

INSIGHTS

Internal Bilateral Transactions: Regulatory Risk & Confusion Reign

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Internal Bilateral Transactions (IBTs) are bilateral transactions occurring between market participants within a Regional Transmission Organization (RTO) market. While these transactions have differing names in various RTOs (*IBTs* in PJM, ISO-NE, and NYISO; *Financial Schedules* in MISO; *Inter-SC Trades* in CAISO; and *Capacity/Energy Trades between QSEs* in ERCOT), they all have similar characteristics. That is, they are bilateral power transactions transacted entirely within a nodal market. Given the characteristics of nodal market design, these transactions are the only way that market participants can undertake a forward bilateral forward purchase and sale of power within such a market. While these transactions have been commonplace for years, recent developments are raising questions about their validity and jurisdictional grounding.

The DC Energy Complaint Against PJM

In deciding a complaint filed by DC Energy against PJM for finding IBTs DC Energy had entered into with its affiliate were not compliant with the PJM Tariff, FERC issued an order that appears to significantly limit the scope of permissible IBTs.¹ FERC's order implies that, for IBTs to be compliant, the power sold must be a part of the physical dispatch of the system.² This "physicality" requirement is inconsistent with the manner in which IBTs actually function in the PJM *eSchedule* system; does not recognize that IBTs are not and cannot be a part of the dispatch process, but can be *eScheduled* as many as three days after flow date; and would invalidate the vast majority of IBTs, which are *eScheduled* at a trading hub with the hub acting as both the source and sink.

After the FERC order was issued, PJM initially stated that it would provide guidance to market participants as to IBT acceptability. But PJM has not done so. Instead, it has instructed market participants to consult the *DC Energy Order* and their legal counsel. However, PJM has told FERC, in reply to DC Energy's Request for Rehearing, that:

A validly reportable physical IBT . . . requires a physical entity [physically generating/consuming the power] in the transaction chain. For example, a load serving entity may purchase physical power via an IBT with a trader like DC Energy at the Western Hub and then deliver the purchased power to its load elsewhere on the system via its network transmission service. The load-serving entity in this example might pay a fee or premium to the trader as consideration for taking the Western Hub price fluctuation risk. The trader would purchase the power from the market to fill its IBT obligation and transfer title to the load serving entity at the Western

Hub.³

Therefore, power both sourced and delivered at hub that is "not deliver[ed] . . . to . . . load elsewhere on the system via its network transmission service" could be non-compliant. The majority of hub transactions (which originate and end at the hub) in PJM appear non-compliant according to this construct. According to PJM, such transactions are "swaps or other financial transactions."⁴

Given that FERC has referred DC Energy's IBTs to its Office of Enforcement⁵ and PJM has indirectly informed market participants that traditional hub trades are potentially non-compliant (while directing those who ask for clarification to consult counsel), continued *eScheduling* of IBTs in PJM without ensuring that they meet the new and much more limited eligibility could result in either a retroactive finding of non-compliance (as occurred in *DC Energy*), FERC Enforcement review, or both. However, notwithstanding the both language FERC's order and PJM's response to DC Energy's rehearing request, both appear to have taken a view, as of this time, that only the three entities referenced in the DC Energy matter have violated the physicality test in the tariff.

A FERC order on rehearing as well as further clarification from PJM, could provide needed clarity to market participants regarding acceptable IBTs.

ISO-NE, CAISO, and Filings at the CFTC

As noted above, PJM has referred to IBTs as "swaps" or "financial transactions." This characterization gives rise to significant jurisdictional issues. Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), both power swaps and the platforms upon which they trade are pervasively regulated by the CFTC. In February 2012, the various RTOs filed a request with the CFTC under Section 4(c) of the Commodity Exchange Act to obtain a "public interest exemption" for specified products traded in their markets that are subject to FERC regulation.⁶ IBTs were not included within the scope of this request.

Since then, ISO-NE has amended its filing seeking to include IBTs in its request for exemption. ISO-NE characterized IBTs in the following way:

[T]ypical uses of IBT transactions (like Financial Transmission Rights (FTRs)) are integrated with the operation of the ISO in their mission to provide electricity to the wholesale power markets within their respective service areas. The ISO accepts these transactions for clearing using similar mechanics historically used by the futures markets to bridge the cash and futures markets—the Exchange of Derivatives for Related Positions (ERDPs).

Under an IBT transaction, two parties to a contract for the purchase and sale of electricity agree to submit a bilaterally negotiated off-market obligation (Related Transaction) to the ISO for clearance and settlement at an ISO-market determined price through the creation or exchange of a related market position (ISO Position). One party is a buyer of the off-market Related Transaction and the seller of an ISO Position, and the other party a seller of the off-market Related Transaction and a buyer of an ISO position. As will be provided under the ISO's amended Tariff, the term "Related Transaction" is a spot, forward or derivatives contract that contemplates the transfer of energy or a MW obligation to or from a Market Participant. And, the ISO Position may be any obligation that can be entered into on the markets administered by

the ISO based on openly and competitively determined Day-Ahead, Real-Time, Ancillary Services, or Forward Capacity market prices.⁷

The CAISO is in the process of preparing its own CFTC filing to seek that Inter-SC Trades receive an exemption from CFTC jurisdiction.⁸

Where Are We?

The convergence of all of the foregoing creates significant ambiguity and risk for market participants.

- **Can IBTs be validly scheduled in RTOs?**

Until PJM's actions and FERC's *DC Energy Order*, the answer was a clear "Yes." IBTs were viewed as bilateral FERC-jurisdictional energy transactions. We now know that, at least in PJM, certain bilateral transactions could be non-compliant, with no FERC-jurisdictional non-derivative alternative vehicle available to conduct such transactions.

- **Are IBTs "Swaps"?**

While we do not yet have a definition of "swap" from the CFTC, we know that PJM has stated that transactions that have been conducted as IBTs are swaps. We have not heard from all of the other RTOs, but ISO-NE and CASIO are evidently concerned enough to amend their CFTC exemption requests to include IBT and IBT-equivalent transactions.

- **What IF IBTs "Are Swaps"?**

The CFTC regulation of swaps under Dodd-Frank is pervasive and, arguably, exclusive.⁹ Swaps must be cleared and exchange-traded unless they are bespoke or subject to an exception. The exchanges on which they trade are CFTC-jurisdictional. Those who trade swaps above a *de minimis* level may be regulated Swap Dealers.

Thus, if IBTs are swaps or they are not exempted pursuant to CEA Section 4(c): (1) they may not be FERC-jurisdictional; (2) the RTOs that include them in their markets may be CFTC-jurisdictional; and (3) the entities that trade IBTs may be Swap Dealers under Dodd-Frank.

This issue, until very recently, has flown beneath the radar screen. At this time, there are three differing approaches taken by the various RTOs:

- PJM appears to have acted to limit the scope of acceptable IBTs, creating ambiguity and risk for market participants;
- ISO-NE and CAISO are working to insure that IBTs and Inter-SC trades can continue to exist as they do today in their market design without limitation as to scope and without regulatory ambiguity; and
- MISO, NYISO and ERCOT have not taken any action.

As the CFTC continues to move forward to implement its Dodd-Frank swap market regulatory authority, it is important that this issue is resolved without ambiguity. If the scope of IBTs is significantly limited or they are found to be CFTC-jurisdictional swaps (or both), it is clear that there will be material impacts on today's bilateral forward market for power in RTOs and that

there will be a jurisdictional shift from FERC to the CFTC.

¹ *DC Energy, et al. vs. PJM Interconnection, L.L.C.*, 138 FERC ¶ 61,165 (2012) (“DC Energy Order”).

² *Id.* at PP 66-67.

³ *DC Energy, et al. vs. PJM Interconnection, L.L.C.*, Docket No. EL12-8-001 Answer of PJM Interconnection, L.L.C. to Request for Rehearing (Apr. 24, 2012) at 9-10.

⁴ *Id.* at 11.

⁵ *DC Energy Order* at n.156.

⁶ *Cal. Indep. Sys. Op. Corp., et al., Application for Exemptive Order Under Section 4(c) of the CEA* (Feb. 7, 2012).

⁷ *ISO New England Inc., In the Matter of the Application for Exemptive Order Under Section 4(c) of the CEA* (Apr. 30, 2012) at 5.

⁸ *Draft Final Proposal – Exempting Inter-SC Trades from CFTC Jurisdiction*, Cal. Indep. Sys. Op. Corp. (May 11, 2012), available at http://www.aiso.com/Documents/Exempting%20Inter-SCTrades_CFTCJurisdictionDraftFinalProposal-Call05_18_12.htm.

⁹ The CFTC has taken the position that it, not the FERC, has exclusive jurisdiction over the regulation of futures markets, and the manipulation thereof, and, by extension, the regulation of swaps markets and the manipulation thereof. See *CFTC filing dated April 25, 2012 in Brian Hunter v. FERC*, No. 11-1236 (D.C. Cir. filed June 20, 2011); *Brian Hunter*, 135 FERC ¶ 61,054 (2011), *reh'g denied* 137 FERC ¶ 61,146 (2011).