

CLIENT ALERT

Is There Any Limit to FERC’s Discretion in Determining Just and Reasonable Rates?

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The Federal Energy Regulatory Commission’s (“**FERC**” or the “**Commission**”) discretion is at its zenith when fashioning remedies. In *XO Energy*, the D.C. Circuit upheld the Commission’s denial of over four years’ worth of refunds (January 19, 2017 through May 20, 2021) to PJM market participants who incurred forfeitures under PJM’s 2017 Proposed Forfeiture Rule (“**2017 Proposed Rule**”).¹ The D.C. Circuit affirmed FERC’s denial of refunds under the 2017 Proposed Rule, even though FERC subsequently found aspects of the rule unjust and unreasonable and accepted PJM’s replacement rule in 2021 (“**2021 Rule**”).

XO Energy, along with other recent D.C. Circuit opinions affirming FERC’s exercise of its discretion to determine the justness and reasonableness of rates, reinforce courts’ “great” and “particular[]” deference to FERC and unwillingness to “substitute [their] own judgment” for FERC’s, when it comes to assessing the justness and reasonableness of rates and charges, including refunds, within the Commission’s jurisdiction.² The decision also remanded the 2021 Rule for further explanation of the Commission’s failure to consider the potential impact of leveraged positions, but declined to vacate the rule.

General Background

PJM’s electricity market is comprised of both day-ahead and real-time auctions. In these auctions, electricity is priced using locational marginal pricing (“**LMP**”), which accounts for the costs of production, delivery to a particular location, and other factors. Among these other factors are congestion costs, which reflect the costs associated with congestion on the electric

¹ *XO Energy MA, LP v. FERC*, No. 22-1096 (D.C. Cir. July 14, 2023) (hereinafter “*XO Energy*”).

² *Id.* at 7.

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transmission path during periods of high power demand. PJM allows market participants to hedge their exposure to changing congestion costs with a financial product called a Financial Transmission Right (“FTR”). The holder of an FTR pays or receives based upon the difference in day-ahead congestion prices between two points on a transmission path. When congestion exists on a particular transmission path, an FTR acts as a rebate where the FTR holder receives a share of the congestion charges paid by other customers.³

In addition to FTRs, PJM offers “virtual” transactions, where a market participant can buy (or sell) electricity in the day-ahead market, and then sell (or buy) an equal amount of electricity in the real-time market to flatten its position. These financial transactions benefit market participants if the price differential between the real-time and day-ahead markets is favorable. If the differential is unfavorable, the virtual transaction may result in a loss. However, because virtual transactions can increase congestion levels in the day-ahead market, there is the potential for cross-product manipulation under a theory that a scheming market participant could enter into virtual transactions in order to affect congestion costs, thereby benefiting an FTR position.⁴

To combat the possibility of market manipulation, in the early 2000’s PJM added a forfeiture rule to its tariff that required FTR holders to forfeit any profits from their rights when they submitted a related virtual transaction that resulted in higher day-head prices than real-time prices.⁵ PJM updated its forfeiture rule in 2013 to expand the definition of virtual transactions for forfeiture purposes (“**Pre-2017 Rule**”). On January 19, 2017, after several years of back-and-forth over the justness and reasonableness of the Pre-2017 Rule, the Commission found the rule unjust and unreasonable and directed PJM to revise its rule.

PJM ultimately filed the 2017 Proposed Rule.⁶ Under the 2017 Proposed Rule, forfeiture would occur when a market participant’s virtual transaction (1) had an “appreciable impact” on congestion and (2) increased the value of an FTR by one-cent or more.⁷ In April 2020, XO Energy filed a Section 206 complaint against PJM, alleging that the 2017 Proposed Rule was unjust and unreasonable, and sought refunds of FTR forfeitures dating back to the rule’s implementation. In May 2021, FERC found certain aspects of the 2017 Proposed Rule unjust and unreasonable; namely the one-cent threshold to trigger a forfeiture, and ordered PJM to revise the rule and study the feasibility of issuing refunds for the period the rule was in effect.⁸ In 2021, PJM proposed the 2021 Rule, which FERC approved. FERC declined to order refunds for losses incurred from January 2017 through May 2021 under the 2017 Proposed Rule. XO Energy then sought judicial review, alleging that FERC erred by (1) not requiring refunds be paid to market participants who incurred forfeitures under the

³ PJM Manual 06: Financial Transmission Rights at 10 (July 26, 2023).

⁴ *Id.* at 5.

⁵ *Id.*

⁶ *Id.* at 5 – 6.

⁷ *Id.*

⁸ *Id.* at 6.

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Proposed 2017 Rule, which the Commission had found unjust and unreasonable, and (2) approving the 2021 Rule, because the rule burdened legitimate hedging activities in ways that do not deter potential manipulation.

The Court's Decision

The court of appeals affirmed FERC's denial of refunds to market participants. The court began by noting the limited scope of its review: "[G]reat deference' is accorded to the Commission's expertise under this standard, and the court 'may not substitute [its] own judgment for that of the Commission,' particularly in 'technical area[s] like electricity rate design.'"⁹ The Commission has broad discretion in determining remedies for statutory violations, including the ability to choose no remedy at all. In fact, the court noted that the Federal Power Act contains "no statutory command mandating refunds [when a violation occurs]."¹⁰

In response to XO Energy's claim that FERC's decision not to order a refund was arbitrary, the court found that FERC acted reasonably. FERC reviewed record evidence submitted by PJM that explained the "significant difficulty and expense of calculating refunds."¹¹ PJM's report explained that in order to calculate refund amounts, it would need to develop new software and systems that could determine whether and when a market participant violated the Pre-2017 Rule, which would come at considerable expense.¹² Furthermore, it would be difficult to determine which market participants were entitled to refunds because of ownership and organizational changes that occurred during the nearly five-year period the rule was in effect. Finally, FERC considered the fact that refund issuance would, among other things, involve extensive discretionary judgments regarding which entities were entitled to refunds. As a result, the court found that FERC had properly considered the matter in deciding not to order refunds.

XO Energy also argued that FERC's approval of the 2021 Rule was overbroad because it burdened legitimate hedging activities in ways that do not deter potential manipulation. Specifically, XO Energy objected to two elements of the 2021 Rule: (1) FERC erred by not requiring the entirety of market participants' FTR portfolios be reviewed (the 2021 Rule only requires review of market participants' virtual transaction portfolios); and (2) non-leveraged positions were not exempted from the 2021 Rule. The court affirmed FERC's determination not to require review of participants' FTR portfolios, while remanding for further consideration the decision not to exempt non-leveraged positions from the 2021 Rule.

In deciding not to require review of FTR portfolios, the court recognized that the purpose of the forfeiture rule is to reduce the likelihood of manipulative conduct involving virtual transactions that impact specific FTRs and not FTR portfolios generally. Consideration of an entire FTR portfolio could mask the manipulation of individual FTRs. In addition, the court noted that according to the Commission, in order to analyze the impact of virtual transactions on an FTR-related constraint,

⁹ *Id.* at 7.

¹⁰ *Id.* at 8 (quoting *Towns of Concord v. FERC*, 955 F.2d 67, 72 (D.C. Cir. 1992)).

¹¹ *PJM Interconnection, L.L.C.*, 179 FERC ¶ 61,010, at P 14 (2023).

¹² *XO Energy* at 9.

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the entire virtual transaction portfolio, but not the entire FTR portfolio, must be reviewed. Consequently, the court affirmed the Commission's approval of PJM's decision not to require review of participants' entire FTR portfolios.

XO Energy also argued that FERC acted in an arbitrary and capricious manner by failing to require PJM to exempt non-leveraged positions from the 2021 Rule, because non-leveraged positions provide no economic incentive to engage in manipulative conduct. Non-leveraged positions are those where the losses from virtual transactions exceed the gains from related FTRs. XO Energy argued that only leveraged positions can facilitate market manipulation. The court reviewed FERC's explanation as to why it did not include an exemption for non-leveraged positions in the 2021 Rule, which the court characterized as "brief, but inadequate."¹³ The court found that FERC's explanation failed to address XO Energy's position that non-leveraged positions cannot contribute to market manipulation and did not adequately explain how the 2021 Rule as written "strikes the appropriate balance between preventing manipulative conduct and not hindering legitimate hedging activity."¹⁴ Accordingly, while the court upheld the 2021 Rule, rather than vacate it, the court remanded for further explanation FERC's decision not to exempt non-leveraged positions from the 2021 Rule.

Conclusion

This decision puts to rest a number of outstanding issues concerning PJM's 2021 Rule. Although the court remanded for additional explanation the decision not to include an exemption for non-leveraged positions, the court noted a "significant possibility" that the Commission may find an adequate explanation for its actions on remand.¹⁵ More broadly, the court's decision is one of a number of recent opinions that reinforce judicial deference to Commission determinations of just and reasonable rates, and the difficulty of setting aside such determinations. PJM market participants should be aware that courts will likely continue to defer to FERC in such matters and, therefore, should not count on judicial reversals. This also means that the best opportunities to shape a proposed rate may be during the RTO/ISO stakeholder process or in the Commission proceeding considering the proposal.

¹³ *Id.* at 13.

¹⁴ *Id.*

¹⁵ *Id.* at 14.

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