

CLIENT ALERT

FERC Directs GreenHat and its Owners to Explain Conduct in PJM's FTR Markets

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On May 20, 2021, the Federal Energy Regulatory Commission (“FERC” or the “Commission”) issued an Order to Show Cause and Proposed Penalty (“Show Cause Order”) directing GreenHat Energy LLC (“GreenHat”) and its owners (the “GreenHat Parties”) to explain why they should not be required to pay approximately \$229 million in civil penalties and disgorge nearly \$13.1 million in unjust profits for wholesale electric energy market manipulation of PJM Interconnection LLC’s (“PJM”) Financial Transmission Rights (“FTR”) market in a multi-pronged scheme allegedly perpetrated between 2015 and 2018.¹ FERC issued the Show Cause Order based upon the Office of Enforcement’s (“OE”) report which alleged that GreenHat’s owners profited from GreenHat’s manipulative FTR market activity at the expense of PJM’s utility members, downstream ratepayers, GreenHat’s bilateral counterparties, and even GreenHat’s PJM membership and financial solvency when GreenHat purchased FTRs with knowledge that GreenHat would default on its FTR market settlement obligations, but sold purchased FTRs to third parties to benefit GreenHat’s owners.

Based upon OE’s report, the Commission directed GreenHat and its owners to explain why their activity did not violate Section 222 of the Federal Power Act (“FPA”), FERC’s anti-manipulation rule (18 C.F.R. § 1c.2), and PJM’s Open Access Transmission Tariff (“OATT” or “Tariff”) and Operating Agreement (“OA”).²

¹ *GreenHat Energy, LLC*, 175 FERC ¶ 61,138 (2021) (“Show Cause Order”).

² *Id.* at P 10.

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Background

PJM is the Regional Transmission Organization (or "RTO") that operates the wholesale electricity market and coordinates the transmission of electricity in the District of Columbia and 13 states. It is the largest RTO in the U.S. and serves around 65 million people. PJM's operating procedures, market rules, and transmission planning and expansion protocols are contained in its OATT.

In addition to running day-ahead and real-time energy auctions every day, PJM conducts periodic auctions for FTRs, which are purely financial instruments³ whose returns depend on day-ahead congestion prices across a future period.⁴ Utilities may use FTRs to hedge against congestion charges they could incur from electric grid congestion in the PJM footprint; however, PJM also permits financial firms such as GreenHat to trade FTRs for speculative purposes.⁵

"An FTR makes or loses money based on the difference (or 'spread') between the congestion prices at two PJM nodes (the 'source' [electric energy receipt point] and the 'sink' [electric energy delivery point] of the FTR) during a specified future period: a month, a quarter, a year, or a three-year strip."⁶ OE explained:

Significantly, no money changes hands when a market participant acquires an FTR; instead, the purchaser pays, or is paid, only when the FTR settles, which may be as much as three years later. Until the FTR's settlement date, the only cash a purchaser needs to put up is collateral in an amount determined by a PJM formula.⁷

However, market participants can also bilaterally trade FTRs with each other outside of the PJM-administered FTR market.⁸ This can generate cash prior to settlement if the entity sells its FTRs to a bilateral counterparty.

To participate in an FTR auction, a market participant must be a member of PJM and meet the credit requirements for the FTR.⁹ Under PJM's Tariff, losses on defaulted portfolios are "socialized" among all other PJM members, even though the other members may never have even owned any FTRs.¹⁰

³ As explained by OE, "FTRs are purely financial instruments: '[t]hey do not represent a right for physical delivery of power' and the 'holder of an FTR is not required to deliver energy in order to receive a congestion credit.'" *Id.* at Appendix A, Enforcement Staff Report and Recommendation, at 12 ("OE Report").

⁴ *Id.* at 10.

⁵ *Id.* at 12.

⁶ *Id.* at 10-11.

⁷ *Id.*

⁸ *Id.*

⁹ *Id.* at 12.

¹⁰ *Id.* at 4.

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Alleged Violations

OE alleged that GreenHat's three owners took advantage of PJM's market, credit, and collateral rules between 2015 and 2018 to build up the largest FTR portfolio in PJM. GreenHat acquired FTRs from PJM in which it was only required to post a small amount of collateral. Then GreenHat allegedly used bilateral transactions to generate immediate cash from in-the-money FTRs, even though the FTRs would not settle until months or years later. In some instances, when GreenHat's bilateral counterparties sold the FTRs in PJM's FTR auction, GreenHat again bid on the FTRs but at an inflated price point.

According to OE, these were the key elements of GreenHat's scheme:

- Amassing a huge FTR portfolio based not on market fundamentals but on acquiring FTRs with virtually no upfront cash;
- Buying only long-term FTRs, to allow ample time to sell the profitable FTRs to third parties;
- Planning to default at settlement;
- Generating cash for GreenHat's owners by selling in-the-money FTRs to third parties at a discount; and
- Rigging the FTR auction by bidding an inflated price on FTRs that it had transferred to a counterparty and that the counterparty was selling in the PJM auction.¹¹

When GreenHat defaulted in June 2018, GreenHat had only \$559,447 in collateral, against approximately \$179 million in losses on its FTR portfolio.¹² OE explained that since GreenHat's default, every PJM member has been billed for GreenHat's losses, and they will continue to be billed until GreenHat's FTRs finish settling in May 2021.¹³

The Show Cause Order highlighted that even though GreenHat defaulted on its large portfolio, GreenHat's three owners obtained \$13.1 million when it sold profitable FTRs in its portfolio to third parties in bilateral deals. Though profitable for the owners, losses on GreenHat's remaining portfolio of FTRs in PJM increased. According to OE, GreenHat's alleged scheme is an example of "a type of fraud in which perpetrators acquire assets with no intent to pay for them and then try to turn the assets into immediate cash for themselves."¹⁴

¹¹ *Id.* at 18.

¹² Show Cause Order at P 3.

¹³ OE Report at 4.

¹⁴ Show Cause Order at P 4.

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GreenHat's owners also allegedly misrepresented to PJM that GreenHat's bilateral deals would generate enough cash to mitigate PJM's concern that GreenHat was headed towards default in 2017. OE stated that this misrepresentation "was a fraudulent invention by [GreenHat's owners] to persuade PJM not to shut down GreenHat's FTR business."¹⁵

Based upon this conduct, the Show Cause Order directed GreenHat and its owners to explain why they did not violate anti-market manipulation rules administered by FERC under the Federal Power Act, Section 222, and Section 1c.2 of the Commission's regulations, as well as specific rules administered under PJM's OATT and Operating Agreement. OE Staff recommended that GreenHat and its owners be made jointly and severally liable with respect to: (i) disgorgement of unjust profits of \$13,072,428, plus interest; and (ii) civil penalties for \$179 million, \$25 million, and \$25 million, respectively, for GreenHat and two of its owners. The GreenHat Parties have until June 21, 2021—30 days from the date of the Show Cause Order—to respond to the Commission.

Takeaways

The Show Cause Order is consistent with an uptick in FERC enforcement activity since the change in administrations and the appointment of Richard Glick as Chairman of the Commission. Unlike fiscal year 2020, for example, when FERC enforcement negotiated three settlements imposing \$553,376 in civil penalties and disgorgement, the alleged conduct in the GreenHat proceeding could itself result in a higher penalty than all of the civil penalties and disgorgement collected by enforcement in 2020. That being said, the investigation of GreenHat, like investigations that resulted in recent settlements and Show Cause Orders, undoubtedly began several years ago long before the Glick Chairmanship.

The alleged manipulative conduct may lead organized market operators like PJM to further tighten credit and collateral requirements either voluntarily or pursuant to FERC directive and raises additional questions about how new market rules could affect RTO members.

Last year, FERC approved certain proposed revisions to PJM's Tariff in light of the GreenHat default. PJM updated its market participant credit rules by establishing or revising, among other things:

- The criteria PJM uses to evaluate market participant and guarantor risk for participation in all of the PJM markets;
- The types of documents and other information applicants, market participants, and guarantors must submit for review in the credit evaluation process;
- PJM's ability to request additional collateral and/or restrict the use of collateral posted by applicants and market participants;

¹⁵ *Id.* at P 6.

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- Provisions for demonstrating minimum capitalization requirements and other measures of creditworthiness; and
- PJM's authority to limit, suspend, or terminate market participants that represent unreasonable credit risk to PJM markets or fail to meet PJM's minimum participation requirements.¹⁶

In a joint concurrence, Commissioners Danly and Glick stated that the revisions were “an important first step in enhancing PJM's credit risk evaluation process, but they are just that: *a first step*. Further changes should be considered, not only in PJM, but in *all organized markets*.”¹⁷ In light of their comments, it is still unclear how PJM or other RTO market rules may be revised to address credit risks and collateral requirements of market participants.

Although this topic was discussed in the Commission's February 25-26 2021 technical conference (Docket No. AD21-6), which addressed principles and best practices for credit risk management in organized wholesale electric markets, it is likely that GreenHat and its aftermath will result in more changes to organized market rules or credit and collateral requirements.¹⁸ Market participants should continue to closely monitor how the Commission resolves the issues implicated by this proceeding.

¹⁶ See *PJM Interconnection LLC*, 171 FERC ¶ 61,173 (2020).

¹⁷ *Id.* (Danly and Glick, Comm'rs, concurring) (emphasis added).

¹⁸ See, e.g., *RTO/ISO Credit Principles and Practices*, Technical Video Conference of Feb. 26, 2021, at Tr. 185-4-10, Docket Nos. AD21-6-000 and AD20-6-000 (posted Apr. 26, 2021) (mentioning reducing risks of socializing the costs of another FTR default).

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