

CLIENT ALERT

The D.C. Circuit's Public Citizen Decision May Offer Roadmap to Challenge ISO Market Outcomes

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On August 6, 2021, the United States Court of Appeals for the District of Columbia Circuit (the "D.C. Circuit") issued an opinion that explores the relationship between market manipulation and the Federal Power Act's (the "FPA") requirement that rates be just and reasonable.¹ The case arose from a complex set of facts and procedural history involving the results of the April 2015 Midcontinent Independent System Operator ("MISO") capacity auction for a zone covering most of Illinois. Prices in that zone were more than 40 times higher than the prices in neighboring zones and nearly nine times higher than the prior year's price in the Illinois zone. The Federal Energy Regulatory Commission ("FERC" or the "Commission") subsequently: (1) found that the MISO auction rules were unjust and unreasonable and fixed them prospectively; (2) opened and later closed a market manipulation investigation; and (3) upheld the results of the auction as just and reasonable. On appeal, the D.C. Circuit denied in part and granted in part Public Citizen's petition for review. Notably, the court held that the Commission was not required to explain its decision to close a market manipulation investigation, but that the Commission had acted in an arbitrary and capricious manner by failing adequately to explain why the auction had resulted in just and reasonable electricity capacity rates.²

¹ *Public Citizen, Inc. v. FERC*, No. 20-1156, slip op. at 2-3 (D.C. Cir. Aug. 6, 2021).

² *Id.* at 38.

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Background

In April 2015 MISO, the regional transmission organization responsible for operating the grid across 15 states and the province of Manitoba, held an auction for electrical capacity (the “2015 Auction”). During the 2015 Auction, capacity prices hit \$150 per megawatt-day (“MW-day”) for Zone 4, which covers most of Illinois, while selling at \$3.50 per MW-day for neighboring zones within MISO. In the prior year, the capacity prices for Zone 4 were \$16.75 per MW-day.³

Public Citizen, the State of Illinois, Southwestern Electric Cooperative, and Illinois Industrial Energy Consumers filed complaints under section 206 of the Federal Power Act (the “Act”), blaming the higher prices on Dynegy Inc. (“Dynegy”).⁴ The complainants alleged that Dynegy had exercised market power through its recent acquisition of four power plants in Zone 4 and that the “demand for capacity could not be met” without purchasing power from Dynegy.⁵ FERC reviewed MISO’s tariff and opened a market manipulation investigation.⁶

During the 2015 Auction, MISO had mitigation rules in place, two of which were at issue in the case: (i) capacity offers could not exceed the cost of entry for a new power plant in that particular zone; and (ii) prices would be compared to an “initial reference level” designed to prevent generators from selling capacity at prices substantially higher in MISO than the amount they would receive from exporting their capacity to another market, such as MISO’s neighboring system operator, PJM Interconnection LLC (“PJM”).⁷

As a result of its review, in 2015 the Commission ordered prospective changes to the MISO auction rules “to prevent unjust and unreasonable price spikes” (the “2015 Order”).⁸ The Commission found that changes to PJM’s capacity market made it harder to compare prices in MISO and PJM.⁹ In addition, the Commission found that the demand for capacity in PJM, as well as transmission availability into PJM, made such sales improbable.¹⁰ Therefore, MISO’s formula for calculating an initial reference level was no longer viable.¹¹ Instead, the Commission ordered the initial reference level to be set at \$0 per MW-day.¹² The Commission also concluded that MISO’s tariff miscalculated the amount of capacity

³ *Id.* at 2.

⁴ *Id.* at 14.

⁵ *Id.*

⁶ *Id.* at 15-16.

⁷ *Id.* at 12-13.

⁸ *Id.* at 2.

⁹ *Id.* at 16.

¹⁰ *Id.* at 17.

¹¹ *Id.*

¹² *Id.*

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needed to be procured from generators located within each MISO zone, because the tariff did not properly consider counter-flows in assessing the local clearing requirement. As a result, the methodology was unjust and unreasonable.¹³

Several years later, in 2019, over a dissent from then-Commissioner Richard Glick, the Commission denied the complaints’ remaining challenges that rates in Zone 4 were not just and reasonable (the “2019 Order”).¹⁴ The Commission announced that its investigation had not found market manipulation and concluded that prices resulting from the 2015 Auction were just and reasonable because (i) the 2015 Auction was conducted in compliance with MISO’s then-current tariff, which was designed to mitigate market power, and (ii) there was no evidence showing Dynegy had violated the terms of the tariff.¹⁵ The Commission rejected Public Citizen’s argument that the Commission was required to review individual auction prices across the board for justness and reasonableness before allowing the prices to take effect. Public Citizen subsequently sought rehearing, which the Commission denied (the “2020 Rehearing Order”).¹⁶

Issues on Appeal

In its petition for review by the D.C. Circuit of the 2019 Order and the 2020 Rehearing Order, Public Citizen raised three arguments: (i) the Commission failed to meet its obligation under the FPA to ensure that rates were just and reasonable, as it did not review prices resulting from the 2015 Auction before they went into effect; (ii) the Commission’s determination was arbitrary and capricious because it failed adequately to explain its decision to close its market manipulation investigation; and (iii) the Commission failed adequately to explain its conclusion that the results of the 2015 Auction were just and reasonable.¹⁷

The D.C. Circuit’s Decision

The D.C. Circuit had little difficulty rejecting Public Citizen’s first two arguments. First, the court held that FERC does not need to give “affirmative approval” to each market price before the price can take effect. “Nothing in the statute dictates the precise methodology the Commission must use to ensure the justness and reasonableness of rates, whether through individualized review or through reviewing and monitoring the process by which rates are computed.”¹⁸ Second, the court concluded that it lacked the power to review the Commission’s decision to close the market manipulation investigation or the Commission’s “brief and non-substantive passing word of explanation” for closing the investigation.¹⁹ “That type of

¹³ *Id.* at 17-18.

¹⁴ *Id.* at 18.

¹⁵ *Id.* at 19.

¹⁶ *Id.*

¹⁷ *Id.* at 23.

¹⁸ *Id.* at 26.

¹⁹ *Id.* at 23, 27.

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Commission decision not to pursue further investigation or enforcement “is a paradigmatic instance of an agency exercising its presumptively nonreviewable enforcement discretion.”²⁰

The court, however, agreed with Public Citizen’s third argument that the Commission had failed adequately to explain its conclusion that the results of the 2015 Auction were just and reasonable.²¹ According to the court, the Commission did not provide the type of “reasoned explanation” required by the law for its apparently inconsistent conclusions.²²

Most notably, the Commission failed to reconcile its prospective holding that the tariff could no longer protect against anticompetitive behavior with its conclusion that the conspicuously uneven 2015 results—obtained under the same flawed tariff terms—were not similarly infected. *Nor did the Commission provide any explanation for its determination that market manipulation did not lead to unjust and unreasonable rates.*²³

The court rejected the Commission’s reasoning that, because Dynegy’s auction offers were permissible under the then-governing tariff, the results of the auction were necessarily just and reasonable.²⁴ The court reasoned that prospective changes to PJM market rules were not the only basis for the 2015 Order. Instead, the Commission had also relied upon existing problems with the MISO tariff’s assumptions, including the limited opportunity in 2015 for MISO generators to sell into PJM because of limited demand and transmission capacity.²⁵ In the absence of those flawed assumptions, the D.C. Circuit explained that the initial reference level likely could have been \$0, not \$155.79, and Dynegy would have been limited to offering capacity at no more than \$25 per MW-day, not \$150 per MW-day.²⁶

Moreover, the court held that the Commission failed adequately to address Public Citizen’s allegation that market manipulation had produced unjust and unreasonable results in the 2015 Auction. First, the court rejected the Commission’s argument that Public Citizen did not adequately define “market manipulation” in its complaint.²⁷ Public Citizen had alleged economic withholding, which the court described as a “paradigmatic form of prohibited market manipulation.”²⁸ Second, the court found that Public Citizen had presented sufficient evidence to require a reasoned assessment from the Commission: “the \$150 per MW-day auction clearing price, which was 40 times higher than all of

²⁰ *Id.* at 28 (quoting *Baltimore Gas & Elec. Co. v. FERC*, 252 F.3d 456, 460 (D.C. Cir. 2001)).

²¹ *Id.* at 38.

²² *Id.* at 30.

²³ *Id.* (emphasis added).

²⁴ *Id.* at 31.

²⁵ *Id.* at 31-32.

²⁶ *Id.*

²⁷ *Id.* at 35.

²⁸ *Id.*

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the other auction clearing prices in zones where Dynegy lacked such market dominance, should have raised eyebrows.”²⁹ The court dismissed the Commission’s assertion that higher prices alone do not suggest market manipulation:

The clearing price was not just higher, but was massively higher than the rates in every other zone, and substantial evidence in the record raised the question of a market failure. What this record required was nothing more and nothing less than a reasoned assessment of the evidence as a whole.³⁰

Finally, the court rejected the Commission’s “breezy” claim that the Zone 4 clearing price was necessarily just and reasonable because it resulted from the application of MISO’s tariff, which had previously been accepted as just and reasonable. The court noted the apparent inconsistency of this conclusion with the Commission’s conclusion in the 2015 Order that the MISO tariff was unjust and unreasonable. In addition, the court observed that a market participant could abide by a tariff and still manipulate the market so as to produce an unjust and unreasonable outcome.³¹

The court emphasized that an “extraordinary price spike” does not necessarily constitute evidence of market manipulation.³² On an appropriate record, the Commission could “reasonably conclude that a particular price spike, while unusual was not unjust or unreasonable.”³³ Here, however, “the Commission did not do that work,” which rendered its order arbitrary and capricious.³⁴

The court remanded to the Commission to provide further analysis and explanation.³⁵

Implications

On remand, the Commission will have a challenge on its hands. Can it find the clearing price in Zone 4 to be just and reasonable in light of the 2015 Order? The D.C. Circuit sounded more than a little skeptical. If the Commission cannot justify the clearing price and finds the outcome to be unjust and unreasonable, it will be limited to granting prospective relief under FPA section 206 from the date of the complaints. Public Citizen had asked the Commission to set a refund effective date as of May 28, 2015, the date of its complaint.

In some respects, what happened here was not surprising. On the one hand, in the interest of regulatory certainty, the Commission is typically reluctant to disturb market outcomes. A single market clearing price allows market participants

²⁹ *Id.* at 36.

³⁰ *Id.* at 37.

³¹ *Id.*

³² *Id.* at 38.

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.*

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lower in the bid stack to receive the higher price. Thus, granting even prospective relief from the dates of the complaints related to the clearing price could be complicated and affect the other entities that cleared in the auction.

Similarly, at another level, the D.C. Circuit's decision is understandable. It is well established that an agency's decision not to prosecute is unreviewable. Market manipulation also requires proof of scienter, or an intent to defraud. Unjust and unreasonable prices do not. Thus, it is possible to have a market outcome in which no manipulation occurred, but where the result is nevertheless unjust and unreasonable.

What is surprising, however, is that even though the Commission found no market manipulation and was not required to provide an explanation why in order to close the enforcement investigation, the D.C. Circuit held that the Commission was nevertheless required to explain why market manipulation did not render the auction results unjust and unreasonable. The Commission undoubtedly thought that the former determination disposed of the latter claim. There is little precedent that explores the relationship between an enforcement action and a ratemaking issue, but *Public Citizen* can be read to stand for the proposition that a reviewing court will not second-guess the Commission's decision to close an enforcement investigation, while not allowing the Commission to rely upon the mere fact that it closed the investigation as the basis for finding a market outcome just and reasonable. At least where the record on its face raises "a substantial question,"³⁶ the Commission must provide a reasoned basis for its determination that market manipulation did not result in an unjust and unreasonable outcome.

The fact pattern in *Public Citizen* is also unusual, so the outcome may be somewhat anomalous, unlikely to be repeated. The results of the auction in Zone 4 were dramatic and "should have raised eyebrows."³⁷ The Commission opened a market manipulation investigation after the auction, and Public Citizen filed an FPA section 206 complaint. The Commission's 2015 Order decided one set of issues raised by the complaints with respect to the market rules, while not deciding the justness and reasonableness of the market results. Having found the MISO capacity market rules unjust and unreasonable, the Commission was hard-pressed to defend the results of the auction before the D.C. Circuit. Perhaps the Commission could have provided, and ultimately will provide, a more fulsome, better-reasoned explanation for why market manipulation did not impact the market.

Nevertheless, *Public Citizen* may create a blueprint for future complainants who wish to contest market outcomes: seek a market manipulation investigation *and* file a section 206 complaint alleging that prices were unjust and unreasonable as a result of market manipulation. The market manipulation claim may be probed in the section 206 proceeding, even if FERC closes its enforcement investigation. A market participant that suspects manipulation occurred is unlikely to receive an explanation from enforcement staff if staff closes an investigation, but after *Public Citizen*, the Commission may have to provide such an explanation in the related section 206 proceeding. FERC's anti-manipulation authority does

³⁶ *Id.*

³⁷ *Id.* at 36.

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not allow a private right of action, but carries potential penalties of more than a million dollars a day per violation. In contrast, private parties can file section 206 complaints, though the FPA only allows for refunds, not penalties. An entity subject to both a market manipulation investigation and a section 206 complaint arising out of the same evidentiary record would be well-advised to harmonize its defense to both actions and not to celebrate prematurely if it prevails on the former, while the latter remains outstanding.

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