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FERC Order Appears to Find Most PJM Internal Bilateral Transactions Improper

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In an order resolving a complaint filed by DC Energy, LLC and DC Energy Mid-Atlantic, LLC against PJM Interconnection LLC (PJM),[1] the Federal Energy Regulatory Commission (FERC) has ruled that in order for an Internal Bilateral Transaction (IBT) to be "reported to" PJM, it must meet a newly clarified physicality test set forth in Section 1.7.10 of the PJM Tariff. The application of this order may have a significant impact on forward transactions in PJM, particularly those with a PJM Western Hub delivery point. Trading hubs, such as the PJM Western Hub, were created to provide a vehicle for market participants to engage in forward trades of a regional product. Rather that representing a generation or load bus, the Western Hub is made up of an amalgamation of 109 busses from Erie, PA to Washington, DC. A PJM Western Hub IBT typically takes the form of a fixed price forward sale from Party A to Party B of a set block of power (i.e. 50 MWs). When delivery is to occur, the parties eschedule the transaction as an IBT in which Party A sources power from the PJM market and sells/delivers the power to Party B that sinks the power in the PJM market. The sale/delivery occurs at the Western Hub. The propriety of such a transaction is now questionable. In its order, FERC clarified Section 1.7.10 in a manner that appears to have rendered Western Hub trades such as that described above non-compliant. In its order, the Commission stated:

Section 1.7.10 of the Tariff currently"¦ provides that "[i]n addition to transactions in the PJM Interchange Energy Market, Market Participants may enter into bilateral contracts for the purchase or sale of electric energy to or from each other or any other entity"¦Such bilateral contracts shall be for the physical transfer of energy to or from a Market Participant and shall be reported to and coordinated with the Office of the Interconnection"¦." Furthermore, "[b]ilateral contracts that do not contemplate the physical transfer of energy to or from a Market Participant are not subject to this Schedule, shall not be reported to and coordinated with the Office of the Interconnection, and shall not in any way constitute a transaction in the PJM Interchange Energy Market."

To understand section 1.7.10's physicality requirement, we must examine the reason for deviation charges and why some market participants are not required to pay them. Deviations between day-ahead INCs and DECs and real-time generation and load create imbalances that are subject to deviation charges. As PJM explains, when a sale or purchase is cleared in the day-ahead market and generation or load does not materialize in real-time, costs are incurred by PJM to reconcile the differences (imbalances or deviations). For example, such imbalances or deviations can cause PJM to incur the cost of requesting resources in real-time to start-up, ramp-down, ramp-up, or extend run times on schedules that deviate from the schedules or levels cleared in the day-ahead market. The Commission has held that it is appropriate for all market participants with real-time deviations or imbalances from their day-ahead positions to be assessed deviation charges to cover these costs.

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Thus, while the phrases "for the physical transfer of energy"� or "contemplate the physical transfer of energy"� are not defined elsewhere in the Tariff, we find that these phrases indicate that, to be properly reported under section 1.7.10, the IBTs must have the potential for a physical transfer of energy to offset the deviation created by transactions in the day-ahead market. The potential to provide such energy via an IBT is the basis for not charging such market participants deviation charges under section 1.7.10. The meaning of section 1.7.10 is discernable when viewed in the context of the reasons for deviation charges and for permitting them to be avoided.[2]

Therefore, FERC's order appears to hold that a "PJM Western Hub"� transaction can no longer qualify as IBTs as "the potential for a physical transfer of energy to offset the deviation created by transactions in the day-ahead market"� is not present in FERC's view in these transactions. While these transactions are physical since the buyer and seller are transacting in physical power purchased from and sold to PJM Settlement, they do not appear to meet FERC's newly announced deviation-based physicality test. This holding has significant ramifications since, as DC Energy reported in its FERC pleadings, the Commission's EQR data show that for the second quarter of 2011 alone, there were 473 participants that traded 116,247,968 MWh as "physical"� IBTs in the PJM market[3] (the vast majority of which were Western Hub IBTs). FERC's holding may have significant ramifications for the power markets. Given the manner in which RTO markets operate, the only vehicle to undertake bilateral transactions within the borders of an RTO is an IBT (or the equivalent in non PJM RTOs). If entire classes of transitions are eliminated by FERC, then the market for forward contracts in RTOs may be severely constrained in scope and parties may have no option but to use swaps for forward transactions. As the notional quantity of swaps in a market participant's book may be determinative of whether that entity is a Swap Dealer under the Dodd-Frank Act, the more power sellers are required to utilize swaps rather than forwards, for forward transactions, the more potential regulatory concerns emerge. FERC's order is subject to rehearing. It is unclear at this time whether PJM will cease accepting Western Hub IBTs. ______________________________ [1] *DC Energy, LLC et al. v. PJM Interconnection, L.L.C.,* 138 FERC ¶ 61,165 (2012). (*DC Energy*). [2]*DC Energy* at P. 63-64, 66. [3]*DC Energy* Answer at pp 19-20.