. For example, in a 1997 Northern Natural Gas Co. proceeding, FERC stated that it favored “pipelines being able to ensure system integrity and to deter gaming or other conduct that would endanger that integrity. [The pipeline] needs adequate penalties to ensure the operational integrity of its system.” (77 FERC ¶ 61,282 (1997)). Penalty levels should be set high enough to “discourag[e] shippers from taking actions that may have a detrimental effect on other shippers.” (77 FERC ¶ 61,337 (1996)). Typically, these penalties are specified in the jurisdictional pipelines’ tariffs and establish fixed penalties for each MMBTU in excess of particular thresholds. The penalties are set high enough to make crossing the specified thresholds economically unattractive to shippers.

Second, the Securities and Exchange Commission (SEC) has long allowed self-regulatory organizations (e.g., the New York Stock Exchange) to monitor and penalize market participants. The New York Stock Exchange (NYSE) is the leading self-regulatory organization (SRO) in the U.S. securities industry. In its role as an SRO, the NYSE, through its Market Surveillance division, regularly conducts market surveillance to protect against manipulative trading practices. It also develops rules and evaluates the performance of market participants. (For example, the NYSE recently adopted rules for stock analysts in an effort to combat conflicts of interest between investment banking and research arms of brokerage houses and, in response to the highly publicized accounting scandals of Enron and Worldcom, has proposed corporate governance rules that would apply to firms listed on the NYSE.) The NYSE Market Surveillance division takes

disciplinary action for certain rules violations, and refers other matters warranting formal disciplinary action to the NYSE Division of Enforcement (or the SEC for matters outside NYSE jurisdiction). The NYSE Division of Enforcement acts as the prosecutorial arm of the NYSE and can initiate a formal charge against a member firm. If formal charges are warranted, a formal proceeding involving an Exchange Hearing Panel follows. Appeals of Panel decisions are made to the Board and thereafter to the SEC.

SROs like the NYSE, in conjunction with SEC rulemaking and oversight, have worked well in financial markets for decades. This is a sound model for energy markets where regional ISOs develop and enforce tariffs, in conjunction with FERC rulemaking and oversight.

In summary, it is imperative that there are clear consequences to violations of market rules and the penalties imposed are sufficient to deter this behavior. The ISO has proposed a reasonable mechanism for monitoring, investigating, and penalizing rule violations. The ISO should be granted the authority to penalize violations of its market rules. If this authority is not granted, another public agency must take responsibility for penalizing market participants who violate these rules. This has the obvious shortcoming that it will introduce significant and unnecessary time lags and uncertainty in the market oversight and investigations process. Absent timely and transparent enforcement with penalties set at levels sufficient to deter these activities, market participants have strong incentives to engage in practices that are profitable, but threaten the reliability and efficiency of energy markets.