PROJECT NO. 26201

RULEMAKING TO ADDRESS ENFORCEMENT OF WHOLESALE MARKET RULES	**§ § §**	**PUBLIC UTILITY COMMISSION OF TEXAS**

ORDER ADOPTING NEW §25.503
AS APPROVED AT THE JANUARY 29, 2004 OPEN MEETING

The Public Utility Commission of Texas (commission) adopts new §25.503, relating to Oversight of Wholesale Market Participants with changes to the proposed text as published in the August 15, 2003 issue of the *Texas Register* (28 TexReg 6466). The proposed new rule is necessary to protect the public interest by facilitating the efficient and reliable operation of wholesale electricity markets and the reliable delivery of electricity during the transition to and the establishment of a fully competitive electric power industry in Texas. This new section is adopted under Project Number 26201.

The new rule establishes: (1) the standards that the commission will use in monitoring the activities of entities participating in the wholesale electric market in Texas and enforcing the statutory provisions, rule requirements, market Protocols, and operating guidelines applicable in that market; (2) the standards and criteria for enforcement of market Protocols and procedures adopted by the Electric Reliability Council of Texas (ERCOT); and (3) the ethical standards that apply to market participants and define the duties and prohibitions applicable to market participants. In addition, the new rule requires market entities to maintain certain records to demonstrate their compliance with the rule, creates a procedure for obtaining official interpretations and clarifications of ERCOT Protocols, identifies the role of ERCOT in enforcement actions, and describes an informal fact-finding review procedure that may be used by commission staff in reviewing compliance with the rule.

The new rule is needed to enable the commission to assure the efficient and reliable operation of electricity markets and the reliable delivery of electricity at reasonable prices during the transition to a fully competitive electric power industry in Texas. The Texas Legislature has determined that Texas should change from a system in which electric power is fully regulated by the commission to a system in which competitive forces will determine the rates, operations, and services that are available to the public. The Legislature has directed that the commission implement these changes in a manner that provides customers safe, reliable, and reasonably priced electricity. Recent experience in Texas and other states has shown that during the transition to competition, the developing wholesale and retail markets can be subject to practices by market participants that serve the private interests of the participants at the expense of the public interest. These practices have resulted in unjustified increased prices to customers and market participants, reduced reliability of the electric power grid, and ultimately threaten the implementation of a successful competitive electric market. As an example, in California, market manipulation by market participants contributed to elevated retail prices that were estimated to be $3 billion to $11 billion higher than would have occurred in a properly functioning market. These high prices also contributed to higher prices for long-term contracts for wholesale electric power. The impact on the California economy was enormous, including the bankruptcy of a major electric utility and many days of rolling blackouts that further crippled the economy and threatened the public health and safety. To protect the public interest from these possible effects, the commission finds that it is important that the obligations and restrictions applicable to market entities be specified. The new rule establishes those standards.

The new rule provides many public benefits, including the protection of customers and market entities from unfair, misleading and deceptive practices; the availability of reliable transmission and ancillary services at reasonable prices to all market entities; clarification of the obligations and restrictions applicable to market entities to reduce uncertainty in the wholesale markets; clarification of the commission's procedures and standards for overseeing the activities of market entities; and the protection of the developing wholesale market from potential market power abuses. Each of these benefits is important to meeting the legislative directive to protect the public interest by facilitating the efficient and reliable operation of electricity markets and the reliable delivery of electricity at reasonable prices during the transition to a fully competitive electric power industry.

The rule was proposed as part of the commission's efforts to adopt competition rules to protect the public interest during the transition to and in the establishment of a fully competitive electric power industry under Chapter 39 of the Public Utility Regulatory Act (PURA), Texas Utility Code Annotated §§ 11.001-64.158 (Vernon 1998 & Supp. 2004). Chapter 39 of PURA delegated many important functions to the commission in order to "protect the public interest during the transition to and in the establishment of a fully competitive electric power industry." Among those functions were the adoption and enforcement of rules to ensure customer protections and customer entitlements; the establishment of rules governing ERCOT and oversight of ERCOT activities; the assessment of market power; and the mitigation of market power abuses. In order to protect the public interest and to assure that prices are determined by the normal forces of competition, the commission finds that it must adopt this rule governing the

enforcement of wholesale electricity markets and ERCOT administered markets. Accordingly, the commission concludes that this rule is a competition rule under PURA Chapter 39.

A public hearing on the rule was held at the commission's offices, located in the William B. Travis Building, 1701 North Congress Avenue, Austin, Texas 78701, on Tuesday, October 7, 2003 at 10:00 a.m. Representatives from American Electric Power Service Company (AEP), Coral Power, L.L.C. (Coral), Reliant Resources, Inc. (Reliant), the Competitive Market Participants (CMP), TXU Energy Retail Company, LP (TXUE), Public Utilities Board of the City of Brownsville, Texas (Brownsville PUB), Brazos Electric Power Cooperative (Brazos), American National Power, Inc. (ANP), and CenterPoint Energy Houston Electric, LLC (CenterPoint) appeared at the hearing. However, none of the persons in attendance at the public hearing chose to make any comments on the proposed rule.

The commission received comments on the proposed new section from AEP, Coral, Reliant, CMP, CenterPoint, the TXU Companies (TXU), the City of Austin d/b/a Austin Energy (Austin Energy), BP Energy Company (BP), the City of San Antonio, acting by and through the City Public Service Board of Trustees (San Antonio), the Electric Reliability Council of Texas (ERCOT), the Office of Public Utility Counsel (OPUC), the Lower Colorado River Authority (LCRA), the City of Garland (Garland), Cap Rock Energy Corporation (Cap Rock), and Denton Municipal Electric (Denton). Reply comments were received from TXU, San Antonio, Coral, CMP, Reliant, AEP, OPUC, and the Independent REP Coalition (IRC).

On January 2, 2004, the commission faxed a notice to all persons who had submitted comments in this proceeding. The notice included a copy of a "redlined" version of the proposed rule showing the changes that commission staff proposed to make to the rule in its recommendation to the commission. This notice and redlined version of the proposed rule were also placed on the commission's website for review by interested persons. The notice indicated that interested persons could file comments on the redlined version within five calendar days, or by January 7, 2004. In response to that notice, additional comments were received from San Antonio, Coral, Austin Energy, TXU, CMP, CenterPoint, Reliant, AEP, OPUC, ERCOT and the Electric Power Supply Association (EPSA). A summary of the supplemental comments is included within the discussion of initial and reply comments in the following portions of this order. Similarly, the commission response also responds to the supplemental comments.

Cost benefit analysis

In its notice of proposed rule, the commission invited specific comments regarding the costs associated with, and benefits that will be gained by, implementation of the proposed section. Comments were received from CMP concerning the costs and benefits of the new rule. In various places, CMP asserted that market participants would incur additional costs in trying to comply with the rule. CMP also asserted that the commission should use a "cost-benefit analysis when choosing between a broad requirement and one narrowed to fit the problem and to allow market participants to avoid related costs and risks." CMP chided the commission for "instead addressing only the costs and benefits of having a rule versus having no rule."

Commission response

The commission disagrees with CMP's assertions that it has not properly assessed the costs and benefits of the proposed rule. Under Texas Government Code Annotated §2001.024, the notice of a proposed rule is to contain a note about public costs and benefits stating "(A) the public benefits expected as a result of adoption of the proposed rule; and (B) the probable economic cost to persons required to comply with the rule." The commission complied with these requirements in its notice published in the August 15, 2003 edition of the *Texas Register*. There is no requirement that the commission conduct a detailed cost-benefit analysis in the manner CMP proposes. Nevertheless, the commission has considered both costs imposed and the benefits derived from the proposed rule. The commission finds that the alleged costs identified by CMP and other commenters either were speculative and not adequately quantified or were based upon an exaggerated and improper interpretation of the rule requirements. The commission concludes that the public benefits outweigh the costs created by the rule and that the rule should be adopted.

FERC rules

In its notice of proposed rule, the commission referenced a June 26, 2003 Order issued by the Federal Energy Regulatory Commission (FERC) in Docket Nos. EL01-118-000 and EL01-118-001, *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations,* which proposed changes to the tariffs applicable to public utilities authorized to charge market-based rates. The proposed changes would have imposed provisions prohibiting a seller from engaging in anticompetitive behavior or the exercise of market power. The proposed tariff

provisions identified certain transactions and practices that are prohibited and imposed reporting and record retention requirements on sellers. The order indicated that a violation of these proposed provisions would constitute a tariff violation and the seller could be subject to disgorgement of unjust profits, suspension of its market-based rate authorization, or other appropriate non-monetary penalties. Because the FERC order and proposed tariff provisions address much of the same subject matter that the commission addresses in the new section, the commission invited comments from interested persons concerning the two proposals. Specifically the commission requested that interested persons answer the following questions:

1. Compare and contrast the differences between the commission's proposed rule and each of the six market behavior rules in the proposed tariff revisions in the FERC order. What aspect of each proposal is best suited to prevent potential anti-competitive and deceptive practices by market participants in the ERCOT market, and why?
2. Should the commission attempt to harmonize the proposed new section to the FERC's proposed tariff revisions? If so, what steps can and should the commission take to that end?

Comments on Preamble Questions

The comments that were submitted in response to these questions and the commission's responses are presented below. The comments have been grouped by topic.

FERC's philosophy on market behavior rules compared to the proposed rule

AEP provided a comparison of what it perceived as two different philosophies behind the two proposed rules, in spite of the fact that both sets of rules seek to address similar problems. AEP favored FERC's stated philosophy regarding the oversight and monitoring of markets and stated that, in comparison, the commission's rule demonstrates a fundamental distrust of the market, requiring that a market participant either not engage in any activity not specifically permitted by the rules or seek approval. In contrast, AEP believed that FERC's philosophy gives a market participant more flexibility in that, "within established limits, if it is not prohibited, the behavior is permitted." AEP, Reliant, and CMP approved of FERC's three stated goals to: 1) provide effective remedies against anticompetitive behavior or market abuses; 2) provide clearly-delineated "rules of the road" without impairing the commission's ability to prevent abuses; and 3) avoid unlimited regulatory uncertainty to the detriment of participants and the market by providing reasonable bounds within which conditions on market conduct will be implemented. AEP added another FERC stated purpose for its rule, which is to foster a "stable marketplace with clearly defined rules (that) benefits both customers and market participants and creates an

environment that will attract much-needed capital." However, AEP and Reliant believed that the FERC proposal fell short of those stated purposes.

Commission Response

The commission disagrees with AEP that compared to the FERC's proposed rule; the commission's rule demonstrates a fundamental distrust of the market. FERC stated that its proposed market behavior rules have been informed by "what we have learned about the types of behavior that occurred in the Western markets during 2000 and 2001." Similarly, the preamble of the proposed rule invokes experience in other states, and in particular in California, where market manipulations by market participants were a major factor causing prices so high as to cause the bankruptcy of one major electric utility, rolling blackouts, a crippling of the economy, and a threat to the public health and safety. The commission believes that, to protect the public interest from these possible destructive effects, it is important to specify market participants' obligations and restrictions. Similarly, FERC's proposed rules are motivated by the need "to provide regulatory safeguards to ensure that customers are protected from potential market abuses." The commission agrees that its proposed rule is more detailed and has more specificity than the FERC rule, which the commission sees as an advantage if the goal is to provide "clearly delineated rules of the road," a goal stated by FERC. The commission however, disagrees that FERC's philosophy gives a market participant more flexibility in that, "within limits, if it is not prohibited, the behavior is permitted." Like the commission's rule, the FERC's rule attempts to complement a generic standard of behavior with "a non-exclusive list of

prohibited activities that illustrates the types of activities that adversely affect competitive outcomes." FERC added: "we have also included a generic standard which will allow us to take remedial action if we discover additional activities of a seller taken in contravention of our market behavior rules affecting the justness and reasonableness of rates." The generic standard adopted by FERC in its proposed rules is a rate impact standard, a very different position from the one portrayed by AEP. Further, FERC stated that it will impose sanctions if it is demonstrated that a "transaction or behavior not expressly prohibited in our market behavior rules appears to be in violation of this rule, *i.e.*, that a given transaction or behavior is causing prices to reflect outcomes not reflective of market forces," unless the identified seller can show good cause. The commission sees one major difference in the standards included in the proposed rule compared to the FERC's proposed rules. Whereas FERC has set two main generic standards, a market power abuse standard prohibiting behavior and transactions that are anti-competitive, and a rate impact standard prohibiting behavior and transactions that cause unjust and unreasonable prices, unlike the proposed rule, it does not have a reliability standard. In the proposed rule, a market participant is prohibited from engaging in activities that are likely to adversely and materially affect the reliability of the electric system.

It would be incorrect to infer from the proposed rule that the commission has a "fundamental distrust of the market." The commission simply recognizes that market participants will engage in all the profit maximizing activities that are not expressly prohibited. When sufficient competition exists, the forces of competition set the limits that

ensure that profit maximizing activities do not result in unreasonable prices, and no government intervention is needed to protect customers from price gouging. However, the commission recognizes that competition is not yet fully established in the ERCOT markets, and therefore market behavior rules are necessary to protect the public interest during the transition period. The Legislature recognized the need for protection of the public interest during this period of transition in PURA §39.001(a) when it stated: "the public interest in competitive electric markets requires that…electric services and their prices should be determined by customer choice and the normal forces of competition. As a result, this chapter is enacted *to protect the public interest during the transition to and in the establishment of a fully competitive electric power industry*." FERC was even more specific when it stated: "the potential for market abuse and the exercise of market power may exist in any region where the evolution towards a competitive market is not yet complete." (FERC Docket No. EL01-118-000, Order Seeking Comments On Proposed Revisions To Market Based Rate Tariffs And Authorization, June 26, 2003, paragraph 11.)

Like FERC, the commission recognizes that a difficult balance needs to be achieved between the need to protect the public interest with limiting rules that deter market abuses, and the risk of rules that are so restrictive as to create an unfavorable business climate and deter investments. In light of the comments received, the commission recognizes that the proposed rule can be modified to bring more balance in this respect and reduce the perception of uncertainty created by the proposed rule. However, in the area of reliability in particular, there are limits as to how much the commission can compromise and still

protect the public interest. The Legislature has assigned independent organizations the function to ensure the reliability and adequacy of the regional electrical network. However, the independent organizations cannot accomplish this mandate without the cooperation of market participants. It is the commission's philosophy that market participants have certain responsibilities regarding the reliability of the electric system and cannot ignore the impact some of their profit maximizing activities may have on reliability, to the extent that this impact is predictable. Further, the Legislature has given the commission the authority to address market power in PURA §39.157. The commission cannot allow a market participant who has market power, by virtue of owning a facility essential to maintaining reliability, to exercise such market power and extract enormous profit to the detriment of the market. The commission recognizes that power plant owners should be justly compensated for helping reliability in ERCOT and has relied on the stakeholder process to develop incentive compatible market rules and Protocols that accomplish this purpose. However, in some instances the Protocols have failed to include requirements necessary for ERCOT to adequately protect reliability. In such instances, the reliability standard contained in the proposed rule is intended to be an essential stop gap until appropriate adjustments are made in the Protocols.

Analysis of the FERC rules' content compared to the proposed rule

AEP found that the FERC's rule is unclear as to what activity is prohibited, that it lacks "intent" as an element, and that it does not recognize that "market participants can operate consistent with

existing operational, environmental, and legal constraints without running afoul of the market rules." AEP supported the FERC's proposed rule only if amended as proposed by the Electric Power Supply Association (EPSA). Reliant did not embrace the FERC market behavior rules as proposed either. Reliant said that the FERC proposed market behavior rules lack clarity and the requisite standard of intent, and that they will not only prevent anti-competitive behavior and deceptive practices, but they will also prevent prudent business behaviors and activities. The commission's proposed rule, Reliant stated, suffers from the same maladies, and in addition, it incorporates detailed provisions that produce further confusion and do not really address market power abuse. According to Reliant, both the FERC proposed rules and the commission proposed rule require further review and revision, although Reliant found the FERC proposed rules less restrictive and favored the limited focus on the activities the rules are intended to govern.

AEP noted that the commission's proposed rule requires "official interpretations and clarifications regarding the Protocols" and sets out the process by which the staff would initiate informal "reviews." In contrast, the FERC proposal does not provide procedures to obtain clarifications and does not address investigations. AEP thought that these matters are addressed more generally in the FERC's practice and procedures.

Austin Energy said that the proposed FERC code is much closer to achieving the aims articulated by the commission for its rulemaking than the commission's proposal, which is unnecessarily prescriptive and leads to more confusion than clarity. Austin Energy suggested that the FERC proposal can serve as a model for the commission in revising the proposed rule, as

it is "much more effective at establishing clear, enforceable standards." In addition, Austin Energy added, comments filed at FERC indicate that the FERC proposal can be improved even further.

San Antonio stated that the FERC proposal contains areas of ambiguity and non-clarity and would be improved if it incorporated the comments submitted at FERC. San Antonio declined to draw specific comparisons between the FERC proposal, given the likelihood of changes to this proposal, and the commission's proposal.

Coral declined to be specific in its comparison of the two rules, but offered some general comments. First, Coral noted that the FERC rule is grounded in its ratemaking authority, whereas the commission's rule is outside its ratemaking authority. However, Coral continued, several things are common to both proceedings: both are trying to address market behavior; they will affect the same stakeholders; they are "struggling with the balance between being overly prescriptive and being adequate to protect the public interest;" and they fail to adequately recognize the element of "intent." Coral concluded that, although the FERC proposal needs work, it avoids many of the pitfalls that flaw the commission's proposed rule, and it is closer than the commission's proposal to being clear, concise and to the point, without overreaching.

Commission Response

The commission notes that many market participants who offered comments in response to the preamble questions do not think that the FERC market behavior rules offer a good

model, even if they are deemed slightly less prescriptive or overreaching than the proposed rule, and notices that criticisms of the FERC rules, both in the comments received by the commission and the comments received at FERC, point to similar issues, including the lack of an intent element in both rules, vagueness, the lack of specificity and clarity, and uncertainty as to what activities are not prohibited. The commission believes that it is not appropriate to compare the proposed rule to the FERC proposed rules as "amended by EPSA" or by any other selectively picked party that submitted comments at FERC, as several market participants have attempted to do, while ignoring comments submitted by other groups such as the Electricity Consumers Resource Council (ELCON) that are supportive of the anti-manipulation provisions in the FERC rules. The commission notes that the FERC has modified its proposed rules to address some of the concerns expressed in the comments it received and has adopted a final set of market behavior rules that it considers just and reasonable. The commission has considered the modified language of the FERC rules in revising the proposed rule.

Different Grants of Authority

AEP compared the different remedies in the two proposed rules. Whereas the commission's rules include requiring corrective action, administrative penalties, criminal prosecution, revocation of licenses, or other remedies deemed appropriate, FERC's proposed penalties include the disgorgement of unjust profits, revocation of authority to sell at market-based rates, and revisions to the applicable tariff or code of conduct. Those differences stem largely from

"the different grants of enforcement authority to the commission and the FERC," which, AEP stated, make it difficult to harmonize the commission's proposal with FERC's market rules. AEP and Reliant pointed out that FERC proposed its market behavior rules in the context of its market based rate authority, which contrasts with the commission's more limited authority over the wholesale market. Given this different scope of jurisdiction, AEP concluded that the manner of implementing consistent rules should be achieved through the ERCOT Protocols rather than through commission rules. Reliant, on the other hand, pointed out that the commission has the authority pursuant to PURA §39.157 to identify market power and enforce penalties against those who commit market power abuses.

Commission Response

The commission agrees with AEP, Reliant and others that there are significant differences in enforcement authority between FERC and the commission that necessarily limit the extent to which the proposed rule can track the FERC market behavior rules. Although the commission agrees with Coral that there are similarities in the stated purposes of the rules, there is a major difference. FERC's market behavior rules are intended "to complement any RTO or ISO tariff conditions and market rules that may apply to sellers in these markets." (FERC Docket No. EL01-118-000, Order Seeking Comments On Proposed Revisions To Market Based Rate Tariffs And Authorization, June 26, 2003, paragraph 8.) The commission's proposed rule specifically applies to the ERCOT markets, and is therefore meant to include more specific standards in addition to generic standards similar to those included in the FERC rules. The commission disagrees with AEP's

statement that, given the different scope of jurisdiction, the manner of implementing consistent rules should be achieved through the ERCOT Protocols rather than through commission rules. PURA §39.151 requires that the Protocols be consistent with commission rules. Given the recent failure of ERCOT to adopt code of conduct rules, as discussed elsewhere in this order, the commission believes it is more appropriate to act now rather than waiting for possible future action by ERCOT, which may not occur or may prove ineffective in addressing the commission's concerns.

Need to Harmonize

In response to the preamble question on the need to harmonize the proposed rule with the proposed FERC rules, CMP answered that the commission should attempt to harmonize the proposed new section to the FERC's proposed tariff revisions, stating that "Texas behavioral requirements need to track those FERC adopts for the rest of the country." AEP added that it is desirable to have a consistent set of rules in all parts of Texas. CMP extended the need to harmonize the commission's proposed rule to not only the proposed new section of FERC's proposed tariff's revisions, but to all FERC rules for consistency, and to reduce costs and confusion. With respect to reporting requirements, CMP asserted, consistency with other FERC rules on reporting requirement will also introduce in the Texas rule more moderating language as to intent, materiality or harm, a rebuttable presumption of good faith and an exception for inadvertent error. CMP provided a list of additional benefits of mirroring the FERC's rules: the rule would be shorter, simpler, easier to understand and apply, and, because the FERC rule has a

broader application, a rewrite would be less likely when the ERCOT market design changes. CMP added that FERC is knowledgeable about what behavioral requirements are needed to avoid a California type situation because it has jurisdiction over California. CMP also stated that "a rule mirroring the FERC's proposed rules would produce more competitive ERCOT markets than would the proposed rule and avoid creating additional seams between ERCOT and other markets."

Coral's response to the preamble question concerning the need to harmonize was "yes," because the objective of both commissions is essentially the same. In Coral's view, the FERC rule is further along in the development of the appropriate concepts, and the commission can benefit from FERC's analysis. In addition, Coral stated, consistency in behavioral expectations is especially important because many market participants are involved in multiple markets. Coral admitted that it has not performed an exhaustive analysis to determine the implications of harmonizing the two rules. Nevertheless, Coral opined, even if harmonizing the proposed rule with the FERC proposal (as it develops) requires substantive changes and the commission has to re-publish the rule as a result, "any delay associated with getting it right … will be small compared to the significant delays associated with the legal challenges that Coral believes will most certainly result under the current proposal."

BP agreed with the commission that it is appropriate to look at the proposed tariff revisions in the FERC order. However, BP saw a lack of clear and specific rules necessary to give market participants regulatory certainty in both proposals. BP added that the commission cannot turn to

other states for best practices because other states have not developed similar market conduct rules. Neither can the commission turn to other states or to FERC for a complete and workable set of market oversight rules.

In response to the preamble question, BP believed that it is vital for the commission to harmonize its rule with FERC's, otherwise the cost to a market participant of complying with two sets of rules that may be divergent could be extremely high and result in some parties deciding not to participate in Texas markets.

In response to the preamble questions, the LCRA offered one specific comment, stating that the commission should follow FERC's lead and clarify that actions taken for a legitimate business purpose are not "Prohibited Activities" as defined in the proposed rule. LCRA was concerned that actions taken for entirely legitimate reasons and with no intent to manipulate or otherwise affect market prices may result in rule violations.

CMP, San Antonio, Coral, BP and AEP stated that the commission should wait until FERC adopts its final rule before adopting the proposed rule. In reply comments, Reliant disagreed, stating that there are no overwhelming advantages to be gained by delaying action on the proposed rule in an effort to "harmonize" it with the FERC rule.

TXU urged the commission not to attempt to harmonize the proposed rule with the FERC's proposed tariff revisions. TXU stated that, in many areas of the proposed rule, the commission

staff has incorporated the comments of market participants and provided clarity and detail to definitions and to the conduct intended to be required and/or prohibited. TXU concluded that "to now move backwards towards the more vague standard provided for in FERC's proposed tariff revisions would create great uncertainty in the ERCOT market." TXU quoted FERC's description of market manipulation as "actions or transactions without a legitimate business purpose which manipulate or attempt to manipulate market prices, market conditions or market rules for electric energy and/or electric energy products which do not reflect the legitimate forces of supply and demand…" as an example of a standard that is vague and difficult for market participants to understand and comply with. In contrast, TXU continued, the commission rule provides concrete examples of activities that are, in fact, prohibited, even though it does include catch-all prohibited activity language such as "includes, but is not limited to."

OPUC stated that the commission's proposed rules are generally more comprehensive and specific than the FERC's proposed market behavior rules, and that all types of market behaviors addressed in the FERC rules are already covered in the commission's rule. OPUC did not see any need to harmonize the commission's rule with the FERC's proposed tariff revisions because the commission's rules are more detailed and comprehensive, and they are not in any way contrary or inferior to the FERC rules. In reply comments, San Antonio disagreed and stated that comprehensiveness and specificity are not the sole criteria to be considered in determining the usefulness of FERC's efforts. According to San Antonio, the main challenge for FERC and the commission was "drafting conduct rules that strike a careful balance between the need to

allow the competitive market to operate freely based on competitive principles while protecting participants and transactions from the effects of abusive practices."

In reply comments, CMP disagreed with OPUC and stated that the proposed rule is contrary to the FERC rules, including on the key question of including intent in the behavioral requirements. One example CMP offered was the FERC "legitimate business purpose" standard, which CMP deemed to be an "intent" standard.

In support of its argument for harmonization with the FERC rule, CMP provided two documents in reply comments. One was a letter from Texas Governor Rick Perry to the Southern Governors' Association addressing the sale of wholesale electricity. In his letter, Governor Perry expressed general support for FERC's efforts in the area of wholesale electricity markets and supported "standardization of market rules." The Governor listed the benefits of competition in electricity markets and stated his belief that legislative reform has led to vibrant competition in the production of electricity in Texas. The second document was a FERC order that suspended proposed Amendment No. 55, a document that sets forth nine proposed market behavior rules of the California Independent System Operator (CAISO), until February 21, 2004, pending further review and in conjunction with FERC's proceeding relating to market behavior rules. CMP quoted FERC as stating that its postponement decision "will allow these issues to be addressed in a coordinated manner." AEP made a similar argument in reply comments. In addition to advocating an intent standard consistent with the one used in the FERC proposed rule (*i.e.*, the "legitimate business purpose standard") CMP warned that if the commission and FERC

adopt significantly different definitions of economic and physical withholding, there could be serious consequences in wholesale markets. In reply comments, AEP urged the commission to "wait until final FERC action, and then assess to what extent it would be desirable to harmonize the ERCOT rules with those in effect in ERCOT." (Probably meaning at FERC.)

In supplemental comments, CMP, EPSA objected that the commission's proposed rule did not mirror the language contained in the FERC's rules. They argued that the commission's proposed rule addresses similar subjects as the FERC's rules but does not use the same language and often includes additional subjects not addressed by the FERC's rules.

Commission Response

The commission notes that it will not be necessary to delay adoption of its rule and wait for FERC because FERC has now finalized its market behavior rules. The commission agrees with CMP, AEP, and others that consistency with FERC's market behavior rules is desirable to avoid confusion and possibly reduce compliance costs for market participants operating in FERC regulated markets as well as in ERCOT. However, the commission does not believe that consistency means that it must adopt all FERC rules as stated by CMP, as this goes beyond the intent of the preamble questions. The commission notes that commenters do not agree on what constitutes an intent standard, or a vague standard. For example, CMP considers that the FERC's "legitimate business purpose" is a clear standard and that the intent element is inherent in the standard because, if someone acts with a legitimate business purpose, then it lacks an intention to manipulate the market or market

prices. In contrast, TXU considers this same standard as an example of a standard that is vague and difficult for market participants to understand and implement. And while CMP praises FERC for having an intent standard, FERC has been assailed with commenters' criticisms for lacking such a standard. The commission also notes that, while FERC received praises for being effective at establishing clear, enforceable standards from Austin Energy, it received criticisms from TXU, who thinks the proposed rule is more specific, and from BP and others who see a lack of clear and specific rules necessary to give market participants regulatory certainty in both proposals. The commission agrees with OPUC that the proposed rule is more detailed and comprehensive than the FERC rule but also agrees with San Antonio that a major challenge lies in being able to draft rules that strike a proper balance between minimizing restrictive rules that may impede legitimate activities while protecting participants and customers from the effects of abusive practices.

The lack of consistency among the commenters in their criticisms of the behavior standards laid out in the proposed rule and the FERC rules underscores the difficulties in developing clear and enforceable market behavior rules. A common theme in the comments to both sets of rules is the need to provide more specificity as to the type of activities that are prohibited, and to reassure market participants that they will not be found guilty in hindsight based on information they could not foresee at the time of the activity. The commission agrees with AEP and Reliant that it may not be possible for the commission's rule to exactly track the FERC rules because of different areas of authority. The commission has focused on the similarities of efforts and considered the rules adopted

by FERC as it assessed the concerns directed both at the FERC's rules and at the commission's proposed rule. To the extent possible, the commission has strived to avoid inconsistencies with the FERC rules. However, as the FERC stated, its rules are to complement other market rules that apply to sellers, not to replace such rules. Therefore, it would not be appropriate to mirror the FERC's rules or to adopt the same language used by FERC. Instead, the FERC's rules should be viewed as minimum requirements for market participants designed to apply on a nation-wide basis to all markets regardless of the market structure in place. In contrast, the commission's rule is designed to apply to ERCOT and contains the additional complementary requirements appropriate to the ERCOT market and market structure. The commission recognizes, however, that the two rules should be harmonized wherever possible to avoid burdening the market participants who operate outside ERCOT with having to comply with inconsistent rules at the local and federal levels, and has made changes to the rule accordingly.

General Comments on the Proposed Rule, by topic.

Rule exceeds commission's authority

Coral stated that the proposed rule exceeds the commission's authority. CMP stated that commission jurisdiction is limited to violations of ERCOT requirements and to specified steps to mitigate market power abuses found to be occurring. Reliant affirmed that, under PURA, since

the commission does not have authority to regulate or approve prices, its authority is limited to penalizing market participants for abuses of market power. Reliant added that the rule violates PURA because under PURA §35.004(e), the commission is bound to accept as reasonable, prices that the ERCOT ISO pays for ancillary services on a non-discriminatory basis, but the rule imposes a different standard in section (a)(2).

Austin Energy noted that the sanctions and penalties of Subchapter B are not applicable to municipally owned utilities and electric cooperatives, but suggested that any market participant found to be in violation of the Protocols or other market rules be required to refund inappropriately gained revenue and take remedial action. Austin Energy suggested that subsection (k) should specifically refer to the commission's authority under PURA §15.023. Austin Energy questioned whether the commission has the authority to seek "criminal prosecution under the Public Utility Regulatory Act" as stated in section (l) of the proposed rule.

Commission Response

The commission disagrees with these comments and finds that it has the necessary authority to adopt the rule, as revised. This conclusion is based upon a review of PURA in its entirety. Section 14.002 of PURA grants the commission broad rule-making authority, directing the commission to "adopt and enforce rules reasonably required in the exercise of its powers and jurisdiction." In executing its duties under PURA, the commission is guided by the language and intentions of the Legislature, as stated in various portions of PURA. The Legislature found, in §11.002(c), that changes in technology "have increased the need

for minimum standards of service quality, customer service, and fair business practices to ensure high-quality service to customers and a healthy marketplace where competition is permitted by law." The Legislature has also established that the purpose of PURA is "to grant the Public Utility Commission of Texas authority to make and enforce rules necessary to protect customers of telecommunications and electric services consistent with the public interest." In PURA §39.001(a), the Legislature stated that Chapter 39 was enacted "to protect the public interest during the transition to and in the establishment of a fully competitive electric power industry." These legislative policies and directives must be considered in determining the scope of the commission's rulemaking authority under §14.002.

PURA §39.101(b)(6) states that a customer is entitled to be protected from unfair, misleading or deceptive practices. Although some portions of §39.101(b) are limited to particular providers (*e.g.*, "retail electric providers") or are limited to particular types of services (*e.g.*, "energy efficiency services"), subsection (b)(6) contains no such limitations. Section 39.101(e) expressly gives the commission authority "to adopt and enforce such rules as may be necessary to carry out" subsection (b) and provides the commission with "jurisdiction over all providers of electric service in enforcing subsections (a)-(d)." Because of the breadth of the commission's rulemaking authority and jurisdiction under subsection (e) and the lack of limitations contained in subsection (b)(6), the commission interprets §39.101 to grant it authority to protect customers against unfair, misleading or deceptive practices, regardless of whether such practices occur in the wholesale or retail

markets and regardless of the type of electric service provider involved. Contrary to comments filed by some parties, the heading of Subchapter C, entitled "Retail Competition", does not limit the commission's authority under §39.101(b) to only the retail market. Section 311.024 of the Texas Government Code specifically provides that, "The heading of a title, subtitle, chapter, subchapter, or section does not limit or expand the meaning of a statute." Therefore the title of Subchapter C does not limit the commission's authority to adopt and enforce rules under §39.101.

PURA §39.151(d) requires the commission to oversee and review the procedures adopted by an independent organization, such as ERCOT; directs market participants to comply with such procedures; and authorizes the commission to enforce such procedures. The commission's authority under this section is not limited to taking enforcement action after ERCOT acts, as some commenters have suggested. Instead, the statute is clear that ERCOT's procedures must be "consistent with this title and the commission's rules." Thus, the commission has the authority to specify the scope and reasonableness of ERCOT's procedures through its prospective rulemaking process and not just through a post-hoc complaint process. PURA §39.151(j) requires all providers of electricity, including municipally owned utilities and electric cooperatives, to comply with the ERCOT procedures and authorizes the imposition of administrative penalties for failure to comply with those procedures. Another section, PURA §39.157, directs the commission to monitor market power associated with the generation, transmission, distribution and sale of electricity and provides enforcement power to the commission to address any market

power abuses that it discovers. Section 39.157 specifies the remedies available to the commission in the event of a market power abuse, including "seeking an injunction or civil penalties as necessary to eliminate or to remedy the market power abuse or violation as authorized by Chapter 15, by imposing an administrative penalty as authorized by Chapter 15, or by suspending, revoking, or amending a certificate or registration as authorized by Section 39.356." The rule, as adopted by the commission, is consistent with this grant of authority.

The rule is also based upon and consistent with PURA §15.023, which authorizes the commission to impose an administrative penalty against a person who violates the statute or a commission rule; PURA §39.356, which allows the commission to revoke certain certifications and registrations for violation of ERCOT's procedures, statutory provisions, or the commission's rules; and PURA §39.357, which authorizes the commission to impose administrative penalties in addition to the revocation, suspension, or amendment of certificates and registrations.

The rule is intended to protect customers of electric services from market power abuses and the effects of unfair, misleading or deceptive practices in the ERCOT-administered markets and the wholesale electric markets by requiring all wholesale electric service providers to meet certain criteria and by prohibiting them from engaging in activities that threaten the reliability of the network, that force ERCOT to incur inordinately high costs in order to operate the electric network in a secure way, or that prevent the ERCOT

market from functioning as a healthy competitive marketplace. Based upon the PURA sections cited above and the legislative policies and directives embodied in PURA, the commission finds that it has the necessary authority to adopt the rule as a reasonable means to protect customers during the transition to a fully competitive market.

The commission also disagrees with comments suggesting that its authority to adopt the rule is abrogated by PURA §39.001(d), which requires that the commission, and other regulatory authorities, "authorize or order competitive rather than regulatory methods to achieve the goals of this chapter to the greatest extent feasible and shall adopt rules and issue orders that are both practical and limited so as to impose the least impact on competition." Experience in both the California market and in the ERCOT market has shown that some market participants are concerned only with their own self-interest and are, at best, indifferent to the effect of their actions on customers or on competition. As discussed elsewhere in this preamble, the commission agrees that a competitive solution is preferable to a regulatory solution to govern the activities of market participants. However, for a competitive solution to be effective, a structurally competitive market must exist. Unfortunately, at this stage of its development, the wholesale electric market in Texas is not structurally competitive and competition cannot be relied upon to effectively govern the activities of market participants. This rule is especially necessary for assuring the protection of customers in the absence of a structurally competitive market in Texas and during the transition to competition. The ERCOT Protocols, adopted by the ERCOT Board after considerable input from stakeholders, contain many instances in which the

duties and obligations of market participants are not clearly stated. The Protocols do not always contain the proper incentives to motivate market participants to act in a way that benefits them as well as the market as a whole. In some instances, the Protocols contain provisions that make it possible for market participants to take actions that benefit them but harm the efficient and reliable operation of the electric network while still claiming that they are not in violation of the Protocols. Ambiguities and provisions that are not incentive-compatible prevent the Protocols from adequately protecting the interests of the public from the self-interest of individual market participants. During the time that the commission was developing this new rule, the commission invited ERCOT stakeholders to develop, through the stakeholder process, protocol revisions that would add a code of conduct to the Protocols and specify market participants' prohibited activities in the Protocols. However, the code of conduct and the list of prohibited activities developed by the stakeholders were not approved by the ERCOT Board. In particular, the Board opined that a closed list of prohibited activities was inadequate because it inferred that any activity not expressly mentioned was therefore permissible. The commission views these factors as demonstrating that, at least at this stage in the development of competitive electric markets in Texas, reliance on stakeholder-developed market rules is not adequate to the task of achieving the goals established by the Legislature in PURA relating to customer protection and the establishment and protection of a fully competitive electric power industry. Because the stakeholder process has failed in the task, and in the absence of a structurally competitive market, the commission must act to ensure that legislative goals are achieved.

As required by PURA §39.001(d), the new rule is both practical and limited so as to impose the least impact on competition. The commission is not implementing traditional regulatory tools, such as mandatory tariffed offerings, but instead has established standards to protect customers; ensure the reliability of the electric network at a reasonable cost, and ensure proper accounting for the production and delivery of electricity within the ERCOT market. The commission notes that gaming and market power abuse also have a negative impact on competition. The regulatory burden of behavioral standards must therefore be weighed against the anticompetitive behaviors that such standards are designed to deter. This rule will have a net effect of improving competition, which is the Legislature's explicit intent. As long as a market participant complies with these minimum levels of regulation, it remains free to develop its own unique service offerings and compete for business in ERCOT. Accordingly, the commission concludes that the new rule is consistent with the requirements of PURA §39.001(d).

Open-ended list of Prohibited Activities creates uncertainty

To achieve the goal of discouraging only unwanted actions, AEP asserted, the rule should clearly define the behavior that is prohibited, and the list of prohibited activities should not be open-ended. AEP noted that in a memorandum to the commission, the staff noted that the commissioners requested that the rule include a list "of prohibited activities that are specific and well defined." AEP further stated that, as a consequence of the uncertainty created by an open-

ended list, market participants may curb or reduce their activity to avoid the risk of violation, but that even by curbing their activities, they cannot ensure that their actions will not be later determined to be a violation because of unforeseen consequences of their actions. CMP differed. Consistent with the proposed rule and with FERC's proposed behavior rules, CMP agreed that the list of prohibited activities should be open ended, but stated that the rule is one-sided in that it uses open-ended lists when the list could be used to prosecute a market participant, but includes closed lists when the list could be used to defend a market participant. CMP proposed to use open-ended lists where the proposed rule allows for exclusions from obligations or prohibited activities.

Commission Response

The commission agrees with AEP that the goal of this rulemaking should be to discourage detrimental behavior without also discouraging behavior that is beneficial. The commission notes, however, that this standard is hard to achieve in this type of rulemaking without reducing somewhat the flexibility afforded market participants.

The commission believes that a balance can be achieved between the need to discourage market abuses that can distort pricing and impede the development of a competitive market, and the risk of being so restrictive as to discourage participation in the ERCOT market. To achieve this balance, the commission believes that the rule should include a list of prohibited activities that are specific and well defined, but not exhaustive. A closed list would imply that the activities not listed are therefore tolerated. The commission has

complemented the list of prohibited activities with a set of guiding principles for acceptable and unacceptable market behavior. Like FERC in its proposed rules, the commission believes that market behavior rules should discourage not only a closed list of specific activities, but also a range of similar activities that, even if not specifically listed, have the potential to result in prices not reflective of competitive market forces. The commission believes that no list can include all the activities that can harm competition, and that it could not adequately protect customers from high prices such as those experienced during the California crisis in 2000 and 2001 if it limited prohibited activities to a closed list. The commission notes that the ERCOT stakeholders developed a closed list of prohibited activities that they submitted to the ERCOT Board for inclusion in the Protocols. Subsequently, at its June 18, 2003 meeting, the Board voted to reject the stakeholders list of prohibited activities, on the grounds that such exclusive list implied that activities not included therein were therefore permitted.

The commission disagrees with AEP that market participants should fear sanctions as a result of unforeseen consequences of their actions. Subsection (k) of the proposed rule provides that the commission staff will initiate informal fact-finding reviews as a first step prior to any formal investigation "to obtain information regarding facts, conditions, practices, or matters that it may find necessary or proper to ascertain in order to evaluate whether any market participant has violated any provision of this section." Subsection (k)(1) states that the purpose of such fact-finding reviews is to afford the market participant an opportunity to explain its activities. The commission agrees that it should

further clarify that market participants will not be sanctioned if it is found that a problem is due to unforeseen and unforeseeable consequences of their action. To this end, the commission is modifying the rule to add a new subsection on affirmative defenses that specifies the opportunity a market participant has to show that its actions should not be subject to sanction by the commission.

Intent/hindsight analysis

According to AEP, the proposed rule holds market participants to standards that are unachievable because it measures compliance by the consequences of an action without regard to the merit of the participant's intentions, whether the participant could foresee the consequences, or whether the participant was aware of alternatives to its action. AEP added that, toward the end of discouraging only inappropriate activity, the element of intent should be added to the description of prohibited activities. CenterPoint concurred, adding that without the intent element, it is conceivable that market participants will be increasingly engaged in dispute resolution to resolve allegations, adding to the cost of participating in the ERCOT market.

AEP believed that the staff has overestimated the burden of establishing intent. AEP added that, as the Enron case demonstrates, there are often memoranda, e-mails, honorable people, and watchful competitors that will reveal ill intent on the part of a market participant. Further, AEP stated that the record keeping requirements in the proposed rule will be essential in assisting staff's determination of a participant's ill intent.

Austin Energy made a similar argument, adding that evidence of prior written warning, the frequency of the conduct, the duration of the conduct, a pattern of action, history of prior violations, or the circumstances surrounding the prohibited activity can support a finding of intent. In addition, Austin Energy noted that the commission's rule recognizes that "intent" can be considered in determining whether to initiate enforcement actions or determining penalty, and reasoned that standards for finding that a violation occurred should similarly include consideration of "intent" or gross negligence. Austin Energy added that if the commission clearly specifies required or proscribed behaviors, it will be easier to prove "intent." BP made a similar argument.

CMP concurred, stating that intentional misconduct is the problem to be addressed, and that there should be an intent standard in the proposed rule. CMP affirmed that under the proposed rule, a violation could be based on matters beyond a market participant's control or caused by a third party; or a violation could be determined only using hindsight based on information not known to the market participant at the time of the conduct. Reliant concurred. LCRA presented a similar argument. Reliant and CMP gave the example of the Commodities Exchange Act, which requires that, in order to establish manipulation, "it must be proven that the defendant intended to improperly manipulate price, and that: 1) the defendant had the ability to influence price; 2) an artificial price existed; and 3) the defendant caused the artificial price." Reliant urged the commission to adopt these accepted elements as an overarching principle in the proposed rule, apply it to each definition and prohibition, and include it in a "Purpose or Policy"

provision in the rule. In reply comments, AEP added its support for the Commodity Exchange Act's four part test for determining whether there was market manipulation. Coral also referred to the securities and commodity trading industries, and stated that federal statutes, regulation and applicable case law have included intent as an element to be addressed or proven when addressing behavioral issues. Coral stated that consideration of the design, resolve, or determination with which a market participant acts is critical in identifying unacceptable conduct. Coral, based on a definition of intent from Section 8A in the Restatement (Second) of Torts, stated that the rule needs "to determine whether from any acts or facts proven that the market participant desired to cause the consequences of his or her act or that he or she believed that the consequences were substantially certain to result from it." Coral added that, under PURA §15.030, an "offense is committed if a person 'willfully and knowingly' violates the statute."

Building on the concept of intent in relation to market manipulations, TXU referred to the Commodity and Futures Trading Commission (CFTC) and in particular Section 4c of the Commodity Exchange Act (CEA), which makes it unlawful for any person to participate in wash trades. TXU stated that "decisions at the CFTC and in the courts have defined such terms as 'wash trade' and 'accommodation trade' to inherently include an intent requirement." TXU quoted the Ninth Circuit Court's position in *Commodity Futures Trading Comm'n v. Savage*, 611 F.2d 270, 284 (9th Cir. 1979), as stating that "One cannot have an 'accommodation' sale or a 'fictitious' transaction if one in fact believes he is bargaining faithfully and intends to effect a bona fide trade. Nor can one enter a transaction to cause the reporting of a false price without an

intent to do so." TXU concluded that the courts and the CFTC have recognized that "rules that prohibit 'manipulation' of a market necessarily include an intent element."

TXU stated that a similar finding applies to the "market manipulation" rule of the Securities and Exchange Commission (SEC). TXU advised that "the commission should obviate the need for a Texas court to imply an element of 'intent' in this rule and should specifically include such an element in the rule along with a delineated means of proving intent as discussed below." TXU went on to say that intent can be proven by a number of means, including the establishment of a pattern of action, severity of action, or overt manifestations of intent. TXU gave definitions from the Texas Deceptive Trade Practices Act for the words "knowingly" and "intentionally". For example, "Knowingly means actual awareness at the time of the act or practice complained of, of the falsity, deception, or unfairness of the act or practice giving rise to the consumer's claim or, in an action brought under Subdivision (2) of Subsection (a) of Section 17.50, actual awareness of the act, practice, condition, defect, or failure constituting the breach of warranty, but actual awareness may be inferred where objective manifestations indicate that a person acted with actual awareness." TXU concluded that the commission can establish in the confines of the rule a reasonable means of proving "intent."

In reply comments, Coral stated that the fundamental challenge involves distinguishing between behavior driven by a legitimate business purpose and anti-competitive behavior, and provided a short review of antitrust law that addresses this challenge. Coral described a conceptual framework developed by the courts known as the "rule of reason." According to Coral, in

applying the rule of reason, a court balances the perceived anticompetitive effects of the challenged conduct against the pro-competitive benefits it may have, and behavior that is not illegal per se is judged by two criteria: the intent that accompanies it, and its probable effect on competition. Regarding the intent criterion, Coral stated that the courts have distinguished between two kinds of intent: objective intent, which is inferred from a party's observable conduct; and subjective intent, which involves the actor's state of mind. Coral stated that, in "rule of reason" antitrust cases, the courts have used a standard of objective intent whereby, if a defendant can show a "legitimate business purpose with competitive benefits" that offset the perceived harm to competition, there is not only a justifiable inference that the party intended to achieve a legitimate goal, but also that the merits of the conduct outweigh the harm to competition. In this way, according to Coral, the courts have avoided the difficulties associated with the subjective intent standard, and Coral advised that the commission borrow the standard of objective intent used in antitrust cases to distinguish anticompetitive from legitimate conduct: "the proposed rule should expressly allow market participants to explain how their conduct, if it is challenged, is justified by legitimate business purposes."

Reliant also saw an example of hindsight analysis in the list of prohibited activities in subsection (g) of the proposed rule. For example, Reliant stated that under the subsection, a violation would occur whenever a market participant's decision adversely affects the reliability of the regional network. Reliant claimed that a market participant would have to know the condition of the entire network, or it could not possibly know whether its individual decision will "adversely" affect the network. Reliant criticized subsection (g)(9), which states that a market participant is

prohibited from engaging in a bidding strategy that increases market prices above competitive levels during certain emergency conditions when the ERCOT ISO must procure all bids. Reliant criticized the standard for being vague: a market participant does not know how the "competitive level" is determined, and therefore does not have enough guidance to know what he can and cannot do. In addition, Reliant objected to the standard as being based on hindsight, since a market participant will not know at the time of his action that the ERCOT ISO will have to procure the entire bids offered into the market.

In reply comments, Reliant stated that, in addition to the commission's statutory guidelines, there are precedent setting guidelines available now that should be followed to develop acceptable rules. Among the precedent setting guidelines, Reliant listed the comments of the Electric Power Supply Association (EPSA) and of the Federal Trade Commission (FTC) to the FERC proposed rules.

LCRA proposed as a solution that the commission, following FERC's lead, clarify that actions taken for a legitimate business purpose are not "Prohibited Activities."

In their supplemental comments, most of the commenters again raised the issue of adding an intent element to the commission's rule. TXU, CMP, EPSA, Coral, AEP, Reliant and CenterPoint stated that the rules adopted by FERC include an intent element and urged the commission to mirror the FERC's action by including intent in the proposed rule.

Commission Response

The commission disagrees with comments suggesting it should add intent as a necessary element of a finding of a violation of the rule. The statutory scheme contained within PURA provides a range of enforcement actions available to the commission to address violations of the statute and commission rules or orders and specifies varying elements of proof applicable to each. PURA §15.030 provides for the imposition of criminal charges against any person who "willfully and knowingly violates this title." Thus, in order to obtain criminal penalties against a person, an intent to violate PURA must be demonstrated. In order to obtain civil penalties of up to $5,000 per day under PURA §15.028, the commission or the attorney general must demonstrate that one of the indicated service providers "knowingly violates this title." In contrast to these provisions, PURA §15.023 allows the commission to impose an administrative penalty against "a person regulated under this title who violates this title or a rule or order adopted under this title." Section 15.023 imposes no requirement that the violation must be done "knowingly", as in the case of civil penalties, and no requirement that the violation must be done "willfully and knowingly", as is required for criminal prosecution. Similarly, PURA §39.356, which allows the commission to revoke certificates and registrations, does not include an intent requirement but allows the commission to act in response to "significant violations" or even the failure to maintain required financial and technical qualifications. Based upon a review of the express language of PURA, the commission concludes that the Legislature did not intend to limit the commission's administrative enforcement actions to those instances in which a person acts "knowingly" or "willfully" or with any other specific improper

intent. Because the Legislature did not require a finding of intent for administrative enforcement actions, the commission lacks the authority to amend PURA by adding such a requirement to the statutory language. *Harrington v. State*, 385 S.W.2d. 411 (Tex. Civ. App. – Austin, 1964, overruled on other grounds, 407 S.W.2d. 467).

The commission's conclusion on this issue is supported by the decision in *Fay-Ray v. Texas Alcoholic Beverage Commission*, 959 S.W.2d 362 (Tex. App. – Austin, 1998, no writ). In that case, which involved an appeal of an administrative enforcement action that resulted in revocation of a mixed beverage permit, the court rejected a contention that a specific intent to violate the statute was required before a permit could be revoked. The court stated, at page 366, that the section of the statute "does not contain any language which would indicate that a specific intent to violate that statute is required." The court also considered and rejected an argument that because intent is required in some criminal sanctions under the statute, a similar intent standard must be imposed in regard to civil sanctions. The court stated that,

> **"the fact that there must be specific intent to find a permittee or licensee criminally negligent for selling beer to a minor and to cancel a permit for this violation does not require us to 'harmonize' the Code by imposing a requirement of specific intent before a permit may be revoked for the negligence addressed by the Dram Shop Act in another section of the Code or under section 11.67." (*Id.*, at p. 366).**

Like the situation in *Fay-Ray*, there is nothing in PURA §15.023 which requires a specific intent before administrative penalties may be assessed and there is no need to "harmonize" the criminal provisions of PURA with the administrative enforcement provisions of PURA by imposing an intent requirement that is not found in the statute.

The lack of an intent requirement in PURA §15.023 is also evidenced by the language contained in PURA §15.024(c), which prevents the commission from imposing an administrative penalty if the violation is remedied with 31 days after the person receives a notice from the commission and the person satisfies the "burden of proving to the commission that the alleged violation was remedied and *was accidental or inadvertent*." (Emphasis added.) There would be no need for this provision, and it would be rendered ineffective, if the commission had the burden of proving "intent" in order to establish a violation under §15.023. In interpreting the statute, the commission must seek to give meaning to all parts of the statute and must avoid an interpretation that renders the statute meaningless. *Southwestern Bell v. Public Utility Commission*, 79 S.W.3d 226, 229 (Tex. App. – Austin 2002, no writ). Applying this concept, the commission concludes that intent is not an element that it must prove in order to establish a violation of the statute in administrative enforcement actions. Lack of intent, *i.e.*, the fact that an action was accidental or inadvertent, is an affirmative defense that may be raised by the person alleged to have committed a violation. In order to reflect this, the commission has included language in the rule recognizing this affirmative defense.

Some of the parties submitting comments argued that an intent element must be implied in PURA, citing various federal cases in which intent was implied concerning violations of federal trade statutes. The commission finds that these cited cases do not establish that the commission has the need or the ability to imply an intent element when the Legislature has not included one in PURA. In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the United States Supreme Court ruled that proof of scienter (intent) is a necessary element in a private damage action under §10(b) of the Securities Exchange Act of 1934. The Court's decision was based upon three factors: (1) the language of the section in question; (2) the legislative history of the Act; and (3) the relationship of the section to other remedies available under the Act and the effect of the requirement on the overall statutory scheme. This analysis has been followed in subsequent cases involving the interpretation of federal regulatory statutes.

Applying the factors enunciated in *Hochfelder* the commission concludes that it would not be proper to infer an intent element as a requirement for administrative enforcement of its rules. The decision in *Hochfelder* was based upon federal law that prohibited the use of "any manipulative or deceptive device or contrivance" in the purchase or sale of securities. Based upon the use of the term "manipulative or deceptive device or contrivance", the court concluded that the law was intended to proscribe knowing or intentional misconduct. Similarly, other federal cases have relied upon the use of terms such as "fraud", "accommodation trade", "fictitious trade", or "for the purpose of" to indicate the need to imply an intent element. Unlike the federal law, the language of PURA §15.023 does not

contain these provisions or similar provisions that imply the need for an intent element. All that is required under §15.023 is a determination that a person has "violate(d) this title or a rule or order adopted under this title." Therefore, the first factor from *Hochfelder*, the language of the section in question, does not indicate the need to imply an intent element. The legislative history of PURA, and the public policies expressed in PURA, also do not support the need for the creation of an intent element. The Legislature has directed that the commission has authority to "make and enforce rules necessary to protect customers of telecommunications and electric services consistent with the public interest" and that it must "protect the public interest during the transition to and the establishment of a fully competitive electric power industry." There is nothing in these policies that states or implies that customers are only to be protected from "knowing and willful" violations of the commission's rules. Finally, the third factor, the relationship of the section to other remedies available under the Act and the effect of the requirement on the overall statutory scheme, also argues against creation of an intent element. As noted previously, PURA authorizes the commission to take various enforcement actions and specifies varying levels of proof to support those actions. Requiring all of those enforcement actions to be subject to the same proof requirement (a "knowing and willful" violation) would effectively amend PURA and upset the carefully structured regulatory scheme that it creates.

The commission also notes that federal courts have primarily focused upon the statutory language in determining whether scienter was a required element of proof and have not required the same scienter requirement to apply to all parts of a statute. In *Aaron v.*

***Securities and Exchange Commission*, 100 S. Ct. 1945 (1980), the U.S. Supreme Court held that, although one subparagraph of Section 17 the Securities Exchange Act of 1934 should be implied to include a scienter requirement, the remaining subparagraphs concerning enforcement actions do not include such a requirement. The court ruled that subparagraph 17(a)(1) contained a scienter requirement because it used the term "defraud", as well as the terms "device", "scheme", and "artifice", which had been relied upon in *Hochfelder* as embracing a scienter requirement. The court found no scienter requirement under subparagraph 17(a)(2), which prohibits obtaining money "by means of an untrue statement of a material fact, or any omission to state a material fact." The court stated that such language was "devoid of any suggestion whatsoever of a scienter requirement." The court also found no scienter requirement under subparagraph 17(a)(3), which prohibits a transaction that "operates or would operate" as a fraud. Even though subparagraph 17(a)(3) contained the word "fraud", the court declined to require scienter, stating that the language "quite plainly focuses upon the *effect* of particular conduct on members of the public, rather than upon the culpability of the person responsible." (Emphasis in the original, at page 1956.) Thus, although one portion of the statute required a finding of scienter, the Court did not extend that requirement to other portions of the statute in the absence of explicit statutory language.**

The commission finds that the new rule is similar to activities prohibited by the Deceptive Trade Practices and Civil Remedies Act (DTPA), TEXAS BUSINESS & COMMERCE CODE ANN. §17.41, et seq. (Vernons 2003). In *Smith v. Baldwin*, 611 S.W.2d 611, the

court rejected an argument that proof of intent was required to recover under §17.46(b)(7) of the DTPA. The court noted that certain subdivisions of §17.46(b) contained language requiring proof of intent, but subdivision (7) did not. The court reasoned that the Legislature could easily have included similar language in subdivision (7), but it did not do so. The court ruled that, "When the Legislature has carefully employed a term in one section of a statute, and has excluded it in another, it should not be implied where excluded." Because the Legislature has included an intent element in both PURA §§15.028 and 15.030, but has excluded it from §15.023, it should not be implied in PURA §15.023 as some commenters have suggested.

Like the DTPA, subsection (g) of the new rule contains both a general prohibition against any act "that adversely affects the reliability of the regional electric network or the proper accounting for the production and delivery of electricity" as well as a list of specific "prohibited activities." The need for such a structure was recognized in *Pennington v. Singleton,* 606 S.W.2d 682 (Tex. 1980), an early DTPA case, in which the Court stated, at page 688:

> **A broad interpretation is warranted, however, due to human inventiveness in engaging in deceptive or misleading conduct. The Legislature did not intend its express purpose of protecting customers from false trade practices to be circumvented by those who seek out loopholes in the Act's provisions. For this reason, the Legislature initially provided consumers with an action**

under the "catch-all" provisions of §17.46(a), as well as for the violations listed in §17.46(b).

The commission finds that the same analysis should apply to this rule. The Legislature intended to authorize the commission to protect customers from unfair, misleading and deceptive practices during the transition to competition. In order to provide such protection while also recognizing the "human inventiveness" in seeking loopholes in a regulatory provision, the commission finds that it is appropriate that the rule contains both a "catch-all" provision as well as a list of specific prohibited activities.

The commission has considered the FERC's action but does not believe that it is appropriate or consistent with the commission's authority under PURA. As discussed previously, the express statutory language of PURA does not include an intent element and the commission may not add it to the statutory criteria. The remedies proposed by FERC, disgorgement of profits and the revocation of market based rate authority, are more punitive than those available to the commission and that factor may justify the FERC's decision to include an intent element. The commission also notes that the FERC rule is stated in the alternative, *i.e.*, actions "that are intended to or foreseeably could" manipulate market prices or market rules are prohibited. Thus, if it is foreseeable that an action would result in a violation of market rules, FERC does not need to inquire into or prove the intent behind the market participant's actions.

In conclusion, the commission declines to impose an intent element in the list of prohibited activities because such an element is neither required nor implied by the statutory language of PURA.

FTC's quote regarding need for structurally competitive markets

AEP, Reliant, Coral and CMP quoted from the comments submitted by the FTC to the FERC regarding the FERC's proposed market behavior rules. In its comments, the FTC stated that the goal is to develop structurally competitive markets, and that antitrust experience has shown that competitive markets with ease of entry are more likely than behavioral rules to protect consumers, and warned that rules and policies that create barriers to entry will undermine the development of a "structurally competitive market."

AEP and Coral added that the FTC warned FERC against detailed rules that conflict with established norms for competitive behavior as defined by antitrust laws.

AEP also added that the FTC's advice to the FERC is consistent with the Legislature's directive to the commission to "authorize or order competitive rather than regulatory methods to achieve the goal of this chapter." Reliant concurred, saying that PURA §39.001(d) does not authorize the commission to impose stringent regulatory methods instead of competitive methods that impose the least impact on competition.

Commission Response

The commission agrees with the FTC that, generally speaking, structurally competitive markets that exhibit ease of entry are more likely than behavioral rules imposed on market participants to protect consumers and result in efficient pricing, output and investment. However, the commission recognizes that the wholesale electricity market in Texas was not structurally competitive at the outset of market open, and is not structurally competitive today. The Legislature acknowledged that a fully competitive electric power industry is not yet established in Texas, and stated so in PURA §39.001(a). Until sufficient competition develops in the wholesale electricity markets in ERCOT and in Texas, the commission believes that there will continue to be a need for market rules to protect the public interest. Therefore, the commission believes that there needs to be a proper balance between allowing competition to govern market participants' activities and enacting limited regulations to provide consumer protection rules, and will strive to reach this difficult balance.

The commission believes that, with time, a more structurally competitive wholesale market will develop as power companies affiliated with incumbent utilities lose generation share, and less behavioral regulation will be needed. However, the commission believes that one must be careful not to rely on broad statements applicable to competitive markets in general while ignoring the specific characteristics of electricity markets that may render these statements insufficient to address local market power, or market power that results

from emergency conditions. For example, the commission is aware that local market power may continue to exist for a long time in load pockets due to transmission constraints that cannot be easily resolved and where new generation investments are not economically attractive.

The commission has always supported and will continue to support the development of market rules that provide proper incentives for efficient generation location and for competitive pricing of electric services as the best way to help a more structurally competitive market develop. However, the commission sees the development of such rules as a work in progress that needs to be complemented with market behavior rules as a practical matter. The commission believes that in several instances, such rules can do no harm to competition in that they simply will not be activated in a competitive environment. For example, a restrictive rule that is triggered when a pivotal bidder is able to set the market price will never be triggered in a competitive market, which is defined by the absence of pivotal bidders. Nevertheless, the commission is sensitive to comments that have pointed to specific instances where restrictive regulation may impede competition and the normal conduct of legitimate business activities and has taken these statements into account. Following the FTC suggestion, the commission adds the concept of materiality to the rule so as not to chill pro-competitive behavior while maintaining proper safeguards against activities that are clearly not legitimate.

Reliant stated that the proposed rule provides what the FTC has characterized as less efficient "indirect approaches" to achieving a structurally competitive market and that the proposed rule would undermine the development of such a market in ERCOT. CMP affirmed that the proposed rule could discourage entry into the ERCOT market because requirements are so absolute that compliance is unachievable or too costly.

Commission Response

The commission believes that the FTC comments regarding the inefficiency of "indirect approaches" must be analyzed in context. In its comments to FERC, the FTC states that "the benefits of competition are most likely to accrue to consumers when markets operate unburdened by substantial and durable market power." In the presence of market power, the FTC advocates "policies that reduce concentration, ease of entry impediments, and facilitate price-responsive programs." However, the FTC recognizes that such direct approaches may be too costly, slow, or otherwise unavailable. When such is the case, the FTC accepts that less direct means, such as bid caps and must run obligations, may warrant consideration on an interim basis as a means to curtail market power. Thus, although the FTC encourages "FERC and the states to emphasize direct approaches to achieving structurally competitive electricity markets," as a more efficient approach, it also recognizes that "indirect approaches," although less efficient, may be necessary to prevent anticompetitive behavior and achieve consumer protection goals.

Austin Energy quoted the FTC as stating that if a seller's market power can be assessed *ex ante*, FERC can negate awarding or renewing the seller's market-based rate authority, which would diminish the need for the application of behavioral rules after the fact.

Commission Response

The commission notes that this FTC recommendation to FERC is not applicable to ERCOT. The commission does not have rate making authority over market participants in ERCOT and therefore does not have the option to negate market-rate authority as a way to address market power ex-ante. The commission notes that the FTC favors price responsive demand as an ex-ante measure that keeps prices at competitive levels, and praises the New York Independent System Operator's (NYISO's) Emergency Demand Response Program that allows customers to bid in the capacity reserves market. The commission fully agrees and has placed a high priority on addressing barriers to demand participation in the ERCOT markets. The commission points out that ERCOT has achieved exemplary demand participation in the Responsive Reserve market and that other forms of demand response through voluntary curtailment have begun to take place. Efforts continue, with the commission's support, to reduce barriers for demand participation in all ERCOT markets. The success of such efforts will be achieved when demand curtailments measurably bring prices down one or two intervals after prices start to spike, or when demand offers compete with and displace supply offers. Such results cannot be assumed at this stage other than in the Responsive Reserve market where demand participation has been effective in reducing market concentration.

FTC's position on a market impact standard v. an intent standard

In reply comments, TXU quoted the FTC's advice that FERC not condemn all actions or transactions that manipulate prices, but instead focus only on conduct that leads to unjust and unreasonable rates.

CMP stated that the FTC urges a cost-benefit analysis when choosing between a broad requirement and one that has been narrowed to fit a particular problem, and criticized the preamble to the proposed rule for addressing only the cost and benefits of having a rule versus having no rule. CMP quoted the FTC as saying that "if the conduct is not likely to result in anti-competitive *effects*, prohibition of the conduct may lead to less efficient market operations." Elsewhere, CMP criticized the proposed rule for violating PURA; excluding intent and other crucial considerations, and imposing standards of perfection and strict liability; and violating several constitutional protections. CMP added that adding intent to the standards would ameliorate most of these concerns to a significant degree.

With regards to the proposed prohibition concerning collusion, CMP and Coral quoted FTC as warning that some agreements among competitors may create efficiencies as well as carry the potential for competitive harm, and therefore care should be exercised when assessing the competitive implications of particular agreements.

With regards to antitrust law, CMP agreed when the FTC criticized FERC's use of antitrust-type terms that may conflict with how those terms are employed in antitrust enforcement, and approved of the approach taken in the proposed rule subsection (g)(5) stating that the subsection has to be interpreted in accordance with federal and state antitrust and judicially-developed standards under such statutes regarding collusion.

Commission Response

The commission notes that the FTC, in its comments to FERC, recommends focusing on the impact of market participants' activities rather than on the intentions of the market participants when they engaged in the activity. This focus on market impact rather than on market participant intent is in contrast to the concern expressed by many market participants that the proposed rule lacks an "intent" element. The commission cannot reconcile the fact that CMP, who claims that the proposed rule is unconstitutional because it excludes intent, and TXU, who strongly supports an intent standard, would also support the FTC's market impact standard, since the FTC recommended approach is to ignore intent, and focus on impact. The FTC also suggests a materiality standard that would result in tolerance for activities FERC may otherwise consider illegal, as long as the activities do not result in a significant market impact, or in a material anti-competitive effect. Thus, as TXU stated, FTC advocates tolerance for a certain amount of price manipulation, and recommends FERC action only if there is a significant price impact; it states that it is not unlawful under the antitrust laws for a seller with market power to charge a profit maximizing price; and it asserts that agreements among competitors may

create efficiencies as well as carry the potential for competitive harm. What matters, according to the FTC, is the price impact of certain behavior, and the competitive implications of particular agreements. The FTC refers to FERC's example of prohibited activity under its Behavior Rule # 2: "collusion with another party for the purpose of creating market prices at levels differing from those set by market forces." The FTC disagrees with the apparent intent requirement of the example and states that "the modern antitrust view is that antitrust enforcement against anticompetitive agreements among competitors does not require proof of intent."

The FTC also disagrees with FERC when it states, "another instance in which FERC's Market Behavior # 2 may conflict with antitrust principles is in the use of the term "without a legitimate business purpose." Antitrust laws usually apply the standard to exclusionary conduct. In some instances, the FTC continues, "antitrust has asked whether an agreement had a 'legitimate business purpose' as a way of inquiring into whether the agreement had a pro-competitive justification, as by creating efficiencies sufficient to make the market more, rather than less, competitive."

The FTC concludes: prohibition of conduct not likely to result in anticompetitive effects may lead to less efficient market operation; and by analogy, prohibition of conduct that does not lead to unjust and unreasonable rates may lead to less efficient market operation.

To avoid confusion and the potential conflicts identified above when different agencies are involved in policing anticompetitive behavior, the FTC advises FERC to reaffirm in its general rule that sellers with market-based rate authority are prohibited from engaging in conduct that would violate the antitrust laws. Further, the FTC observes that conduct that is likely to violate the Federal Powers Act's (FPA's) "just and reasonable" standard may not violate the antitrust laws. Therefore, the FTC advises, FERC should also prohibit conduct that leads to "unjust and unreasonable rates."

The commission believes that the FTC's recommendations are also applicable to the Texas situation. As discussed above, the commission believes that it has the authority to prohibit wholesale market participants' activities that may result in unreasonably priced electricity for retail customers. The commission will take into account materiality so that only activities that result in significant anticompetitive effects, or in unjustifiably high retail prices with no competitive benefits for retail customers will be penalized.

Purpose of market monitoring standards

CMP described four objectives of creating market monitoring standards that it believes are consistent with PURA: to provide the means to monitor the ERCOT administered market; to ensure the reporting of information on market structure and operations; to propose appropriate action relating to efficiency opportunities, market design flaws, market rule violations, and market power; and to ensure a market monitoring program that is fair and independent and

minimizes interference with open and competitive markets. CMP compared these objectives to, and finds consistency with, the three policy goals stated by FERC in developing market behavior rules. CMP described these as: to provide for effective remedies when market abuses occur; to provide clear market rules regarding violations known today, while allowing for remedies for market abuses that may occur in a form not envisioned today; and to provide reasonable bounds on regulation to avoid regulatory uncertainty for market participants. Further, CMP stated that FERC considers the two objectives of providing certainty to the market and protecting customers against market abuses to be equally important. CMP added that FERC acknowledges that there must be a balance between affording a complaining party the right to obtain financial compensation, and providing finality to the sellers who are the subjects of the complaint. CMP quoted FERC as saying that anticompetitive activities and abuses of market power are prohibited and must be made subject to remedial action, but that transactions consistent with the operations of supply and demand and that constitute legitimate business activities should not be discouraged or impeded.

TXU suggested that the rule should be consistent with the following principles: the proposed rule must not inhibit the effectiveness of competitive market forces in encouraging pro-competitive behavior and punishing anticompetitive behavior; it should not have the unintended effect of returning to cost of service regulation; it must protect competition, not competitors; it must be sufficiently clear as to the conduct that is being prohibited; it should include a finding of intent as a prerequisite to establishing a violation; affirmative defenses should be available where there

is sufficient justification for engaging in the alleged anticompetitive actions; and it should ensure consistency with the Protocols and the market structure.

Commission Response

The commission generally agrees with the four objectives of market monitoring quoted by CMP, but would modify the third and fourth objectives. While the commission has enforcement authority over operating standards within ERCOT, it also has oversight authority over procedures developed by ERCOT relating to the reliability of the regional electrical network. One of the objectives of market monitoring not mentioned by CMP is to ensure that ERCOT has sufficient tools to maintain the reliability of the electric network. The commission would modify CMP's third objective to include reliability and gaming of market rules as two additional areas where the market monitor could recommend that the commission take appropriate action. Regarding the fourth objective, the commission believes that there should be a balance between enforcement of proper market behavior to ensure that customers are protected from potential market abuses, and minimizing interference with the development and normal operations of a competitive market. The commission would modify the fourth objective to read: "to ensure a market monitoring program that is fair and independent and minimizes interference with open and competitive markets while ensuring proper action to deter and if necessary penalize activities that cause unreasonable prices, do not serve a legitimate business purpose, or that have significant anticompetitive effects." The commission believes that these objectives, as modified, are consistent with PURA.

The commission agrees with the three goals stated by FERC in developing market behavior rules, as reported by CMP. The commission agrees that it has a mandate to provide for effective remedies on behalf of customers in the event anticompetitive behavior or other market abuses occur. The commission also agrees that it is necessary to provide clear market rules regarding violations known today, while allowing for remedies for market abuses that may occur in a form not envisioned today. For this reason, the commission believes it is appropriate to include in the rule generic standards to provide the necessary guidance as to the types of activities that the commission considers to be anti-competitive or in other ways unduly harmful to customers or to the developing market, along with a list of prohibited activities that serve as examples of the kind of activities market participants should not engage in. And lastly, the commission agrees that it needs to provide reasonable bounds on regulation to limit regulatory uncertainty for market participants and revises the proposed rule to better reflect this goal.

The commission does not fully agree with CMP's rendering of the FERC statement that transactions that are consistent with the operations of supply and demand and that constitute legitimate business activities should not be discouraged or impeded. FERC states: "transactions and practices which are consistent with the normal operation of supply, demand, and true scarcity, or which otherwise have a legitimate business purpose, should neither be discouraged nor impeded." It is important to specify "transactions consistent with the *normal* operation of supply and demand *and true scarcity"* because

there can be emergency situations during which conditions do not exist for a *normal* operation of supply and demand. There can also be situations where market manipulations can create *artificial scarcity*. These important qualifiers were lost in CMP's remarks. Secondly, FERC does not refer to legitimate business activities, but to activities with a legitimate business purpose. The difference is important, because although profit maximizing is a legitimate business goal, not all profit maximizing activities have a legitimate business purpose in the view of the commission. The FTC points out in its comments to the FERC that, in antitrust law, the term "legitimate business purpose" applies to activities that have "a pro-competitive justification, as by creating efficiencies sufficient to make the market more, rather than less, competitive." The commission agrees with the FTC definition and in particular, agrees that an activity that has anti-competitive effects cannot be considered to serve a legitimate business purpose. In addition, the commission does not consider activities that can foreseeably endanger the reliability of the electric network or force ERCOT to take otherwise unnecessary costly actions to protect the reliability of the electric network to have a legitimate business purpose.

The commission agrees with TXU that the rule should not inhibit the effectiveness of competitive market forces. To the extent that competitive market forces are at work, the role of the commission in guiding market behavior should be greatly reduced. As is indicated above, however, the commission does not believe that the market is structurally competitive at this time. Therefore, some regulation of market behavior is necessary. The commission agrees with FERC's statement that: "this potential for market manipulation

was not limited to the California market. In fact, the potential for market abuse and the exercise of market power may exist in any region where the evolution towards a competitive market is not yet complete; or where the design structure of the market is otherwise ill-equipped to promote competition." (Order seeking Comments, June 26, 2003, paragraph 11). Therefore, the commission agrees that, when competitive market forces are in effect, very little market interference from regulators should be necessary, whereas in situations where anticompetitive activities and market power abuses are observed, the commission has a duty to be vigilant and to take action to protect consumers. The commission agrees that the rule should protect competition, not competitors, but points out that protecting competition includes protecting competitors from unfair practices that aim at restricting their access to the market. The commission agrees that it must be sufficiently clear as to the conduct that is being prohibited and revises the proposed rule to improve clarity in this respect. The commission does not agree with TXU that a finding of intent is necessary to establish a violation. This issue is discussed in more depth in other parts of this order. The commission agrees that affirmative defenses should be available so that market participants have the opportunity to provide a justification for their activities and revises the proposed rule to include such. In addition, the commission notes that under subsection (k), redesignated as (l), relating to investigations, a market participant will have an opportunity to explain its activities during an informal fact-finding review. Finally, the commission believes that there should be consistency between the final rule and the Protocols, but that should an inconsistency exist, it will be appropriate to change the Protocols to conform to the commission rules. As to the need for consistency with the

market structure, the commission points out that the market structure is currently undergoing fundamental changes, and that the rule may have to be re-evaluated and modified for consistency when the new market structure is in place.

Rule too broad and vague

CMP and Coral stated that the proposed rule is far broader than needed to address the potential problem. CMP's view was that potential problems in ERCOT could not be similar in magnitude to those experienced in California because of adequate supply and better market design. In support of this assertion, CMP quoted statements made by the commission in various reports to the Legislature to the effect that Enron trading strategies for the most part could not be used in ERCOT because they were specific to California's market rules and the configuration of its electric grid. CMP also referred to the commission's Market Oversight Division 2002 annual report stating that staff's review of 175 responses from market participants did not reveal widespread gaming of the ERCOT market. Coral stated that although the Preamble to the rule mentions the California market gaming problems, more specific Texas-related concerns need to be articulated. Coral added that the scope should be reduced to cover specific types of potential manipulation or abuse that have or could reasonably be expected to happen in the ERCOT market, absent a prohibition.

Commission Response

The commission disagrees with CMP and Coral that the proposed rule is far broader than needed to address the potential problem. The commission believes that it is only prudent to provide clear and complete "rules of the road" to market participants and revises the rule to further improve its clarity as the best way to avoid the California experience. CMP's arguments are unconvincing: the commission does not believe that adequate supply in ERCOT will last forever, and points out that ERCOT is in the process of redesigning its market to address design flaws that have been identified since the market opened and that ERCOT has not been able to resolve. CMP's mention of reports to the Legislature regarding the potential for gaming activities in ERCOT is incomplete. It misses the most important piece, which is the presentation entitled "Mitigation Measures for Gaming Opportunities in the ERCOT Wholesale Electricity Market" that was presented to the Electric Utility Restructuring Legislative Oversight Committee on June 18, 2002. This presentation identifies 13 gaming opportunities in the ERCOT market, and although for each gaming opportunity identified, steps are described by which the commission intends to address the problem, many of those steps have not yet been taken or been finalized. The commission strongly disagrees with Coral that the rule should address more specific Texas-related concerns because the 13 potential gaming activities identified in the above named presentation served as the background for the development of the proposed rule. It would be imprudent to assume that only the California market could be gamed, and that only Enron could manipulate the market. FERC testifies to the need for market behavior rules when it states: "the commission has been informed … by what we have learned about the

types of behavior that occurred in the Western markets during 2000 and 2001. We also have gained additional experience in other competitive markets, particularly those with organized spot markets in the East." (Docket Number EL01-118-000, Order, June 26, 2003, par. 4) FERC adds: "we also noted that this potential for market manipulation was not limited to the California market. In fact, the potential for market abuse and the exercise of market power may exist in any region where the evolution towards a competitive market is not yet complete; or where the design structure of the market is otherwise ill-equipped to promote competition." (Id., par. 11) The commission believes that experience in California and other markets, as discussed by FERC, and the commission's own experience with the ERCOT market, as discussed above, demonstrate the need for the rule. Therefore the commission declines to reduce the scope of the proposed rule.

According to AEP, the rule contains a number of provisions that are overly broad or are subject to a wide range of interpretations. BP stated that numerous provisions in the rule are too vague to be enforceable, and added that the commission should precisely specify the particular types of conduct it wishes to preclude. As example, BP referred to market power abuses defined as practices "that are *unreasonably* discriminatory or *tend to unreasonably* restrict, impair, or reduce the level of competition," and stated that the terms "unreasonably" and "tend to" are too vague to provide meaningful guidance. BP advised that the commission should limit the definition of market power abuses to instances where a market participant with market power *intentionally* discriminates or *intentionally* reduces the level of competition. Finally BP believed

that the commission should specify what types of conduct wholesale market participants are allowed to engage in under the proposed rule. While recognizing that it is difficult to specify all modes of permissible conduct precisely, BP is looking for guidance as to specific actions that are acceptable and those that are not acceptable under conditions of market scarcity.

Commission Response

The commission agrees that some areas of the proposed rule are subject to interpretation and revises these areas to provide more clarity. The commission is conscious, however, that the rule is facing an ambiguity-specificity paradox that is characteristic of all attempts to guide behavior. If a rule is too broad, it is subject to self-serving interpretation and creates uncertainty as to what is prohibited. If a rule is too specific, actors will tend to focus on the principle itself rather than on the objective behind the principle, causing a neglect of everything that has not been specified. The proposed rule has attempted to not only describe the standards, but also the objectives behind the standards. The broad provisions of the proposed rule are intended to describe the general objectives of the standards. However, the proposed rule also includes lists of specific obligations, and of prohibitions that are intended to serve as examples of activities the commission considers to be market abuses. The commission will revise the generic standards to bring more clarity to the general objectives that are intended. However, BP's suggestion that the commission should precisely specify the particular types of conduct it wishes to preclude and that it should specify exactly what types of conduct are allowed is unrealistic and would be mired by the problems associated with too much specificity. It would be

unrealistic because a specific list of prohibited activities or of tolerated activities would have to be modified every time a new type of market abuse or manipulation is discovered and every time someone thinks of an activity that should be tolerated. Strict specificity of prohibited activities would send the message that an illicit activity that was omitted is allowed. Strict specificity of allowed activities would kill creativity. Instead, the commission believes that the rule can give better guidance as to what constitutes acceptable practices even if they are not strictly specified, drawing on the concepts of materiality and impact recommended by the FTC so as not to impede pro-competitive activities, and on the standard of predictability adopted by FERC in its final market behavior rules so as to eliminate uncertainty caused by hindsight regulation. Thus, referring to BP's definition of market power abuse example, a practice can be considered "unreasonably discriminatory" if the conduct can lead to anticompetitive effects, or cause prices that would not prevail in a competitive environment, provided the anti-competitive effect or the price impact are material. The commission disagrees with BP that an intent standard is needed in the market power abuse definition, and notes that PURA definition of market power abuse does not include an intent standard. The intent standard is discussed in other parts of the order.

Coral stated that "a rule is fatally vague if it exposes potential actors to some risk or detriment without giving fair warning of the nature of the proscribed conduct." Coral added: the standard for vagueness is whether "persons of common intelligence must guess at what is required." Further, Coral stated that a rule adopted under a statute that imposes a penalty for violation is

subject to the same tests as a penal statute and must define with reasonable certainty what conduct will invoke the penalty.

Reliant criticized the proposed rule for being premised on hindsight analyses and vague standards that are inconsistent with prudence review standards acceptable under PURA, and also inconsistent with general fairness standards. Reliant stated that a properly constructed rule should provide the market participant with concise and certain descriptions of what is and what is not acceptable behavior in the market. Reliant added that the analyses should be based on the information and alternatives available to the decision maker at the time the decision was made, and not on the impact of an activity.

Commission Response

As previously stated, the commission agrees with and will adopt FERC's "foreseeable" standard so that a market participant will only be responsible for the negative impact of its activities if such negative impact was foreseeable, in other words, if the market participant knew or should have known that such impact would result from its activities, based on the technical knowledge one would expect of a market participant operating in ERCOT's wholesale electricity markets. The commission disagrees with Reliant that the analysis should not be based on the impact of an activity if the impact was foreseeable and material.

TXU stated that it recognizes and supports commission staff's concern that if the commission rules are too narrowly tailored, the rules will not effectively deter all anticompetitive behavior.

However, TXU stated, if in the end a broader rule is more detrimental than helpful, the overriding purpose – protecting competition – is not served. TXU expressed its concern that vague requirements in the proposed rule do not provide fair notice to market participants and invite arbitrary enforcement by the commission. TXU gave several examples. First, TXU stated that the proposed rule allows the commission to punish behavior that is "not expressly addressed" in the Protocols, but is in violation of the "purpose and intent" of the Protocols. TXU asked: how can a market participant ensure that its interpretation of the intent of the Protocols is the same as the commission's interpretation, if the intent of the Protocols is not expressly addressed in the Protocols? In another example, TXU referred to subsection (g), which it said allows the commission to punish any behavior that adversely affects the reliability of the regional electric network, and asked: how can a market participant ensure that its conduct will not affect the reliability of the regional electric network when it does not have real time transmission system information regarding the activities of other market participants? In addition, TXU included in the list of vague requirements a reference to an evaluation of whether a market participant's activities unfairly impacted other market participants, and reference to a requirement that market participants seek clarification of Protocols that are unclear. TXU also stated that if benign conduct can result in a violation under the proposed rule, this will deter market entry and pro-competitive behavior.

Austin Energy advised the commission, when developing its rules for market oversight, to ask the question: "is the action taken sufficient to remedy the harm and sufficiently circumspect to impose the minimum possible restraint and/or transactions costs on the market?" In the case of

the proposed rule, Austin Energy asserted that the answer is no: the proposal fails to achieve proper balance by "establishing unachievable standards"; "establishing standards that are not clear"; "imposing price regulation;" and "being overly broad." Austin Energy predicted that these failures will potentially stifle activity and investment in the wholesale market, and increase transaction costs.

Commission Response

The commission agrees with TXU that rules that are too broad will not deter anticompetitive behavior because they are open to self-serving interpretations. The ambiguity-specificity paradox in rules that attempt to guide behavior has been discussed above. There is no easy way of resolving the paradox. However, both the proposed rule and the FERC Market Behavior Rules have adopted the approach recommended in the literature: they provide generic standards that are broad and give a description of the objectives behind the standards, and they add a non-exclusive list of specific examples of the kind of behavior that is prohibited for illustrative purposes. Subsection (a) describes the objectives of the rule and of the commission. The purpose of subsection (d) is to inform market participants of the criteria that will be used by the commission when reviewing the activities of a market participant. The commission modifies the language in subsection (d) to introduce an additional standard it will use in its review of market participants' activities, the standard of materiality recommended by the FTC in its comments to the FERC. The foreseeable standard adopted by the FERC in its final market behavior rules is included in new subsection (h), Defenses, as an affirmative defense. The commission

believes that the addition of these two standards addresses the concern expressed by TXU and other parties that vague requirements do not provide fair notice to market participants and invite arbitrary enforcement by the commission. The foreseeable standard also addresses TXU's and other parties' concern that a market participant may not know in advance how its actions will impact the reliability of the electric network, or the efficient operation of the market; and it addresses the concern expressed by TXU and Reliant about hindsight regulation. The materiality standard addresses the concern expressed by TXU and several other parties that a market participant may be found in violation of the rule even though its actions had little or no effect on reliability, or on the competitiveness or efficient operation of the market.

The commission disagrees with TXU that the requirement that market participants seek clarification of Protocols is unclear. No other party has indicated that this requirement is unclear.

In response to comments, the commission has clarified or deleted some provisions to address concerns about vagueness, particularly in subsections (d) and (e) of the proposed rule. Some commenters argued that the rule is unconstitutionally vague because it allegedly forbids or requires an act in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application. Others argued that the rule does not provide the kind of notice that will enable ordinary people to understand what is prohibited or required and that it authorizes or encourages arbitrary and

discriminatory enforcement. These comments have confused the standard that applies to penal statutes with the lesser standard that applies to economic regulations. As applied to economic regulations, such as this rule, a rule is vague only if it commands compliance in terms so vague and indefinite as really to be no standard at all or if it is substantially incomprehensible. *Ford Motor Co. v. Texas Dep't of Transportation,* 264 F.3d 493, 507 (5th Cir. 2003). Other cases have held that rules do not need to achieve "meticulous specificity" and may instead employ "flexibility and reasonable breadth." *Grayned v. City of Rockford*, 408 U.S. 104, 92 S. Ct. 2294, 33 L.Ed.2d 222 (1972). Rules satisfy due process if a reasonably prudent person, familiar with the conditions the regulations are meant to address and the objectives the regulations are meant to achieve, has fair warning of what is required. *Freeman United Coal Mining Co. v. Federal Mine Safety & Health Review Comm'n,* 108 F.3d 358, 362 (D.C. Cir. 1997). In *Ford*, the court upheld the statute in question despite contentions that it did not provide "fair notice", stating at page 509:

> **In drafting §5.02C(c), the Legislature probably intended, permissibly so, to capture whatever creative conduct could be imagined by manufacturers to circumvent the statute's intended prohibition. A statute is not unconstitutionally vague merely because a company or an individual can raise uncertainty about its application to the facts of their case.**

The commission finds that the same analysis applies to the rule. The commission has established both an overall prohibition on conduct that affects the reliability of the network or the proper accounting for the production and delivery of electricity as well as a specific list of prohibited activities in order to protect customers during the transition to a

competitive electric market in Texas. These prohibitions provide fair notice to persons subject to the rule. A reasonably prudent market participant, familiar with the conditions the rule was meant to address and the objectives of the rule, has fair warning of what is required. The fact that some commenters can envision scenarios in which uncertainty may arise, regarding the application of the rule in specific circumstances, does not serve to make the rule unconstitutionally vague.

Some commenters suggest that the more prescriptive constitutional standard applicable to penal statutes should also apply to the rule, claiming that the rule is "quasi-criminal". The commission disagrees with this contention. In the *Ford* case, cited previously, the court refused to apply the standard for penal statutes to an administrative enforcement action. The court noted, at page 508, that "while the potential fines are substantial, no prohibitory effect or quasi-criminal penalties are associated with a violation of the Code." Although stated as "civil penalties" in the *Ford* case, the proposed penalty of $1.8 million is analogous to the administrative penalties imposed by the commission under PURA §15.023. Thus, the fact that administrative penalties are involved does not serve to designate the rules as "quasi-criminal".

Even if the rules are labeled as "quasi-criminal," the commission finds that the rules meet the more stringent vagueness requirement. The rules are not like those involved in *Women's Medical Center of Northwest Houston v. Bell*, 248 F.3d 411 (5th Cir. 2001). In that case the court upheld a preliminary injunction against enforcement of rules adopted by the

Texas Commissioner of Health. The court found each of the rules unconstitutionally vague because, as stated at page 422:

> **… it impermissibly subjects physicians to sanctions based not on their own objective behavior, but on the subjective viewpoints of others. Each of these three provisions measures compliance by the subjective expectations or requirements of an individual patient as to the enhancement of her dignity or self-esteem. Even a state's witness who had helped draft the provisions conceded that there are no objective criteria for assessing compliance with the "enhancement" provisions, undermining the efficacy of the administrative process from which licensee may seek clarification. These provisions fail to "afford fair warning of what is proscribed. (Citation omitted.)**

The commission's new rule is not based upon the subjective viewpoints of others, but upon the act or failure to act of a market participant. As in other cases, the fact that the rule includes broad standards or language that could be interpreted in different ways does not serve to render it vague.

As noted previously, the rule is structured similar to the DTPA. Many of the actionable claims under the DTPA are broadly stated in terms such as "causing confusion or misunderstanding", "using deceptive representations" and "making false or misleading statements" and most do not include an intent element. The DTPA was attacked as being unconstitutionally vague due to the terms used and the lack of an intent element. The

Texas Supreme Court rejected those arguments in *Pennington v. Singleton*, cited previously. The court ruled, at 606 S.W.2d 690, that the "terms used are not so vague or indefinite as to violate due process, and we will not read into them an intent requirement merely to restrict the scope of their coverage." The court explained, at page 689, that "The boundaries of illegality under the DTPA must remain flexible because it is impossible to list all methods by which a consumer may be mislead or deceived." The same rationale applies to the broad terms used by the commission in this rule. The commission finds that the terms used in the rule are not unconstitutionally vague or indefinite and that there is no need to include an intent requirement merely to restrict their scope.

Marginal cost pricing and concern about return to cost of service regulation

Austin Energy asserted that the proposed rule imposes restrictions on bidding in the ERCOT energy and capacity markets that are tantamount to price regulation. TXU made a similar argument. Austin Energy referred to subsections (g)(8) and (g)(9) of the proposed rule that prohibit behavior that may lead to prices "above competitive levels." Under subsection (g)(8), economic withholding occurs if: 1) a market participant's offer into the market is sufficiently large that the market cannot clear without the offer; 2) part or all of the offer is priced above competitive market levels; and 3) the offer results in a price that is not reflective of a competitive market. Austin Energy believed that the practical effect will be imposing marginal cost bidding on all market participants, which Austin Energy equated to imposing price regulation, or more correctly, offer regulation, and which Austin Energy believed is in contradiction of PURA

§39.001. PURA, Austin Energy said, requires that prices be set in markets, not through price regulation. Austin Energy explained that, in a market, it is the interplay of buyers and sellers that disciplines bidding behavior. If a supplier chooses to bid above its costs, a lower bid will win the award, and the supplier will have to change its bidding behavior or will be driven out of business. Austin Energy concluded: "the commission staff has yet to demonstrate – outside of a few instance of poor market design – the breakdown of the market's natural discipline over bidding behavior. Short of making that finding, the commission is not justified in reintroducing price regulation."

Austin Energy recognized that "economic withholding is a serious matter that if allowed to fester could wreck havoc on the ERCOT market – even a cursory look at the California debacle shows the potential for damages." But, Austin Energy advised, rather than regulating bidding behavior, "the commission should focus on establishing a fair and level competitive market and rooting out true instances of market power abuse."

Commission Response

The commission emphasizes that its attention to marginal cost is part and parcel of its concern about market power. The commission agrees with Austin Energy that the interplay of buyers and sellers should discipline bidding behavior. The ability of the market to provide such discipline, however, depends on robust competition. Pricing in excess of marginal cost by a seller who is immune from the chastening hand of competition is an abuse of market power.

Marginal cost pricing conceptually includes a normal profit, which is defined as the average profit expected in the industry when conditions of competition prevail. Under the theory of marginal cost pricing, a seller makes an offer at its marginal cost and, if selected, receives the market clearing price. A seller with an efficient unit offered at marginal cost is almost assured to be selected and paid more than its marginal cost. The only seller who does not receive more than its marginal cost is the one with the least-efficient unit among those selected. This unit's marginal cost is equal to the market clearing price.

If a seller decides to submit an offer above its marginal cost, or if it chooses to inflate its expectation of a normal profit, it should run the risk of being replaced in the market by another seller. As long as competition can impose this risk on the seller, pricing above marginal cost does not present a regulatory concern. In the absence of a fully competitive market, the commission has an obligation to ensure that the seller does not impose on buyers a price substantially higher than would prevail under competitive conditions. PURA §39.001(a) entitles the public to electricity prices that are determined by the *normal* forces of competition. Prices that are substantially above the marginal cost of the marginally efficient unit when not tempered by competition are, therefore, injurious to the public interest. The commission has a duty to protect the public from such prices.

In electricity markets, it is difficult to find markets that continuously operate under a competitive environment, and it is not unusual to find local market power in geographical

pockets, even when the generation share of each resource owner is low, because transmission constraints or other reliability constraints often give some resource owners temporary or localized market power. Market power is a dynamic phenomenon in electricity markets, and the commission must have the ability to address abuses that occur during the times when the market is not competitive, even as those times become less frequent. The commission is therefore particularly concerned with sellers' offer prices in load pockets where competition is absent.

In the real world, a unit that is always marginal will submit offers higher than its marginal cost because its marginal cost alone would not allow it to recover its short run fixed costs. This unit may be selected only a few times a year and will bid at a level that allows it to continue to run a few times a year and cover its maintenance cost. In a competitive market, this unit will be selected if capacity reserves are short, setting the market price at a high level for all energy sold. If the unit is selected with high frequency, it will send a signal that will attract investments in new generation. Thus, market prices above the marginal costs of the least efficient unit in this instance is a reflection of scarce supply and high demand and is not a regulatory concern. However, in a market where one or more market participant can exercise market power, offering the most inefficient unit to the market or bidding above marginal costs may not be a reflection of scarce supply, but instead a market manipulation to push prices high above the marginal cost of the least efficient unit needed to meet the demand. For example, a market participant who has market power may withhold production from more efficient units and offer its least

efficient unit at that unit's marginal costs or higher, with confidence that the unit will be selected and set the price for all energy sold. Such withholding of production may bring in enormous profit to the market participant. Another example of market manipulation occurs when a market participant bids all or a large part of its production at a very high price, regardless of marginal costs. Here again, the market participant who has market power is confident that it will be rewarded often enough to bring in large gains that more than compensate for the times when its bid is not selected. Thus, artificial scarcity can be created through either physical withholding of production, or in the second example, economic withholding of production. Both of these practices, when used by suppliers insulated from competition, are abuses of market power and constitute violations of this section and of PURA §39.157(a). The commission eliminates proposed subsection (g)(8) to address Austin Energy, TXU, BP, and other commenters' concerns about establishing a marginal cost bidding requirement, and replaces it with new subsection (g)(8) to clarify that physical and economic withholding of production are considered market power abuses that violate this section.

Reliant objected that the rule would not allow increasing prices in reaction to a "short term" market condition to send appropriate price signals necessary for continued investments.

In support of its opposition to subsection (g)(8) and (g)(9) relating to marginal cost bidding, Austin Energy gave the example of a bidder who would offer in every interval the same quantity of power at the same price, but above its marginal cost. According to Austin Energy, the

"consistent bidder" would be guilty of economic withholding if for some intervals other bidders left the market and it became pivotal as a result, even though this was not the bidder's intent.

Commission Response

Under the rule, if a "consistent bidder" were to become a pivotal bidder, as described by Austin Energy, and set the market price above competitive levels, and if it were established through the informal or formal investigative processes that the market participant had market power and that the bidding behavior served no legitimate business purpose, the bidder would be in violation of the rule. It would still be a violation if there was a foreseeable possibility that the supplier would have market power at some point (even momentarily) and the efficacy of the strategy inherently relied on market power. The practice of a hockey stick bidder who routinely bids a few megawatts (MWs) at the highest possible price in the hope of setting the market price when an emergency occurs that creates temporary scarcity of supply does not serve a legitimate business purpose. The use of such practices by a market participant with market power, which ensure price gouging and hold customers hostage in times of emergency, is a reflection of the exercise or abuse of market power even if temporary. Contrary to Reliant's assertion, such abuses of market power should not be tolerated regardless of whether they may send price signals that attract investments. The commission believes that customers must be protected from such practices.

Austin Energy opined that the commission has already decided that hockey-stick bidders do not exercise market power abuses in relation to the Modified Competitive Solution Method (MCSM) in that it allows the hockey-stick bidder to be paid as bid. Surely, Austin Energy contended, the commission would not have approved pay-as-bid for the hockey-stick bidder if it were exercising market power abuse.

Commission Response

Contrary to Austin Energy's assertion, the commission has not determined that hockey-stick bidders do not exercise market power abuses. Regarding the MCSM, by deciding to allow the hockey-stick bidder to be paid as bid, the commission chose to implement a less intrusive form of regulation aimed at establishing incentives compatible with desired behavior rather than imposing pure command and control measures. Under the commission's ruling, a bidder will no longer benefit from a hockey-stick bid because the bid, if struck, will no longer set the market price for all previous quantities bid and the bidder will only receive the price it bid for the insignificant one or two MWs that are typical of hockey-stick bids. By adopting this pricing method, the commission did not rule or imply that use of a hockey-stick bid is not a form of market power abuse. Austin Energy's interpretation of the commission's action in this regard is misguided.

According to Austin Energy, in order to establish that a hockey-stick bidder has market power the commission would have to establish that the bidder had prior knowledge that its bid was

essential to clearing the market for a number of intervals and that it had intent to commit price gouging.

Commission Response

In response to Austin Energy's and other parties' argument that a supplier cannot predict when conditions will exist that would render the supplier pivotal, the commission suggests that it is not necessary for a pivotal supplier to know exactly when such conditions exist to exercise market power. If a market participant is frequently able to set the market clearing price, it can consistently submit high bids with the assurance that it will be selected frequently enough and that the return will be high enough to outweigh its loss when it is not selected. The commission believes that it is appropriate to evaluate a pivotal supplier's offers on a case by case basis when the offers result in consistently high market clearing prices, to determine whether the supplier has market power and is exercising its market power. If the market participant did not know and could not reasonable anticipate that its bid would adversely affect the market, and if the activity served a legitimate business purpose, the market participant has an opportunity to establish those facts as an affirmative defense under new subsection (h) of the rule.

Coral said that the provision on economic withholding implies that a generating facility that is unavailable for any reason other than unscheduled maintenance is potentially guilty of "economic withholding," which Coral equated to outlawing scheduled maintenance. In addition,

Coral opined that under PURA, there is no obligation to serve associated with the wholesale market.

In supplemental comments, several market participants also indicated that the definition of artificial shortage in subsection (c)(2) amounts to a "must-offer" requirement.

Commission Response

The commission is unable to see how a prohibition against economic withholding could possibly be equated to outlawing scheduled maintenance, as economic withholding is the result of a pricing strategy. However, a market participant who falsely declares that a unit is unavailable for maintenance reasons may be found in violation of the section for physically withholding the unit and making false representations to ERCOT regarding its capability.

Regarding Coral's assertion that under PURA, there is no obligation to serve associated with the wholesale market, the commission agrees that ERCOT currently does not have a universal "must-offer" requirement. However, the commission points out that, under PURA §39.157(a), if a market participant has market power, withholding of production is an example of an abuse of market power. Therefore, PURA §39.157(a) indirectly establishes a "must-offer" obligation for a market participant who has market power. The commission also points out, however, that the affirmative defenses described in subsection (h) would still apply. A supplier with market power must offer all its available capability, but if taking a unit off-line served a legitimate business purpose (as in the case of

equipment failure or manufacturer-specified maintenance, for example,) it would not be in violation of this rule.

The commission agrees with commenters who stated in supplemental comments that the proposed definition of artificial shortage may be interpreted as establishing a universal "must-offer" requirement and eliminates this definition. A more detailed discussion of this item is included under the discussion of subsection (c)(2) below.

Standard Needed for Finding Market Power Abuse

Austin Energy quoted PURA's definition of market power abuses as "practices by persons possessing market power that are unreasonably discriminatory or tend to unreasonably restrict, impair, or reduce the level of competition." Austin Energy insisted that the commission's authority to address market power abuses must be linked to a finding that the market participant possesses market power. Therefore, Austin Energy continued, it is crucial that the commission define market power to provide market participants proper guidance and clarity about inappropriate behavior, and that it address the questions: what does it mean to possess market power; and, how is market power identified and measured?

Austin Energy added that there should be a debate as to the proper definition of market power, and a ruling by the commission as to what constitutes market power and market power abuse in order to achieve needed regulatory balance. In addition, Austin Energy advised, the commission

should identify and prohibit anti-competitive behavior and behavior that constitutes abuse of market power, while at the same time neither discouraging nor impeding legitimate business.

Commission Response

The commission agrees that a person can only be found to have committed market power abuses if it has market power, as stated in PURA. In order to avoid any potential conflict between the rule and PURA, the commission deletes this definition from the rule and will rely on the statutory definition of "market power abuses" in implementing the rule.

The commission agrees with Austin Energy and others that it needs to define market power and will do so in a separate project, Project No. 29042, *Rulemaking on Definition of Market Power*. The commission will invite further debate regarding the definition of market power in its newly initiated rulemaking.

Role of ERCOT in Enforcing Operating Standards

Subsection (i) of the proposed rule requires ERCOT to develop and submit for commission approval an internal process to monitor occurrences of non-compliance with the Protocols that have the potential to impede ERCOT operations, or represent a risk to system security. ERCOT stated that such an internal process already exists and that therefore, it is unnecessary to include this requirement in the rule. Further, ERCOT argued, the Protocols are "somewhat self-enforcing" because they are designed to provide incentives for market participants to behave

properly and to use specific market mitigation measures to address situations where incentives will not work. Thus, ERCOT noted, the Protocols require all Qualified Scheduling Entities (QSEs) to sign a Standard Agreement, and if they violate the Agreement, their ability to participate in the ERCOT market may be terminated. ERCOT also referred to the Modified Competitive Solution Method (MCSM) adopted by the commission as a market mitigation method designed to help make the Protocols self-enforcing. ERCOT also pointed to "other market mitigation measures that are under discussion as part of the Texas Nodal market rule development process" in Project Number 28500 relating to Activities Related to the Implementation of a Nodal Market in ERCOT, as further evidence that there is no need for enforcement procedures. ERCOT recognized, however, that "diligent and timely enforcement of operating requirements is necessary for ERCOT to manage the grid in a reliable and safe manner." ERCOT also recognized that failure to perform under every provision of the Protocols may not always have a financial penalty.

Commission Response

The commission agrees with ERCOT that, where proper incentives exist in the Protocols, there is no need to add authoritative command-and-control measures. The commission does not believe, and ERCOT has not demonstrated, that the incentives for proper behavior and mitigation measures contained in the Protocols are sufficient to address all opportunities for activities that can be harmful to the market, or threaten reliability. It would not be prudent or responsible for the commission or for ERCOT to rely solely on the Protocols as a set of self-enforcing market rules that can ensure an efficient and reliable

functioning of the market, as the ERCOT market is immature, and the market rules contained in the Protocols are still in the developmental stage, as evidenced by the 400 Protocol Revision Requests that have been submitted in the two years since the market opened. As ERCOT itself points out, market mitigation measures are under discussion as part of the new market redesign process, a discussion that has only recently begun. Such measures are being discussed because the market cannot be expected to discipline itself, and because it is unlikely that the new market design and resulting Protocols will be self enforcing. Further, the commission fails to see how the current discussion of market mitigation measures could be a justification for relaxing or eliminating ERCOT's enforcement of its operating procedures. The commission believes that an ERCOT procedure for enforcing operating requirements is necessary to protect customers and ensure that safe and reliable electricity service will be available to them. In determining that proposed subsection (i) relating to ERCOT procedures for enforcing operating standards is necessary, the commission seeks to make clear that ERCOT has a duty to monitor compliance with the ERCOT Protocols and Operating Standards and to report non-compliance to the commission's Market Oversight Division when such non-compliance has the potential to impede the efficient and reliable operation of the market by ERCOT. The need for ERCOT to perform monitoring and enforcement activities was clearly foreseen by the Legislature in PURA §39.151(i). Further, PURA §39.151(d) requires the commission to oversee and review the procedures adopted by an independent organization, such as ERCOT, and authorizes the commission to enforce such procedures.

Garland supported the provisions of subsection (g) of the proposed rule relating to prohibited activities as necessary to assist with the improvement of reliability. Garland believed that the section clearly outlines workable and equitable definitions of "prohibited activities" and "economic withholding." Garland added that such clear definitions are necessary to avoid a situation in which "the competition to provide energy and services often takes second place to a competition to discover loopholes and create opportunities in which some market participants can reap substantial benefits that would not be available in a truly equitable and competitive markets."

Commission Response

The commission agrees with Garland. The commission removes subsections (g)(8) and (g)(9) for reasons explained in the discussion of marginal cost pricing above. However, the commission adds new subsection (g)(8) to clarify that a market participant who has market power and engages in withholding of production, whether economic or physical withholding, is in violation of this rule for abusing its market power.

Garland added that, to further support an equitable and competitive market, the rule should add language to subsection (d) stating that the Protocols are intended to support the efficient operation of the market "while ensuring that users of services provide fair compensation to providers of services, and that providers of services deliver what they are compensated for providing."

Commission Response

The commission agrees with the concept of fair compensation for services provided and recognizes that the Protocols do not always provide for such fair compensation to the providers of reliability services to ERCOT. The commission is also aware that attempts are being made through the ERCOT protocol revision process to remedy this problem and actively supports these efforts. The commission also agrees with the second part of Garland's statement and believes that it relates to gaming activities. The commission believes that the second part of the statement is addressed by subsections (g)(4) and (6).

Cap Rock supported the goal of the proposed rule and urged the commission to take into account the new market design adopted by the commission in Docket Number 26376 and to make sure that the rule will be applicable to the new market rules currently being designed.

Commission Response

The commission is aware of the need to ensure consistency of the rule with the new market design and will assess the need to make changes to the rule once the new market design is known and adopted.

The Independent REP Coalition believed that the proposed rule is an important measure for the stability of the market that will provide some assurances to outside entities looking to invest in deregulated energy activities.

Commission Response

The commission agrees with the Independent REP Coalition that the rule is essential to the stability of electricity markets in Texas.

Comments on specific subsections

§25.503(a)

TXU recommended adding a new subsection (a)(10) to explicitly identify that one purpose of the rule is to "be practical and limited so as to impose the least impact on competition."

CMP proposed revisions to clarify that the rule applies to REP activities in the wholesale market only, and not in the retail market. In addition, CMP would add a new Subsection (a)(10) similar to the one proposed by TXU; and a new subsection (a)(11), to specify that one purpose is to provide fair procedures that meet due process requirements.

AEP would strike (a)(1) and (a)(3), stating that phrases taken from the retail customer protection sections of PURA Chapter 39 are inapplicable to wholesale markets.

Reliant would strike the phrase "including practices in the ERCOT administered market" in subsection (a)(1), explaining that the phrase is unnecessary because it is clear from the general purpose statement that the rule applies to the ERCOT region. Reliant would delete (a)(2), claiming that, based on Reliant's reading of PURA §35.004, the standard of reasonable prices for

ancillary services is met upon the introduction of customer choice and upon acquisition by the ERCOT ISO of ancillary services on behalf of market participants.

BP took exception to the proposed rule's goal of prescribing "ERCOT's role in enforcing operating standards with the ERCOT regional network," saying that as a private entity comprised of market participants, ERCOT should not be engaged in the enforcement of the operating standards, but that enforcement should remain with the commission. BP added that ERCOT's role should be limited to ensuring compliance with the Protocols.

Commission Response

The commission disagrees with TXU and CMP that a new Subsection (a)(10) is appropriate to explicitly identify that one purpose of the rule is to "be practical and limited so as to impose the least impact on competition." The quoted language applies generally to rules and orders issued by the commission governing the establishment of a competitive wholesale electricity market. While the commission has complied with this requirement in adopting this rule, the language does not accurately identify the purpose or the reason for the rule. Accordingly, the commission declines to list it as a specific purpose of this rule.

The commission disagrees with CMP that a new subsection (a)(11) is needed to specify that one purpose of the rule is to provide fair procedures that meet due process requirements. The commission provides fair procedures that meet due process requirements in all of its

rules. As in the previous discussion, the commission declines to list this general requirement as a specific purpose of this rule.

The commission disagrees with AEP that subsections (a)(1) and (a)(3) should be eliminated because they are taken from the retail customer protection sections of PURA Chapter 39 and are inapplicable to wholesale markets. As explained elsewhere in this order, the commission believes that PURA expressly gives the commission jurisdiction and authority to enforce rules as may be necessary to protect customers against unfair, misleading or deceptive practices, regardless of whether such practices occur in the retail or wholesale market.

The commission modifies (a)(1) to indicate: "practices that may occur in wholesale electricity markets, including ERCOT administered markets," so as to eliminate any ambiguity about which markets are affected by the rule. The commission believes that this change addresses CMP's concern as it clarifies that the rule applies only to the wholesale market and not to retail prices and services. The commission similarly clarifies in different parts of subsection (a) that the subsection refers to the wholesale market.

The commission disagrees with Reliant's interpretation of the commission's authority over ancillary services pricing. ERCOT's acquisition of ancillary services is governed by the procedures contained within the ERCOT Protocols and other operating procedures.

Pursuant to PURA §39.151(d), those procedures must comply with the requirements of the commission's rules and the commission retains oversight authority to review and revise those procedures as necessary to ensure compliance with the statute and commission rules. PURA §35.004 should not be read in isolation, as Reliant does, to negate this explicit grant of authority to the commission.

The commission disagrees with BP that ERCOT should not be engaged in the enforcement of its operating standards. PURA §39.151 (d) states: "An independent organization certified by the commission for a power region shall establish and enforce procedures … relating to the reliability of the regional electrical network and accounting for the production and delivery of electricity among generators and all other market participants. The procedures shall be subject to commission oversight and review." In addition, section 39.151 (i) states: "The commission may delegate authority to the existing independent system operator in ERCOT to enforce operating standards within the ERCOT regional electrical network and to establish and oversee transaction settlement procedures. The commission may establish the terms and conditions for the ERCOT independent system operator's authority to oversee utility dispatch functions after the introduction of customer choice." The commission adds language in subsection (a)(9) to clarify the purpose of the rule in this respect.

§25.503(b)

ERCOT suggested changing "market participants" to "market entities", as ERCOT is not a market participant.

Commission Response

The commission agrees with ERCOT and changes the rule accordingly.

§25.503(c)

The commission received comments concerning the following definitions, which are included in subsection (c).

Artificial congestion

Reliant argued that the definition of artificial congestion is faulty because it assumes that a market participant has an expectation that congestion will occur the next day at the time he submits a schedule to ERCOT, which may not be the case. Coral objected to the definition on similar grounds, adding that any single generator does not cause congestion, rather it is caused by a combination of factors, most of which are beyond the control of any single party.

Austin Energy, AEP, BP and TXU said this term should include the element of intent. Austin Energy said that the definition should track the one used by FERC, which specifies that a market participant "first creates congestion, and then relieves it for the purpose of receiving payment."

TXU recommended a similar change, adding that the commission could consider information available at the time.

Reliant said a market participant could submit a day-ahead schedule to ERCOT expecting no congestion the following day, but could still be penalized if that expectation turned out to be wrong because of factors beyond its control. Reliant and TXU also commented that under the proposed definition of artificial congestion, a market participant could be found in violation any time the commission could in hindsight identify some economically feasible redispatch that would have avoided or mitigated congestion. Coral, CPS, Reliant and TXU pointed out that market participants do not have timely access to aggregated information regarding the state of the transmission system or activities of other market participants, which makes their compliance dependent on factors beyond their control. Coral commented further that congestion is not caused by any single generator.

CMP said the definition should be deleted from the rule altogether because the standard is not in PURA and would probably conflict with antitrust law. AEP also said this definition should be deleted from the rule and should instead be defined in the ERCOT Protocols. If kept in the rule, AEP added, the definition should specify that the MP's purpose was to create congestion, and should be limited to entities with market power.

In supplemental comments, San Antonio, Austin Energy, TXU, CMP, CenterPoint, Reliant, and AEP called attention to how staff's redline differed from FERC's definition of artificial

congestion on two points. These parties stated that staff's redline failed to take into account whether the scheduled power flows were uneconomic, and if so, whether the market participant purported to relieve the congestion it had created. TXU, CMP, and AEP said further that staff's redline amounted to a hindsight evaluation because it was implicitly based on information that the market participant would not have at the time the schedule was submitted.

Commission Response

The commission agrees that the definition should be amended and revises it by clarifying two conditions. First, the definition specifies that a market participant has a number of options for scheduling, dispatching or operating a resource. Second, from among those options, the market participant chooses one that is more likely to create or exacerbate congestion instead of an option that does not have that result.

The commission agrees with commenters that artificial congestion should be understood in the context of information available at the time, and of choices and circumstances within a market participant's control. However, the commission declines to add the intent language recommended by Austin Energy and others. For reasons elaborated elsewhere in this order, intent is not a necessary element of a finding of violation under this rule. The commission agrees with the parties providing supplemental comments, and modifies the wording to bring it closer to FERC's definition. The commission specifies that the multiple options for scheduling must be knowable, that the selected option must one that foreseeably causes congestion, that the market participant is paid to relieve the congestion it created,

and that the action would be economically inferior without the congestion payments. This definition should be interpreted to include rent payments that the market participant receives from congestion revenue rights.

The commission disagrees with AEP and CMP that this definition should be omitted from the rule. Many commenters in this rulemaking have called for greater clarity with respect to activities that could be subject to enforcement action, and defining terms such as "artificial congestion" is necessary to provide clarity. Furthermore, because artificial congestion could be the subject of an enforcement action, it would be inappropriate for the commission to cede the task of defining this term to stakeholders who themselves may eventually come under investigation.

Artificial shortage

Austin Energy, AEP, Reliant, LCRA, and CPS said the rule's definition of artificial shortage should include the intent to raise prices. For example, LCRA noted that a supplier may have a contract for standby services that commits a resource, with the result that the resource is not scheduled. LCRA said the supplier may have no intent to affect prices and may be unable to predict that such maintenance will affect prices. Similarly, TXU suggested specifying that legitimate activities that take resources out of the market – routine maintenance, for example – would not be considered an artificial shortage. AEP further called for limiting the definition to entities with market power, or for deleting the definition altogether.

BP commented that a "safe harbor" provision could provide clarity with respect to artificial shortages. For example, a market participant who provides ERCOT with reasonable advance notice for non-emergency maintenance could be exempted from the rule's provisions related to artificial shortage. Similarly, TXU and CenterPoint sought clarification that legitimate conduct – scheduled, non-emergency maintenance, for example – would not violate the rule's artificial shortage provisions. Coral said that however the term is defined, it should take into account dual-grid plants, adding that such a resource should not be required to bid or schedule into ERCOT when its supply is directed to a non-ERCOT power area.

Reliant disagreed with the proposed rule's definition of artificial shortage, which would be created when a resource owner undertakes non-emergency maintenance and such action "affects market prices through the withholding of production." Reliant objected that a standard that does not take into account the possibly legitimate reasons for undertaking the maintenance should not be adopted. Reliant was concerned that the definition could create a liability for normal maintenance that needs to be performed pursuant to warranty requirements, and does not allow for honest mistakes that could be made in reporting plant capability.

CMP said the definition should be deleted altogether because the commission should not craft sweeping new definitions and standards that are not in PURA and are likely to conflict with antitrust law.

In supplemental comments, Austin Energy, TXU, CMP, and CenterPoint said that the staff's redlined version inappropriately created a must-offer requirement for generators because of the ending phrase "or in other ways operating and scheduling its facilities in a manner that materially affects market prices through withholding of supply." These parties claimed that, under this definition, legitimate reasons for not running or offering a unit into the market could be considered withholding of capacity.

Commission Response

The commission acknowledges that the staff's redlined version may be perceived as introducing a universal "must-offer" requirement, which is not its intention in this rulemaking. The commission agrees that a "must-offer" requirement does not currently exist in the Protocols. Deleting the last two phrases of the definition in staff's redlined version eliminates this universal requirement. The commission notes that the first part of the definition addresses a generator's false representation of its operational capabilities. For example, declaring a unit available in the day-ahead resource plan and withdrawing it an hour before real-time could constitute "falsely representing the operational capabilities" of a resource if the owner profited by the resulting price increase and could not show a legitimate reason for suddenly changing the unit's status. The commission agrees, however, that truthfulness and accuracy in reporting the availability of a generating unit to ERCOT is addressed in subsection (f)(9) and does not need to be repeated. Therefore the commission concludes that this definition is not necessary and agrees to withdraw it.

Although a universal "must-offer" requirement does not currently exist in ERCOT, the commission finds that a higher standard for withholding of production exists for suppliers possessing market power. PURA §39.157(a) states that "market power abuses are practices by persons possessing market power," and that market power abuses include withholding of production. In other words, withholding of production by a person possessing market power is a violation of PURA. Thus by statute, suppliers with market power must offer all their available production and capacity into the market, and failure to do so without a legitimate business reason would constitute an abuse of market power.

The commission therefore withdraws the definition of artificial shortage in subsection (c)(2) and reference to the definition in subsection (g)(2) to remove the universal "must-offer" requirement from the rule. However, the commission also revises subsection (g)(8) to clarify that persons with market power may not withhold production unless they can demonstrate a legitimate business purpose or other affirmative defense.

The commission believes that removal of subsections (c)(2) and (g)(2) addresses the concerns expressed by all the parties who provided comments and supplemental comments regarding the definition of artificial shortages.

Economically viable resource

Many commenters recommended deleting this definition because the term is not used in the rule and therefore does not need to be defined. Coral further objected to the definition because it

implies that the commission has the authority to set or determine appropriate prices, although PURA makes it clear that the commission has no such authority. Coral and Reliant also said the definition fails to provide for long-term costs, opportunity costs or profits. Consequently, Reliant said, it exposes market participants to penalties even though they may be making reasonable business decisions based on the information available at the time. AEP said that if the definition is maintained, it should clearly be limited to short-run economic feasibility. Denton noted that "economically viable" is subjective, and even when defined, actions that are not economically viable may be necessary to ensure reliability and stability of the electrical system.

Commission Response

The commission agrees that this definition is not necessary and deletes it from the rule.

Efficient operation of the market

CMP requested that the definition be struck, stating that the term is used to describe a purpose of the Protocols, about which the Protocols are silent or ambiguous; and because the definition and aspects of that definition are not in PURA. CMP added that the definition imposes a standard of perfection because it refers to the "optimal" utilization of resources, that it is contrary to PURA's regulatory scheme for that same reason, and that market participants would not know in advance whether the conduct would meet the standard. CMP stated that the term: "just compensation" is impermissibly vague, and added that the reference to resolving congestion would make no sense if congestion was not the alleged problem.

Austin Energy stated that efficiency is an improper criterion for determining market abuses because it is an ideal outcome that is unachievable. Austin Energy stated that the Legislature avoided reliance on this hypothetical notion by not imposing economic efficiency, and instead, "it imposes competitive markets," in recognition that "competitive electric markets lead to economic efficiency," a basic economic teaching according to Austin Energy. Austin Energy would favor competitive versus anticompetitive behavior as an easier standard to evaluate when conducting market oversight. San Antonio made a similar argument. Austin Energy and San Antonio gave examples in the Protocols where economic efficiency is second to other goals such as fairness, simplicity and reliability.

Commission Response

The commission finds that it is not limited to conduct described or mentioned in the Protocols when it prohibits activities that it finds contrary to the public interest. Neither is the commission limited by terms mentioned in PURA. The term does not describe a specific conduct required of a market participant, but it describes the potential impact of a market participant's conduct. As used in the rule, the definition provides guidance to market participants concerning the factors the commission will review in enforcement actions and the factors they should consider in operating ethically. The commission modifies the language so that it is clear that market participants are expected to not engage in activities that interfere with the efficient operation of the market, and to support the

efficient and reliable operation of the market through their market activities in general. This change addresses CMP's concern that the definition imposes a standard of perfection.

The commission believes that Austin Energy and San Antonio incorrectly equated "the efficient operation of the market" with "economic efficiency." These two concepts do not equate and may even conflict at times. The definition of "Efficient Operation of the Market" in the proposed rule is intended to refer to the optimal utilization of resources, subject to transmission constraints, and not to the "economically efficient" utilization of resources, as Austin Energy and San Antonio incorrectly infer. The commission agrees to modify the definition to eliminate any confusion and further clarify its intention when it uses the term "Efficient Operation of the Market."

Market participant

ERCOT commented that the term "market participant" as defined in the proposed rule differed from the definition used in the ERCOT Protocols. Moreover, ERCOT is not a market participant. ERCOT therefore recommended the term "market entity" and suggested adding a list of the kinds of entities included.

TXU recommended deleting "load-serving entity" (LSEs) from the definition of market participant because, as worded in the proposed rule, it was unclear whether the term included retail electric providers (REPs). TXU requested that the rule also clarify that transactions

between REPs and their end-use retail customers are not viewed as wholesale enforcement issues.

Commission Response

The commission agrees to change "market participants" to "market entity" in subsection (b). However, the commission is retaining a definition of "market participant" as a market entity other than ERCOT so that the rule can clearly differentiate between provisions that apply to all market entities and those that apply to entities other than ERCOT.

The commission declines to delete the term "load-serving entity" from the definition of market participant because it is clear from subsection (a), Purpose, that the rule applies to the activities of LSEs, including retail electric providers (REPs), participating in the wholesale electricity markets and markets administered by ERCOT.

Market power abuses

Austin Energy said the proposed rule's definition of market power abuse failed to provide clarity or standards for findings of market power abuse. Austin Energy observed that if the commission were to address how market power is identified and measured, it would provide the clarity that is presumably the intent of this rulemaking. Austin Energy reiterated its recommendation that the commission adopt the common definition of market power found in the Department of Justice and Federal Trade Commission merger guidelines, specifically "the ability profitably to maintain

prices above competitive levels for a significant period of time." Austin Energy added that market power must be defined in order to inform standards for market power abuse.

BP said that the terms "unreasonable' and "tends to" in the definition of market power abuse are too vague to provide market participants with meaningful guidance as to what kinds of behavior constitute a market power abuse.

AEP, BP, CMP, San Antonio and Reliant said the proposed rule failed to track PURA's definition of market power abuse. These parties stated that the rule should recognize that the possession of market power is a necessary condition of market power abuse. TXU said the definition should also add language from PURA that specifies "the possession of a high market share in a market open to competition may not, of itself, be deemed to be an abuse of market power…." TXU also said the rule should specify that violations of §25.272 of this title will be dealt with under that rule. CenterPoint said the rule should define predatory pricing.

Commission Response

The commission agrees with Austin Energy that a definition of market power is needed. Because the proposed rule attempts to define market power *abuse* and not market power, however, adding a definition of market power at this time could raise procedural issues. The commission will open a separate rulemaking project to define market power.

With respect to market power abuse, the comments by various parties support the conclusion that the term need not be defined in this rule. PURA §39.157 defines market power abuse, and that statutory definition necessarily controls the provisions of this rule. The commission therefore deletes the definition of market power abuses contained in the proposed rule.

Official interpretation of the Protocols

The definition is eliminated as subsection (h) sufficiently describes the process intended under this term. Comments regarding this item and commission response are to be found under the discussion of subsection (h) (redesignated subsection (i).)

Protocols

ERCOT noted that the definition of "Protocols" contained in the proposed rule is different from how ERCOT defines the Protocols. In addition, TXU noted that ERCOT's Protocols control when they conflict with ERCOT's Operating Guides, even though the definition in the proposed rule equates the two. Reliant said further that while the Protocols are approved by the commission, the Operating Guides are not. ERCOT said that the term "ERCOT procedures" may be more appropriate to the rule. Austin Energy suggested language clarifying that the version of the Protocols in effect at the time of alleged misconduct would govern with respect to the action being investigated by the commission.

In supplemental comments, parties requested that the ERCOT procedures referred to in this section be limited to procedures that are public and exclude administrative procedures internal to ERCOT. Parties also requested adding language to specify that, when there are inconsistencies between the Protocols and the Operating Guides or other ERCOT procedures, the Protocols govern.

Commission Response

The commission agrees with ERCOT and adopts the term "ERCOT procedures." The interpretation of this term comprises not only the content of the Protocols and the Operating Guides, but the procedures governing how the two relate to one another and are amended. On the other hand, the commission declines to specify in the definition that the version of the Protocols in effect at the time of the alleged misconduct is what governs. The commission may be called upon to interpret the Protocols and, as part of that process, may need to consider other matters, including, but not limited to, the meaning of technical terms, the application of electric industry standards and practices, the object sought to be obtained by the provision, the consequences of a particular interpretation, and previous or pending Protocol revisions. Consistent with this change in definition, the commission has revised references to "Protocols" in other portions of the rule to now refer to "ERCOT procedures", where appropriate, in order to conform to the new defined term.

The commission agrees to add language to indicate that the reference to ERCOT procedures in this section is limited to procedures that are public and excludes

administrative procedures internal to ERCOT. The commission also clarifies that the Protocols generally govern whenever there are inconsistencies between the Protocols and the Operating Guides, except when ERCOT staff determines that a provision contained in the Operating Guides or other ERCOT procedures is technically superior for the efficient and reliable operation of the network.

§25.503(d)

Austin Energy objected that subsection (d) was based upon a concept of economic efficiency and that economic efficiency is an unachievable standard for evaluating market performance. Austin Energy also questioned whether the commission would ever be able to determine whether any conduct undermined the efficient operation of the market. San Antonio also objected to the rule provision declaring that one of the purposes of the Protocols is "the efficient operation of the market." San Antonio argued that this standard is vague and that in many cases the "efficient operation of the market" is not achieved in the Protocols. San Antonio also objected to the list in subsection (d)(2) of the considerations the commission will use in reviewing a market participant's activities. San Antonio argued that any such list should consist solely of (1) the provisions of applicable statutes; (2) the provisions of applicable commission rules; and (3) the provisions of applicable ERCOT Protocols.

BP stated that the standards contained in subsection (d) are too vague to provide any meaningful guidance to market participants. BP noted that ERCOT has routinely considered and rejected

attempts to include Protocol provisions stating the purpose and intent of the Protocols. BP asserted that ERCOT has decided that the Protocols should only be interpreted based upon their express language and BP encouraged the commission to take the same approach. BP suggested that references to "unfair, misleading or deceptive" practices should be replaced by references to "fraudulent or deceptive trade practices." BP asserted that by referring to this "existing legal standard" the market participants would clearly understand what practices the commission deems unacceptable. BP also objected to language referring to an activity that "reduced the competitiveness of the market." BP asserted that the phrase was too broad and vague and could potentially include activities that served a legitimate business purpose.

CMP argues that application of the rule would violate constitutional provisions concerning vagueness, retroactivity and ex post facto laws. CMP argued that market participants are only required to comply with the Protocols as written and that the rule should be revised to simply refer to PURA's purposes, if a description of purposes is retained. Similarly, CMP suggested that the list of considerations should be revised to list the factors contained in PURA §15.023. CMP also suggested that the language be clarified to indicate it only applied to the activities of market participants in the ERCOT administered wholesale market. CMP requested the addition of new language stating that certain acts or omissions are not considered a violation of the rule, including acts that were beyond the participant's control, acts that are consistent with supply and demand or have a legitimate business purpose, and acts that are not intentional.

TXU and AEP suggested that the reference to "unfair, misleading, or deceptive practices affecting customers" be deleted because it is based upon a PURA provision that deals with retail service while the rule concerns the wholesale market. TXU also requested the deletion of language concerning the commission's ability to address conduct not "expressly addressed" in the Protocols. TXU asserted that such provision does not give market participants fair notice of required behavior. At most, the commission's reliance upon the purpose and intent of the Protocols should be limited to the interpretation of ambiguous Protocol language. TXU argued that the factors listed in subsection (d)(2) included only factors that would count against the market participant and did not include any factors that would tend to indicate that a market participant had not engaged in improper conduct. To remedy this, TXU suggested the addition of such factors, including the market participant's history of compliance and any efforts to correct errors. TXU also objected that the list of factors failed to include a consideration of the market participant's intent and that the factors tended to protect individual competitors rather than protecting competition.

Reliant suggested that subsection (d) should be expanded to also monitor the activities of the ERCOT ISO as well. Rather than relying on the purpose and intent of the Protocols, Reliant stated that the Protocols revision process, contained in Section 21 of the Protocols, should be used to clarify any ambiguities. Reliant also noted that the list of purposes did not include the accounting function described in PURA §39.151(a) and requested that it be added. Reliant argued that portions of the list of considerations in subsection (d)(2) were vague and requested that they be revised and an intent element be added.

Austin Energy requested deletion of language indicating that the commission would be guided by the intent and purpose of the Protocols, asserting that market participants should not be held to any standards unless they have been warned by individual notice that their activity is prohibited by the Protocols. Austin Energy argued that the intent and purpose of the Protocols was established by ERCOT in Section 1.2 of the Protocols, which is to carry out the Legislature's charge for an Independent Organization under PURA.

AEP argued that the rule creates uncertainty, and explained that the Protocols either address a subject or they do not. A market participant should be able to rely upon the express language of the Protocols and not subject to second guessing as to whether an action is consistent with the purpose and intent of the Protocols. AEP also requested that an intent element be added to this subsection.

Garland requested that subsection (d)(1)(B) be revised to indicate that users of services are required to pay fair compensation for the services they receive and that providers of services are compensated for the services they provide. Garland argued that many of the problems in ERCOT involve attempts by some market participants to shift the burden of their operating decisions to other participants, efforts by market participants to obtain compensation for costs incurred in following ERCOT instructions and claims for payment by some market participants for services they did not provide. Garland asserted that the rule should contain a clear articulation of this concept in order to create an environment in which participants compete to

provide services instead of competing to implement inequitable market structures. In reply comments, CMP asserted that the Protocols do not serve the purpose Garland identified and that the commission lacks the jurisdiction to impose such a requirement.

Commission Response

For reasons discussed elsewhere in this order, the commission disagrees with the suggestion to add an intent element to this rule and disagrees with comments suggesting that references to "unfair, misleading or deceptive" practices should be deleted. The commission reiterates that its authority to protect customers is not limited to practices in the retail market but extends to unfair, misleading or deceptive practices in the wholesale market as well. The commission agrees with comments suggesting that the provision requiring market entities to comply with the purpose and intent of the Protocols introduces uncertainty concerning the scope of the rule. In order to remove such uncertainty, the commission is deleting the list of the purposes and intent of the Protocols. Deletion of the language also addresses concerns about vagueness, retroactivity and *ex post facto* laws and a possible conflict with Protocols language that were raised by some commenters, and comments suggesting additions or revisions to the list of purposes. However, deletion of the language should not be interpreted as an agreement that market participants are only required to comply with the Protocols as written, as CMP stated, or that the commission does not have the ability to address conduct not "expressly stated" in the Protocols. The commission has the authority to address unfair, misleading or deceptive practices and market abuses that affect the reliability of the electric network, the efficient functioning of

the market, or the competitiveness of the market, such as any activity that unduly restrains trade or unreasonably excludes firms from the market or significantly impairs their ability to compete, regardless of whether these activities are expressly addressed in the Protocols.

Concerning the list of factors considered by the commission when reviewing the activities of market participants, the commission declines to limit the list to a mere repetition of PURA §15.023 as suggested by Austin Energy, or to add factors listed under this section of PURA as suggested by TXU. This provision is intended to provide some guidance to market participants of the types of market impacts that adversely affect the competitive market. By providing a list of adverse market impacts the commission will monitor, the commission places market participants on notice of the results that they should strive to avoid if they want to avoid an administrative enforcement action, to the extent that such results are foreseeable. This notice function is different than, and does not replace, the factors that the commission will consider under PURA §15.023 in determining the amount of an administrative penalty in the event the rule is violated. In response to a comment from Reliant, the commission is revising this list to include a reference to the accounting function that is provided by ERCOT. For reasons discussed elsewhere in this order, the commission disagrees with the comments of Austin Energy and San Antonio that mistakenly allege that the rule incorporates an unachievable standard of economic efficiency.

The commission disagrees with BP's assertion that language referring to an activity that "reduced the competitiveness of the market" is too broad and vague, and that an activity that reduces the competitiveness of the market can have a legitimate business purpose. As stated by the FTC in its comment to the FERC, "in some instances, antitrust has asked whether an agreement had a "legitimate business purpose" as a way of inquiring whether the agreement has a procompetitive justification, as by creating efficiencies sufficient to make the market more, rather than less, competitive." (FERC Docket Number EL01-118-000, Comment of the Federal Trade Commission, p. 13, August 28, 2003.) The commission agrees with the FTC that an activity that reduces the competitiveness of the market cannot have a legitimate business purpose. However, the commission is adding a new subsection (h), Defenses, which will allow market participants to invoke the legitimate business purpose standard when appropriate as an affirmative defense. The new subsection also addresses CMP's request for language that indicates that acts beyond the control of the market participant are not considered a violation of the rule, provided that all elements of the affirmative defense are proven.

In addition, to add clarity to the rule and reduce uncertainty, the commission adds a materiality standard, as suggested by the FTC in its comments to the FERC, so that actions having a benign impact, or no adverse impact, on market competitiveness, or the efficient and reliable operation of the market, will not be considered in violation of the rule. However, the commission may request that a market participant discontinue a practice that has the potential to harm the reliability of the electric network, or the efficient

operation or competitiveness of the market, even if the practice does not always produce an undesirable outcome.

Garland's comments regarding the need for fair compensation for reliability services provided to ERCOT are addressed elsewhere in this order. The commission believes that Garland's concerns about market abuses, such as a market participant getting paid for a service not provided and other such gaming activities, are addressed by subsections (f) and (g).

The commission agrees with TXU that the purpose is to protect competition and not individual competitors and modifies subsection (d)(2)(B), redesignated as subsection (d)(2), to specify that the commission will consider activities that materially reduce the competitiveness of the market, including activities that unfairly impacted other market participants in a way that restricts competition. Additionally, the commission is eliminating proposed subsection (d)(2)(E) as it is duplicative of proposed subsection (d)(2)(B), redesignated as subsection (d)(2).

§25.503(e)

AEP asserted that the requirement to "ensure the efficient and reliable operation of the ERCOT electric system" was an unachievable standard and created economic uncertainty. AEP requested that it be revised to state that a market participant should not knowingly interfere with

the operation of ERCOT. AEP also objected to subsection (e)(4) as a matter that is more properly addressed in the ERCOT Protocols.

Austin Energy objected to requiring market participants to comply with the "purpose and intent" of the Protocols. As in their comments to subsection (d), Austin Energy asserted that the standard is too vague.

Reliant, Austin Energy, and TXU all made similar comments, asserting that the language of this subsection is too vague and recommended removing the requirement to comply with the "purpose and intent" of the Protocols. Reliant also recommended that an intent element be included in the ethical standards, otherwise market participants could be subject to penalties for virtually any action they took. Reliant stated that subsection (e)(3) was included within the requirements of subsection (e)(1) and was therefore repetitive and should be deleted.

TXU suggested deleting this subsection because it is redundant of other requirements. Alternatively, if the subsection is only a list of expectations, TXU suggested the deletion of subsection (g)(10), so that violation of subsection (e) would not be a prohibited activity subject to penalties. TXU also argued that the rule is too broad and suggested that it be revised by limiting the requirement to comply with laws and regulations to only those laws and regulations within the jurisdiction of the commission; eliminating a redundant requirement to schedule, bid and operate their resources consistent with the efficient and reliable operation of the market; and

deleting a redundant requirement to not engage in activities that create artificial congestion or artificial shortages.

Commission Response

The commission agrees with AEP that requiring market participants to "ensure" the efficient and reliable operation of the market may be an unachievable standard and modifies the language to indicate that the commission expects market participants to "support" the efficient and reliable operation of the market. The commission believes that this expectation is fully consistent with the legislative goal of developing a competitive electricity market, protecting customers from unfair, misleading, or deceptive practices, and ensuring that customers have access to safe, reliable, and reasonably priced electricity. The commission believes that there are often situations in which it is quite possible for a market participant to anticipate that a seemingly profit maximizing activity could jeopardize the efficient operation of the electric network by ERCOT and result in high costs to the market. An example taken from factual observation is a market participant who would schedule a planned outage for the month of January, then decide a few days before the outage start date to postpone the plant's scheduled maintenance to March because market prices appear to be on an upward trend as January gets closer. The result would be that ERCOT would first direct transmission companies to plan for scheduling maintenance transmission outages for lines affected by the plant outage in January, and then would have to order these transmission outages to be re-scheduled to another month, March for example. This rescheduling could potentially create very high cost to the market, and add the additional risk that rescheduling the transmission outages for March may not be possible or may conflict with other outages previously scheduled for March. The market participant's decision in this example undermines the efficient and reliable

operation of the electric network, even though it is not an express violation of the Protocols. It may force ERCOT to operate the electric system in an unsafe state, or to take actions resulting in inordinately high costs in order to maintain reliability, and may have a substantial impact on prices ultimately paid by customers. A reasonable alternative to the market participant's action in this example would be for the market participant to inform ERCOT of its desire to reschedule the outage and only go ahead with the rescheduling if ERCOT can accommodate it without substantial reliability issues that are inordinately costly to resolve. Another alternative would be the direct assignment to the market participant of the costs incurred by its last minute decision to deviate from the outage plan it previously submitted to ERCOT, providing a work-around exists that will enable ERCOT to maintain a safe operation of the network. These alternatives, which are not addressed in the Protocols, serve to illustrate the need for this section given that the Protocols fail to sufficiently protect the market and reliability.

Although the commission greatly favors incentive compatible market rules over behavioral standards to ensure the efficient and reliable operation of the market, experience has shown that it takes time to identify flaws in the market rules, and even more time to implement a remedy through the stakeholder process. The commission believes that, when evaluating a market participant's activity, it should ask: should the market participant have known that its action would interfere with the reliable or efficient operation of the market by ERCOT? In the above example, there should not be any confusion or uncertainty to the market participant about the impact of its action, because ERCOT has

effectively provided numerical evidence as to the cost of such action to the market. In other instances when the market impact is not foreseeable, the market participant will have the opportunity to demonstrate during an informal review process under subsection (k), Investigations, that it could not have anticipated the impact of its action on the reliable and efficient operation of the market. In addition, the commission adds a foreseeable standard in new subsection (h), Defenses, that will ensure that the action will not be subject to penalty. The commission therefore believes that the standard is fair, that it is consistent with legislative goals, and that it should be retained.

For reasons discussed elsewhere in this order, the commission disagrees with the suggestion to add an intent element to this rule. However, the commission agrees with comments suggesting that this subsection on ethical standards should be seen as aspirational in character. The commission is revising the rule to clarify that point by deleting subsection (g) (10) that makes a violation of the guiding ethical standards a prohibited activity subject to penalties. The commission also agrees to remove the requirement to comply with the "purpose and intent" of the Protocols. The commission believes that these changes sufficiently address the comments concerning the alleged uncertainty created by subsection (e), Guiding ethical standards, and eliminates concerns about potential vagueness. The commission stresses that the proper functioning of a competitive electricity market depends upon customer confidence that market participants are acting in accordance with effective ethical standards. In order to provide assurances of ethical conduct to the public,

the commission recommends that each market participant adopt ethical standards consistent with this subsection.

§25.503(f)

CMP proposed to eliminate subsection (e) and add two new subsections to (f) corresponding to (e)(2) and (e)(3).

Commission Response

In light of the changes made to subsection (e), the commission believes that the concerns expressed by CMP have been addressed. Subsection (e) contains guiding ethical principles that do not subject market participants to penalties, whereas subsection (f) lists market participants' obligations. Each of the subsections serves a purpose and the commission declines to eliminate subsection (e) and transfer part of it to subsection (f), as suggested by CMP.

TXU commented that a number of the affirmative duties in this subsection are more appropriately addressed as prohibited activities and should be moved to subsection (g), Prohibited Activities. TXU added that the commission should add an intent element to the list of prohibited activities.

BP commented that this subsection is well structured, sets forth specific, affirmative activities that market participants must follow in order to comply with the rule, and that market participants will know exactly what action they need to take to ensure they do not violate the rule. BP stated that this type of regulatory clarity is vital to a healthy wholesale electricity market.

Commission Response

The commission disagrees with TXU that it should add an intent element to the list of prohibited activities for reasons discussed elsewhere in this order. The commission does not believe that the duties listed in subsection (f) would be more appropriately placed in the "prohibited activities" section, as suggested by TXU, and agrees with BP that this subsection is well structured and clearly specifies activities market participant should engage in to comply with the rule. The commission declines to make the change suggested by TXU.

Subsection (f) (1)

Reliant suggested eliminating this subsection stating that "knowledgeable" is not clearly defined and is redundant of subsection (e)(1) in which the market participant is expected to conduct business activities in accordance with the Protocols. AEP also suggested deleting this subsection stating that it puts the commission in the business of regulating the affairs of unregulated entities.

Commission Response

The commission disagrees with Reliant that "knowledgeable" is not clearly defined and believes that this provision is necessary to clarify that a market participant cannot plead ignorance of the Protocols as a defense. The commission disagrees with AEP and believes that it has the authority to require that market participants know and observe the market rules. PURA §39.151(j) requires that all market participants must "observe all scheduling, operating, planning, reliability, and settlement policies, rules, guidelines, and procedures established" by ERCOT. As part of their technical qualifications for obtaining certification, retail electric providers (REPs) must demonstrate their ability to comply with the ERCOT procedures under §25.107 of this title (relating to Certification of Retail Electric Providers). The commission's form for REP certification also requires that the REP submit an affidavit in which the REP swears that it will comply with "all system rules and standards" established by ERCOT. Both REPs and power generation companies (PGCs) can have their certifications revoked for failure to maintain their qualifications, including the failure to comply with procedures adopted by ERCOT. (See, §25.107(j)(9) and §25.109(i)(1) & (2), relating to Registration of Power Generation Companies and Self-Generators.) The commission fails to see how market participants can comply with this requirement without taking steps to assure that their employees are knowledgeable of the contents of the ERCOT procedures that they have sworn to follow.

Subsection (f)(2)

TXU suggested that (f)(2) should be added to (g) and should be a prohibition against intentionally violating the Protocols. In addition, TXU suggested modifying (f)(2)(C) to identify circumstances where violation of an ERCOT instruction, Protocol requirement, or written commitment is justified. CMP and Reliant proposed removing references to "official interpretations of the Protocols issued by ERCOT." CMP also proposed adding to the list of exclusions: "when required by applicable law; or for other good cause." AEP suggested deleting this entire section stating that the items are more appropriately addressed in the ERCOT Protocols, but if this provision is retained, AEP requested that language be added to allow a market participant to be excused from compliance for good cause.

Commission Response

The commission declines to move any of the duties described in this subsection to the subsection on prohibited activities, as suggested by TXU. The commission agrees to add a generic safe harbor provision to (f)(2)(C) to catch any possible circumstances that could excuse non-compliance with an ERCOT instruction, Protocol requirement, or written commitment, as suggested by CMP, AEP and Reliant. The commission disagrees with AEP that the items in this subsection are more appropriately addressed in the ERCOT Protocols and declines to eliminate the subsection.

The commission declines to eliminate references to official interpretations of the Protocols by ERCOT for reasons explained later in the discussion of proposed subsection (h) (redesignated subsection (i).)

Subsection (f)(3)

TXU, CMP and Reliant proposed eliminating the "good faith effort" language from (f)(3) stating that the definition of "good faith effort" is widely understood, does not need definition and should not be a requirement of strict adherence. AEP suggested deleting (f)(3) as it believes this is more appropriately addressed in the Protocols. TXU indicated that currently ERCOT Protocol §6.8.3.1(5) provides that market participants shall provide good faith estimated details identifying eligible expenses for reliability must run monthly costs for initial settlements. TXU expressed concern that although these are intended to be estimated details related to costs, (f)(3) as written would require in reality actual RMR costs be provided.

CMP proposed adding in a "good cause" exemption for not meeting the requirements of this subsection. Reliant added that there should be an allowance for honest mistakes. CenterPoint requested that a provision be added to allow the market participant to consider possible financial implications when exercising a best effort or good faith effort in meeting a requirement.

Commission Response

The commission disagrees that this subsection should be eliminated as suggested by CMP, Reliant and AEP, noting that the subsection is needed for added clarity because the term

"good faith effort" is used several times in the Protocols but lacks definition. The commission considers that the example provided by TXU is not applicable, as a "good faith estimate" is still an estimate, which is a well understood term. Good faith estimates are the results of conscious efforts to provide estimates that are based on well supported data, and the requirement for good faith estimates cannot be interpreted as a requirement for actual data.

The commission agrees to add an exemption for good cause as suggested by CMP. The commission believes that Reliant's concern regarding "honest mistakes" is addressed by the addition of a subsection on affirmative defense to this rule.

The commission disagrees with CenterPoint that a negative financial impact is sufficient reason for a market participant to not follow the Protocols. There are costs and risks associated with participating in the wholesale electricity market or any market. A market participant can decide not to participate in a market if it does not like the market rules, but cannot decide which rules it will follow once it has entered the market.

Subsection (f) (4)

CMP stated that in the event that ERCOT sends out instructions that cannot be complied with, a market participant must have flexibility to inform ERCOT through a single notification of compliance difficulty, and not have to repeat that notification every interval.

CMP stated that "immediately" should not be construed to prevent a market participant from addressing safety issues first. Reliant made a similar argument and requested that "as soon as practical" be used to replace "immediately."

AEP proposed to delete the first sentence stating that it concerns the ERCOT process and is a subject matter more properly addressed in an ERCOT Protocol. AEP suggested adding that a market participant has the burden to demonstrate "in any commission proceeding in which the failure to comply is raised," why it cannot comply, to clarify that the market participant is not obligated to initiate a proceeding to seek a declaration that its non-compliance is excusable.

Commission Response

The commission agrees with CMP regarding a single notification to ERCOT of inability to comply and changes the rule accordingly. However, as a result of this change, the commission notes that each market participant must be made responsible for notifying ERCOT when the problem ceases and adds this requirement to the rule as well.

The commission declines to change "immediately" to "as soon as practical" as requested by CMP and Reliant. When an event occurs at a facility that also has the potential to affect the reliability of the network, the operator of a market participant has an obligation to tend to both the safety of the facility involved and the safety of the network by notifying ERCOT. Additionally, this provision provides a safe harbor in cases when circumstances are such that the operator is unable to inform ERCOT immediately. The commission

clarifies the rule by adding the language suggested by AEP that a market participant who does not comply with a Protocol requirement has the burden to demonstrate "in any commission proceeding in which the failure to comply is raised," why it cannot comply.

Subsection (f)(5)

CMP proposed to add a requirement that information requests from commission staff must be in writing and subject to limitations on discovery applicable in contested cases. CMP also proposed to further define a "complete" response demonstrating the claimed inability to comply, as a response explaining the circumstances surrounding the alleged failure and providing documents and other materials relating to such alleged failure. CMP further requested a change from seven days to five business days to account for holidays. CMP, Reliant and TXU requested more flexibility in the requirement for a market participant response deadline of seven days. In supplemental comments, CenterPoint requested that it be allowed 20 days to respond, as allowed under commission rules for responding to requests for information in a contested case.

CenterPoint commented that the commission staff should be required to respond within 30 days or other reasonable time limit of a market participant's notification of non-compliance. If the commission staff fails to meet this deadline, the market participant's failure to comply would be deemed justified and not in violation of this rule. In reply comments AEP agreed, arguing that such time limit will allow timely closure of the matter.

Commission Response

The commission notes that formal investigations are already governed by the rules of contested cases, and declines to adopt CMP's proposal to subject commission staff requests for information to limitations on discovery applicable in contested cases. The commission agrees that commission staff requests for information will be in writing.

The commission agrees to add further clarification as to the expected market participant response, as suggested by CMP, and specifies that a market participant is expected to provide a "detailed and reasonably complete response." The commission emphasizes that a market participant is expected to provide as complete a response as it possibly can if it is to cooperate fully with the commission staff's review. The commission agrees to change the response time from seven days to five business days as suggested by CMP, and to amend the rule to give commission staff the ability to extend the deadline if necessary. These changes should address the need for more flexibility expressed by CMP, TXU and Reliant. The commission disagrees with CenterPoint's request to extend the time limit for responses to 20 days. The information concerning a notification of failure to comply with the Protocols should not be voluminous and should not take significant time to assemble and deliver. If there is need for additional time in a particular situation, the market participant can seek an extension under the rule. However, this exceptional circumstance should not be used to set the time limit for all circumstances involving a failure to comply.

The commission disagrees with CenterPoint and AEP's proposal for a time limit for commission staff response as it believes that the time required for investigating a violation of the rule depends on the circumstances of the event and may exceed 30 days or other time limit, and that such time limit could interfere with the commission's ability to protect the public interest against inappropriate activities in the wholesale market.

Subsection (f)(6)

CMP stated that the proposed rule imposes an unreasonably strict liability standard whereby a market participant commits a violation if its bid resource is unavailable due to a *force majeur* event and in addition the rule makes no allowance for inadvertent error. CMP proposed a remedy by adding a requirement that such actions must be knowingly performed by the market participant. Reliant expressed similar concerns and requested deleting the requirement and stating that the bids must be consistent with the Protocols. AEP also proposed to delete this section, stating that this provision concerns the operation of the market and ERCOT's functions and is more properly addressed in an ERCOT Protocol.

Coral commented that since the purpose of this rulemaking is to position the commission to address intentional market manipulation in a manner that causes harm to others, the words, "willfully and knowingly" should be added to this section.

San Antonio suggested that a requirement that energy bids be consistent with the portfolio ramp rate specified in the bid be deleted because it is unclear how a bid could be inconsistent with the

applicable ramp rate. CenterPoint suggested that "portfolio" ramp rates should be changed to "applicable" ramp rates to make this rule applicable to all resources.

Commission Response

The commission believes that the addition of an affirmative defense section to the rule addresses the concerns expressed by CMP regarding cases of *force majeur* and inadvertent error. The commission does not add "willfully and knowingly" or other intent element for reasons discussed elsewhere in this order.

The commission declines to delete this subsection, as suggested by Reliant, AEP, and San Antonio. Changes in scheduled energy, and bids of ancillary services, in excess of the physical capability of a portfolio to timely ramp its generation, have been observed to affect the frequency of the interconnection. The deployment of ancillary services to compensate for such ramp rate failures leaves fewer resources available to ensure the safe and reliable operation of the grid. A ramp rate violation occurs when a QSE schedules an increase or decrease in generation of a magnitude in excess of the observed physical capability of its portfolio to implement during the ten minute window across schedule intervals. A ramp rate violation also occurs when a QSE bids quantities of ancillary service capabilities in excess of the observed physical ability of its portfolio to implement when deployed by ERCOT. The commission revises the rule to refer to "applicable" ramp rates as suggested by CenterPoint.

Subsection (f)(7)

TXU and Austin Energy suggested that (f)(7) be modified to address reporting to publishers of indices only and that a new subsection (f)(8) be added to address statements by market participants to ERCOT and the commission.

CMP suggested adding an intent standard by referring to market participants "knowingly" submitting false information, and a materiality standard by referring to omission of "material" information. AEP, Coral and TXU would also add an intent standard. CMP stated that the word "complete" is unduly subjective and imposes a standard of perfection. CMP's proposed revision would require that market participants not submit incomplete, inaccurate or misleading information subject to adequate standards of confidentiality and in accordance with industry standards.

Reliant asserted that PURA does not give the commission the authority to govern the content of messages that are part of a company's free speech, and concluded that the reference to the media should be deleted. AEP made a similar argument. Reliant added that a market participant should not be held accountable for any information that it does not have access to at the time the report is required. Reliant would add language to require that "authorized" personnel submit all information. TXU proposed to limit the requirement to information reported to publishers of electricity and natural gas price indices.

CenterPoint requested that the rule be modified such that it assigns responsibility for information as it pertains to the market participant's own assets only. CenterPoint suggested that this is particularly applicable as it pertains to a QSE because while a QSE may be an aggregator of information from other market participants such as PGC's and power marketers it is not in a position to ensure the accuracy of all information that may be required from such entities.

Austin Energy, recognizing the abuses that have recently been revealed regarding the reporting of false prices to manipulate market indices, agreed that companies should be prohibited from manipulating markets by falsely reporting prices to index services, but considers it unnecessary to require that market participants be responsible for the accuracy of statements, data and information other than transaction prices to reporters or publishers of market indices. Austin Energy agreed that the rule should be modified to make the market participant responsible for the veracity of information submitted to the commission and ERCOT.

TXU commented that consistent with the "safe harbor" provided in the FERC's Policy Statement on Natural Gas and Electric Price Indices, the commission should "not seek to prosecute and/or penalize parties for inadvertent errors in reporting."

In supplemental comments, CMP stated that subsections (f)(7)-(8) are inconsistent with the FERC rules and they imposed a separate duty of due diligence instead of limiting the scope of the provisions.

Commission Response

The commission agrees to address statements made to ERCOT and the commission separately from information reported to publishers of indices as suggested by TXU and Austin Energy. In order to accomplish this, the commission divides the broad requirements of proposed subsection (f)(7) into two separate subsections. Information provided to publishers of market indices is covered by the revised subsection (f)(7), while the provision of information to ERCOT and the commission is addressed in new subsection (f)(8). The commission adds a materiality standard in new subsection (f)(8) to address the materiality concern expressed by CMP.

The commission declines to add an intent standard as suggested by CMP, TXU, AEP and Coral for reasons discussed elsewhere in this order. The commission changes the rule to specify that information provided by market participants to market publications and publishers of surveys and market indices for the computation of an industry price index shall be true, accurate, reasonably complete and shall be consistent with the market participant's activities, subject to generally accepted standards of confidentiality and industry standards. The commission believes that this change, which focuses on false reporting to price index services, removes the "perfection" standard, allows for confidentiality considerations, and allows market participants to follow industry standards in choosing what information they will disclose. The commission finds that this action addresses the concerns expressed by CMP, TXU, Austin Energy, and Reliant. By taking this action, the commission should not be viewed as agreeing with Reliant's and AEP's

assertions that the rule, as proposed, violated constitutional fee speech protections. The commission disagrees with Reliant and AEP. The courts have held that commercial fee speech, like that addressed in the rule, is not subject to the same constitutional protections as other forms of fee speech. In *Central Hudson Gas & Electric Corporation v. Public Service Commission*, 447 U.S. 557, 100 S. Ct. 2343, 65 L. Ed.2d 341 (1980), the U. S. Supreme Court held that "there can be no constitutional objection to the suppression of commercial messages that do not accurately inform the public of lawful activity." (447 U.S. at 563). Because the rule requires the submission of true and accurate information and only prohibits the submission of false and misleading information, it comes within the bounds of acceptable regulation of commercial speech. Reliant's and AEP's arguments on this point are rejected, and the revisions to the rule make them moot.

The commission declines to require that authorized personnel only be able to submit information as suggested by Reliant and instead adds language in subsection (f)(7) and new subsection (f)(8) to require that each company exercise due diligence to avoid the reporting of false information. As a part of that due diligence, market participants may choose to limit how, and by whom, information is provided to market publications and publishers of market indices. The commission does not believe that it is necessary to specify that QSEs are not responsible for the accuracy of information that pertains to the owner of an asset they represent, since the QSE can always establish that the information came from the asset owner, and all market participants are required to maintain their own records of information under subsection (j). The commission believes that the new subsection on

affirmative defense sufficiently addresses the concern expressed by TXU regarding inadvertent errors in reporting. The commission disagrees with CMP's assertion that the due diligence language is not consistent with the FERC's rules. The FERC rule clearly establishes due diligence as an affirmative defense that can be relied upon by a market participant. The due diligence language of subsections (f)(7)-(8), read in conjunction with the new affirmative defense language in subsection (h), also establishes due diligence as a defense.

Subsection (f)(8), redesignated as (f)(9)

Reliant and San Antonio commented that notification "immediately" was not always possible and suggested replacing "immediately" with "as soon as practical". AEP proposed to eliminate the second sentence stating that reporting to ERCOT about operational changes is more appropriately addressed by an ERCOT Protocol. AEP requested a clarifying change to specify that market participants should comply with all "applicable" reporting requirements. TXU suggested a modification to require market participants to notify ERCOT "immediately after the market participant is aware of the event, and only if the event materially affects the operation of resources."

ERCOT filed supplemental comments suggesting that the reporting requirement of subsection (f)(8) should only apply to market participants and should not apply to ERCOT. ERCOT argued that it is already required to respond to information requests pursuant to §25.362 of this title, relating to Electric Reliability Council of Texas (ERCOT) Governance, so there was no need to

include the reporting requirement in this rule. ERCOT also argued that it already provides a wide variety of information to the commission pursuant to the Protocols. ERCOT was concerned that much of the data it provides to the commission is not complete and must be adjusted later and that such filing could be considered a violation of this subsection.

Commission Response

The commission determines that timely reporting of the availability and maintenance of a generating unit or transmission facility is of crucial importance and necessary to allow ERCOT to operate the electric grid in a safe and reliable manner, and therefore declines to remove the requirement that reporting be done immediately as suggested by several commenters. The commission believes that, if circumstances are such that they do not allow immediate reporting, the new subsection on affirmative defense ensures market participants sufficient opportunity to demonstrate as much and not be penalized. The commission agrees to add a materiality standard as suggested by TXU. The commission disagrees with AEP that reporting requirements are sufficiently addressed in the Protocols and do not need to be addressed in the rule. Experience with instances in which market participants have delayed in providing essential information to ERCOT, and the effect of such delays on the market, demonstrate the need for this rule. The commission does not believe that it is necessary to specify that market participants should comply with all "applicable" reporting requirements as suggested by AEP, as all reporting requirements governing the availability and maintenance of a generating unit or transmission facility are

applicable. AEP failed to give an example of a reporting requirement that would not be applicable.

The commission disagrees with ERCOT's request to exempt it from the requirements of subsection (f)(8). Although other commission rules and the Protocols may require ERCOT to provide information to the commission, subsection (f)(8) goes beyond a mere reporting requirement and requires that the information be accurate and not false and misleading. The commission believes that it is important that this requirement be imposed on both market participants and on ERCOT. If the information to be submitted is preliminary or subject to later true-up ERCOT can clearly indicate such facts in order to avoid liability for inaccuracies. Accordingly, the commission declines to adopt ERCOT's revision.

Subsection (f)(9), redesignated as (f)(10)

CMP proposed to impose limitations on discovery to requests for information from ERCOT similar to those applicable in commission contested cases. TXU proposed to delete the requirement to provide information as specified in "ERCOT instructions". TXU complained that market participants should only be required to provide information that is specified in the Protocols and pursuant to Protocol time limits.

Commission Response

The commission does not believe that it is necessary or appropriate to put a limitation on information requests from ERCOT similar to limitations on discovery applicable in

commission contested cases. The commission declines to delete "ERCOT instructions" from this requirement as ERCOT may on occasion need information beyond that specified in the Protocols in order to ensure the safe and reliable operation of the grid.

Subsection (f)(10), redesignated as (f)(11)

CMP proposed a clarification to specify that the proposed rule does not prohibit a market participant from seeking a Protocol revision rather than a formal Protocol interpretation. CMP also proposed a revision to clarify that informal efforts to obtain clarifications are not discouraged or prohibited as informal communications can be highly beneficial in helping market participants understand what is required or permitted and providing ERCOT early notice of market or technological developments or needs for Protocol revision. CMP also pointed out that, in an emergency requiring immediate decision or action, there might not be time to seek a formal Protocol clarification or interpretation. CMP stated that its proposed revisions preserve the commission's current ability to consider what informal efforts were appropriate and what weight to give them.

Reliant proposed that when a Protocol is unclear or a situation is not contemplated under the Protocols, the process for revision or clarification should be as is contained in the Protocols and references to subsection (h) should be deleted.

Commission Response

The commission changes the rule to address the concerns expressed by CMP. The commission declines to delete subsection (h) (redesignated as subsection (i)), and references

to it, as suggested by Reliant, for reasons explained later in this order in the discussion of subsection (h) (redesignated as subsection (i)).

Subsection (f)(11), redesignated as (f)(12)

Reliant stated that this subsection imposes an excessive requirement but does not clearly define what level of participation in the protocol revision process is required. Reliant suggested that the requirement should be to bring the issue to the attention of the appropriate subcommittee and/or the ERCOT staff. CMP suggested changing the proposed rule from "requiring" to "allowing" a market participant who identifies a provision or procedure that produces outcomes inconsistent with the efficient and reliable operation of the ERCOT market to call the provision to the attention of the appropriate ERCOT subcommittee, and to eliminate the requirement to work proactively to develop Protocols that are clear and consistent. CMP argues that without these changes the fiscal note would require a much larger cost estimate as it would require employees to act outside their company's core business area, and it is unclear what working proactively means.

AEP proposed to revise the obligation to report Protocol inefficiencies and to pro-actively work with ERCOT subcommittees so that it was also applicable to members of ERCOT or the commission staff.

TXU suggested clarifying that the provision referred to in this section is a Protocol provision.

Commission Response

The commission does not agree with CMP that calling an inefficient provision in the Protocols to the attention of the appropriate ERCOT subcommittee would require additional personnel and legal support on the part of market participants. This is something market participants already do routinely when the inefficiency affects their business. The rule should not be interpreted to affirmatively require market participants to microscopically examine the Protocols for inefficient provisions. Instead, the rule simply adds a reporting requirement when a market participant identifies such a provision. CMP failed to show how this reporting requirement could cause a company to hire additional employees or to perform work outside its core business area. The commission therefore declines to make this requirement optional. The commission agrees to reduce the perceived burden on market participants by changing the requirement to "pro-actively work with ERCOT subcommittees" to a requirement to "cooperate with ERCOT subcommittees."

The commission believes that it is not necessary to extend the obligations of this subsection to members of ERCOT or the commission staff. The commission notes that the commission staff is not a market entity, and additionally, the commission and its staff already operate under a legislative mandate to promote the development of a competitive market. Secondly, in many instances market participants who actively participate in the development of market Protocols at ERCOT have diverse interests given their loyalty to the company that employs them, whereas this is not the case for either the ERCOT staff,

who operates under a legislative mandate to independently maintain the reliability of the grid, or to the commission staff, who is under a mandate to represent and defend the public interest. Since these parties have no self interest in retaining and possibly exploiting inefficient Protocol provisions, there is no need to require them to report such inefficiencies when discovered. The commission is confident that both of these parties will continuously work to eliminate errors or inefficiencies in the Protocols.

The commission agrees with TXU and changes the rule to indicate that the term "provision" in the rule refers to a provision in the ERCOT procedures, which include the Protocols and the Operating Guides.

Subsection (f)(12), redesignated as (f)(13)

CMP suggested limiting this requirement to affected personnel while excluding administrative staff and others. AEP proposed to eliminate this section stating that it regulates the internal affairs of non-regulated entities, which is beyond the commission's and ERCOT's authority.

OPUC proposed that the internal procedures be required to be written and that they should be provided to the commission upon request, as it may be useful for the commission to review the applicable internal procedures and recommend changes to the procedures as part of a mitigation measure. In reply comments, CMP disagreed with OPUC's proposal because it contended that effective procedures to instruct personnel typically include both written and oral instruction, and stated that the second sentence is not needed because that obligation already exists.

Commission Response

The commission agrees with CMP that the requirement should address affected personnel only and modifies the rule accordingly. The commission disagrees with AEP's contention that it does not have the authority to require market participants to establish internal procedures for its personnel. As discussed previously in this order, PURA and the commission's rules require that market participants must comply with the requirements of the ERCOT procedures. In order to comply with these technical requirements for continued certification and with representations made in its certification request, a market participant is required to take steps to assure that its employees are aware of the requirements applicable to the entity. The commission agrees with OPUC that the internal procedures should be documented and changes the rule to add this requirement. The commission agrees with CMP that the obligation for a market participant to provide its internal procedures to the commission upon request already exists in the rule under proposed subsection (k) (redesignated as subsection (l)), which specifies that the commission staff may require the market entity to provide information reasonably necessary for the purposes of a fact finding review or an investigation.

§25.503(g)

CMP opined that the commission has no authority to prohibit every activity that adversely affects the reliability of the electric network and proposed to eliminate the first sentence that prohibits such activities because it lacks an intent element. CMP stated that prohibited activities

should exclude not only acts or practices expressly allowed by the Protocols but also those "required" by the Protocols; and acts or practices conducted in compliance with express directions from ERCOT but also those "required to be conducted." CMP suggested adding to the list of exceptions language referring to "other legal authority" to prevent market participants from being faced with conflicting legal requirements from different sources. Reliant made a similar argument. Reliant criticized the general definition of prohibited activities in the introductory paragraph as lacking an intent element and subjecting good-faith behavior to hindsight review. CMP proposed to strike the reference to "prices that are not reflective of market forces" as being unclear. Reliant would replace it with a reference to "prices that are not reflective of competitive market forces."

TXU and Austin Energy proposed striking the first sentence describing prohibited activities and TXU wanted to introduce an intent standard stating that "it shall be a violation of this section for a market participant to knowingly engage in prohibited activities." TXU proposed that the list of prohibited activities be a closed list. TXU would remove "activities that constitute market power abuses" from the introductory paragraph and add such activities to the list of specific prohibited activities. Austin Energy proposed to indicate that the list of prohibited activities in this subsection is an example of market power abuses.

BP suggested that the commission should clarify the definition of market power abuses, stating that the definition in the proposed rule as "practices that are unreasonably discriminatory or tend to unreasonably restrict, impair, or reduce the level of competition…" is too vague to provide

market participant with meaningful guidance as to what constitutes market power abuse under the rule. BP would add an intent element in the definition of "market power abuses."

AEP would define prohibited activities as "any act or practice in violation of a commission rule, ERCOT protocol, or PURA," and strike the first sentence in the introductory paragraph as being overly broad and lacking any element of intent. AEP proposed to remove the list of prohibited activities from this subsection, stating that these specific items concern the daily operation of the market and therefore should be addressed in the Protocols.

LCRA proposed to add an exclusion for acts and practices that have a "legitimate business reason" in the definition of prohibited activities.

Garland praised the provisions of subsection (g) as assisting with the improvement of reliability, and noted that this subsection clearly outlines workable and equitable definitions of "prohibited activities" and "economic withholding." Garland claimed that vagueness and varied interpretations of these concepts have been troublesome during the transition to competition.

Commission Response

The commission adds a materiality element in the definition of prohibited activities, which is now defined as "any act or practice of a market participant that *materially and adversely* affects the reliability of the regional electric network," in recognition of the fact that the commission does not prohibit legitimate and routine activities that do not have a material

impact on reliability or force ERCOT to take substantial and costly actions to maintain the safety of the grid. In case of an inadvertent event such as the loss of a unit or tripping of a line, a market participant has the option to demonstrate to commission staff the inadvertent nature of the event during an informal fact finding review if one is initiated. Alternatively, under new subsection (h), Defenses, a market participant will have the opportunity to show that a reliability problem was caused by an inadvertent event as a defense if necessary. The commission believes that CMP's concern about the commission's authority to prohibit every activity that adversely affects reliability is addressed by this change. The commission declines to add the words "or required" and "required to be conducted" as proposed by CMP as those words would be duplicative, since an activity that is required is a subset of all allowed activities. The commission agrees to add reference to "other legal authority" as proposed by CMP and Reliant. The commission declines to strike the reference to "prices that are not reflective of market forces" as suggested by CMP, but agrees to replace it with a reference to "prices that are not reflective of competitive market forces," as suggested by Reliant.

The commission declines to strike the first sentence defining prohibited activities, as suggested by TXU, Austin Energy, and AEP, and declines to add an intent element to the definition as suggested by TXU, AEP and RRI, for reasons discussed elsewhere in this order. The commission also declines to make the list of prohibited activities a closed list, as suggested by TXU, for reasons discussed elsewhere in this order. The commission agrees to remove the reference to market power abuses from the introductory paragraph of this

subsection and include it as an additional prohibited activity in the list that follows, as suggested by TXU. The commission declines to add or subtract from the definition of "market power abuses" as suggested by BP because the term is statutorily defined in PURA §39.157(a), and notes that PURA does not have an intent element in its definition of market power abuses. The commission declines to characterize the list of prohibited activities as example of market power abuses, as proposed by Austin Energy, as several of the activities listed can be exercised by a market participant who does not have market power.

The commission declines to remove the list of prohibited activities from this subsection as suggested by AEP. The commission notes that the Protocols do not contain a list of prohibited activities, and that the ERCOT Board rejected a proposal from market participants to include in the Protocols a closed list of prohibited activities. Thus the commission believes that the list, whose purpose is to provide examples of prohibited activities, serves an important purpose to guide market participants' behavior as they operate in the ERCOT market.

The commission declines to add an exclusion for activities that have a legitimate business purpose, as suggested by LCRA, and instead adds a new subsection (h), Defenses, that affords a market participant the opportunity to use the legitimate business purpose standard as a defense.

The commission agrees with Garland that this subsection is necessary to improve reliability by increasing market participants' awareness of their responsibility to support the reliability of the electric grid and subjecting to sanctions activities that have the potential to undermine such reliability. Accordingly, the subsection is being retained.

Subsection (g)(1)

TXU and other commenters proposed to strike the phrase "or artificially worsens existing congestion," as being redundant. CMP proposed to strike the entire paragraph and replace it with a prohibition to "engage in transactions or schedule resources with the intent of creating congestion to manipulate prices or jeopardize the security of dispatch operations."

Reliant and other commenters would also add an intent element. Reliant stated that, without knowing how other market participants are operating their units, there is no way to know if the operation of a unit will create artificial congestion as it is defined. BP made a similar argument. Reliant added the word "energy" after "schedule" for added clarity.

Commission Response

The commission agrees to strike the phrase "or artificially worsens existing congestion," as being redundant. The commission adds the word "energy" after "schedule" as suggested by Reliant.

The intent element has been previously discussed and rejected. The commission partly agrees with Reliant and BP that one cannot create artificial congestion without knowing how others operate their units. However, the commission believes that a market participant can determine with some accuracy which of its units can create congestion and which can relieve it when the pattern is repeated. Based on this ability to determine which of its units could create congestion, and which units could solve congestion, Enron engaged in various gaming practices in California during the 2000-2001 period, including the so-called "Death Star," "Wheel Out," and "Load Shift" strategies. In addition, the "Dec Game" widely practiced by California market participants at the time, consisted of a market participant operating a unit on one side of a constraint with the result of creating congestion, and being paid to relieve the congestion with a unit located on the other side of the constraint. The commission agrees that the normal operation of a unit for legitimate purposes can inadvertently create congestion. The commission does not refer to this type of congestion as "artificial" congestion and has redefined "artificial congestion" in subsection (c)(1) to improve clarity and reduce uncertainty. In addition, new subsection (h), Defenses, provides an opportunity for a market participant to invoke a legitimate business purpose as a defense if it becomes necessary.

Subsection (g)(2)

CMP proposed to put a definition of artificial shortage in this subsection instead of subsection (c), Definitions. CMP's definition would require compliance with the Protocols, and makes reference to obligations market participants have under PURA §39.151(j). CMP and Reliant

added an intent element. CMP stated that there is no broad regulatory obligation to provide service applicable to the wholesale market, that such an obligation applies to retail service only, and that the proposed rule goes beyond legislative intent. CMP proposed additional minor wording changes, replacing "operate their facilities" with "run their generating plants" and "schedule such facilities" with "schedule such resources or other power supplies." CMP changed "jeopardizing" to "risk jeopardizing" in (g)(2)(A), and changed "not economically viable" to "uneconomic" in (g)(2)(C). Reliant added "at the time of the decision not to operate, bid or schedule" to (g)(2)(C).

Regarding the exemption afforded by (g)(2)(C), Denton asked who would be making the determination that the given circumstances are such that it would not be economically viable to operate a facility, and stated that such determination would be very subjective. Denton stated that in some cases, it may on occasion be necessary, in order to ensure reliability and stability of the transmission system, for a market participant to operate facilities even though such operation might not be economically viable for that particular market participant. Denton therefore suggested that this provision be properly qualified to ensure the reliability of the system. Independent REP Coalition makes a similar argument.

Austin Energy proposed to add an exclusion in a new subsection (g)(2)(D) for "other reasonable public policy purposes of a municipal governing body."

Commission Response

The commission eliminates subsection (g)(2) for the reasons discussed in other portions of this order (see discussion of subsection (c)(2)). This change addresses CMP's concern regarding a wholesale service obligation. The commission addresses the prohibition against withholding of production by a market participant who has market power in subsection (g)(8) below. Elimination of this subsection also addresses other concerns expressed by commenters.

The commission agrees with Denton and recognizes that (g)(2)(C) would have allowed arbitrary decisions as to whether a unit is economically viable under the circumstances. Further, the commission agrees with Denton that in some cases, it may be necessary in order to ensure the reliability and stability of the transmission system for a market participant to operate facilities even though such operation might not be economically viable for that particular market participant. However, this issue is no longer a concern here with the elimination of the subsection.

Subsection (g)(3)

CMP and Reliant, proposed adding an intent element. OPUC noted that the California Oversight Electric Board indicated in FERC Docket EL01-118-000 that the restriction of wash trades to transactions involving the same parties is potentially problematic because wash trades can be accomplished through independent or affiliated third party arrangements. OPUC proposed to amend (g)(3)(B) to include: offsetting buy and sell trades with the same counterparty "or with

multi-parties." In reply comments, CMP stated that OPUC's suggestion is an example of why the commission should await federal developments before adopting a rule. CMP stated that pending national energy legislation includes language that combines OPUC's idea with the concept of intent.

In supplemental comments, AEP objected to adding a materiality standard to FERC's definition of wash trades. FERC prohibits trades that (among other elements of the definition) involve "no net change" in beneficial ownership. AEP objected to rule language that would prohibit more transactions than does the FERC definition.

Commission Response

The element of intent has been previously discussed and rejected. The commission agrees with OPUC that wash trades may be accomplished through independent or affiliated party arrangements. The commission also agrees with CMP that this is a problem that is not ERCOT specific and therefore it is desirable to harmonize the rule with FERC policies. The commission adopts FERC's Behavior Rule Number 2(a) regarding wash trades and adds "or through third party arrangements" to address OPUC's concern. Although the issue raised by the California Oversight Electric Board were brought up during the comment period in FERC Docket EL01-118-000, FERC did not explain why it did not adopt the recommendation of the California Board. FERC explained that there are two key elements in a wash trade, *i.e.*, "transactions which are (i) prearranged to cancel each other out; and (ii) involve no economic risk." However, under the FERC rule, transactions

with these characteristics would not be considered violations if an independent or affiliated third party was involved, which the commission believes needs to be corrected. The commission notes that FERC declined to add an intent element to its Market Behavior Rule (2)(a), stating that "wash trades, by their very nature, are manipulative and purposely so. By definition, parties to a wash trade intend to create prearranged off-setting trades with no economic risk." FERC Docket No. EL01-118-000, November 17, 2003, pp.19-20.

The commission finds that AEP's argument against including the word "material" in subsection (g)(3), pertaining to wash trades, is unpersuasive. The commission notes that FERC's definition of wash trades is new and untested, therefore it has yet to be seen whether market participants will attempt to game this definition. AEP is correct in observing that the staff redline would prohibit more transactions than would a strict reading of FERC's definition. To be more precise, the additional transactions captured by the commission's definition are wash trades with a minuscule (as opposed to zero) net change in beneficial ownership. These transactions are no less harmful or deceptive than wash trades with zero net change. By adding the materiality standard, the commission's version makes it harder to game the definition. It also implicitly introduces the expectation that the practice serve a legitimate business purpose. Finally, the commission points out that it has adopted a materiality standard throughout the rule following a recommendation from the FTC in its comment to the FERC and in response to comments from TXU and others as a way to add clarity and reduce uncertainty in the rule. The commission considers it appropriate to add this standard here as well.

Subsection (g)(4)

CMP suggested changing "reliability products" to "reliability services." CMP and Reliant would add an intent element. Reliant stated that there are circumstances in which a unit trips in real time, which may have been unforeseen at the time the unit was committed.

Commission Response

The commission agrees to change "reliability products" to "reliability services" as suggested by CMP. The intent element has been previously discussed and rejected. The commission notes that in the example of an unforeseen event provided by Reliant, the market participant will be able to explain the circumstances during the informal fact-finding review, if one is initiated. Additionally, the market participant has the option to establish a lack of foreseeability as a defense under new subsection (h) if necessary.

Subsection (g)(5)

CMP proposed adding an intent standard. Reliant declared that this subsection does not have any bearing on the operations or reliability of the ERCOT region and for that reason should be deleted.

Commission Response

The intent standard has been previously discussed and rejected. The commission declines to delete this subsection as suggested by Reliant because trades that are conducted with the

result of misrepresenting the financial conditions of the organization adversely affect the health and competitiveness of the market, as demonstrated by the decline in the electric markets following the allegations of financial misrepresentations by market participants during and after the California crisis.

Subsection (g)(7)

CMP strongly supported the second sentence, which states that this provision should be interpreted in accordance with federal and state antitrust statutes and judicially developed standards under such statutes regarding collusion. TXU proposed to remove "regarding collusion." CMP proposed to remove the entire statement from (g) (7) and create a new subsection (l) that would include the same message more broadly applying to the entire section. In addition, CMP struck "to affect the price or supply of power" from the prohibition because this would encompass activities that are benign or beneficial.

Commission Response

The commission declines to remove the second sentence and create a new subsection to indicate that the entire section and terms used in the section should be interpreted consistently with applicable federal and state antitrust law for the reasons explained elsewhere in this order. The reference to federal and state antitrust provisions is appropriate when referring to collusion and will be retained. The commission declines to broaden the application of that statement as proposed by TXU for the same reasons. The commission agrees that agreements that affect the price and supply of power in a way that

is beneficial to competition should not be prohibited and modifies the rule to indicate that only agreements intended to "manipulate" the price and supply of power are prohibited.

Subsections (g)(8) and (9)

TXU requested adding that "market participants may properly bid in a manner to recover their operating costs" to (g)(8), and adding language to recognize that the competitive market levels at times of emergencies may be higher than normal in (g)(9).

CMP stated that the requirements in these two subsections raise several concerns: they lack an intent standard, a foreseeable standard, and a materiality standard. CMP added that opportunity costs and transactional commitment risk must be considered. CMP pointed out that PURA states that the possession of a high market share is not, in and of itself, an abuse of market power. CMP added that language such as "competitive market levels" and "price that is not reflective of a competitive market" is too broad, and asked for clarification as to whether those terms refer to the laws of supply and demand at that specific time and place. CMP also asked clarification as to whether scarcity pricing was acceptable.

Reliant also found the reference to "competitive market levels" problematic, and stated that this amounts to a hindsight penalty. Reliant stated that the proposed definition of economic withholding is not a workable definition that would allow a distinction between behavior intended to be economic withholding and legitimate business behavior, and it ignores the characteristics of specific units. Reliant added that taking the "competitive market level" as a

price reference does not allow a distinction between a unit that runs only a few hours per year and a unit that runs continuously, and is an unknown standard. Further, Reliant contended, any bid that is below the administratively set cap of $1000 should be exempt of any allegation of economic withholding. In addition, Reliant contended, implementation of the Modified Competitive Solution Method provides a sufficient mitigation measure to eliminate the ability to economically withhold, and therefore (g)(8) should be eliminated. Reliant requested that (g)(9) should also be eliminated, stating that market prices could increase as a result of legitimate bidding strategies.

Austin Energy stated that the provision of these subsections is too far reaching and vague, and that the practical effect is to impose marginal cost bidding on all market participants, *i.e.*, imposing price regulation in contradiction of PURA §39.001(a).

San Antonio commented that economic withholding is a practice that generally is considered a market power abuse, and therefore is only exercisable by an entity possessing market power and should be addressed in subsection (g) under the provision that "activities that constitute market power abuse are also prohibited." San Antonio also stated that a market participant could not know if its bid was essential for the market to clear, unless a market participant has a sufficiently large presence in a region or local area, such that it is quite clear over time that its bids would be required. San Antonio requested that (g)(8) and (g)(9) be deleted.

BP stated that subsection (g)(8) can be interpreted as meaning that only cost-based bidding is allowed under the rule, or alternatively, that marginal cost bidding is required. BP requested clarification as to whether the commission wishes to impose a marginal cost-based bidding regime, and whether scarcity pricing is disallowed under the rule, which BP contended could potentially discourage participation in the ERCOT market. BP made a similar argument regarding subsection (g)(9).

Denton was also concerned about the reference to "competitive level" prices in (g)(8) and (g)(9), and proposed that the commission instead adopt language broad enough to restrict bidding without a legitimate business purpose that raises market prices, or alternatively clearly set a cap on prices during emergencies.

CenterPoint proposed adding to (g)(9) language requesting that market participants not engage in bidding strategies that increase market prices above both "the market participant's marginal, variable, and short term fixed costs along with return on investment, and competitive level." CenterPoint defined "short term fixed costs" to include, but not be limited to, "labor expenses, administrative and general expenses and wear and tear costs."

Commission Response

The commission agrees with TXU that "market participants may properly bid in a manner to recover their operating costs," and that "the competitive market levels at times of emergencies may be higher than normal." The commission agrees with CMP that

opportunity costs and transactional commitment risk must be considered. The commission disagrees with several commenters and believes that "prices reflective of a competitive market" is a valid standard, and that such a standard can be established under different possible scenarios and for different unit characteristics. The commission also disagrees with Reliant that such a standard cannot allow a distinction between a unit that runs only a few hours a year and a unit that runs continuously. However, the commission agrees that, until such price standards are developed, the concept may create uncertainty as to what constitutes prices reflective of a competitive market. The commission disagrees with Reliant that any bid that is below the administrative cap of $1000 should be exempt of any allegation of economic withholding, and notes that a market participant who has market power may be able to repeatedly set prices close to the $1000 bid cap through economic withholding and cause considerable damage to the market and to competition by doing so. In addition, the commission believes that Reliant overstated the effect and purpose of the Modified Competitive Solution Method, which the commission adopted to address the limited problem of hockey stick pricing during times of no zonal congestion. This mechanism is not designed to mitigate the entire gamut of economic withholding strategies as implied by Reliant. Economic withholding can occur outside the bounds of hockey stick pricing and can occur when the transmission system is congested.

The commission agrees with San Antonio that economic withholding is a practice that generally is considered a market power abuse, and that it should be addressed under the provision that prohibits activities that constitute market power abuses. The commission

agrees to eliminate subsections (g)(8) and (9), and substitute new subsection (g)(8), which lists market power abuse as a prohibited activity. With this change, the commission clarifies, as requested by BP, that marginal cost bidding is not required under the rule for market participants who do not have market power. The commission believes, however, that a market participant who has market power and prices its services substantially above its marginal cost may be found to be economically withholding and therefore may be in violation of the rule. The commission adds language to further specify that withholding of production, whether it is economic withholding or physical withholding, by a market participant who has market power, constitutes abuse of market power and is therefore a violation of this section. With this change, the commission believes that it has addressed the concerns expressed by the commenters as well as the commission's concerns about economic and physical withholding by entities possessing market power, and the commission's concern about price gouging during emergencies by entities possessing market power. The commission recognizes that market power and market power abuses will have to be further defined to add clarity and reduce uncertainty and will do so in its new rulemaking on market power in Project Number 29042.

Subsection (g)(10)

TXU, CMP, AEP, and Reliant objected to the commission giving ethical standards the same legal effect as obligations and requested that this provision be eliminated.

Commission Response

The commission agrees that the ethical standards provided in subsection (e) are guiding ethical standards and should not be given the same legal standing as obligations, and therefore removes subsection (g)(10).

OPUC indicated that the March 24, 2003 strawman rule included a prohibition against risk hedging by market participants that resulted in an adverse effect on system reliability or shifted costs to other market participants. This provision was subsequently deleted. OPUC objected to the removal of this provision, noting that the Market Oversight Division has evidence of market participants engaging in improper hedging in the past. OPUC requested a new paragraph under subsection (g) stating: "a market participant shall not manage or hedge its risks at the expense of system reliability, or in a way that is inconsistent with the efficient operation of the market or unduly shifts costs onto (an)other market participant(s)."

In reply comments, Reliant and CMP disagreed, stating that the provision lacked clarity and subjected the market participant to hindsight evaluation. AEP agreed with Reliant and CMP and stated that the provision was overly broad and could encompass many otherwise innocent activities. CMP added that the language is beyond the scope of market power abuses as defined in PURA §39.157(a) and does not conform to PURA §39.001(d). TXU also objected to reinstating this provision, claiming that market participants would have great difficulty managing and hedging risks without inadvertently violating the section.

Commission Response

The commission agrees with Reliant, CMP, AEP and TXU that hedging risks is generally a legitimate business activity. However, the commission agrees with OPUC that some market participants may have engaged in risk hedging activities in the past that were not for a legitimate purpose. The commission also agrees with OPUC that market participants should not engage in risk hedging activities that materially and adversely affect the reliability of the regional electric network. However, the commission believes that the concern about the effect of certain risk hedging activities on system reliability is addressed within subsection (g) in the definition of prohibited activities, and that risk hedging may not be used as a defense under new subsection (h), Defenses, if the activity does not have a legitimate business purpose and adversely affects the reliability of the regional electric network. The commission also agrees that a market participant should not engage in risk hedging activities that unduly shift costs onto other unknowing market participants, but notes that a risk hedging activity that would unduly shift costs onto other unknowing market participants would be considered anti-competitive and would therefore also be a violation of this section. Subsection (d) was modified to specify that, when reviewing the activities of a market entity, the commission will consider whether the activity was conducted in a manner that materially reduced the competitiveness of the market, including whether the activity unfairly impacted other market participants in a way that restricts competition. The commission therefore finds that hedging activities that are not for a legitimate business purpose are already prohibited in the rule and declines to re-insert the paragraph as suggested by OPUC.

OPUC indicated that the March 24, 2003 strawman rule included a provision prohibiting market participants from unnecessarily claiming that information is confidential, and objected that the provision was subsequently removed. OPUC requested that the commission include a new paragraph under subsection (g) stating that "a market participant should not claim that information provided to ERCOT is confidential unless the information is market sensitive. Entities claiming that information provided is confidential must be able to demonstrate as much."

In reply comments, TXU disagreed and stated that "this broadly-worded prohibition infringed upon a market participant's right to interpret applicable law relating to the confidentiality of trade secret and other information and to advocate its interests based upon that interpretation." CMP also disagreed stating that the ERCOT Protocols and other applicable law address confidentiality in depth and already prohibit a violation of the Protocols. CMP and AEP added that under current laws, market sensitivity is not the only basis for confidentiality. AEP added that it is unnecessary to create another process in these rules for evaluating confidentiality beyond current protective order provisions.

Commission Response

The commission staff removed the provision regarding confidentiality of information provided to ERCOT from the strawman rule because it found that the Protocols sufficiently address the confidentiality of information provided by Market Participants to

ERCOT in great detail. Section 1.3.1.1. of the Protocols lists items that are considered protected information; section 1.3.1.2 lists items that are not considered to be protected information; section 1.3.3 discusses the expiration of protected information status; section 1.3.8 allows the commission to reclassify protected information as non-confidential in accordance with commission rules; and section 1.3.9 describes how a market participant can petition the commission to include specific information with the definition of protected information. The commission therefore finds that there is no need for the requested language and declines to re-insert this provision in subsection (g).

§25.503(h), a new subsection

As noted previously, several commenters suggested that the commission add an intent element to the rule. Others suggested that the commission include provisions to assure that market entities would not be punished for unintended or unforeseen results of actions that were taken for a legitimate business purpose.

In supplemental comments, Austin Energy generally supported the commission's inclusion of an affirmative defense subsection and the defenses listed therein. CMP and AEP argued that the commission's new provision for affirmative defenses was not sufficient and imposed more regulatory risk and burdens on market participants. AEP, TXU and CenterPoint objected that the affirmative defense language improperly shifted the burden of proof to the market participant. CMP also noted that the market participant should not have the burden of proof because it does

not have access to the information that is most probative concerning intent and foreseeability. Coral commented that the proposed language failed to indicate that the defenses would also be applicable to allegations of violations of subsections (e) and (f), as well as subsection (g). Coral also noted that the defenses were stated in the conjunctive form so that a market participant would have to satisfy all three elements in order to claim a defense. Coral suggested that the language be changed to disjunctive by using the word "or" instead of the word "and". AEP and CenterPoint made similar comments. Reliant recommended adopting the FERC's approach to intent and eliminating subsection (h) since it would no longer be needed.

Commission Response

The commission rejects the requests to limit the application of the rule to intentional or knowing and willful violations of the Protocols or the rule for reasons previously stated in this order. Although intent is not a required element of a violation of PURA or the commission's rules or orders, the commission can consider intent in determining whether to pursue an enforcement action in a particular case or in determining the level of penalty to be assessed in response to a particular violation. PURA §15.023(b) specifically directs the commission to consider certain matters in calculating the amount of an administrative penalty, including "the nature, circumstances, extent, and gravity of a prohibited act", the "history of previous violations", "efforts to correct the violation", and "any other matter that justice may require." PURA §15.024(c) prevents the commission from assessing an administrative penalty against a person if the person has remedied the violation within 30 days and if the person meets the burden of proof to demonstrate that the violation was

remedied and was accidental or inadvertent. The commission interprets these statutory provisions as giving it the discretion to consider a person's intent in an administrative enforcement action. Thus, although intent is not a required element of proof for a violation in an administrative enforcement under the rule, the commission will consider a person's intent in determining whether an enforcement action is necessary and the type and extent of any remedy required.

The commission disagrees with comments that the rule requires that market participants have perfect knowledge of all of the conditions of the network and the scheduling activity of other parties. Such an exaggerated and excessive reading of the rule is unreasonable and improper. The commission does not expect perfect knowledge of the network, but one of the goals of the rule is to encourage all market participants to consider the reliability of the network in their decision making process and recognize the potential effect that their individual actions can have on network reliability, based on the knowledge a market participant operating in the ERCOT markets is expected to have. The commission recognizes that individual market participants do not always have sufficient information available to anticipate what effects their actions may generate, however, the commission also does not want to implicitly encourage market participants to ignore network reliability as a means of avoiding potential liability for their actions. In order to address both the commission's concerns about reliability and the participants' concerns about an exaggerated application of the rule, the commission has added a new subsection concerning affirmative defenses. The new subsection allows a market participant to avoid

enforcement if its actions served a legitimate business purpose and "it did not know, and could not reasonably anticipate, that its actions" would otherwise result in a violation. The defense is based both on what the market participant actually knew as well as what it should have known. The commission believes the new subsection sufficiently addresses the market participants' concerns without allowing them to be intentionally ignorant or consciously indifferent to the impact of their actions on the overall reliability of the network and the proper functioning of the market.

The commission believes that the new subsection allows market entities to protect themselves when they are truly without fault. The rule also places the burden of proof upon the market entity to prove the elements of the claimed affirmative defense. The burden of proof provision is consistent with PURA §15.024((c) and with recognized principles placing the burden of proof on the party having peculiar knowledge of the facts to be proved. *Dessommes v. Dessommes*, 505 S.W.2d 673, 679 (Tex. Civ. App. – Dallas, 1973, writ ref'd n.r.e.). The commission disagrees with CMP's assertions that it does not have access to information needed to demonstrate its intent or knowledge of a particular situation. The facts that are necessary to prove the elements of these types of affirmative defenses (a legitimate business purpose or the steps the market participant has taken as due diligence) are peculiarly within the knowledge of the market entity claiming the defense and therefore it is appropriate to place the burden of proof on the market entity to support its claim.

The commission agrees with comments that the defenses should also be available for alleged violations of subsection (f) and revises the rule accordingly. No defenses are needed concerning subsection (e) because the ethical obligations stated in that subsection are aspirational and a "violation" of that subsection, standing alone, will not subject a person to enforcement action by the commission. The commission also agrees that the language of subsection (h) should be clarified. The due diligence defense is only intended to apply in situations in which the rule requires due diligence, and the rule is revised accordingly.

The commission disagrees that a legitimate business purpose and a lack of foreseeability should be separate affirmative defenses. Instead, to qualify for an affirmative defense, the market participant must demonstrate both that the violation served a legitimate business purpose and that it did not know and could not reasonably anticipate the adverse affect of its actions. In adopting its rules, the FERC expressly stated that "manipulative actions engaged in by sellers are not undertaken for a legitimate business purpose." The FERC went on to note that "an action or transaction which is anticompetitive (even though it may be undertaken to maximize seller's profits), could not have a legitimate business purpose under our rule." Thus, under the FERC rules, if an action is "intended to or foreseeably could manipulate market prices, market conditions, or market rules," the action cannot be said to serve a legitimate business purpose. In order to avail itself of the "legitimate business purpose" defense, a market participant must also demonstrate that there was no foreseeable anticompetitive impact or intentional manipulation. The commission agrees with the way FERC defines the applicability of the "legitimate business purpose" standard.

§25.503(h), redesignated as subsection (i)

CMP stated that ERCOT should designate more than one employee for the purpose of issuing official interpretations and clarifications regarding the Protocols, that the person should be ERCOT staff as opposed to a stakeholder serving on the ERCOT Board or on an ERCOT committee, that ERCOT should only clarify what it has the ability to clarify, and that the requestor should have the option to not take the contemplated action and not seek a protocol revision.

CMP believes that a process for interpretations and clarifications of the Protocols when made publicly available could assist with consistent interpretation of and compliance with the Protocols, and solve problems market participants have had finding appropriate ERCOT personnel to answer questions. CMP, however, stated that the proposed process is problematic because CMP interprets it as including a duty to comply with the clarification or interpretation that would be instantaneous. In addition, CMP warned against a process that would substitute ERCOT official clarifications and interpretations of the Protocols for Protocol revisions, for which there is an established process in the Protocols.

CMP objected to the provision that the ERCOT official would consult with the commission staff before issuing a clarification or interpretation of the Protocols, stating that if there is consultation of commission staff, there also needs to be public input.

In addition, CMP stated that the proposed rule is an unconstitutional delegation, specifying that a delegation occurs "when an entity is given a public duty and the discretion to set public policy, promulgate rules to achieve that policy, or ascertain conditions upon which existing laws will apply." CMP's proposed remedy is to specify that ERCOT and the commission would not be bound by an official interpretation and market participant would have no affirmative duty to comply with it.

TXU stated that, because of the potentially substantial economic and reliability impacts of many requests for Protocol interpretations and clarifications, such interpretations and clarifications must be issued promptly or the process would be useless. TXU suggested a requirement that ERCOT respond to the requestor within 10 business days of ERCOT's receipt of the request.

AEP stated that, while it supports a procedure such as that provided by subsection (h), the process by which ERCOT provides official interpretations should be left to ERCOT.

ERCOT, Reliant and Austin Energy stated that the proposed process for Protocol clarifications and interpretations is unnecessary because a process called Protocol Revision Request already exists in the Protocols to serve the same purpose. Austin Energy stated that under that process, the Protocol Revision Subcommittee is responsible for interpreting the Protocols, subject to approval of the ERCOT board and to commission oversight. Austin Energy added that the role of the ERCOT staff is limited to implementation of the Protocols, while the stakeholders are

responsible for policy matters. San Antonio made the same argument. In reply comments, CMP and AEP supported the recommendation to delete subsection (h).

BP stated that "official interpretations" of the Protocols must come from the commission through a formal process; otherwise, the result could be unpublished rulings that escape formal review and appeal.

Commission Response

The commission agrees with CMP that a process for interpretations and clarifications of the Protocols would assist with consistent interpretation of and compliance with the Protocols, and solve problems market participants have had finding appropriate ERCOT personnel to answer questions. Accordingly, the commission agrees with TXU and AEP that the process is needed. The commission believes that the current Protocol Revision Request Process is insufficient to address the need of market participants to communicate frequently with an official entity to better understand and comply with ERCOT procedures, and therefore declines to delete this subsection. The commission disagrees with AEP that the process should be left entirely to ERCOT, as the commission was given oversight and review authority over ERCOT procedures in PURA §39.151(d). The commission changes the rule to clarify that a market participant seeking an interpretation or clarification of the Protocols shall use the PRR process contained in the Protocols whenever practicable, but that if an unforeseen situation arises and it is not practicable to submit the issue to the PRR process, a market entity may seek an official interpretation or

clarification from a designated ERCOT official. The commission believes that this change addresses the concerns expressed by CMP, Reliant, ERCOT, and Austin Energy.

The commission agrees with TXU that interpretations and clarifications must be issued promptly or the process would be useless, and changes the rule to specify that ERCOT shall respond to the requestor within ten business days of ERCOT's receipt of the request for interpretation or clarification. The commission changes the rule to specify that ERCOT shall respond with either an official Protocol interpretation or a recommendation that the requestor take the request through the PRR process, and makes a similar change in redesignated subsection (i)(4) to address concerns expressed by CMP that ERCOT should only clarify what it has the ability to clarify, and that the requestor should have the option to seek or not seek a protocol revision. The commission also agrees with CMP that ERCOT should be able to designate more than one ERCOT official who will be authorized to receive requests for clarification and issue official interpretations as ERCOT may need this flexibility to adequately respond to the needs of market participants. The commission changes the rule accordingly.

The commission agrees with CMP that the person authorized to issue official interpretations or clarifications of the Protocols should be ERCOT staff as opposed to a stakeholder serving on the ERCOT Board or on an ERCOT committee but believes that its intention is sufficiently clear in the rule.

The commission disagrees with CMP that the ERCOT official should not consult with the commission staff before issuing a clarification or interpretation of the Protocols, or that if there is consultation of commission staff, there also needs to be public input. The commission also disagrees with BP's proposition that "official interpretations of the Protocols must come from the commission through a formal process, otherwise the result could be unpublished rulings that escape formal review and appeal." The commission believes that ERCOT officials should consult with commission staff to ensure that the clarification or interpretation they issue is consistent with commission orders, rules and policies as well as with ERCOT procedures. If an issue is of such nature that it requires a new policy decision with public input, the requestor will be referred to the PRR process or to the commission. Thus the commission declines to make CMP's requested change.

The commission also disagrees with CMP's assertions that the rule contains an unconstitutional delegation of authority. Reviewing the factors listed in *Texas Boll Weevil Eradication Found., Inc. v. Lewellen,* 952 S.W.2d 454 (Tex. 1997), the commission finds that the delegation of authority to ERCOT is valid. PURA §39.151(d) and the rule allow for meaningful review of ERCOT's actions by the commission, the state agency charged with oversight of ERCOT. If an affected market participant disagrees with the official interpretation issued by ERCOT, it may seek an amendment of the Protocols as provided for in the Protocols, appeal the interpretation to the commission, or both. During either an appeal or a protocol amendment proceeding, persons affected by the interpretation can be heard and their views considered in deciding whether, and how, the Protocols may be

revised. Pursuant to PURA §39.151, ERCOT is authorized to enforce the Protocols and, as part of that activity, it may be necessary to interpret the Protocol provisions. Such interpretations provide market clarity regarding the application of the Protocols to particular individuals. Although ERCOT may be able to identify rule or Protocol violations, it is not authorized to implement any of the enforcement actions that the Legislature has delegated to the commission. Therefore, ERCOT has no power to impose criminal sanctions against any individual. ERCOT has no pecuniary or personal interest in the authority to interpret and enforce the Protocols. PURA §39.151 requires that an "independent organization", like ERCOT, must be "sufficiently independent of any producer or seller of electricity that its decisions will not be unduly influenced by any producer or seller." The commission has previously determined that ERCOT meets this requirement, so there is no indication of a pecuniary or personal interest that would conflict with ERCOT's public function under PURA and the rule. The rule's delegation of authority to ERCOT is limited in extent and subject matter and only applies in situations where the use of the Protocols Revision Request procedure is impracticable. ERCOT has special qualifications and training concerning the creation, amendment and application of the Protocols because it is charged with implementing and enforcing them on a daily basis and thus has the qualifications to perform the task that is assigned to it. The Legislature has provided standards concerning the type of activities that ERCOT is to perform and ERCOT will be guided by those standards in exercising its tasks under PURA and the rule. Finally, the commission, through its oversight authority, can review any decisions made by ERCOT in administering its delegated authority and can assure that ERCOT complies

with the statutory and rule requirements. For the above stated reasons, the commission rejects CMP's contention that the rule results in an unconstitutional delegation of authority to ERCOT.

§25.503(i), redesignated as subsection (j)

ERCOT suggested deleting subsection (i). ERCOT stated that the provisions in subsection (i) are more appropriately included as part of ERCOT's internal processes than in a commission rule, and stated that it already had an internal process substantially in compliance with the proposed rule language. ERCOT added that such internal process includes notifying MOD of significant violations, and suggested that it can work with MOD to make sure that ERCOT internal procedures are adequate to meet MOD's needs. In Reply comments, CMP supported ERCOT's recommendation to delete subsection (i).

TXU requested clarification regarding occurrences of non-compliance with the Protocols that have the potential to "create significant burden or place significant costs on the other market participants." TXU proposed that ERCOT appoint a qualified representative that would be responsible for making a final evaluation of whether the ERCOT Protocols have been violated before issuing a notice of non-compliance. This way, ERCOT would be able to speak in a more unified voice with a more uniform interpretation of the Protocols. TXU recommended changing the rule to require that notices of non-compliance be in writing to allow ERCOT and the market participants to track ERCOT's interpretations of the Protocols and ensure consistency in

interpretation. In addition, TXU suggested adding language that would require ERCOT to inform the commission staff and the market participant in writing if the issue is not resolved at ERCOT level after the system operator has informed the market participant of the problem in writing. This, TXU stated, would give the market participant one last opportunity to remedy the non-compliance prior to commission staff action and ensure that an appropriate market participant decision maker is aware of the notice of non-compliance.

CMP suggested that the prescribed procedures be limited to material occurrences. CMP added that ERCOT should not report an occurrence of non-compliance immediately to commission staff if the issue is not resolved in a single call to the market participant. CMP suggested adding a provision that ERCOT promptly provide information to and respond to questions from market participants to allow the market participant to understand and respond to an alleged material occurrence of non-compliance with the Protocols.

Reliant suggested replacing "mandatory bids" with "decremental bids," explaining that decremental bids are the only mandatory bids in the ERCOT region, and proposed inserting "shall" instead of "should" in the sentence regarding non-compliance for continuity. Reliant suggested eliminating the word "immediately" in subsection (i)(3), and allowing for the market participant to be given a "reasonable time" within which to notify the ERCOT ISO as to why an instance of non-compliance has taken place or has been repeated in the event that a non-compliance issue has not been resolved.

BP opined that ERCOT is ill-suited to enforce its operating guidelines, and that this function should be left to the commission. BP added that any actions taken by ERCOT must be bounded explicitly within the ERCOT Protocols.

Commission Response

The commission believes that this subsection is necessary to add guidance to the existing ERCOT internal compliance process and formally add a provision for commission oversight and review of the referred ERCOT procedure. The commission therefore disagrees with ERCOT and with CMP that this subsection should be deleted.

In light of TXU's comment seeking clarification regarding occurrences of non-compliance with the Protocols that have the potential to "create significant burden or place significant costs on the other market participants," the commission concludes that ERCOT's role should be limited to enforcing compliance with ERCOT procedures as they relate to the reliable operation of the electrical network. The commission decides that market participant activities that have the potential to create significant burden or place significant costs on the other market participants are potential market abuses that more properly fall under the commission's Market Oversight Division authority for monitoring and enforcement purposes. The commission therefore deletes this sentence.

The commission adds language to clarify that this subsection addresses material occurrences of non-compliance with ERCOT procedures to address the materiality

concern expressed by CMP. The commission also specifies that ERCOT shall inform the commission staff if the material occurrence of non-compliance is not resolved after the system operator has verbally informed the market participant operator, and subsequently notified the supervisor of the operator. The commission believes that this clarification addresses the concerns expressed by CMP that "ERCOT should not report an occurrence of non-compliance immediately to commission staff if the issue is not resolved in a single call to the market participant." The commission believes that this changes also sufficiently addresses TXU's concerns that the market participant be given one last opportunity to remedy the non-compliance prior to commission staff action and ensure that an appropriate market participant decision maker is aware of the notice of non-compliance. However, the commission does not believe that the notice should necessarily be in writing. Notification of non-compliance by ERCOT under the described procedure typically takes place to correct harmful activities in real time, when compliance is required immediately to address unsafe conditions and prevent a reliability event. If compliance is not possible, ERCOT must be informed immediately of the reason why so it can take action to maintain security. Requiring that the market participant be informed in writing before commission staff is made aware of the problem could delay compliance or remedial action and may result in ERCOT operating under unsafe conditions for prolonged periods of time. The commission therefore declines to require written notification of the operator's supervisor before ERCOT informs the commission staff of the material occurrence of non-compliance, as requested by TXU and by other commenters in supplemental comments. The purpose of making the commission staff aware of a material occurrence of non-compliance is both to

put the market participant on notice that the Market Oversight Division of the commission is watching its activities, and to enable the commission staff to take expeditious action, if necessary, to protect the public interest. The commission declines to require that ERCOT appoint a qualified representative that would be responsible for making a final evaluation of whether the ERCOT Protocols have been violated before issuing a formal notice of non-compliance, as the commission believes that this level of detail should be left to ERCOT. The commission notes that ERCOT already has representatives in its Compliance Division that are qualified to make such final evaluation before written notices of non-compliance are sent to the market participant.

The commission agrees with CMP that adding a provision that ERCOT promptly provide information to and respond to questions from market participants to allow the market participant to understand and respond to an alleged material occurrence of non-compliance with the Protocols may be useful to obtain compliance from the market participant, and adds this requirement. However, this requirement should not be interpreted as allowing the operator of the market participant to refuse to comply with the ERCOT operator's instruction because it disagrees with the ERCOT operator, or to argue with the ERCOT operator about the need for compliance.

Regarding compliance with mandatory bids, the commission agrees with Reliant that at the present time, decremental bids are the only mandatory bids, but wishes to adopt language that is flexible enough to allow for future changes in the requirement. The commission

therefore decides to adopt additional language that will preserve this flexibility while addressing Reliant's concern. The commission also changes "should" to "shall" in the sentence concerning non-compliance indicators monitored by ERCOT, as suggested by Reliant. The commission declines to change the word "immediately" in subsection (i)(3) (redesignated as (j)(3)), and to allow for the market participant to be given a "reasonable time" within which to notify the ERCOT ISO as to why an instance of non-compliance has taken place, as suggested by Reliant, because of the immediacy of real time situations more fully explained above.

The commission disagrees with BP that ERCOT is ill-suited to enforce its operating guidelines. As stated elsewhere in this order, PURA gives ERCOT enforcement authority over its procedures relating to the reliability of the electrical network and the accounting for the production and delivery of electricity among market participants, subject to commission oversight.

§25.503(j), redesignated as subsection (k)

Reliant proposed to amend this section to include ERCOT as an entity that is obligated to maintain records since it too is an entity subject to oversight by the commission. Reliant also suggested clarifying that records of verbally dispatched instructions (VDIs) should also be kept by ERCOT. Reliant suggested changing the requirement to document the "legitimacy" of an outage to a requirement to document the "reasons" of an outage in proposed subsection (j)(2)(C).

Denton stated that the commission should not require market participants to maintain records relative to all planned and forced generation and transmission outages including all documentation necessary to document the legitimacy of the outage because ERCOT already has a process in place to approve or disallow planned outages for generation and transmission.

AEP and Austin Energy proposed to specify that the requirement is to maintain records of information provided to market publications and publishers of surveys and price indices concerning activities in the ERCOT wholesale market and should not include information disclosed to the general media in subsection (j)(2)(D).

TXU companies proposed to use the definition of "transaction" from §25.93 of this title (relating to Quarterly Wholesale Electricity Transaction Reports) as a means to distinguish the transaction information required by the rule from information related to ERCOT retail transactions. TXU also suggested that ERCOT is better equipped to maintain records of VDIs, and for the sake of efficiency and accuracy the commission should require ERCOT to maintain records of VDIs. TXU proposed to clarify that proposed subsection (j)(2)(D) refers to the retention of information described under this section, which includes transaction, pricing, outage, settlement information and other information that would be relevant to an investigation under the proposed rule.

TXU commented that it is unclear who the "entities involved" are under proposed (j)(2)(D) and who the "official of the market participant to whom financial information was reported" is under proposed (j)(2)(E).

Denton stated that the commission should not require market participants to maintain records of information disclosed to the media and reports of financial information under proposed (j)(2)(D) and (j)(2)(E) because these appear to be very over-broad reporting requirements for which no justification is indicated.

TXU proposed modification of proposed (j)(3) to recognize that market participants may not have maintained three years' records at this point and to make the record keeping section a prospective obligation. In reply comments, AEP agreed.

OPUC stated that the rule should be changed to reflect the responsibility of the market participant to show why information should be considered confidential. Additionally, OPUC stated that it should be provided confidential access to all information provided under proposed subsections (j)(4) and (k)(2). OPUC claimed that it is not a competitor and that no harm to the competitive market can occur if OPUC obtains this sensitive market data. In reply comments, CMP and TXU disagreed stating that OPUC lacks regulatory authority and asserting that the Legislature has determined that OPUC should not have this special treatment.

BP suggested a clarification of proposed (j)(4) to specify that market participants may provide records of information to the commission under a confidentiality agreement or protective order if the commission requests such records.

Commission Response

The commission agrees with Reliant and adds ERCOT as an entity that is obligated to maintain records, including records of VDIs, and changes the requirement to document the "legitimacy" of an outage to a requirement to document the "reasons" of an outage. The commission revises the rule to refer to "transactions" as defined in §25.93(c)(3) of this title (related to Quarterly Wholesale Electricity Transaction Reports), as suggested by TXU. The commission agrees to require that ERCOT keep records of VDIs, but will revise this requirement so that it is not applicable to market participants, as suggested by TXU. The commission clarifies that proposed subsection (j)(2)(D) (redesignated as (k)(2)(D)) refers to the retention of information described under this section, which includes transaction, pricing, outage, settlement information and other information that would be relevant to an investigation under the proposed rule, as suggested by TXU, and adds language to that effect in the rule. The new language should address the concerns expressed by AEP, Austin Energy and Denton as it limits the kind of information provided to publishers for which records need to be kept.

The commission disagrees with Denton that ERCOT already has sufficient information about planned and forced generation and transmission outages including all

documentation necessary to document the legitimacy of the outage that could be required for the purpose of an investigation. In addition, the commission notes that Denton is incorrect in that ERCOT does not have the authority to approve or reject generation outages under the Protocols, and therefore has even less information and documentation regarding generation outages than it does about transmission outages.

The commission agrees to clarify that the entities referred to in proposed (j)(2)(D) (redesignated as (k)(2)(D)) are the company employees involved in providing the information as well as the publishers to whom it was provided, and to clarify that the financial reports referred to in (j)(2)(E) (redesignated as (k)(2)(E)) are reports provided to external parties only, and modifies the rule accordingly. This addition should address the concern expressed by Denton that the requirement is over-broad, as it defines the financial reports to be maintained more narrowly.

The commission agrees to make record keeping a prospective obligation as requested by TXU and AEP, and indicates as much in the rule.

The commission disagrees with OPUC that it should be provided access to confidential material on the same basis and terms as the commission staff, and agrees with CMP and TXU that the Legislature did not give OPUC this special treatment. The commission agrees with AEP that OPUC may have access to the protected information if the

information is provided in a proceeding, and when a protective order is issued, or when the parties have a confidentiality agreement in place.

The commission agrees to clarify that market participants may provide records of information under a confidentiality agreement or protective order "if the commission requests records retained pursuant to this section," and indicates as much in the rule.

§25.503(k), redesignated as subsection (l)

CMP generally supported the concept of informal fact-finding as proposed in this subsection. However, CMP suggested revisions to clarify that market participants may withhold information that is privileged or would otherwise not be available in discovery. CMP also requested clarifications that the commission would not direct ERCOT to terminate an agreement with a QSE without following proper procedure and requested that more time be allowed for a market participant to comply with commission requests for information.

TXU proposed deleting subsection (k)(4) because it duplicated matters that TXU proposed for inclusion in subsection (l). TXU also objected that the informal staff review proposed in subsection (k) was open-ended, allowing staff an unlimited time to review a matter before deciding whether or not to pursue formal commission action. TXU claimed that this created additional financial risk and uncertainty in the market. TXU proposed to add a procedure that would allow staff 90 days to review the matter. After that time, the market participant could

petition the commission staff to close the investigation. Staff would then have fourteen (14) days within which to either institute formal enforcement action or close the investigation. In reply comments, AEP supported TXU's request for a time limit on an informal investigation.

San Antonio suggested that the commission adopt the 90-day time limit for enforcement actions contained in the FERC's rule. San Antonio asserted that the provision was needed to avoid regulatory uncertainty and avoid the prospect of an open-ended investigation. AEP and CenterPoint filed similar comments.

Reliant suggested that subsection (k)(1), which allows staff to contact a market participant to give the market participant an opportunity to explain its actions, be revised to give the market participant an opportunity to "demonstrate compliance with the Protocols." Reliant also suggested combining subsections (k)(3) and (k)(4) because they deal with a similar topic, and also requested that subsection (k)(6) be revised to allow any person to file a formal complaint or pursue other relief available under the law.

OPUC suggested that subsection (k)(2) should be revised to require market participants to show why information should be considered confidential before the commission agrees to treat it as confidential under the rule. In reply comments, TXU, Reliant, Austin Energy, San Antonio, CMP and AEP objected to OPUC's proposed treatment of allegedly confidential information, arguing that there was no need for such procedure and that OPUC's proposal was inconsistent with the law. OPUC also requested that subsection (k)(4) be amended to include "disgorgement

of profits" as one of the remedies that the commission could pursue in the event of a violation of the rule or the Protocols. OPUC asserted that the market participant should be required to forego its illegal financial gains and pay a penalty over and above those amounts. OPUC argued that combining disgorgement with administrative penalties was necessary so that the sanction for a rule violation is "large enough to deter market participants from engaging in future illegal market activities." In reply comments, TXU, Reliant, CMP and AEP asserted that the commission lacks the statutory authority to order disgorgement of profits as OPUC requests.

Austin Energy recommended that subsection (k) be revised to include language stating the criteria the commission would use in determining whether to initiate a formal investigation. These criteria would include the factors considered under PURA §15.023, as well as the market participant's intent and whether ERCOT had previously issued a written warning notice to the market participant concerning the behavior involved. Austin Energy argued that these changes would address the issue of intent and provide additional means by which staff could determine intent if the market participant ignored the written warning from ERCOT. Austin Energy also requested that the list of potential remedies in subsection (k)(4) contain an express reference to PURA §15.023. In supplemental comments, OPUC requested that the commission retain the list of remedies included in subsection (k)(4) to provide notice to market participants of the remedies available to the commission.

AEP requested that subsection (k)(5) be revised to indicate that, if a market participant does not fully cooperate with staff, the staff would be able to request a formal investigation of the market

participant. AEP argued that this is preferable to the current language, which could result in the market participant being subject to administrative penalties for failure to fully cooperate with the informal investigation. AEP asserted that this result would violate the constitutional protection against self-incrimination, since other portions of the rule refer to possible criminal prosecution.

CenterPoint requested certain minor clarifications and also requested that the reference to QSE in Subsection (k)(4) be changed to "such market participant." In supplemental comments, CenterPoint stated that the standard for initiation of an enforcement action should be that there is a "reasonable basis to conclude that a violation has occurred."

Commission Response

For reasons discussed elsewhere in this order, the commission disagrees with the suggestion to add an intent element to this rule. The commission also disagrees with comments suggesting that a requirement for a written notice from ERCOT be included in the rule as a means of addressing the issue of intent. The rule provides sufficient notice to market participants without requiring an additional written notice from ERCOT before an enforcement action may be initiated. The commission agrees with Austin Energy's suggestion to include language stating the criteria the commission will use in determining whether to initiate enforcement action but disagrees that such criteria should be based on PURA §15.023. PURA §15.023 only specifies the criteria that the commission must use in setting the amount of an administrative penalty, after a violation has been established and does not establish the criteria for a commission decision to initiate an enforcement action,

which will determine whether a violation occurred. Accordingly, the commission adds language to subsection (k)(4), redesignated (l)(4), to require that, for alleged violations that have been reviewed in the informal procedure established in this subsection, staff make a prima facie case that includes a summary of the evidence indicating to the commission staff that the market participant has violated this section, and other findings resulting from the investigation allowed by this section. This change also addresses CenterPoint's request that there should be a "reasonable basis to conclude that a violation has occurred."

The commission disagrees with comments suggesting that a time limit should be imposed on the informal review process contained in the rule. The review process often requires review of voluminous, complex records and reports from ERCOT and the market participant(s) involved. The time spent reviewing these documents can be significant and can be extended through no fault of the staff, particularly when one or more party may have an interest in delaying or avoiding the review. Although a time limit may serve the interests of a market participant, the commission fails to see how the public interest is served by such time limit. The commission has a very limited number of staff members available to conduct such reviews who also have other responsibilities in rulemaking projects and contested case proceedings designed to protect the public interest. Imposing an arbitrary limit on the time they can spend reviewing a particular transaction may prevent a thorough review of the transaction or prevent them from performing other important functions. The commission encourages its employees to perform their jobs quickly, efficiently, and effectively, but will not include a provision that may lead to a less

than thorough review or the filing of an unnecessary complaint to meet an arbitrary time limit.

Concerning the provision in subsection (k)(4), which lists the remedies available to the commission, the commission disagrees with suggestions that the list should be expanded to include "disgorgement," or that it should be limited to only the remedies specified in PURA §15.023. As in the case of subsection (l), discussed elsewhere, the recitation of remedies in subsection (k)(4) was neither intended to expand nor limit the range of remedies available to the commission, but to provide some notice of the types of remedies available. To avoid any confusion over this point, the commission is revising this language to remove language referring to any particular remedies. The commission will determine the appropriate remedy in any particular enforcement case depending upon the facts in that case and the remedies available at law.

The commission disagrees with OPUC's comments that the rule should include a process for determining whether particular documents are entitled to treatment as confidential information. The goal of the investigation is to obtain information in a timely fashion to determine whether or not more formal enforcement action is needed. Requiring a procedure for determining whether the information is properly treated as confidential would add unnecessary delay to the process. If further action is necessary, the commission could determine issues of confidentiality in the enforcement action. If no action is taken, the information remains subject to the requirements of the Texas Public Information Act

and confidentiality could be determined in response to an open records request. By accepting the information under a claim of confidentiality, the commission is not agreeing with such claims and reserves the right to challenge such claims if necessary. However, the commission will treat such information as confidential until a decision is issued declaring that such treatment is not appropriate. Concerning CMP's comments about other potential bases of a claim of confidentiality, the commission is revising the rule to allow such claims, however, the commission sees no need for the broad language referring to "limitations applicable to discovery in contested cases" as proposed by CMP. The limitations applicable to discovery may vary from case to case, so adding this language would only introduce new uncertainty to the rule.

The commission agrees with some of the suggestions requesting clarifications to the language of the rule and is revising the rule to include these clarifications. The commission declines to adopt Reliant's proposal to change subsection (k)(1) to allow a market participant to "demonstrate compliance with the Protocols." This language may be too restrictive. Because the commission is adding a subsection concerning affirmative defenses, a market participant may be able to demonstrate a situation in which it was not in "compliance with the Protocols" but nevertheless should not be found to be in violation of the rule. The rule language allowing the market participant "an opportunity to explain its activities" would allow it to assert its affirmative defense while Reliant's proposed language would not. Additionally, the commission notes that "compliance with the Protocols" is not the commission's sole consideration. There may be situations in which a

market participant's actions may not be expressly addressed in the Protocols, but which constitute fraud or a market abuse and materially affected the proper functioning or the reliability of the market, either through negligence or in a way that was predictable.

§25.503(l), redesignated subsection (m)

TXU proposed that subsection (l) be revised to indicate that the commission will not take an enforcement action until after notice and an opportunity for a hearing are provided to the market participant involved. TXU also argued that the language of subsection (l) implies that the commission is seeking to impose remedies that are beyond its statutory authority to impose. AEP made similar arguments and suggested that subsection (l) should be revised to state that the only remedies available to the commission are those specified in PURA §39.157. CMP also suggested that the language should be limited to the remedies available to the commission as specified in PURA. Additionally, CMP recommended that the language also reflect that the commission has the discretion to order no relief, such as in cases where no harm has resulted or the harm has already been remedied. On a related matter, CMP requested the inclusion of a new subsection, which would state that the section does not present a basis upon which a party may seek to revoke a bilateral contract; state that the new section does not provide a basis for a third-party cause of action, except for complaints to ERCOT or the commission specifically provided for in the rule; and state that the new section does not provide a basis for changing wholesale power costs under contracts based upon formulary rates, fuel adjustments, or average system costs.

Commission Response

The commission disagrees with these comments and believes that the commenters have misunderstood the purpose of subsection (l). This subsection was included primarily to give notice to market participants about the range of remedies available to the commission. It was intended to neither expand nor limit the types of remedies the commission could require in the event of a violation of this, or any other, commission rule. Therefore, the commission declines the requests to include other language limiting its ability to fashion remedies to address particular violations. However, the comments have shown a need for clarification of subsection (l). The commission determines that the most appropriate change is to revise the language to remove any reference to a particular remedy and to instead indicate that the commission may seek any remedy available at law.

For similar reasons, the commission declines to adopt the additional subsection proposed by CMP, which would limit the remedies available to the commission. The commission will determine the appropriate remedy for any particular violation of this rule based upon the facts in each case and law applicable to the situation.

Other Issues

CMP filed a comment seeking to add a subsection that would indicate that the entire section "should be interpreted consistently with applicable federal and state antitrust law."

Commission Response

The commission sees no need for this provision and declines to adopt it. PURA §39.158(b) states that Chapter 39 is "intended to complement other state and federal antitrust provisions." Thus the rule, which is, in part, adopted pursuant to Chapter 39, should be seen as a complement to state and federal antitrust provisions. PURA does not require that the commission's rules be "consistent with state and federal antitrust provisions" as CMP requested. Where the Legislature wants the commission's rules to be consistent with other law, it expressly states that requirement, as it did in PURA §55.308, requiring that the commission's rules on telecommunications slamming "shall be consistent with applicable federal laws and rules." The difference between rules that "complement" federal law and rules that are "consistent with" federal law is significant and is an indication that the Legislature intended that the commission's authority was not limited solely to implementing existing state and federal antitrust provisions. The rule also contains customer protection provisions that are not dependent upon antitrust law. Stating that the rule will be interpreted consistent with antitrust provisions improperly limits the scope of the rule.

In supplemental comments, San Antonio suggested that the rule should contain a provision requiring an annual evaluation of the rule, given the dynamic character of competitive markets. San Antonio noted that the FERC included a similar provision in its rules.

Commission Response

The commission declines to adopt San Antonio's suggestion. TEXAS GOV'T CODE ANN. §2001.039 requires state agencies to review their rules every four years to determine whether such rules should be readopted. Additionally, TEXAS GOV'T CODE ANN. §2001.021 allows interested persons to submit a petition for rulemaking to propose the adoption of an agency rule. The commission believes that these two provisions provide ample grounds to assure that the rule will receive periodic review to remain compatible with the developing market. There is no need to adopt a provision requiring a more frequent review period, particularly in view of the staff resources that are involved in such endeavor.

All comments, including any not specifically referenced herein, were fully considered by the commission. In adopting this section, the commission makes other minor modifications for purposes of clarifying its intent.

This new section is adopted under the Public Utility Regulatory Act, Texas Utilities Code Annotated §14.002 (Vernon 1998, Supplement 2004) (PURA), which provides the Public Utility Commission with the authority to make and enforce rules reasonably required in the exercise of its powers and jurisdiction; and specifically, PURA §15.023, which authorizes the commission to impose an administrative penalty against a person who violates the statute or the commission's rules; PURA §35.004, which requires that the commission ensure that ancillary services necessary to facilitate the transmission of electric energy are available at reasonable

prices with terms and conditions that are not unreasonably preferential, prejudicial, predatory, or anticompetitive; PURA §39.001, which establishes the legislative policy to protect the public interest during the transition to and in the establishment of a fully competitive electric power industry; PURA §39.101, which establishes that customers are entitled to protection from unfair, misleading, or deceptive practices and directs the commission to adopt and enforce rules to carry out this provision and to ensure that retail customer protections are established that afford customers safe, reliable, and reasonably priced electricity; PURA §39.151, which requires the commission to oversee and review the procedures established by an independent organization, directs market participants to comply with such procedures, and authorizes the commission to enforce such procedures; PURA §39.157, which directs the commission to monitor market power associated with the generation, transmission, distribution, and sale of electricity and provides enforcement power to the commission to address any market power abuses; PURA §39.356, which allows the commission to revoke certain certifications and registrations for violation of an independent organization's procedures, statutory provisions, or the commission's rules; and PURA §39.357, which authorizes the commission to impose administrative penalties in addition to revocation, suspension, or amendment of certificates and registrations.

Cross Reference to Statutes: Public Utility Regulatory Act §§14.002, 15.023, 35.004, 39.001, 39.101, 39.151, 39.157, 39.356, and 39.357.

§25.503. Oversight of Wholesale Market Participants.

(a) **Purpose.** The purpose of this section is to establish the standards that the commission will apply in monitoring the activities of entities participating in the wholesale electricity markets, including markets administered by the Electric Reliability Council of Texas (ERCOT), and enforcing the Public Utility Regulatory Act (PURA) and ERCOT procedures relating to wholesale markets. The standards contained in this rule are necessary to:

(1) protect customers from unfair, misleading, and deceptive practices in the wholesale markets, including ERCOT-administered markets;

(2) ensure that ancillary services necessary to facilitate the reliable transmission of electric energy are available at reasonable prices;

(3) afford customers safe, reliable, and reasonably priced electricity;

(4) ensure that all wholesale market participants observe all scheduling, operating, reliability, and settlement policies, rules, guidelines, and procedures established in the ERCOT procedures;

(5) clarify prohibited activities in the wholesale markets, including ERCOT-administered markets;

(6) monitor and mitigate market power as authorized by the Public Utility Regulatory Act (PURA) §39.157(a) and prevent market power abuses;

(7) clarify the standards and criteria the commission will use when reviewing wholesale market activities;

(8) clarify the remedies for non-compliance with the Protocols relating to wholesale markets; and

(9) prescribe ERCOT's role in enforcing ERCOT procedures relating to the reliability of the regional electric network and accounting for the production and delivery among generators and all other market participants, and monitoring and obtaining compliance with operating standards within the ERCOT regional network.

(b) **Application.** This section applies to all market entities, as defined in subsection (c) of this section.

(c) **Definitions.** The following words and terms when used in this section shall have the following meaning, unless the context indicates otherwise:

(1) **Artificial congestion** — Congestion created when multiple foreseeable options exist for scheduling, dispatching, or operating a resource, and a market participant chooses an option that is not the most economical, that foreseeably creates or exacerbates transmission congestion, and that results in the market participant being paid to relieve the congestion it caused.

(2) **Efficient operation of the market** — Operation of the markets administered by ERCOT, consistent with reliability standards, that is characterized by the fullest use of competitive auctions to procure ancillary services, minimal cost socialization, and the most economical utilization of resources, subject to necessary operational and other constraints.

(3) **ERCOT procedures** — Documents that contain the scheduling, operating, planning, reliability, and settlement procedures, standards, and criteria that are public and in effect in the ERCOT power region, including the ERCOT Protocols and ERCOT Operating Guides as amended from time to time but excluding ERCOT's internal administrative procedures. The Protocols generally govern when there are inconsistencies between the Protocols and the Operating Guides, except when ERCOT staff, consistent with subsection (i) of this section, determines that a provision contained in the Operating Guides is technically superior for the efficient and reliable operation of the electric network.

(4) **Market entity** — Any person or entity participating in the ERCOT-administered wholesale market, including, but not limited to, a load serving entity (including a municipally owned utility and an electric cooperative,) a power marketer, a transmission and distribution utility, a power generation company, a qualifying facility, an exempt wholesale generator, ERCOT, and any entity conducting planning, scheduling, or operating activities on behalf of, or controlling the activities of, such market entities.

(5) **Market participant –** A market entity other than ERCOT.

(6) **Resource** — Facilities capable of providing electrical energy or load capable of reducing or increasing the need for electrical energy or providing short-term reserves into the ERCOT system. This includes generation resources and loads acting as resources (LaaRs).

(d) **Standards and criteria for enforcement of ERCOT procedures and PURA.** The commission will monitor the activities of market entities to determine if such activities are consistent with ERCOT procedures; whether they constitute market power abuses or are unfair, misleading, or deceptive practices affecting customers; and whether they are consistent with the proper accounting for the production and delivery of electricity among generators and other market participants. When reviewing the activities of a market entity, the commission will consider whether the activity was conducted in a manner that:

(1) adversely affected customers in a material way through the use of unfair, misleading, or deceptive practices;

(2) materially reduced the competitiveness of the market, including whether the activity unfairly impacted other market participants in a way that restricts competition;

(3) disregarded its effect on the reliability of the ERCOT electric system; or

(4) interfered with the efficient operation of the market.

(e) **Guiding ethical standards.** Each market participant is expected to:

(1) observe all applicable laws and rules;

(2) schedule, bid, and operate its resources in a manner consistent with ERCOT procedures to support the efficient and reliable operation of the ERCOT electric system; and

(3) not engage in activities and transactions that create artificial congestion or artificial supply shortages, artificially inflate revenues or volumes, or manipulate the market or market prices in any way.

(f) **Duties of market entities.**

(1) Each market participant shall be knowledgeable about ERCOT procedures.

(2) A market participant shall comply with ERCOT procedures and any official interpretation of the Protocols issued by ERCOT or the commission.

(A) If a market participant disagrees with any provision of the Protocols or any official interpretation of the Protocols, it may seek an amendment of the Protocols as provided for in the Protocols, appeal an ERCOT official interpretation to the commission, or both.

(B) A market participant appealing an official interpretation of the Protocols or seeking an amendment to the Protocols shall comply with the Protocols unless and until the interpretation is officially changed or the amendment is officially adopted.

(C) A market participant may be excused from compliance with ERCOT instructions or Protocol requirements only if such non-compliance is due to communication or equipment failure beyond the reasonable control of the market participant; if compliance would jeopardize public health and safety or the reliability of the ERCOT transmission grid, or create risk of bodily harm or damage to the equipment; if compliance would be

inconsistent with facility licensing, environmental, or legal requirements; if required by applicable law; or for other good cause. A market participant is excused under this subparagraph only for so long as the condition continues.

(3) Whenever the Protocols require that a market participant make its "best effort" or a "good faith effort" to meet a requirement, or similar language, the market participant shall act in accordance with the requirement unless:

(A) it is not technically possible to do so;

(B) doing so would jeopardize public health and safety or the reliability of the ERCOT transmission grid, or would create a risk of bodily harm or damage to the equipment;

(C) doing so would be inconsistent with facility licensing, environmental, or legal requirements; or

(D) other good cause exists for excusing the requirement.

(4) When a market participant is not able to comply with a Protocol requirement or official interpretation of a requirement, or honor a formal commitment to ERCOT, the market participant has an obligation to notify ERCOT immediately upon learning of such constraints and to notify ERCOT when the problem ceases. A market participant who does not comply with a Protocol requirement or official interpretation of a requirement, or honor a formal commitment to ERCOT, has the burden to demonstrate, in any commission proceeding in which the failure to

comply is raised, why it cannot comply with the Protocol requirement or official interpretation of the requirement, or honor the commitment.

(5) The commission staff may request information from a market participant concerning a notification of failure to comply with a Protocol requirement or official interpretation of a requirement, or honor a formal commitment to ERCOT. The market participant shall provide a response that is detailed and reasonably complete, explaining the circumstances surrounding the alleged failure, and shall provide documents and other materials relating to such alleged failure to comply. The response shall be submitted to the commission staff within five business days of a written request for information, unless commission staff agrees to an extension.

(6) A market participant's bids of energy and ancillary services shall be from resources that are available and capable of performing, and shall be feasible within the limits of the operating characteristics indicated in the resource plan, as defined in the Protocols, and consistent with the applicable ramp rate, as specified in the Protocols.

(7) All statements, data and information provided by a market participant to market publications and publishers of surveys and market indices for the computation of an industry price index shall be true, accurate, reasonably complete, and shall be consistent with the market participant's activities, subject to generally accepted standards of confidentiality and industry standards. Market participants shall

exercise due diligence to prevent the release of materially inaccurate or misleading information.

(8) A market entity has an obligation to provide accurate and factual information and shall not submit false or misleading information, or omit material information, in any communication with ERCOT or with the commission. Market entities shall exercise due diligence to ensure adherence to this provision throughout the entity.

(9) A market participant shall comply with all reporting requirements governing the availability and maintenance of a generating unit or transmission facility, including outage scheduling reporting requirements. A market participant shall immediately notify ERCOT when capacity changes or resource limitations occur that materially affect the availability of a unit or facility, the anticipated operation of its resources, or the ability to comply with ERCOT dispatch instructions.

(10) A market participant shall comply with requests for information or data by ERCOT as specified by the Protocols or ERCOT instructions within the time specified by ERCOT instructions, or such other time agreed to by ERCOT and the market participant.

(11) When a Protocol provision or its applicability is unclear, or when a situation arises that is not contemplated under the Protocols, a market entity seeking clarification of the Protocols shall use the Protocol Revision Request (PRR) process provided in the Protocols. If the PRR process is impractical or inappropriate under the circumstances, the market entity may use the process for requesting formal Protocol clarifications or interpretations described in subsection

(i) of this section. This provision is not intended to discourage day to day informal communication between market participants and ERCOT staff.

(12) A market participant operating in the ERCOT markets or a member of the ERCOT staff who identifies a provision in the ERCOT procedures that produces an outcome inconsistent with the efficient and reliable operation of the ERCOT-administered markets shall call the provision to the attention of the appropriate ERCOT subcommittee. All market participants shall cooperate with the ERCOT subcommittees, ERCOT staff, and the commission staff to develop Protocols that are clear and consistent.

(13) A market participant shall establish and document internal procedures that instruct its affected personnel on how to implement ERCOT procedures according to the standards delineated in this section. Each market participant shall establish clear lines of accountability for its market practices.

(g) **Prohibited activities.** Any act or practice of a market participant that materially and adversely affects the reliability of the regional electric network or the proper accounting for the production and delivery of electricity among market participants is considered a "prohibited activity." The term "prohibited activity" in this subsection excludes acts or practices expressly allowed by the Protocols or by official interpretations of the Protocols and acts or practices conducted in compliance with express directions from ERCOT or commission rule or order or other legal authority. The term "prohibited activity" includes, but is not limited to, the following acts and practices that have been found to

cause prices that are not reflective of competitive market forces or to adversely affect the reliability of the electric network:

(1) A market participant shall not schedule, operate, or dispatch its generating units in a way that creates artificial congestion.

(2) A market participant shall not execute pre-arranged offsetting trades of the same product among the same parties, or through third party arrangements, which involve no economic risk and no material net change in beneficial ownership.

(3) A market participant shall not offer reliability products to the market that cannot or will not be provided if selected.

(4) A market participant shall not conduct trades that result in a misrepresentation of the financial condition of the organization.

(5) A market participant shall not engage in fraudulent behavior related to its participation in the wholesale market.

(6) A market participant shall not collude with other market participants to manipulate the price or supply of power, allocate territories, customers or products, or otherwise unlawfully restrain competition. This provision should be interpreted in accordance with federal and state antitrust statutes and judicially-developed standards under such statutes regarding collusion.

(7) A market participant shall not engage in market power abuse. Withholding of production, whether economic withholding or physical withholding, by a market participant who has market power, constitutes an abuse of market power.

(h) **Defenses.** The term "prohibited activity" in subsection (g) of this section excludes acts or practices that would otherwise be included, if the market entity establishes that its conduct served a legitimate business purpose consistent with prices set by competitive market forces; and that it did not know, and could not reasonably anticipate, that its actions would inflate prices, adversely affect the reliability of the regional electric network, or adversely affect the proper accounting for the production and delivery of electricity; or, if applicable, that it exercised due diligence to prevent the excluded act or practice. The defenses established in this subsection may also be asserted in instances in which a market participant is alleged to have violated subsection (f) of this section. A market entity claiming an exclusion or defense under this subsection, or any other type of affirmative defense, has the burden of proof to establish all of the elements of such exclusion or defense.

(i) **Official interpretations and clarifications regarding the Protocols.** A market entity seeking an interpretation or clarification of the Protocols shall use the PRR process contained in the Protocols whenever possible. If an interpretation or clarification is needed to address an unforeseen situation and there is not sufficient time to submit the issue to the PRR process, a market entity may seek an official Protocol interpretation or clarification from ERCOT in accordance with this subsection.

(1) ERCOT shall develop a process for formally addressing requests for clarification of the Protocols submitted by market participants or issuing official interpretations regarding the application of Protocol provisions and requirements.

ERCOT shall respond to the requestor within ten business days of ERCOT's receipt of the request for interpretation or clarification with either an official Protocol interpretation or a recommendation that the requestor take the request through the PRR process.

(2) ERCOT shall designate one or more ERCOT officials who will be authorized to receive requests for clarification from, and issue responses to market participants, and to issue official interpretations on behalf of ERCOT regarding the application of Protocol provisions and requirements.

(3) The designated ERCOT official shall provide a copy of the clarification request to commission staff upon receipt. The ERCOT official shall consult with ERCOT operational or legal staff as appropriate and with commission staff before issuing an official Protocol clarification or interpretation.

(4) The designated ERCOT official may decide, in consultation with the commission staff, that the language for which a clarification is requested is ambiguous or for other reason beyond ERCOT's ability to clarify, in which case the ERCOT official shall inform the requestor, who may take the request through the PRR process provided for in the Protocols.

(5) All official Protocol clarifications or interpretations that ERCOT issues in response to a market participant's formal request or upon ERCOT's own initiative shall be sent out in a market bulletin with the appropriate effective date specified to inform all market participants, and a copy of the clarification or interpretation shall be maintained in a manner that is accessible to market participants. Such

response shall not contain information that would identify the requesting market participant.

(6) A market participant may freely communicate informally with ERCOT employees, however, the opinion of an individual ERCOT staff member not issued as an official interpretation of ERCOT pursuant to this subsection may not be relied upon as an affirmative defense by a market participant.

(j) **Role of ERCOT in enforcing operating standards.** ERCOT shall develop and submit for commission approval a process to monitor material occurrences of non-compliance with ERCOT procedures, which shall mean occurrences that have the potential to impede ERCOT operations, or represent a risk to system reliability. Non-compliance indicators monitored by ERCOT shall include, but shall not be limited to, material occurrences of schedule control error, failing resource plan performance measures as established by ERCOT, failure to follow dispatch instructions within the required time, failure to meet ancillary services obligations, failure to submit mandatory bids or offers that may apply, and other instances of non-compliance of a similar magnitude.

(1) ERCOT shall keep a record of all such material occurrences of non-compliance with ERCOT procedures and shall develop a system for tracking recurrence of such material occurrences of non-compliance.

(2) ERCOT shall promptly provide information to and respond to questions from market participants to allow the market participant to understand and respond to alleged material occurrences of non-compliance with ERCOT procedures.

However, this requirement does not relieve the market participant's operator from responding to the ERCOT operator's instruction in a timely manner and should not be interpreted as allowing the market participant's operator to argue with the ERCOT operator as to the need for compliance.

(3) ERCOT shall keep a record of the resolution of such material occurrences of non-compliance and of remedial actions taken by the market participant in each instance.

(4) ERCOT shall inform the commission staff immediately if the material occurrence of non-compliance is not resolved after the system operator has orally informed the market participant of the problem. The occurrence is not resolved if:

(A) the same instance of non-compliance is repeated more than once in a six-month period; or

(B) the occurrence continues after ERCOT has first orally notified the operator of the market participant, and subsequently notified, orally or in writing, the supervisor of the operator of the market participant.

(k) **Standards for record keeping.**

(1) A market participant who schedules through a qualified scheduling entity (QSE) that submits schedules to ERCOT on behalf of more than one market participants shall maintain records to show scheduling and bidding information for all schedules and bids that its QSE has submitted to ERCOT on its behalf, by interval.

(2) All market participants and ERCOT shall maintain records relative to market participants' activities in the ERCOT-administered markets to show:

(A) information on transactions, as defined in §25.93(c)(3) of this title (relating to Quarterly Wholesale Electricity Transaction Reports), including the date, type of transaction, amount of transaction, and entities involved;

(B) information and documentation of all planned and forced generation and transmission outages including all documentation necessary to document the reason for the outage;

(C) information described under this subsection including transaction information, information on pricing, settlement information, and other information that would be relevant to an investigation under this section, and that has been disclosed to market publications and publishers of surveys and price indices, including the date, information disclosed, and the name of the employees involved in providing the information as well as the publisher to whom it was provided; and

(D) reports of the market participant's financial information given to external parties, including the date, financial results reported, and the party to whom financial information was reported, if applicable.

(3) After the effective date of this section, all records referred to in this subsection except verbally dispatch instructions (VDIs) shall be kept for a minimum of three years from the date of the event. ERCOT shall keep VDI records for a minimum

of two years. All records shall be made available to the commission for inspection upon request.

(4) A market participant shall, upon request from the commission, provide the information referred to in this subsection to the commission, and may, if applicable, provide it under a confidentiality agreement or protective order pursuant to §22.71(d) of this title (relating to Filing of Pleadings, Documents, and Other Material).

(l) **Investigation.** The commission staff may initiate an informal fact-finding review based on a complaint or upon its own initiative to obtain information regarding facts, conditions, practices, or matters that it may find necessary or proper to ascertain in order to evaluate whether any market entity has violated any provision of this section**.**

(1) The commission staff will contact the market entity whose activities are in question to provide the market entity an opportunity to explain its activities. The commission staff may require the market entity to provide information reasonably necessary for the purposes described in this subsection.

(2) If the market entity asserts that the information requested by commission staff is confidential, the information shall be provided to commission staff as confidential information related to settlement negotiations or other asserted bases for confidentiality pursuant to §22.71(d)(4) of this title.

(3) If after conducting its fact-finding review, the commission staff determines that a market entity may have violated this section, the commission staff may request

that the commission initiate a formal investigation against the market entity pursuant to §22.241 of this title (relating to Investigations).

(4) If, as a result of its investigation, commission staff determines that there is evidence of a violation of this section by a market entity, the commission staff may request that the commission initiate appropriate enforcement action against the market entity. A notice of violation requesting administrative penalties shall comply with the requirements of §22.246 of this title (relating to Administrative Penalties). Additionally, for alleged violations that have been reviewed in the informal procedure established by this subsection, the commission staff shall include as part of its prima facie case:

(A) a statement either that –

(i) the commission staff has conducted the investigation allowed by this section; or

(ii) the market participant has failed to comply with the requirements of paragraph (5) of this subsection;

(B) a summary of the evidence indicating to the commission staff that the market participant has violated one of the provisions of this section;

(C) a summary of any evidence indicating to the commission staff that the market participant benefited from the alleged violation or materially harmed the market; and

(D) a statement that the staff has concluded that the market participant failed to demonstrate, in the course of the investigation, the applicability of an exclusion or affirmative defense under subsection (h) of this section.

(5) A market entity subject to an informal fact-finding review or a formal investigation by the commission has an obligation to fully cooperate with the investigation, to make its company representatives available within a reasonable period of time to discuss the subject of the investigation with the commission staff, and to respond to the commission staff's requests for information within a reasonable time frame as requested by the commission staff.

(6) The procedure for informal fact-finding review established in this subsection does not prevent any person or commission staff from filing a formal complaint with the commission pursuant to §22.242 of this title (relating to Complaints) or pursuing other relief available by law.

(m) **Remedies.** If the commission finds that a market entity is in violation of this section, the commission may seek or impose any legal remedy it determines appropriate for the violation involved.

This agency hereby certifies that the rule, as adopted, has been reviewed by legal counsel and found to be a valid exercise of the agency's legal authority. It is therefore ordered by the Public Utility Commission of Texas that §25.503, relating to Oversight of Wholesale Market Participants, is hereby adopted with changes to the text as proposed.

ISSUED IN AUSTIN, TEXAS ON THE 9th DAY OF FEBRUARY 2004.

PUBLIC UTILITY COMMISSION OF TEXAS

_____

JULIE PARSLEY, COMMISSIONER

_____

PAUL HUDSON, CHAIRMAN

Q:\PD\TXR-Rules Management\Rules\Rulemaking Projects\Electric\26201\26201adt.doc