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Big Settlement Shows FERC's Pursuit Of Market 'Gaming'

Law360, New York (February 22, 2017, 11:22 AM EST) -- On Feb. 1, 2017, the Federal Energy Regulatory Commission (FERC) approved a settlement agreement between its Office of Enforcement (Enforcement) and GDF SUEZ Energy Marketing NA Inc. (GSEMNA) resolving Enforcement's investigation into whether GSEMNA violated the Commission's Anti-Manipulation Rule. To resolve the matter, GSEMNA agreed to pay a civil penalty of $41 million, disgorge $40.8 million in unjust profits and undertake compliance reporting.

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The settlement is significant for two key reasons. First, it reflects the Commission's continued use of its anti-manipulation authority to prosecute "gaming" of organized wholesale electric markets (i.e., RTOs and ISOs) through bidding strategies that technically comply with market rules, but are inconsistent with the "purpose" of the rules — one of the more controversial theories of market manipulation pursued by FERC in recent years.

Second, the $81.8 million settlement is the largest enforcement settlement in almost four years, and it comes at a time when subjects of enforcement actions are increasingly deciding to litigate cases rather than settle with FERC — particularly when major civil penalty and disgorgement amounts are at stake.

Conduct at Issue

This case concerns the PJM Interconnection LLC (PJM) wholesale electric markets and, specifically, PJM's market rules that allow certain generators to collect revenues associated with lost opportunity credits (LOCs). The PJM tariff provides for payment of LOCs to combustion turbines (CTs) and certain other generators that clear the day-ahead energy market, but are not dispatched in the real-time market.

PJM established LOCs to encourage generators to keep their resources as part of PJM's pool-scheduled resources, and thereby allow PJM to control their output to manage system operations and maintain reliability.

In essence, PJM's grid management and dispatch decisions benefit from the flexibility afforded by having control over these generators — and the generator owners are willing to cede that control because of lost opportunity payments they could obtain when PJM decides not to run their plants.

The key issue in the investigation turned on when and how LOCs were paid out, and whether GSEMNA engaged in a scheme to improperly take advantage of PJM's LOC payment formulas to obtain LOC dollars it should not have obtained.

As to the payment formula details, during the May 2011 to September 2013 time period at issue, PJM paid lost opportunity credts equal to the higher of (a) the difference between the real-time locational marginal price and the day-ahead locational marginal price, or (b) the difference between the real-time locational marginal price and the higher of the unit's price-based or cost-based incremental energy offers.

The LOC formula did not subtract start-up and no-load costs, although such costs would be incurred if the unit were dispatched by PJM in the real-time market. As a result, a generator with a day-ahead award could earn a greater margin when it received LOCs and was not dispatched in the real-time market than it would have earned if it was dispatched.

Beginning in or around June 2011, GSEMNA implemented a strategy to profit from LOCs by offering CT units in the day-ahead market below the CT units' calculated costs with the goal of clearing the day-ahead market and then collecting LOCs if the units were not dispatched. GSEMNA discounted its day-ahead price-based offers below calculated costs, knowing that the CT units likely would run at a loss if dispatched.

In November 2011, after PJM corrected an error in which it was calculating LOCs based on price-based offers rather than the higher of the price-based or cost-based offers as required by its tariff, GSEMNA began discounting the cost-based offers for the units to the level of its price-based offers.

As a result, the LOCs that GSEMNA received for the CT units would continue to be based on the discounted offer and would be higher than if they were based on estimated costs.

GSEMNA continued to implement its strategy during the relevant period by discounting a given CT unit's day-ahead offer based on an assessment of the likelihood that the CT unit would not be dispatched in the real-time market, weighing the risk of running the CT unit at a loss if dispatched against the potential reward of LOCs if not dispatched.

At times, GSEMNA discounted offers for the CT units to get day-ahead awards in order to obtain LOCs by offering the units with discounts as deep as -$25/MWh. When GSEMNA expected a CT unit to be dispatched in the real-time market, it did not discount its day-ahead offer, and GSEMNA typically did not discount offers for units that were not eligible for LOCs.

Enforcement's Findings

Enforcement concluded that GSEMNA violated the Anti-Manipulation Rule by engaging in a strategy to target and inflate the receipt of LOCs in PJM.

Enforcement found that GSEMNA's strategy of targeting and inflating LOCs was "contrary to supply and demand fundamentals" and "impaired the functioning of the LOC provisions of the PJM market and PJM's unit commitment process."[1]

Enforcement further found that GSEMNA's offers "did not reflect the price at which it wanted to generate power, but rather the price at which it could obtain a day-ahead award and then receive LOCs during periods when the discounted CT units likely could not be operated economically" — conduct Enforcement concluded was "contrary to LOCs' purpose of compensating generators for lost opportunity costs due to PJM's decision not to dispatch a generation unit."[2]

Key Takeaways

Only the fourth "gaming" settlement

While FERC's pursuit of electric market "gaming"[3] cases has gained much attention in the industry, Enforcement has brought relatively few of these cases to date (whether through settlements or Orders to Show Cause and follow-on federal court litigation). This case is only the fourth such settlement.

The other three were a $410 million settlement with JP Morgan Ventures Energy Corporation (JPMVEC) in 2013 for various bidding strategies in California (CAISO) and Midcontinent (MISO) markets, an approximately $81,000 settlement with Oceanside Power, LLC in 2013 for an up-to congestion product bidding strategy in PJM and an $8 million settlement with Maxim Power Corp. for certain bidding activities in ISO New England.[4]

Largest settlement in almost four years

In recent years, subjects in enforcement cases have increasingly elected to defend themselves in court rather than settle, particularly in cases involving large civil penalties. This case is by far the largest enforcement settlement in almost four years, since JPMVEC's $410 million settlement in 2013.

On the other hand, there are several cases involving potential eight-or nine-figure penalties that are being contested at the Commission or in court. Notwithstanding this settlement, we think the recent trend of subjects electing to litigate rather than settle large cases will continue, at least until there are more federal court decisions providing clarity on the scope of FERC's Anti-Manipulation Rule.

Lack of quorum could temporarily halt certain enforcement actions

FERC approved two enforcement settlements during the first week of February: the GSEMNA settlement and a $36,000 settlement with Covanta Haverhill Associates LP for allegedly violating ISO New England's tariff.

FERC almost certainly made an effort to approve these settlements (along with numerous orders in other, non-enforcement cases) at this time because, following Commissioner Norman Bay's resignation effective February 3, FERC no longer has a quorum of commissioners needed to issue orders in many types of proceedings.

While it is not clear how long FERC will be without a quorum (i.e., how long it will take for the president to nominate, and the Senate to confirm, at least one new commissioner), the lack of a quorum will likely preclude enforcement cases requiring formal Commission action from moving forward.

While most investigation work does not require formal Commission action, Commission orders are required to, among other things, approve settlements and initiate and issue orders in formal agency enforcement actions (i.e., Order to Show Cause proceedings).

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Disclosure: David Applebaum had supervisory responsibility over this investigation while he was at FERC. The settlements were entered into and approved by FERC after Applebaum left the agency.

[1] Settlement at P 16.

[2] Id.

[3] Enforcement staff frequently characterizes these types of cases as involving "gaming" of RTO market rules. The Enforcement defense bar and other industry participants and FERC watchers use the term as well. The Commission itself — which must approve settlement orders and enforcement actions — rarely uses the term "gaming." In any case, whether the term "gaming" is used or not to describe allegedly improper RTO bidding strategies, what matters is whether the conduct violates the specific terms of the Anti-Manipulation Rule.

[4] In Re Make-Whole Payments and Related Bidding Strategies, 144 FERC ¶ 61,068 (2013); In re PJM Up-To Congestion Transactions, 142 FERC ¶ 61,088 (2013); Maxim Power Corp., 156 FERC ¶ 61,223 (2016). There are also three related "gaming" cases — all of which involve up-to congestion transactions in PJM — that did not settle and are currently being litigated in federal district court. In one of these cases, the court agreed with FERC's legal theory that the gaming conduct at issue, if proved, would violate the Anti-Manipulation Rule. FERC v. City Power Mktg. LLC, 2016 WL 4250233 (D.D.C. Aug. 10, 2016). However, that was on a motion to dismiss, and neither that court nor any other court has yet ruled on the merits of a "gaming" case.
