

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

**Fact-Finding Investigation
Into Possible Manipulation Of
Electric And Natural Gas Prices**

DOCKET NO. PA02-2-003

**COMMENTS OF
THE ELECTRICITY CONSUMERS RESOURCE COUNCIL (ELCON)**

The Federal Energy Regulatory Commission (FERC) invites briefing on Commission Staff's interpretation of provisions in the California Independent System Operator's (CAISO's) and California Power Exchange's (CalPX's) Market Monitoring and Information Protocol (MMIP) that prohibit gaming and market manipulation. FERC Staff relies on these provisions to recommend enforcement action against sellers who have "engaged in market manipulation (including Enron trading strategies and economic withholding and inflated bidding)."¹

SUMMARY

The Electricity Consumers Resource Council (ELCON) recommends that definitions of "gaming" and "anomalous market behavior" equivalent to the definitions in Part 2.1.3 and Part 2.1.1 of the California MMIP should be extended to Transmission Operators (including RTOs,

¹ Order Providing for Submission of Briefs, Docket No. PA02-2-003, slip op. at 6 (April 2, 2003). See FERC Staff's March 26, 2003 Final Report on Price Manipulation in Western Markets, Chapter VI.

ISOs, and ITPs) throughout the United States and that these market monitoring provisions then need to be vigorously enforced by the Commission.

In prior dockets (e.g., EL01-118, RM01-12), ELCON has urged that FERC define unacceptable market behavior. While the market monitoring provisions of the SMD NOPR address price caps and other market power mitigation issues, they do not include specific anti-gaming or anti-market manipulation provisions analogous to those in the California MMIP, which capture a broader range of alleged practices – Enron-type trading strategies, economic withholding and physical withholding. Most ISOs and RTOs lack “gaming” and “anti-manipulation” provisions as specific as those in the California MMIP. “Gaming” and “anti-manipulation” provisions should be included in FERC’s enforcement arsenal by assuring that such provisions are included in the rules or tariffs of all RTOs, ISOs, and ITPs.

To expedite implementation of a standardized Market Monitoring Plan (MMP),² ELCON urges FERC to mandate that all ISOs and RTOs should have an MMP that includes provisions similar to the “gaming” and “anomalous market behavior” provisions in the California MMIP along with proposed penalties and sanctions. Existing MMPs focus too much on mitigation and less on identifying and prohibiting manipulative illegal behavior. FERC should not wait until a final SMD rule is promulgated to order the inclusion of anti-gaming and anti-manipulation provisions in ISO and RTO tariffs. The risk to end-use customers is too great to warrant such delay.

ELCON takes no position on whether or not any of the specific California transactions challenged in FERC Staff’s Final Report on Price Manipulation in Western Markets are unlawful—an issue on which FERC has specifically excluded comment.

² See SMD NOPR ¶ 435.

A. Due To Significant Variation Among RTO Tariffs, Anti-Manipulation Prohibitions Need To Be Strengthened And Standardized

Vague provisions that define the legality of manipulative trading practices are undesirable in any market. This is especially true for the so-called speculative trading business model adopted by many unregulated merchant generators and marketers in the nascent competitive wholesale electricity markets that have been established under FERC leadership since the enactment of the Energy Policy Act of 1992.

First, vague provisions are likely to create uncertainty among market participants as to what behavior is proscribed and thus are less likely to prevent abuse before the fact. Second, ambiguity is likely to cause hesitation and delay prompt action by FERC-sanctioned Market Monitoring Units (MMUs) after the fact as they struggle to determine whether a violation has occurred. Third, vague provisions engender protracted legal proceedings and increase vulnerability on judicial review.

Gaming is defined at Section 2.1.3 of the CAISO's MMIP as follows:

[T]aking unfair advantage of the rules and procedures set forth in the [Cal] PX or [Cal] 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 [Cal] 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.

Anomalous market behavior is defined at Section 2.1.1 of the CAISO's MMIP:

“Anomalous market behavior” . . . is . . . 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:

* * *

unusual trades or transactions;

pricing and bidding patterns that are inconsistent with prevailing supply and demand conditions, e.g., prices and bids that appear consistently excessive for or otherwise inconsistent with such conditions; and

unusual activity or circumstances relating to imports from or exports to other markets or exchanges.

SMD NOPR. In contrast, the “anti-gaming” provisions proposed in paragraphs 445 and 446 of the SMD NOPR for inclusion in ITP tariffs are vague and fail to address the scope of potential manipulations:

445. An important adjunct to the market power mitigation and monitoring plan will be a clear set of rules governing market participant conduct with the penalties for violations clearly spelled out. The Commission proposes to require the Independent Transmission Provider to include in its tariff certain minimum behavioral rules, which will be monitored by the market monitor. These will include, at a minimum, the following rules:

(1) **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.

(2) **Economic Withholding:** Entities may not economically withhold by submitting high bids that are not consistent with the caps specified in the tariff or the participating generator agreements.

(3) **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.

(4) **Factual Accuracy:** All applications, schedules, reports, or other communications to the Independent Transmission Provider or the Market Monitor must be submitted by a responsible company official who is knowledgeable of the facts submitted. All information submitted must be true to the best knowledge of the person submitting the information.

(5) **Information Obligation:** Entities must comply with requests for information or data by the Market Monitor or the Independent Transmission Provider that are consistent with the tariff.

(6) **Cooperation:** Entities must assist and cooperate in investigations or audits conducted by the Market Monitor.

(7) **Physical Feasibility:** All bids or schedules that designate resources must be physically feasible within the limits of the resource, i.e., the resource is physically capable of supplying the energy, ancillary service, or demand response needed to fulfill a schedule or bid according to the physical limitations of the resource.

446. These rules must be accompanied by predetermined penalties, as discussed below in the Enforcement section.

PJM. The PJM market monitoring plan provisions are also vague:

III. Monitored Activities

The Market Monitoring Unit shall be responsible for monitoring the following:

- A. Compliance with the rules, standards, procedures, and practices of the PJM Market set forth in the PJM Tariff, the PJM Operating Agreement, the PJM Reliability Assurance Agreement, the PJM Manuals, and the PJM Regional Practices Document.

- B. Actual or potential design flaws in the PJM Market operating rules, standards, procedures, and practices set forth in the PJM Tariff, the PJM Operating Agreement, the PJM Reliability Assurance Agreement, the PJM Manuals, and the PJM Regional Practices Document and structural problems in the PJM Market that may inhibit a robust and competitive market.
- C. The potential of any Market Participant(s) to exercise undue market power.³

ISO-NE. Under ISO-NE Rules,⁴ “sanctionable behavior” includes failure to provide energy; failure to provide services; failure to respond to dispatch instructions; understatement of high operating limits; misrepresentation regarding operating conditions; misrepresentation of resource availability; failure to follow ISO instructions; failure to provide information; and failure to comply with market mitigation rules.⁵ These rules appear to ELCON to err in the direction of too much specificity and apparently miss the mark in addressing gaming such as the alleged Enron-type trading strategies.

MISO. The Midwest ISO Tariff⁶ offers a useful identification of “Conduct that May Warrant Mitigation.” While this definition specifically addresses economic and physical withholding and authorizes the expansion of the definition to include other forms of conduct identified by the Independent Market Monitor (IMM) in the future, the provision fails to recognize Enron-type trading strategies through an anti-gaming or anti-manipulation provision. Under sections 2.3 and 2.4 of the Tariff:

2.3 Conditions for the Imposition of Mitigation Measures

³ PJM Interconnection, LLC, FERC Electric Tariff, Attachment M, Substitute Original Sheet No. 272.

⁴ NEPOOL Market Rules & Procedures, § 13 – Imposition of Sanctions by the ISO.

⁵ Id. at § 13.4, defining “sanctionable behavior” as a violation of §§ 13.4.1.1 – 13.4.1.3, 13.4.2.1 – 13.4.2.3, 13.4.3.1 – 13.4.4.5 and 13.4.5.

⁶ MISO FERC Electric Tariff, Original Sheet 619H – 619J (effective Dec. 1, 2003). FERC issued an order accepting MISO’s market mitigation measures on March 13, 2003, subject to modifications and a technical conference. Midwest Independent Transmission System Operator, Inc., 102 FERC ¶ 61,280 (2003).

- b) In general, the IMM shall consider a Market Participant's conduct for a given Electric Facility to be inconsistent with competitive conduct if the conduct would (i) reduce the Net Revenue associated with the Electric Facility, but for the effect of the conduct on market outcomes, or (ii) inefficiently reduce the capability of the transmission system. The categories of conduct that are inconsistent with competitive conduct include, but may not be limited to, the four categories of conduct specified in Section 2.4 below.

2.4 Categories of Conduct that May Warrant Mitigation

- a) The following categories of conduct, whether by a single firm or by multiple firms, may warrant mitigation:
 - (1) *Physical withholding of an Electric Facility*, that is, not offering to sell or schedule the output of or services provided by an Electric Facility capable of serving a Midwest Electric Market. Such withholding may include, but not be limited to, (i) falsely declaring that an Electric Facility has been derated, forced out of service or otherwise become unavailable, (ii) refusing to offer bids or schedules for an Electric Facility, (iii) operating a generating unit in real time to produce an output level that is less than the MISO's dispatch instruction, or (iv) operating a transmission facility in a manner that is not economic, is inconsistent with Good Utility Practice and causes a transmission constraint.
 - (2) *Economic withholding of an Electric Facility*, that is submitting bids for an Electric Facility that are unjustifiably high so that (i) the Electric Facility is not or will not be dispatched or scheduled, or (ii) the

bids will set an artificially high market clearing price.

- (3) *Uneconomic production from an Electric Facility*, that is, increasing the output of an Electric Facility to levels that would otherwise be uneconomic in order to cause or contribute to a binding transmission constraint.
- (4) *Uneconomic load bidding or virtual bidding*, that is, bidding in the day-ahead market that is not economically justified based on risk management or other economic considerations, and that causes or contributes to substantial divergence between day-ahead and real-time prices.

- b) A temporary Mitigation Measure may also be imposed to mitigate the market effects of a rule, standard, procedure or design feature of a Midwest Electric Market that allows a Market Participant to manipulate market prices or otherwise reduce the efficient operation of that market, pending the revision of such rule, standard, procedure or design feature to preclude such manipulation of prices or reduction of efficiency. Under these circumstances, the Commission shall be notified immediately and the temporary mitigation measure will be filed with the Commission prior to its implementation.

- d) The IMM shall monitor Midwest Electric Markets for other categories of conduct, whether by a single firm or by multiple firms, that substantially distort competitive outcomes in a Midwest Electric Market. The IMM shall: (i) seek to amend the foregoing list as may be appropriate to include any such conduct that would substantially distort or impair the competitiveness of any of the Midwest Electric Markets administered by the MISO; and (ii) seek such other authorization to mitigate the effects of such conduct from the FERC as may be appropriate.

NYISO. The NYISO Tariff has provisions nearly identical to the provisions in the Midwest ISO Tariff,⁷ and similarly lacks language that directly addresses Enron-type trading strategies separate from physical or economic withholding. However, the NYISO Market Monitoring Plan, adopted in 1999, states that the Market Monitoring Unit will scrutinize “[a]ny evidence of or other information relating to collusive or other anticompetitive or inefficient behavior in or affecting any of the New York Electric Markets.”⁸

B. FERC Has A Statutory Duty To Adopt And Enforce Tariff Conditions To Address Anticompetitive Practices And Exercise Of Market Power As A Condition To Market-Based Rate Authority

Section 206 requires that the Commission take corrective action when it finds that “any rate...or practice” is unjust and unreasonable. FERC recognized in its November 20, 2001 Order in Docket No. EL01-118 that there is current evidence of physical and economic withholding and other evidence of exercise of market power and that it has a statutory obligation to ensure that rates are just and reasonable, thus necessitating the addition of a refund obligation to FERC market-based rate tariffs.

Market-based rates are only just and reasonable if the market is sufficiently competitive that market participants cannot exercise market power. “[W]hen there is a competitive market the FERC may rely upon market-based prices...to assure a ‘just and reasonable’ result.”

Elizabethtown Gas Co. v. FERC, 10 F.3d 866, 870-71 (D.C. Cir. 1993); Louisiana Energy and Power Authority v. FERC, 141 F.3d 364 (D.C. Cir. 1998). “In a competitive market, where neither buyer nor seller has significant market power, it is rational to assume that the terms of their voluntary exchange are reasonable, and specifically to infer that price is close to marginal

⁷ NYISO FERC Electric Tariff, Second Revised Sheet No. 467-68, §§ 2.3, 2.4 (effective June 15, 2001).

⁸ NYISO Market Monitoring Plan, § 5.1.2(2) (July 26, 1999).

cost, such that the seller makes only a normal return on its investment.” Tejas Power Corp. v. FERC, 908 F.2d 998, 1004 (D.C. Cir. 1990). When the Commission authorizes market-based rates, it is under a continuing duty to ensure that the relevant market remains sufficiently competitive to prevent unjust and unreasonable prices. Process Gas Consumers Group v. FERC, 177 F.3d 995, 1002 (D.C. Cir. 1999) (“FERC must remain attuned to the status of the affected market vis-à-vis monopoly and competition.”).⁹

For example, a party that has been extended market-based rate authority may, over time, change its bidding behavior in the market. Bidding behavior could be changed by the way an entity accounts or tracks its marginal costs. A vertically integrated market participant (generates, trades and serves load as one group or multiple groups separated by “Chinese walls”) could change marginal cost by regrouping assets and liabilities (e.g., low-cost generating units, “in the money” power contracts and transmission contracts on constrained paths, POLR customers, QF contracts, “out of the money” power contracts) into an accrual book and a market book. Originally, there would have been only one book. The marginal cost for the one book could be substantially different from the marginal cost of the market book. If the end goal of a competitive market is to achieve prices that are at, or slightly above, marginal costs then this practice should be disallowed.

Inclusion and vigorous enforcement of anti-gaming restrictions will implement FERC’s statutory duty to assure that market-based rates are “just and reasonable.”

⁹ Departures from cost-based rates have been invalidated where competitive markets do not exist and where market power has not been mitigated. In Tejas Power, the court rejected a gas inventory charge that deviated from the cost-based model then in place for natural gas pipeline regulation. The court held that the Commission had erred in accepting the rate as part of a larger settlement package, having “made no prior finding that [the pipeline] lacked significant market power vis-à-vis the [customers].” 908 F.2d at 1004. See also Farmers Union Central Exchange v. FERC, 734 F.2d 1486, 1502 (D.C. Cir. 1984) (invalidating departure from cost-based regulation for oil pipelines).

C. The Commission Has An Obligation To Define The Expected Outcomes Of Bid-Based Markets And To Clearly Specify Acceptable And Unacceptable Behavior

ELCON's comments in the SMD NOPR docket supported the Commission's proposal to include in the SMD Tariff certain minimum behavioral rules. However, the general prohibitions under the proposed rules are subjective and open to conflicting interpretation. Anti-gaming rules would provide benchmarks of expected behavior and improve the efficiency of behavioral rules.

Ample experience to date with bid-based markets in California, PJM and New York demonstrates that generator bids—especially the bids of large portfolio generators with the same owner—do *not* generally approximate expected marginal costs of supply. While it is arguably extremely difficult to determine such costs during times of scarcity, when workably competitive markets are allowed (at least in theory) to charge what the market will bear, most hours during the calendar year are relatively free of scarcity. In fact, during most hours of the year, suppliers are in excess of demand—often by a lot. Yet, the bid records, six-months after the fact, do not support any finding that bids “reflect marginal costs of supply.”

ELCON recommends that the Commission define the expected outcomes of each bid-based market, and that such outcomes be used to establish benchmarks to gauge market performance. Defining expected outcomes is consistent with FERC's statutory responsibility to ensure that rates in bid-based markets are just and reasonable. To assure that the ground rules are clear for enforcing compliance, the Commission needs to establish clear delineation between acceptable and unacceptable bid behavior. Defining benchmarks are essential pre-conditions to the market power mitigation measures proposed in the SMD NOPR, and will help ensure that the labors of the Market Monitors are productively employed. Market Monitors should not be expected to “dredge the data” without clear guidance on what constitutes illegal bidding or other trading behavior.

D. Prior Energy Price Control Regulations Have Included Anti-Gaming Provisions

By analogy, petroleum price control regulations from the 1970s included “anti-sham” regulations to prohibit circumvention of price controls. These regulations were the basis on which federal energy authorities enforced “daisy chain” crude oil resale abuses.

Under the Department of Energy Oil Price Regulations, crude oil resellers were prohibited from engaging in any practice that circumvented or contravened or resulted in the circumvention of the agency’s regulations. 10 C.F.R. § 205.202 provided that:

Any practice that circumvents or contravenes or results in a circumvention or contravention of the requirements of any provision of this chapter or any order issued pursuant thereto is a violation of the DOE regulations stated in this chapter.

A reseller was also prohibited from employing any practice that constituted a means to obtain a price higher than that permitted by the regulations. 10 C.F.R. § 210.62(c). United States v. Sutton, 795 F.2d 1040, 1052 (Temp. Emer. Ct. App. 1986).

CONCLUSION

Thus, “anti-gaming” prohibitions have historically been included in energy price regulation. Prohibitions at least equivalent to the CAISO MMIP provisions should be extended to all regions of the country to protect consumers and assure just and reasonable rates.

DESCRIPTION OF ELCON

ELCON is an association of industrial consumers of electricity organized to promote the development of coordinated and rational federal and state policies that will assure an

adequate, reliable, and efficient electricity supply for all users at competitive rates. ELCON member companies produce a wide range of products from virtually every segment of the manufacturing community. The member companies of ELCON consume approximately five percent of all electricity in the United States.

NOTICES AND COMMUNICATIONS

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing Comments of the Electricity Consumers Resource Council were today mailed to parties on the service list of this proceeding by U.S. mail, postage prepaid.

Dated at Washington, D.C., this 11th day of April, 2003.

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