Order Seeking Comments on Proposed Revisions to Market-Based Rate Tariffs and Authorizations

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Federal Energy Regulatory Commission
Docket Nos. EL01-118-000 and EL01-118-001

Comments

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I. Introduction

The Federal Energy Regulatory Commission (the Commission) has described the tension between supporting efficient electricity markets and protecting against manipulation through the exercise of market power.[2] Providing the right balance is a difficult task. The events of recent years, especially the problems in the California electricity market, provide a context and a motivation for the Commission to act to define and prohibit anticompetitive behavior. In the present docket the Commission seeks comments on its proposed rules to accomplish this end.

The comments offered here emphasize a common theme. In particular, the Commission's proposed rules are too narrowly based on the California case with its

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[2] For example, see discussion of hydropower market power mitigation, Federal Energy Regulatory Commission, *Remedying Undue Discrimination Through Open Access Transmission Service and Standard Electricity Market Design*, Notice of Proposed Rulemaking, 67 Fed. Reg. 55, 452 (August 29, 2002), FERC Stats. & Regs. ¶422 (SMD NOPR).

fundamentally flawed market design. Further, even in the case of California, much of the implicit diagnosis is misplaced. The result is that the bulk of the resulting prescription embodied in the proposed behavioral rules would do harm, not good. Principal elements of the proposed rules would not even have been helpful in California. Further the rules would be starkly at odds with principles of good market design and efficient locational marginal pricing (LMP) that have been applied in the Northeast and sponsored elsewhere by the Commission in its deliberations on the appropriate Wholesale Power Market Platform.[3]

The proposed rules carry with them an implicit view about the design of an electricity market. This implicit design is inconsistent with the Commission's own electricity market design analyses and recommendations, and inconsistent with the successful markets in the Northeast. The implicit design is more like the model originally proposed by Enron, a model that has failed wherever tried and that has already been rejected by the Commission. It would be ironic and costly if the old Enron arguments triumphed in the new Commission market behavior rules. A fundamental problem is that the Commission Staff "Final Report on Price Manipulation in Western Markets,"[4] from which much of the proposed rule flows, implicitly embraced the Enron market design model while analyzing and condemning the practices that followed. The Staff analysis was too narrowly constrained by its context and lacked any broader analytical framework that would separate bad behavior from bad design. The Commission needs to go beyond that analysis of pathology and move on to address real issues in real markets building on the extensive related analytical work the Commission has done to promote efficient market design.

Here we describe the problems and explain why large parts of these particular proposed rules should not be adopted. The parts that could be appropriate are straightforward but limited. Further, we outline why the task ahead for the Commission is both different and more demanding in that it requires careful integration with the different markets in different regions.

II. Overview

The first proposed rule is simple and straightforward. We understand that rule 1 is intended to establish the Commission's authority to order disgorgement of profits in the circumstance of conduct that violates Commission approved tariffs for Independent System Operators (ISO) or Regional Transmission Organizations (RTO). If the Commission's authority is unclear, this rule could be helpful, although it ought not duplicate remedies in RTO and ISO tariffs that already assign financial

[3] Federal Energy regulatory Commission, "White Paper: Wholesale Power Market Platform," Washington, D.C., April 28, 2003.

[4] Federal Energy Regulatory Commission, Staff "Final Report on Price Manipulation in Western Markets: Fact-Finding Investigation of Potential Manipulation of Electric and Natural Gas Price," Docket No. PA02-2-000, March 2003.

consequences to tariff violations.[5] If the proposed rule has a different purpose, that purpose needs to be made clear.

The second proposed rule is neither simple, straightforward, nor appropriate. Some of the conduct prohibited by the second rule would reduce market efficiency, impair reliability and raise the cost of meeting load. Unfortunately, the second rule would also prohibit conduct that increases market efficiency, is essential to maintaining reliability and reduces the cost of meeting load. Indeed, elements of the second rule are so inconsistent with efficient market design and successful market operation that they amount to declaring that Enron wins, that the Enron model with balanced physical schedules must be adopted in the Northeast, long after it has been uniformly rejected by market participants in the Northeast and elsewhere. These conflicting impacts arise in part from the flawed market model reflected in the second rule but are probably also in part inevitable in any rule that attempts to proscribe conduct across a number of markets with very different market rules and philosophies.

Further, the second rule is not necessary. The first rule provides the best approach for addressing issues raised by the conduct described in the second rule. The tariffs of the individual ISOs and RTOs are able to identify conduct that is unacceptable within those markets and the first rule would adopt a Commission enforced disgorgement of profits for such conduct. This approach of reinforcing the tariffs of the individual ISOs and RTOs would deter inefficient and anticompetitive behavior while ensuring that market conduct important to the success and reliability of ISO operation in some regions is not foreclosed by general Commission policies intended to address problems that may exist in markets having a very different market design and structure. It would be particularly counterproductive for the Commission to establish policies that would impose large economic and reliability costs on consumers and market participants of successful ISOs and RTOs in order to have one rule that could accommodate even bad market designs that have repeatedly failed. By allowing individual ISOs and RTOs to adopt rules approved by the Commission and consistent with their software and market systems, the Commission would permit customers of the successful ISOs and RTOs to benefit from the market flexibility accommodated by those designs, and the potentially high cost of inefficient restrictions such as those described by the second rule would only fall on the consumers and market participants of the ISOs and RTOs that choose to include such restrictions in their tariffs.

Finally, the application of Rule 3 needs to be clarified to provide that it is applicable only to formal communications in response to Commission, Market Monitoring unit or ISO inquiries and is not intended to apply to forward schedules.

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[5] For example, the NYISO assigns financial consequences to external transaction schedules that fail check-out with adjacent control areas for reasons within the control of the scheduling entity in order to deter attempts to manipulate market outcomes through transaction schedules that intentionally designed to fail check-out. See NYISO OATT attachment J at sheets 467-467A and NYISO Services Tariff, attachment B at sheets 350-350A.

III. Discussion of Rules 2 and 3

The second rule should be rejected as a general industry wide prohibition on the described conduct. Parts B, C and E in particular would apparently prohibit conduct that is not only permitted in LMP-based markets such as PJM, ISO-NE and New York but is important to the success and future viability of those markets. In particular, virtual load and generation bids, changes in schedule between day-ahead and real-time to respond to real-time conditions, price based management of energy limited resources, and arbitrage between day-ahead schedules and real-time markets are important elements of successful markets in the Northeast that should not be undermined or abandoned. Part A appears to address price reporting issues which are better addressed under Rule 4 and as worded part A would prohibit arrangements which are important for efficient operation of markets and forward hedging. Only part D's prohibition on illegal collusion reflects a sound Commission policy objective that if defined consistent with the antitrust laws should apply broadly to all regions.

A. Wash Transactions

The proposed Rule would prohibit "pre-arranged offsetting trades of the same product among the same parties, which trades involve no economic risk, and no net changes in beneficial ownership." This prohibition does not address market manipulation. In particular, financial transactions with no net impact should not affect market outcomes. The relevant elements of this rule should be included in Market Behavior Rule 4, and applied to price reporting of such transactions.

If the prohibition set forth in this rule were applied to market transactions, rather than to price reporting, this prohibition would have a number of substantial adverse impacts. First, the Commission should recognize that the current wording of the prohibition appears to apply to exchange agreements, which are pre-arranged offsetting trades of the same product among the same parties, but at different locations. Such transactions are particularly common outside RTO markets, because they enable the parties to avoid paying pancaked transmission charges and thus reduce the cost of meeting load. These exchange transactions are legitimate efficiency enhancing business transactions and should not be prohibited. Moreover, although the prices of such transactions do not themselves convey information regarding market price levels, price reporting services might choose to request that these transactions be reported to them because the locational differential embedded in these transactions could provide useful information that may be used by those services to validate other information or in combination with other information to develop price assessments.

Second, the proposed rule does not recognize differences in transaction term (i.e. duration), and would therefore apparently prohibit book out transactions, whereby market participants cash out deliveries under long-term transactions with offsetting

short-term transactions to avoid the transaction costs associated with taking the long-term transaction to delivery. Such a prohibition would also adversely impact the market, raising the cost of settling long-term transactions and therefore at the margin discouraging forward contracts.

Third, the Commission should recognize that a fundamental characteristic of both ISO market systems and bilateral or multilateral electronic trading systems is that there are no retakes. When market participants mistakenly buy instead of selling or buy 10 times as much as they intended, those market participants cannot avoid the financial consequences simply by saying it was a mistake. Instead, they must attempt to close out the erroneous position as quickly as possible, which may entail entering into an offsetting transaction, possibly with the same party or on the same trading platform. These transactions are legitimate and prohibiting them would serve no useful purpose.

Real wash trades that have no legitimate purpose should also have no effect on the market. Overall, the prohibition described under part A would serve no useful purpose and would raise the costs and risks of market participants for no socially appropriate purpose. If the Commission's purpose is to prevent the reporting of wash transactions from impacting price reporting, that purpose should be addressed through Rule 4.

B. False information

Supplying inaccurate information regarding generation availability in forward reliability evaluation processes, supplying inaccurate information regarding real-time generation availability, or scheduling transactions that are designed to fail check out, can provide a method of withholding capacity from the market, or manipulating the resources scheduled to be available in real-time and should be deterred. At the same time, it must be recognized that the essence of a market-based LMP pricing system, as well as most non-LMP market systems, is that individual market participants are free to take financial positions in forward markets that may differ from their real-time consumption or generation patterns. The rule 2 prohibition on "inaccurate load or generation data" would apparently preclude virtual demand and supply bids in day-ahead markets, as these bids and offers would not match any physical load of that supplier, although they might well correspond to overall market load or generation. Similarly, the prohibition on "paper trades" would apparently prohibit virtual supply and demand bids, an important element of Northeast markets[6] and one that not long ago the Commission insisted that the NYISO extend to internal locations as well as to the external proxy buses.[7]

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[6] See, for example, PJM Scheduling Operations Manual, Section 2, pp. 2-3 to 2-5; NYISO OATT Sheets 88 and 88A.

[7] See, for example, the discussion in 97 FERC Para 61,091 Order Accepting Virtual Bidding Proposal and Mitigation Measures, and Directing Compliance Filing, October 25, 2001.

In addition, this rule would apparently preclude a generator operating to cover a bilateral transaction from generating energy in excess of the load covered by a bilateral contract, because its bilateral schedule would then be construed to be based on "inaccurate load data." This ability of generators to enter into financial bilaterals yet remain on dispatch without regard to the actual consumption of the load covered by the bilateral contract is fundamental to the operation of the LMP markets in PJM, New York and now New England and is proposed for MISO.[8] That generators be free to follow their economic dispatch instructions, without regard to their bilateral contracts, is essential for least-cost operation and maintaining liability.

Requiring that generators match their output to physical loads, rather than following ISO bid-based dispatch instructions, was long a goal of Enron. The related balanced schedule requirement in Cal ISO coordinated day-ahead markets was one of the now rejected four pillars of the California market separation rules. This design feature was rejected by the transmission owners, regulators and ultimately all other market participants in the Northeast. Yet the proposed prohibition on "inaccurate" load or generation would apparently require that generators entering into bilateral contracts operate to follow physical loads rather than following dispatch instructions, in effect declaring that "Enron wins" long after Enron's vision is entirely discredited. Moreover, this rule would appear to prohibit generators from self-scheduling to sell power in the spot market, an important market design element in most markets and a element of the Commission's own Wholesale Power Market Platform proposal.[9]

Furthermore, the Commission needs to recognize that even the terms "firm" and "non-firm" have very different meanings in LMP markets than in contract path systems and it is not at all clear what the proposed prohibition on "scheduling non-firm service or products sold as firm" means in LMP markets. In all of these general prohibitions it is necessary to consider what the words mean not only in California under its flawed market design but under each other market design. For this reason, most of these prohibitions are better addressed within individual ISO/RTO tariffs.

Finally, Rule 3 is likely intended to require market participants to provide complete, accurate and factual information, and not submit false or misleading information, or omit material information in filings, or in responses to Commission, market monitor, ISO or RTO inquiries. It might, however, also be construed to require that market participants not submit forward schedules that differ from their actual real-time operations. As discussed above, such an application of the prohibition would be counter-productive. It would eliminate virtual supply and demand bids in forward markets and potentially deter market participants from modifying their real-time operations in response to real-time conditions, if this would cause their day-ahead

[8] See the example in MISO Straw Proposal, pp. 26-28, 32.

[9] See, for example, Federal Energy Regulatory Commission, "White Paper: Wholesale Power Market Platform: Appendix A," Washington, D.C., April 28, 2003, p. 10. See SMD NOPR para 271 and Appendix B, Part 3, Section 1.5; PJM Operating Agreement, Section 1.10; MISO Long-Term Market Design and Congestion Management Straw Proposal, November 29, 2001, pp. 16, 25 and 31; New England Power Pool Market Rules; FERC Electric Rate Schedule No. 7, Section 1.10.3.

schedules to be characterized as "false or misleading" simply because they differed from real-time.

Rule 3 should therefore be modified to clarify its intended applicability and ensure that it does not have unintended consequences.

C. Artificial Congestion

The proposed order would prohibit "transactions in which an entity first creates artificial congestion and then 'relieves' such artificial congestion." There are circumstances in which transactions may be scheduled in forward markets to profitably distort forward prices by creating congestion in forward markets which will not exist in real-time. Where this conduct has arisen, the affected ISOs and RTOs have adopted measures to address it.[10]

The proposed order, however, would apparently prohibit a wide range of desirable conduct seen routinely both in LMP markets in the Northeast and in Transmission Loading Relief (TLR) based congestion management systems outside the Northeast. First, it appears that like the prohibition on "False Information" discussed above, this part of the proposed order would largely preclude the use of virtual load and supply bids for arbitrage of day-ahead and real-time prices. While the proposed order does not define "artificial congestion" it appears to us that any virtual demand offer submitted in a day-ahead market by a physical generator, would likely have the property of creating congestion that might be relieved by that generator's supply offers. Similarly, the virtual supply offers submitted by a Load Serving Entity (LSE) in a day-ahead market would be likely to relieve congestion created by the physical loads of that LSE. These virtual load and supply bids have been successfully implemented in Northeast markets,[11] provide an important mechanism for the arbitrage of day-ahead and real-time markets while avoiding withholding of generation from the day-ahead commitment process. Such a prohibition of virtual load and supply bids would be more likely to reduce, than increase, the efficiency and competitiveness of day-ahead markets.

The potential adverse impact of the proposed order on arbitrage utilizing virtual load and supply bids could be limited to a degree by clarifying the meaning of "artificial congestion" to refer only to congestion that exists in forward markets but is not expected to exist in real-time. This would be analogous to the standard PJM uses in evaluating the impact of virtual load bids on financial transmission rights (FTR) values. Such a definition would clarify that virtual load and supply bids that cause day-ahead congestion to better approximate real-time congestion are legitimate arbitrage. Even with such a definition of "artificial congestion," however, the Commission's order might be construed to prohibit arbitrage transactions by loads

[10] See, for example, the discussion of the use of virtual load bids to create congestion in PJM, PJM Market Monitoring Unit, PJM Interconnection State of the Market Report 2000, pp. 97-98, and NYISO April 1, 2003 filing in Docket ER03-690-000, re non-competitive proxy buses.

[11] They were also called for in the SMD NOPR, described as "financial bids," e.g., p. 127.

and suppliers that turn out in real-time to be unprofitable. Since market participants in practice cannot avoid sometimes misforecasting congestion, the rule would appear to raise the costs of arbitrage by whatever costs are imposed by the prohibition.

This leads to the second concern with the proposed order, that it would apparently prohibit changes in day-ahead schedules in response to changes in market conditions between day-ahead and real-time. In practice, congestion that existed in forward markets may not exist in real-time because market participants have responded competitively to changed real-time conditions. Prohibiting such real-time responses to real-time market conditions would serve to prohibit competition, not to promote it. For example, any import or export transaction scheduled at an external proxy bus that is reversed in real-time would appear to fit the definition of creating artificial congestion (when the transaction is scheduled day-ahead) and then relieving it (when the transaction is backed down in real-time). This behavior, however, is efficient and important to maintaining reliability if the changes are in response to changes in market conditions. It is central to the day-ahead and real-time markets in the Northeast that day-ahead schedules are financial and it is expected that if market prices are different in real-time than expected day-ahead, then market participants will adjust their day-ahead schedules so that real-time schedules are consistent with real-time prices.

The New York ISO in particular utilizes financial scheduling processes at the external proxy buses premised on the operation of competitive markets at these proxy buses, and an important part of this competition is the ability of market participants with day-ahead transactions to reduce or eliminate those schedules in real-time in response to changes in the price differentials across those interfaces. The proposed rule would apparently prohibit much of the competitive response on which the NYISO markets at the external proxy buses are premised and would likely require reevaluation of these market mechanisms.

Moreover, even within the footprint of a given ISO/RTO almost any day-ahead schedule by a vertically integrated utility, such as those that predominate in Midwest ISO (MISO) would create congestion in day-ahead markets that the utility's operations might relieve in real-time as market conditions change. Moreover, the MISO market design explicitly envisions that market participants would utilize virtual demand and supply bids in the day-ahead market process to financially hedge themselves for transmission schedules that might or might not flow in real-time, in much the same way as they reserve transmission today.[12] The Commission should not prohibit conduct that is thus necessary to the prospective operation of LMP-based congestion management and energy markets in this large and important region.

[12] See, for example, MISO "Long-Term Market Design and Congestion Management Straw Proposal," November 29, 2001 pp. 14-16.

Outside LMP markets in regions currently utilizing contract path scheduling practices, it is also expected that market participants will adjust their real-time schedules to reflect actual real-time demand and supply conditions when those are different from those expected day-ahead. These changes at times involve schedules that reverse the direction of flow across constraints. Prohibiting such changes would preclude response to real-time conditions, raising costs and undermining reliability.

Third, the proposed rule would appear to prohibit one of the mechanisms that market participants in the Eastern Interconnection outside the Northeast sometimes utilize to manage congestion and avoid curtailments under TLR procedures. While of limited effectiveness, we understand that some market participants, particularly in the Midwest, have been able to identify some counterflow transactions that they can at times use to offset the impact of other transactions on constraints and thus avoid TLR based curtailments. These transactions by definition involve real-time transactions with off-setting impacts on the constraint.

Indeed, every form of real-time congestion management in effect entails creating "transactions" that relieve the congestion created by other transactions and thus would apparently be prohibited by the proposed rules. Overall, the proposed rule potentially addresses three kinds of transactions. First, transactions scheduled in the same market, i.e., in a day-ahead market, that exactly cancel each other out would be prohibited. These transactions would have no financial impact in an LMP market and there is no need to prohibit them. Market designs that socialize congestion costs and pay constrained-on and constrained-off charges will encounter problems in managing congestion and these market designs provide incentives for a variety of inefficient market participant behavior. The ISOs administering those markets may seek to prohibit conduct that exploits inefficiencies in these market designs but there is no reason to apply such prohibitions to LMP based markets. Moreover, even in markets with such problematic designs we are skeptical that such prohibitions will be effective in deterring inefficient behavior without also deterring desirable and even necessary behavior. In reality, the only effective remedy in such markets is to fix the inefficient pricing rules.

Second, transactions scheduled in a day-ahead market that are reversed in real-time would be prohibited by the proposed rule. These changes in transaction schedules clearly should not be prohibited as the ability of market participants to change schedules between day-ahead and real-time is central to maintaining reliability in any market. Third, the rule would prohibit transactions in the same market whose effects on transmission constraints do not cancel out because they are not quite the opposite of each other and thus the transactions may earn a margin. These kinds of transactions are also desirable and should not be prohibited as these kinds of changes in schedules are critical to congestion management. In fact, this is exactly what redispatch entails, shifting generation from a resource with a large shift factor on a constraint to a resource with a smaller shift factor on that same constraint. Prohibiting market participants from engaging in such behavior or responding to ISO

instructions that results in this outcome would be extremely inefficient and adversely impact reliability. In fact, the whole point of LMP pricing and region wide congestion management in the Midwest is to accomplish just what this rule would apparently prohibit.

D. Collusion

The proposed order would also prohibit "Collusion with another party for the purpose of creating market prices at levels differing from those set by market forces." If there is ambiguity as to whether the antitrust law prohibition on collusion is applicable to behavior in electricity markets, then the Commission should establish such a prohibition. If this is necessary, it would be desirable for the Commission to align its definition of illegal collusion as closely as possible with the definition of illegal collusion under the antitrust laws. In particular, the antitrust laws include a large set of precedents governing the application of the prohibition on collusion to joint ventures, affiliates, and contracts that the Commission should not attempt to replicate under a new definition of illegal collusion.

E. Withholding Available Supply

Part E would prohibit "bidding the output of or misrepresenting the operational capabilities of generation facilities in a manner which raises market prices by withholding available supply from the market." Avoiding the exercise of market power is important, but it is essential that rules intended to deter the exercise of market power, not also deter ordinary competitive behavior that is important to maintaining competition and to the success of market based reliability mechanisms. In December 2001, we submitted comments in this docket that discussed in detail the complexities in applying proposed criteria for identifying economic and physical withholding.[13] Instead of addressing those complexities, the language now proposed makes no attempt to distinguish competitive from anti-competitive behavior. If this proposed rule were literally applied, the existing markets in the Northeast would become unworkable and it would be extremely unwise for state regulators in other regions to permit regulated utilities to operate under RTOs subject to such prohibitions.

First, it should be noted that the criterion of prohibiting the "bidding the output…of generation facilities in a manner which raises market prices by withholding available supply from the market," if taken literally, would apparently prohibit all bids above zero because all such bids withhold supply and thereby raise price. This could not be the Commission's intent but it illustrates the problem of the general prohibitions under rule 2. The earlier proposed order in this docket defined economic withholding in terms of "offering output to the market at a price that is above both its full incremental costs and the market price." At minimum the proposed prohibition needs to be modified to recognize that offering supply at incremental cost does not

[13] Scott M. Harvey and William W. Hogan, "Market Power and Withholding," December 20, 2001.

constitute anticompetitive withholding and should not be prohibited. Even if the proposed order were modified in this manner, the language would fail to address any of the concerns previously noted with the more specific language in the earlier proposed order.

The second problem with this prohibition is that any prohibition on withholding supply from the market or bidding above incremental costs must contain an exclusion or limitation on application of this prohibition to energy limited units. As we previously noted,[14] the offer prices of such units can be and are used by firms lacking market power to allocate the limited output of these units to the hours with the highest value. Moreover, these offer prices also serve the purpose of ensuring that these units retain sufficient ability to provide reserves, whether in formal reserve markets or in the context of self-supply by vertically integrated utilities. A prohibition which prevented limited energy units from "bidding supply" "in a manner which raises market prices by withholding available supply from the market" could have serious adverse impacts on economic efficiency, electric system reliability and consumer costs by causing energy limited units to be inefficiently scheduled to displace high cost generation in a manner that makes the energy limited units unavailable to provide reserves in many other hours of greater need. The Commission's soft bid cap in the California market during 2000-2001 appears to have had this effect by preventing energy limited units from submitting offer prices that were sufficiently high to prevent the units from being dispatched to displace energy from high cost units lacking such energy limits. The soft bid cap may thereby have exhausted the ability of some energy limited units to offer reserves and contributed to the reserve shortages that ultimately required load shedding in California.

Third, it is unclear whether the proposed prohibition would apply only to real-time markets or also to forward markets. It is not anticompetitive or inefficient for market participants to decline to enter into forward contracts at less than the expected market clearing price and any prohibition that imposes such a requirement would give rise to inefficient behavior that would likely undermine reliability without benefiting loads. Indeed, a requirement that physical generation suppliers offer to sell their supply in forward markets at variable cost without regard to expected real-time prices would result in transferring all generation rents to middlemen. Moreover, as we have previously pointed out, any assessment of the cost of providing supply in forward markets must take account of start-up and no-load costs, not simply incremental generation costs.[15]

Fourth, while the Commission's earlier proposed order appeared to recognize that capacity providing reserves is not economically withheld from the market, the current language provides no exemption for capacity providing reserves.[16]

[14] Harvey Hogan 2001 pp. 37-39.

[15] Harvey Hogan 2001, pp. 39-41.

[16] Harvey Hogan 2001, pp. 41-42.

F. General Prohibition

In addition to the specific prohibitions discussed above, the Commission's proposed order also contains a general prohibition on other "actions or transactions without a legitimate business purpose which manipulate or attempt to manipulate market prices, market conditions, or market rules for electric energy, or result in market prices for electric energy and/or electric energy products which do not reflect the legitimate forces of supply and demand…." The Commission notes that in addition to the specifically prohibited behavior, the Commission would take action under this generic standard if it discovers "additional activities of a seller taken in contravention of our market behavior rules affecting the justness and reasonableness of rates." [17]

The Commission should be extremely cautious in adopting such an open ended disgorgement rule. There is a likelihood that the Commission's proposed rule could fatally undermine the very competition it seeks to expand by creating the expectation that arbitrage transactions will be subject to disgorgement if they are profitable, while market participants will be permitted to retain losses. But ISOs rely in part on arbitrageurs to keep some markets competitive. If the Commission were to impose rules that deter arbitrage or materially increase its cost, the competitiveness of these markets might deteriorate markedly.

This proposed general rule as well as the specific prohibitions raise the question of why the Commission would prohibit conduct in an ISO coordinated market that the ISO that coordinates that market would not prohibit. It is not apparent to us why any general prohibitions by the Commission are necessary in addition to those applied by the ISO coordinating the market in question. If the Commission believes that a particular rule needs to be applied in a specific market, this need could be addressed prospectively through the normal tariff conditions process, with all market participants, and the ISO coordinating the market, having an opportunity to comment on the need for and likely effects of the proposed rule, before it is put in place on a prospective basis.

It may be that this proposed rule is motivated by a concern that new bidding strategies or market design failures may emerge and that the time frame for amendments to ISO tariffs that address these problems may be too slow to enable ISOs to modify their tariffs before substantial market inefficiencies and wealth transfers have been incurred. It does not seem to us, however, that such a concern warrants this approach.

There is always a possibility that a software change, a generation or transmission outage, or a mandated change in tariff conditions will create new opportunities for inefficient conduct that was not anticipated by existing market rules. It seems to us that this problem is better addressed by the Commission establishing procedures for ISOs to put in place temporary interim rules approved by their boards to deal with such sudden problems on a prospective basis. Such an approach would permit

[17] FERC para 23.

ISOs and their market participants to address such unanticipated problems, with rules that deter the inefficient conduct without also deterring conduct that is important to the efficient operation of those markets. The approach proposed by the Commission, however, would imply that in the event of such a sudden change, market participants would not know what behavior might be found to be prohibited or not until months later, leading to the worst possible outcome, many market participants pulling out of the market in the interim.

G. California

Even in California during 2000 and 2001, the grim reality is that had rules B, C and E been in place, the outcomes probably would have been worse – not better – and load shedding would likely have begun earlier, lasted longer and affected more customers. When the fault is with the market design, it would be misplaced to prohibit behavior that is necessary to overcome defects within the flawed design. For example, the proposed Rule B is likely intended to prohibit "fatboy" scheduling, whereby resources outside California were self-scheduled as price takers to sell energy into California in excess of their actual California load. This course of action enabled the sellers to comply with the tariffs of intervening systems, permitting them to make additional energy available in the California market. Had the energy not been scheduled into California in this manner, it could not have been delivered, and prices in California would have been higher, and additional load shedding might have been required during reserve short hours.

Part C would likely have prohibited "death star" scheduling. The undisputed reality is that the congestion payments received by those scheduling death star transactions were paid by other market participants that were thereby enabled to sell additional generation into California. The net impact of the death star transactions under the Cal ISO's admittedly flawed contract path scheduling mechanism was that more energy could be imported into California. Had the death star schedules not permitted these additional imports to be delivered into California, prices would have been higher and additional load shedding might have been required during reserve short hours.

Part C would likely also have prohibited "ricochet" transactions whereby exports scheduled prior to real-time were scheduled back into the source region in real-time in response to real-time conditions. Had this conduct been prohibited during the California energy crises, these export schedules would have flowed out in real-time, potentially backing down generation outside California, reducing supply in California and giving rise to the need for additional load shedding during resource short hours. More likely, the resulting price discrepancy would have caused other market participants to sell energy back into California in real-time, with some increase in transaction costs.

Finally part E was in effect implemented to a degree during 2001 by the Commission's soft-bid cap's as applied to energy limited resources. As noted

above, by depleting the ability of energy limited units to supply reserves, the Commission's soft bid cap likely ultimately raised real-time prices and may have led to additional load shedding during reserve short hours.

Hence, even in California during 2000-2001 these prohibitions would have been counterproductive. There is no basis for the Commission to inflict these prohibitions, and their inevitable consequences on consumers and other market elsewhere in the country and particularly not on the consumers and market participants in the Northeast that have developed effective well functioning markets that would be seriously impacted by these prohibitions.

H. Conclusion on Proposed Rules 2 and 3

The prohibitions included in rule 2, parts B, C and E, would prohibit conduct that is efficient and reliability enhancing. Indeed these prohibitions are thoroughly inconsistent with the markets currently operating in the Northeast. The proposed rules would also be inconsistent with the Commission's own analysis of the preferred market design. Outside the Northeast, The prohibition on counter-flow included in part C would undermine existing congestion management mechanisms in the Midwest, leading to greater use of TLRs, while imposition of the prohibitions expressed in parts B and E would likely deter MISO market participants from moving forward with planned market implementation consistent with the Commission Standard Market Design (SMD) that would be rendered unworkable by these prohibitions.

If a regional ISO wishes to impose such prohibitions on market participants in its markets, perhaps the Commission would wish to accommodate the ISO's desire and allow such prohibitions under its tariff, allowing the consequences of these prohibitions to fall on relevant customers. However, the Commission should not inflict those consequences on consumers and regulators throughout the country, particularly those that have rejected such inefficient market designs.

The second rule should also be rejected because it would have a more general effect in deterring market participants from submitting bids and offers in the economic markets coordinated by the ISOs, because of the apparently elevated risks arising from that participation. Northeast markets are successful and provide competitive outcomes that are recognized as legitimate by market participants and regulators because of widespread participation. The second rule could undermine the basis on which the northeast ISOs have successfully operated and make it impossible for them to continue operation on that basis.

Even the suggestion that the Commission would retroactively punish market participant conduct that was profitable, consistent with the relevant ISO/RTO tariff and helped maintain reliability during emergency conditions would adversely impact reliability. It is a fundamental premise of LMP markets that high prices are a signal for market participants to take actions within the scheduling processes defined by

the ISO market rules to increase supply. It is for this reason that the Northeast ISOs and their market participants worry about "getting the prices right." For the Commission to tell market participants that they should not necessarily respond to high prices, nor are they necessarily to respond to emergency conditions by taking actions to increase supply would be unhelpful.

It would be particularly inappropriate for the Commission to impose the consequences of these prohibitions on the consumers and transmission owners in the Northeast. The Transmission Owners in the Northeast have committed themselves to market-based mechanisms for managing reliability, and developed and implemented the successful Northeast markets over Enron's unyielding bitter opposition, with the Commission recently endorsing the wisdom of the successful design. Particularly in New York, an important premise for willingness of the transmission owners to turn over operational control of their system to an ISO was the market-based LMP system that would enable the NYISO to efficiently manage the reliability of the New York transmission system. In prohibiting conduct necessary to maintaining competition and reliability in these markets, the Commission's proposed rules could undermine the ability of the NYISO and other Northeast ISOs to efficiently carry out the reliability as well as market functions expected of them.

Aside from a prohibition on illegal collusion, it is difficult to define prohibitions that are appropriate across all market designs. While a prohibition on misrepresenting the availability of generation for the availability commitment might be appropriate in some LMP markets, it would have been meaningless in California. Similarly, while a prohibition on physical withholding of capacity in real-time might be appropriate in well designed markets, even this rule could lead to reliability problems involving energy limited units if these units cannot be economically withheld from the dispatch and scheduled as reserves through appropriate bids.

IV. An Alternative Approach

Behavioral rules should be consistent with the market design. Hence, different market designs imply different behavioral rules. Further, a good market design provides incentives and settlement schemes that isolate the realm of profitable market manipulation and exercise of market power. Hence, good design in turn simplifies the tasks of monitoring market behavior and applying rules to prohibit inappropriate activity.

This suggests that the priority for the Commission should remain where it has been in developing and implementing good market designs. The Commission has discussed this task at length under the SMD NOPR and the Wholesale Power Market Platform White Paper. In the regions where there is an organized market and a good design, the general prescription for the Commission should be to support the detailed rules in the tariff. This would allow more directed rules that match the real requirements to support a competitive market.

For example, in a market that comports with the Commission Wholesale Power Market Platform, there would be a day-ahead unit commitment market and a real time balancing market. With the accompanying LMP-based pricing system, a rich variety of trading and bidding practices would be allowed and even encouraged. Arbitrage between markets, which inherently would require forward contracts that would be closed out rather than go to delivery, would be encouraged as part of the solution rather than prohibited as part of the problem.

The performance of this Wholesale Power Market Platform would be enhanced through improvements in efficient pricing to provide a better recognition of scarcity conditions. For example, with the Commission's support, the Northeast markets have been developing shortage pricing, including demand curves for reserves and pricing for demand response that would more properly reflect reliability costs at high utilization of available generating capacity.[18] The intent is to improve the efficiency of pricing to reflect scarcity. As part of providing better price signals, these innovations would reduce the incentives to withhold supply. Further, improved pricing would make it much easier to monitor bidding practices.

Since the consequences of bidding and scheduling would be priced, there would not be much that would be done on paper that could be harmful or that would allow for an exercise of market power. The focus would not need to be on trading and financial transactions. The focus then would be on real time outcomes and the necessary requirements of reliability.

Under an efficient market design, the only way to exercise market power would be through physical manipulation of real-time generation (principally through withholding). Hence, the focus of behavioral rules would be to prohibit deliberate misrepresentation of load or generation for reliability commitment, and to prohibit deliberate misrepresentation of real-time generation physical availability.

As the Commission noted in its SMD NOPR, in the case of reliability commitment, this would distinguish between day-ahead bids for virtual load or supply versus information provided about the commitment of specific units. The day-ahead market would include both forward energy contracts and a related evaluation of the commitment decisions for specific units. In effect, all energy transactions in the day-ahead market would be financial, with some transactions intended to hedge real supply or demand and others as virtual transactions intended to support arbitrage across the markets. Virtual bids would be treated like any other bids for the energy dispatch and forward contract commitments. Unit specific commitment information would be used only for the reliability evaluation. In the case of the resulting financial contracts, there would be no need for anything other than financial settlement. In the case of the unit commitment, the real units would need be made available and

[18] See NYISO Filing of "Tariff Modifications to Establish Pricing During Periods of Energy Scarcity," April 23, 2003, Docket ER03-766-000; and the draft RTS schedule 3 and 4 tariffs that have been circulated to NYISO market participants.

hence misrepresentation could a problem that would warrant tariff specific behavioral rules.

Similarly, misrepresenting the availability of generation in real time would affect both system reliability and could be a tool for a sustained exercise of market power. Hence, tariff specific behavioral rules would be appropriate. Just such rules can be found in a well-designed market and the Commission should use its authority to reinforce these rules rather than preempt the efficient design with inferior rules that are not as well targeted and not consistent with competitive market operations.

Outside the regions with an effective market design, current tariffs may be inadequate to support a competitive market and there may be no ISO/RTO to turn to as the instrument of developing good behavioral rules. In these regions, the task would be a combination of defining interim behavioral rules and implementation of better market designs. As discussed above, the rules proposed by the Commission for comment are not likely to be appropriate, or even relevant in these regions. Hence, there would be a requirement to adapt better to the actual market designs in these regions. This process should isolate the counterproductive effects of broad prohibitions of otherwise desirable trading practices and provide strong incentives for market participants to insist on rapid development of RTOs with efficient market designs.

In the end, therefore, the Wholesale Market Platform should be the priority. Behavior rules should derive from the market design. And most importantly, bad behavioral rules, too broadly writ from too narrow a perspective, should not overturn the successful market designs.