124 FERC ¶ 61,295
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Joseph T. Kelliher, Chairman;
Suedeen G. Kelly, Marc Spitzer,
Philip D. Moeller, and Jon Wellinghoff.

DC Energy, LLC Docket No. EL07-67-000

v.

H.Q. Energy Services (U.S.), Inc.

ORDER DENYING COMPLAINT

(Issued September 29, 2008)

1. On June 11, 2007, as amended on June 22, 2007, DC Energy, LLC (DC Energy) filed a complaint against H.Q. Energy Services (U.S.), Inc. (H.Q. Energy), alleging that H.Q. Energy violated the Commission's prohibition of market manipulation, 18 C.F.R. § 1c.2 (2008), by exercising market power to unlawfully affect congestion and energy pricing in the New York Independent System Operator, Inc. (NYISO) energy and Transmission Congestion Credit (TCC) markets. In its September 26, 2007 Order,[1] the Commission directed its Office of Enforcement (OE) to conduct an investigation under 18 C.F.R. § 1b.5 (2008). The Commission directed OE to report its findings to the Commission at the conclusion of its investigation. OE has completed its investigation and, in its report made a part of the record of this proceeding, OE reports that it found no market manipulation in violation of section 1c.2.

2. For DC Energy's complaint of market manipulation to succeed, three elements must be shown: (1) scheme or artifice to defraud, (2) made with scienter, and (3) in connection with a transaction subject to the jurisdiction of the Commission.[2] DC Energy's claims do not rise to the level of a violation of 18 C.F.R. § 1c.2 because DC

[1] *DC Energy, LLC v. H.Q. Energy Services (U.S.) Inc.*, 120 FERC ¶ 61,281 (2007).

[2] 18 C.F.R. § 1c.2 (2008); *Prohibition of Energy Market Manipulation*, Order No. 670, FERC Stats. & Regs. ¶ 31,202, at P 49, 52–53, *reh'g denied*, 114 FERC ¶ 61,300 (2006).

Energy provided, and OE found, no evidence that HQ Energy's NYISO energy and TCC market transactions constituted a scheme or artifice to defraud made with the requisite scienter.[3] As a result, we will take no further action on DC Energy's allegations of market manipulation against HQ Energy. Accordingly, we will terminate the investigation and deny DC Energy's complaint.

The Commission orders:

DC Energy's complaint in this proceeding is hereby denied.

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.

[3] OE September 2008 Report at 3-4, 15-24.

ATTACHMENT 1

FEDERAL ENERGY REGULATORY COMMISSION

Non-Public Investigation into DC Energy's Allegations of Market Manipulation by HQ Energy in the New York Independent System Operator Energy and Transmission Congestion Contract Markets

Enforcement Staff Report

Office of Enforcement
Division of Investigations

I. Executive Summary

On June 11, 2007, and as amended on June 22, 2007, DC Energy, LLC (DC Energy), a privately-held financial trading firm, filed a complaint pursuant to sections 206 and 222 of the Federal Power Act (FPA) and Rule 206 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.206, against HQ Energy Services (U.S.), Inc. (HQ Energy), alleging that HQ Energy violated the Commission's prohibition of market manipulation, 18 C.F.R. § 1c.2, by *inter alia* exercising its market power to unlawfully affect congestion and energy pricing at the interface between the HQ Proxy Node and the NYISO Control Area. More specifically, DC Energy alleges that HQ Energy engaged in a manipulative scheme that involved coordinated actions in the New York Independent System Operator, Inc. (NYISO) energy and Transmission Congestion Contract (TCC) markets designed to leverage its market power to affect congestion and, as a result, the value of TCCs.[4] In the amendment to its complaint, DC Energy adds a claim of predatory pricing – that is, that HQ Energy purchased substantial amounts of energy off-peak for delivery from the NYISO at prices that were substantially higher than the prices at which HQ Energy sold energy on-peak into the NYISO market on the same days.

DC Energy states that it lost approximately $2 million for the period May 1 through June 9, 2007 as a result of HQ Energy's alleged misconduct. DC Energy seeks compensation for its losses and penalties for HQ Energy's alleged violations.

HQ Energy denies engaging in predatory pricing and manipulating the NYISO TCC and energy markets and explains that, during the time period addressed in the complaint, HQ Energy had a large physical position and, to hedge its "long" position, it increased its forward sales into New York and elsewhere. Beginning in 2006, HQ Energy states that it began buying TCCs to hedge congestion on the anticipated increase in imports into New York in 2007. HQ Energy states that having put these hedges in place, it made changes to its energy bidding strategy to reflect its hedged position.

Upon review of the pleadings of DC Energy and HQ Energy, on September 26, 2007,[5] the Commission determined that it did not have sufficient information to grant or

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[4] A TCC is the NYISO's version of a financial transmission right or FTR. A TCC is a financial instrument used by market participants to hedge the risk and cost associated with transmission congestion. Buyers of TCCs are paid by the seller congestion rents from one location in NYISO, the point of injection, to another location in NYISO, the point of withdrawal. The congestion rent approximates the excess of the power price in the day-ahead market at the point of withdrawal over the point of injection. The terms of a TCC vary from one month to one year, and are traded at NYISO-organized auctions.

[5] *DC Energy, LLC v. H.Q. Energy Services (U.S.) Inc.*, 120 FERC ¶ 61,281 (continued)

deny the complaint and directed the Office of Enforcement (OE) to conduct an investigation under 18 C.F.R. § 1b.5 (2008). The Commission directed OE staff to report its investigative findings to the Commission upon completion of the investigation. The instant report is being submitted to the Commission in response to that direction.[6]

For DC Energy's complaint of market manipulation to succeed, three elements must be shown: (1) a fraudulent device, scheme or artifice, (2) made with scienter, and (3) in connection with a transaction subject to the jurisdiction of the Commission.

As to the first element, the facts do not support a finding that HQ Energy employed a fraudulent device, scheme or artifice. To the contrary, the facts discovered by staff during the course of our investigation support HQ Energy's arguments that it had legitimate reasons for using TCCs to hedge against the risk (and cost) of congestion resulting from HQ Energy's increased sales of hydro-generated power into NYISO.

DC Energy contends that HQ Energy historically would offer energy at a price that is estimated to be slightly below the anticipated NYISO Reference price, a byproduct of which was minimal congestion between the HQ Proxy Node or "Zone M" and the NYISO control area. DC Energy alleges that this minimal congestion enabled HQ Energy to acquire TCCs cheaply. After HQ Energy acquired the cheap TCCs, DC Energy alleges HQ Energy changed its bidding strategy, selling power into NYISO as a price-taker and capitalizing on the TCC congestion rents DC Energy had to pay (because DC Energy held TCCs flowing the opposite direction from the TCCs held by HQ Energy). Importantly, there is no allegation by DC Energy that the auctions at which HQ Energy bought TCCs were in any way touched by fraud. Rather, DC Energy's complaint questions the legitimacy of HQ Energy's change in energy bidding strategies.

The facts gathered in discovery support HQ Energy's two main reasons for the change in its business strategy: (1) improved hydro conditions, and (2) increased competition at Zone M.

Hydro-Quebec's load-serving function is operated by Hydro-Quebec Distribution (HQD) and its generation and origination functions are operated by Hydro-Quebec Production (HQP). HQ Energy is the marketing arm of HQP in the United States. For 2007, HQP's reservoir levels increased, which meant HQ Energy anticipated 9 TWh of

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(2007).

[6] If the Commission decides to make this report public, nothing should be construed to release any other documents or information obtained during the course of this investigation.

net export sales in 2007, excluding long-term contracts, an increase from 6.7 TWh in 2005. To hedge its exports, HQ Energy entered into bilateral forward contracts to financially cover approximately 30 percent of its projected 2007 net sales. This resulted in a significant quantity of "must flow" transactions for the upcoming 2007 year. As a result, HQ Energy commenced buying TCCs in 2006 as a hedge to manage the risk of congestion between Zone M and the NYISO Control Area.

In November 2003, only one entity other than HQ Energy bought transmission at Zone M. In November 2005, however, four entities in addition to HQ Energy, including Powerex, sought transmission at Zone M. In February 2007, the Régie de l'énergie du Québec (Regie or Canadian authorities) required HQD to sell 600 MW via a competitive process. HQ Energy concluded that this development would increase further the competition for transmission into NYISO at Zone M. Accordingly, HQ Energy sought to expand its TCC holdings to further hedge its congestion risk associated with this increased potential for competition. The decision of the Regie was made public to all market participants at the same time; HQ Energy had no advance notice of the fact that export volumes from Quebec to NYISO might increase by as much as 600 MW.

DC Energy's further allegation that HQ Energy engaged in predatory pricing by selling power below its "opportunity cost" to maximize the return on its TCCs by creating congestion does not withstand scrutiny. Staff found no evidence that HQ Energy was selling its energy below cost. Rather, HQ Energy was offering energy at its marginal cost, which for a hydroelectric facility can be low in relation to the marginal costs of gas or coal facilities. Even if HQ Energy had been selling below cost, however, the structure of the NYISO market would make it difficult for HQ Energy to later demand monopoly rents as one would expect to see in a scheme of "predatory pricing." This is so because, as confirmed by NYISO's Independent Market Monitor, Dr. David Patton, HQ Energy does not have market power at the NYISO Reference Bus, which means it would be unable to raise prices paid by consumers in New York. The NYISO market, by way of Locational Based Marginal Pricing, operates under a Commission-approved structure whereby market participants are encouraged but are not required to bid their marginal cost of production – that is, to be price-takers.

As to the second element, scienter, staff found no direct or circumstantial evidence demonstrating intent to defraud by HQ Energy. Here too the documents reviewed by staff, as well as the testimony of key HQ Energy personnel, support HQ Energy's position that it had a legitimate business purpose for conducting its business as it did.

Without evidence of intent to defraud, the fact that HQ Energy's price-taker bids in the energy market affected the obligations of holders of TCCs is both known and unsurprising. Further, the relationship between the NYISO energy and TCC markets necessarily contemplates market participants purchasing TCCs to hedge the risk of congestion that may result from price-taker bids.

As to the final element, it is not in dispute that HQ Energy's NYISO energy and TCC market transactions are subject to the jurisdiction of the Commission; however, as mentioned above, staff found no fraudulent device or intent to defraud in connection with those transactions.

In this report, staff provides details of HQ Energy's bidding strategies, the allegedly offending transactions, and the relevant mechanics of the NYISO energy and TCC markets that lead to only one conclusion: HQ Energy did not perpetrate a fraud in connection with its NYISO energy and TCC transactions. Rather, DC Energy speculated unsuccessfully on the TCCs it purchased. For an up-front payment from the NYISO of approximately $114,000, DC Energy acquired TCCs that obligated DC Energy to pay for congestion on imports from Quebec into New York. DC Energy speculated that HQ Energy would continue its historical practice of price-discovery bidding and that there would be no congestion, which meant it would not have to pay congestion charges. There was no obligation on HQ Energy's part to continue its prior bidding practice, and DC Energy took a calculated risk in making its TCC purchases.

Staff recommends this investigation be closed.

II. Background

A. Parties to the Complaint

1. DC Energy

DC Energy, a Delaware limited liability company, operates under a Commission-approved market-based rate tariff and engages in financial transactions in the NYISO energy and TCC markets.[7] According to its website, DC Energy styles itself "a proprietary trading firm that uses a rigorous analytical approach to identify and transact on attractive investment opportunities in the energy markets."[8] In a published interview, Dean Wilde (Managing Director and CEO of DC Energy) said of DC Energy's business, "[p]ower generation plants are connected to demand pockets through a transmission grid, and just like a traffic jam during rush hour, this grid frequently becomes congested, causing large price differentials between different locations at any point in time. People buying and selling power would like to hedge these risks, and they would like prices driven lower by competing suppliers. This is where DC Energy fits in. We make a

[7] DC Energy June 10, 2007 Complaint at p. 7.

[8] http://www.dc-energy.com/about_us.html (last visited July 2, 2008).

market in these power price differentials, providing a significant amount of the total market liquidity. We take on congestion and power price risk so others can hedge. . . . [W]e sustain ourselves by buying low and selling high – easier said than done in these volatile and complex markets."[9]

2. HQ Energy

HQ Energy is the marketing arm of HQP in the United States.[10] HQP is a division of Hydro-Quebec (HQ) and is wholly owned by the Government of Quebec. HQP uses hydro power to generate 97% of its output and manages a generation portfolio of more than 41,000 MW, much of which is equipped with annual/intra-year and multi-year storage capacity in the form of reservoirs. HQ Energy operates under Commission-approved market-based rate authority in the Regional Transmission Organization (RTO) and Independent System Operator (ISO) markets in the United States, primarily the NYISO, ISO New England (ISO-NE), and PJM Interconnection, L.L.C. (PJM). Because of the magnitude and flexibility of HQP's hydroelectric system, HQP can offer significant exports into NYISO after satisfying Quebec's native load.

B. NYISO Electric Energy and TCC Markets

1. NYISO Electric Energy Market

As relevant here, within the NYISO energy markets, the source (or sink) of power transmissions from (or to) Quebec are represented by a Proxy Generator Bus designated as the HQ Proxy Bus or Zone M.[11] In NYISO's day-ahead market, HQ Energy and others offer to sell power from Quebec for export to New York and bid to buy power out of New York for import to Quebec. From Quebec, power flows to Zone M along a high-voltage, high-capacity line ending at Marcy, NY or Zone E (NYISO Reference Bus).[12] While facilities located in Quebec are capable of transmitting as much as 1800 MW into New York, on a day-ahead basis exports to New York are constrained by a maximum capacity limit of 1500 MW at anytime.

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[9] Brian Kozlowski, *Meeting Dean Wilde: CEO of DC Energy*, Harv. Col. Investment Magazine, Winter 2005, at pp. 34, 35.

[10] HQ Energy July 23, 2007 Answer at p. 1.

[11] Affidavit of Mr. Normand Lamothe, July 23, 2007, Exh. No. HQ-2, ("Lamothe Aff.") at ¶ 8.

[12] *See* Appendix B for maps depicting the biddable locations (zones, external proxy nodes, and generator nodes) in NYISO.

NYISO uses Locational Based Marginal Pricing (LBMP) to manage congestion. The LBMP at any point in NYISO reflects three components: (1) the energy component; (2) a loss component; and, (3) a congestion component. The energy component is the locational price of energy at Zone E or the NYISO Reference Bus located at Marcy, NY. The loss and congestion components are set to zero at the NYISO Reference Bus, and for the rest of the NYISO system, the loss and congestion components are calculated in relation to the NYISO Reference Bus. Put another way, when the congestion component at a particular point is zero, the LBMP at that point is equal to the LBMP at the NYISO Reference Bus, save transmission losses. When there is congestion between two points, the LBMPs at those points diverge.

LBMPs are determined for eleven in-state zones and four neighboring areas, including Zone M. Because transmission line congestion is modeled in the day-ahead market and can cause significant differences in prices among the fifteen zones, market participants may acquire TCCs in NYISO-organized auctions to help manage the risk of congestion.

2. NYISO TCC Market

TCCs are financial instruments that allow their holder to receive, or obligate them to pay, the difference in price between two nodes: a source and a sink. A holder of a TCC with source A and sink B will be paid the difference in price between A and B if A's price falls below B's. Conversely, the holder would be obligated to pay the difference in price if A's price rose above B's. In other words, a TCC is designed to provide payments that substantially match and offset the difference in price between two nodes. As such, TCCs are financial instruments designed to allow power providers to hedge against the possibility of congestion on their supply paths. Non-producers may speculate on TCCs.

Auctions are NYISO's primary means of allocating and pricing TCCs. NYISO conducts two main auctions for TCCs, one in the spring and one in the fall. TCCs of six months and one year duration are offered in the auctions. During these periods, auctions allow TCC holders to sell monthly subsets of their TCCs. Each auction consists of a series of sub-auctions in which TCCs of a single month's duration are sold. Each sub-auction is then divided into two stages and each stage may have multiple rounds. [13]

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[13] Transmission Congestion Contracts Manual. NYISO, Manual 3, *Transmission Congestion Contracts ManualVersion 1.3* (2007), available at http://nyiso.com/public/products/tcc/manual.jsp at 2-1 to 3-18 (last visited May 29, 2008).

Auctions are transparent in that participants submit their first bids and then, between rounds, are able to see the source and sink for each TCC awarded, the total number of TCCs purchased, the market clearing price ($/MW), and nodal marginal prices (in $/MW) at each place where NYISO calculates an LBMP. Therefore, it is possible for market participants, for example, to gauge interest in particular TCCs before an auction is complete. After the auction is complete, NYISO will finalize TCC awards and, between the last day of the auction period and the first day of the effective period, will post the identity of the purchasing and selling market participants.[14]

C. Applicable Law

The Commission's prohibition of electric energy market manipulation, 18 C.F.R. § 1c.2, prohibits an entity from: (1) using a fraudulent device, scheme or artifice, or engaging in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity; (2) with the requisite scienter; (3) in connection with the purchase or sale of electric energy or transmission subject to the jurisdiction of the Commission.[15]

The Commission, in Order No. 670, defined fraud generally "to include any action, transaction, or conspiracy for the purpose of impairing, obstructing or defeating a well-functioning market. Fraud is a question of fact that is to be determined by all the circumstances of a case."[16] Fraudulent behavior is often distinguished from legitimate behavior by the scienter behind the behavior in question.[17]

In its order rescinding Market Behavior Rule 2, the Commission further discussed Part 1c and clarified that:

> the intent behind and rationale for actions taken by an entity will be examined and taken into consideration as part of determining whether the

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[14] *Id.*

[15] *Prohibition of Energy Market Manipulation*, Order No. 670, 71 *Fed. Reg*. 4244 (Jan. 26, 2006), FERC Stats. & Regs. ¶ 31,202, 114 FERC ¶ 61,047 (Jan. 19, 2006) (Order No. 670).

[16] *Id*. at P 50.

[17] *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 114 FERC ¶ 61,165, at P 29 (Rescission Order), *reh'g denied*, 115 FERC ¶ 61,053 (2006).

> actions were manipulative behavior. The reasons given by an entity for its actions are part of the overall facts and circumstances that will be weighed in deciding whether a violation of the new anti-manipulation regulation has occurred.[18]

In other words, each case will rely on a determination of all the circumstances concerning the entity's conduct. There are no *per se* violations of Part 1c. Rather, all facts surrounding the conduct must be examined and all of Part 1c's elements must be satisfied. Thus, in this situation, among the factors that staff considered were: (1) whether the actions taken by HQ Energy were explicitly contemplated by the Commission;[19] (2) whether HQ Energy's actions served a legitimate business purpose or were economically rational;[20] (3) whether HQ Energy's NYISO energy and TCC market transactions were fraudulent or deceitful;[21] and (4) whether HQ Energy intended to, or with reckless disregard did, manipulate the NYISO energy and TCC markets.[22] These factors are part of the overall facts and circumstances that we considered to determine whether HQ Energy violated section 1c.2.

D. Scope of Staff's Investigation

Staff investigated DC Energy's allegations that HQ Energy engaged in market manipulation in connection with its NYISO energy and TCC market transactions. As part of the investigation, staff examined HQ Energy's energy bidding behavior, its acquisition of TCCs, and its rationale for changing business strategies with respect to exports of energy into NYISO. Staff reviewed approximately 56,000 pages of internal documents from HQ Energy and deposed both the President and the General Manager of the company.[23] In addition, staff met with personnel of DC Energy in an effort to gather information not in the complaint record. Staff's investigation also made use of the

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[18] *Id*.

[19] *Id*. at P 27.

[20] *Id*. at P 29.

[21] Order No. 670 at PP 49-50.

[22] *Id*. at PP 49, 52-53.

[23] HQ Energy conducts almost all of its business in French, which delayed discovery because of the need for translation to English.

information in the complaint record, including the comments of NYISO (including the affidavit of its market monitor, Dr. David Patton) and other third parties, as well as the affidavits of key HQ Energy personnel, and the affidavits of DC Energy's expert (Dr. Peter Cramton) and HQ Energy's experts (Dr. Roy Shanker and Paul Kevin Wellenius).

III. HQ Energy's NYISO Energy and TCC Market Commercial Strategies

Central to this case is an understanding of the commercial strategies employed by HQ Energy with respect to its NYISO energy and TCC market transactions. To begin, the key considerations in HQ Energy's commercial strategy are three-fold: (1) HQP's contractual commitments to HQD – that is, the power needed to meet HQ's native load obligations; (2) HQP's multi-year water situation, including reservoir levels and water runoff uncertainty; and (3) forecasted market conditions.[24] HQP took these factors into account when publishing its publicly available 2006-2010 Strategic Plan.[25] The Strategic Plan discloses, among other things, HQP's forecast for its "margin of flexibility for managing runoff risk and short-term sales and its uncommitted resources available for long-term sales for the period ranging from 2006-2014."[26]

For purchases and sales of physical energy into and out of the United States, HQ Energy, the marketing arm of HQP, establishes "threshold prices" to buy and sell energy in consideration of physical status reports from HQP and anticipated market conditions. These "threshold prices" are revised on at least a weekly basis to reflect forward market conditions. To hedge its physical positions, HQ Energy makes use of financial tools, such as NYISO's TCCs.

Historically, HQ Energy offered energy in Zone M trying to approximate the NYISO Reference Price. This strategy, known as "price-discovery" bidding, was employed by HQ Energy through early 2007.[27] Under this commercial strategy, substantial blocks of energy are bid at a price that is estimated to be slightly below the anticipated price at the NYISO Reference Bus. If there is no congestion, all such offers will be accepted and the price will equal the NYISO Reference price. If there is congestion, however, the price will be set by the bid for such blocks, which will approximate the NYISO Reference price. Overall, this strategy can be expected to result

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[24] Affidavit of Christian G. Brosseau, July 23, 2007, Exh. No. HQ-1, ("Brosseau Aff.") at ¶ 14.

[25] *Id*. at ¶ 16.

[26] *Id*.

[27] Lamothe Aff. at ¶¶ 14–15.

in little or no congestion. This approach to earning the NYISO Reference price was possible when it was relatively unlikely that other suppliers would bid to sell additional volumes at Zone M. Without competitors, HQ Energy could predict with near certainty how much energy it could offer into NYISO before reaching the 1,500 MW transmission limit into NYISO.[28] Exceeding the 1,500 MW limit would, of course, cause congestion.[29]

HQ Energy asserts that by late 2005, other sellers became active at Zone M.[30] Staff's investigation confirms this fact. As part of our investigation, staff inquired into historical transmission reservation requests from Quebec into New York to test HQ Energy's assertion of increased competition.[31] In November 2003, only one entity other than HQP bought transmission. In November, 2005, however, four entities in addition to HQP, including Powerex, sought to move power into New York. While HQ Energy continued to supply the bulk of power offered at Zone M using its "price-discovery" bidding strategy in late 2005, it did not know how much power would be offered by its competitors, and hence it no longer could predict how much it could offer without causing congestion. Therefore, HQ Energy decided to buy TCCs to hedge the potential congestion risk associated with future exports.[32]

The detailed timeline below provides the HQ Energy power and TCC market transactions that relate to DC Energy's complaint (with citations to the investigative record). The detail is important because it shows that contrary to DC Energy's allegations, TCCs have been a long-standing and integral component of HQ Energy's business under both the "price-discovery" and "hedged" bidding strategies.

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[28] As discussed *infra*, HQ Energy's transactions at Zone M do not affect the price of power in New York generally. 1500 MW is the physical capacity of the line at any given time.

[29] HQ Energy Answer at p. 11.

[30] *Id*.

[31] Publicly-available transmission data for Zone M is accessible on the TransEnergie Oasis website, http://www.transenergie.com/oasis/hqt/en/entree.htmlx (last visited July 11, 2008). On that site, "yearly logs" of "service requests" are available. These show transmission reservation requests from Quebec (Zone M) into New York. On the yearly spreadsheets, filtered to show only the "HQT-Mass" (TransEnergie to Massena) path, one can examine the parties other than HQP (signified as "HQM" on the spreadsheets) that have sought to transmit into New York from Zone M.

[32] Brosseau Aff. at ¶ 33.

- In February and March 2006, HQ Energy purchased 228 MW (-125 MW and +103 MW) of TCCs in rounds 1 to 5 of the Fall 2006 TCC auction for a net position of 22 MW sinking at Zone M for Summer 2006 and Winter 2006. *See* HQ Energy Answer, Exh. Nos. HQ-22 and HQ-23.

- Throughout 2006, HQ Energy's supply forecast for 2007 anticipated 9 TWh of net sales (excluding long-term contracts). Brosseau Aff. at ¶ 37. Acting to hedge a portion of this high volume, HQ Energy entered into bilateral forward contracts financially to cover approximately 30 percent of its projected 2007 net sales. This resulted in a significant quantity of "must flow" transactions for the upcoming 2007 year. *Id*. at ¶ 38.

- On July 31, 2006, HQ Energy was authorized by HQP to purchase up to 750 MW of TCCs sourced at Zone M in the Fall 2006 TCC auction. *See* Bates Ranges HQ001-0005356 to HQ001-0005357 and HQ002-0000136 to HQ002-0000137 (TCC authorization and analysis documents for purchases of 600 MW and 150 MW).

- In August and September 2006, HQ Energy purchased 417 MW of TCCs sourced at Zone M in rounds 1 to 5 of the Fall 2006 TCC auction for Winter 2006 and Summer 2007 (i.e. 12-month period). *See* HQ Energy Answer, Exh. Nos. HQ-22 and HQ-23.

- On September 12, 2006, HQ Energy was authorized by HQP to purchase 417 MW sinking at Zone M for the Winter 2006 TCCs period only. *See* Bates Range HQ001-0005358 to HQ001-0005360 (TCC Authorization). HQ Energy did so during rounds 6 to 10 of the Fall 2006 TCC auction held between September 18 and October 16, 2006. *See* HQ Energy Answer, Exh. Nos. HQ-22 and HQ-23. These purchases economically offset the 417 MW for Winter 2006 TCCs purchased earlier.

    - At this time, the runoff situation had deteriorated for the near-term and HQP decided to replenish its reservoirs by both importing energy into Quebec and limiting electricity exports. Brosseau Aff. at ¶ 34.

- During 2006 and through early 2007, HQ Energy engaged in price-discovery bidding for its sales of power in the NYISO Day-Ahead Market (DAM) at Zone M. *See* Affidavit of Dr. Roy J. Shanker, July 23, 2007, Docket EL07-67, Exh. No. HQ-3 ("Shanker Aff.") at ¶¶ 56-61.

- On February 7, 2007, the Regie held a hearing on the issue of 600 MW of

excess capacity purchased by HQD from HQP. Brosseau Aff. at ¶ 41.

- Following short-term actions to replenish its reservoirs, HQP's supply forecast for 2007 indicated that a target of 9 TWh of net sales was anticipated (9 TWh represents the ability to sell 9,375 MW per hour for the 960 summer peak period hours). To hedge its anticipated 2007 sales, HQ Energy by the end of 2006 entered into bilateral forward contracts to financially cover approximately 30 percent of its projected 9 TWh in net sales. On February 15, 2007, HQ Energy was authorized by HQP to purchase 632 MW (524 MW + 108 MW) of TCCs sourced at Zone M for Summer 2007 and 312 MW (262 MW + 50 MW) of TCCs sourced at Zone M for Summer 2007 and Winter 2007. *See* Bates Range HQ001-0005362 to HQ001-0005365 (TCC Authorization).

- On February 20, 2007, HQ Energy purchased 136 MW of TCCs sourced at Zone M in round 1 of the Spring 2007 TCC auction for Summer 2007 and Winter 2007. *See* HQ Energy Answer, Exh. No. HQ-22.

- On February 26, 2007, HQ Energy purchased an additional 136 MW of TCCs sourced at Zone M in round 2 of the Spring 2007 TCC auction for Summer 2007 and Winter 2007. *See* HQ Energy Answer, Exh. No. HQ-22.

- Also on February 26, 2007, the Regie issued a public order requiring HQD to resell the excess supply through a RFP process. Brosseau Aff. at ¶¶ 42-43; Bates Range HQ002-0002722 to HQ002-0002741. HQ Energy concluded that this new development probably would increase exports to Zone M, and sought to expand its TCC holdings to further hedge its congestion risk. *See* Brosseau Aff. at ¶ 46; Lamothe Aff. at ¶¶ 9-11; *see also* HQ Energy Answer, Exh. No. HQ-23 (detailing HQ Energy's TCC purchases in 2007).

- On March 5, 2007, HQ Energy was authorized by HQP to purchase 138 MW of TCCs sourced at Zone M for Summer 2007 and Winter 2007. *See* Bates Number HQ001-0005366 (TCC Authorization).

- On that same day, HQ Energy purchased 129 MW of TCCs sourced at Zone M in round 3 of the Spring 2007 TCC auction for Summer 2007 and Winter 2007. *See* HQ Energy Answer, Exh. Nos. HQ-22 and HQ-23.

- On March 7, 2007, HQ Energy was authorized by HQP to purchase up to 1,200 MW of TCCs sourced at Zone M for April 2007. *See* Bates Range HQ001-0005367 to HQ001-0005368 (TCC Authorization for 800 MW and

400 MW).

- On March 12, 2007, HQ Energy purchased 789 MW of TCCs sourced at Zone M in the April 2007 TCC reconfiguration auction for April 2007. *See* HQ Energy Answer, Exh. Nos. HQ-22 and HQ-23.

- On March 19, 2007, HQ Energy purchased 227 MW of TCCs sourced at Zone M in round 4 of the Spring 2007 TCC auction for Summer 2007. *See* HQ Energy Answer, Exh. Nos. HQ-22 and HQ-23.

- On March 26, 2007, HQ Energy purchased 242 MW of TCCs sourced at Zone M in round 5 of the Spring 2007 TCC auction for Summer 2007. *See* HQ Energy Answer, Exh. Nos. HQ-22 and HQ-23.

- Beginning in April 2007, HQ Energy adopted what is referred to as "a hedged-bidding" strategy by Dr. Shanker. *See* HQ Energy Answer, Shanker Aff. at ¶ 17. Energy surpluses were made available for HQ Energy sales due to the substantially improved hydraulic conditions on the HQP system. *See* Brosseau Aff. at ¶¶ 36-40. Accordingly, HQ Energy increased its volumes of forward bilateral contracts for on-peak exports from Quebec to New York. *See* Lamothe Aff. at ¶¶ 14-15.

- On April 2, 2007, HQ Energy purchased 213 MW of TCCs source at Zone M in round 6 of the Spring 2007 TCC auction for Summer 2007. *See* HQ Energy Answer, Exh. Nos. HQ-22 and HQ-23.

- On April 3, 2007, HQ Energy amended its February 15, 2007, TCC authorization of 524 MW to increase the amount by 10 MW for a total of 534 MW. *See* Bates Number HQ001-0005369 (TCC Authorization).

- Also on April 3, 2007, HQ Energy amended its February 15, 2007, TCC authorization of 108 MW to increase the amount by 43 MW for a total of 151 MW. *See* Bates Number HQ001-0005370 (TCC Authorization).

- On April 16, 2007, HQ Energy further amended its April 3, 2007, authorization of 151 MW to allow the purchase of these TCCs sourced at Zone M through the monthly auctions. *See* Bates Number HQ001-0005371 (TCC Authorization).

- As a result, for April 2007, HQ Energy's net TCC position established by these purchases was 770 MW sourced at Zone M. *See* HQ Energy Answer, Exh. Nos. HQ-22 and HQ-23.

- During Summer 2007, HQ Energy's net TCC position established by these purchases was 1,500 MW sourced at Zone M. *See* HQ Energy Answer, Exh. Nos. HQ-22 and HQ-23.

During the period at issue in DC Energy's complaint, DC Energy held a total of 242 MW of "counterflow" TCCs sourcing at the NYISO Reference Bus (Zone E) and sinking at Zone M. The economic relationship between the TCCs held by HQ Energy and DC Energy can be described under two scenarios:

> Scenario One: Congestion caused the price of energy at the source, Zone M, to be less than the price at the sink, Zone E. Under this scenario, HQ Energy would receive payment from DC Energy equal to the difference in price between Zones M and E.
>
> Scenario Two: Congestion caused the Zone E price to be higher than the Zone M price. Under this scenario, HQ Energy would pay DC Energy the difference in price between the two zones. [33]

IV. Investigative and Legal Analysis

A. 18 C.F.R. § 1c.1

To make out a claim of market manipulation under 18 C.F.R. Part 1c, facts satisfying three elements must be present: (1) a fraudulent device, scheme or artifice, (2) made with scienter, and (3) in connection with a transaction subject to the jurisdiction of the Commission. Staff found no evidence that HQ Energy's NYISO energy and TCC market transactions were a device, scheme or artifice to defraud or that they were entered into with an intent to defraud.

1. Fraudulent device, scheme or artifice; or engaged in any act, practice, or course of business that operates or would operate as a fraud

As to the first element under 18 C.F.R. § 1c.2, the facts do not support a finding that HQ Energy employed a fraudulent device, scheme or artifice, or engaged in an act, practice, or course of business that operated or would operate as a fraud or deceit upon DC Energy or any other market participant. As will be discussed in detail below, HQ

[33] The HQ Proxy Bus, the HQ Proxy Node, and the Chateuguay Interface, may be referred to as Zone M, as they are functionally the same with respect to the charge of market manipulation.

Energy's energy market price-taker bids and reliance on TCCs to hedge the risk of congestion are, in staff's view, legitimate actions or transactions "explicitly contemplated in Commission-approved rules and regulations" of an applicable power market. Such actions do not constitute fraud.[34] HQ Energy's transactions were "explicitly contemplated" because the NYISO market, by way of LBMP, operates under a Commission-approved structure whereby market participants are encouraged, but not required, to bid their marginal cost of production – that is, to be price-takers. The relationship between the NYISO energy and TCC markets necessarily contemplates parties such as HQ Energy purchasing TCCs to hedge the risk of congestion that may result from price-taker bids.

a. DC Energy's Allegations of Fraud by HQ Energy

Based on DC Energy's pleadings, the following four steps summarize DC Energy's allegations of manipulation by HQ Energy:

> Step 1: HQ Energy offers energy in a manner that minimizes congestion at the HQ Proxy Node.
>
> Step 2: HQ Energy purchases large volumes of TCCs, the prices of which are low because of HQ Energy's offer strategy in Step 1.
>
> Step 3: HQ Energy offers energy into NYISO as a price-taker at the HQ Proxy Node (i.e. at an "opportunity cost" loss) and causes congestion.
>
> Step 4: HQ Energy recovers (or over-recovers) losses incurred in Step 3 with TCC payments collected from DC Energy and others, which results in harm to competition.

DC Energy alleges that, as part of HQ Energy's fraudulent scheme, HQ Energy decreased congestion prior to the Spring 2007 TCC auction in order to purchase TCCs more cheaply.[35] DC Energy argues, by analogy to *Energy Trading Partners, L.P.*, 120 FERC ¶ 61,086 at P 41 (2007) ("ETP"),[36] that HQ Energy (1) behaved against its interest in the way it bid energy in the day-ahead market in order to (2) benefit is position in the TCC market (i.e., collecting TCC rents that more than offset any loss in the day-ahead

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[34] Order No. 670 at P 67.

[35] DC Energy Complaint at pp. 3-5.

[36] DC Energy Aug. 16, 2007 Answer at pp. 2-3.

energy market).[37]

As DC Energy concedes in its amended complaint, this alleged scheme is "highly complicated."[38] DC Energy alleges that HQ Energy undertook steps 1 through 4 above with the intent to defraud.

DC Energy also alleges that HQ Energy engaged in "predatory pricing." In support of this allegation, DC Energy claims that "HQ Energy purchased substantial amounts of energy off-peak for delivery in Canada from the NYISO at prices that were substantially higher than the prices at which HQ Energy sold energy on-peak into the NYISO market on the same days."[39] DC Energy argues that HQ Energy's bidding strategy resulted in a "wealth transfer" from suppliers that purchased and resold the energy into the NYISO market to HQ Energy via its TCC position.[40] In so doing, DC Energy concludes that "HQ Energy was able to defraud competitors of a fair market price and extract disproportionately high congestion rents through artificially inflated congestion."[41] As will be discussed below, DC Energy's claim that HQ Energy bought high and sold low in the energy market to benefit its TCC positions is not supported by the facts.

b. HQ Energy Did Not Engage in Fraud

Staff found no evidence that HQ Energy manipulated the NYISO day-ahead market to profit from its TCC holdings. As discussed below, HQ Energy's NYISO energy and TCC transactions are legitimate: it had additional power it wished to sell into NYISO at competitive prices while hedging the risk of congestion attributable to those increased sales and other market forces via TCCs.[42]

Up to late 2005, there was little competition in Zone M, which meant that HQ Energy did not need to rely on TCCs to hedge the risk of congestion there.[43] In 2006, HQ

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[37] *Id.* at pp. 3, 5-8.

[38] DC Energy June 22, 2007 Amended Complaint at p. 2.

[39] *Id*. at p. 3.

[40] *Id*. at p. 15.

[41] *Id*.

[42] HQP Strategic Plan 2006-2010 Backup Data (Bates Range HQ003-0000295-HQ003-0000298); Run Off Reports 2006-7 (Bates Range HQ003-0000730 to HQ003-0000755); HQ Exh. Nos. 10-21.

[43] Authorization to purchase counterflow TCCs, Sept. 12, 2006 (Bates Number

(continued)

Energy bought TCCs in the direction of NYISO, and then reversed their TCC position when it became clear their forecast for the year was incorrect.[44] This is so because in the summer of 2006, the runoff situation had deteriorated unexpectedly and HQP decided to replenish its reservoirs by both importing energy into Quebec and limiting electricity exports.[45]

In April 2007, the 600 MW offered by HQD pursuant to the Regie decision should have made plain to all market participants that the congestion at Zone M may increase because the marketers acquiring the 600 MW may elect to sell that power into NYISO. Acting in response to the risk of increased congestion, and in line with its long-standing plan to export additional power into NYISO, HQ Energy commenced purchasing additional TCCs as a hedge but did not buy them all at once in April 2007.[46] Rather, HQ Energy purchased TCCs incrementally beginning in October 2006. HQ Energy brought its holdings of TCCs up to 1500 MW only after it learned of the Regie's decision, a market development requiring HQD to sell 600 MW and that logically could add to the Zone M to Zone E congestion.

HQ Energy bid energy as a price-taker at Zone M in April 2007. HQ Energy's bids were consistent with the LBMP model employed by NYISO and explicitly contemplated by the Commission. HQ Energy's April 2007 offers did have the effect of increasing congestion from Zone M to the NYISO Reference Bus during peak hours. As a result, the price differential between Zone M and the Reference price also increased during peak hours. As the holder of the other side of some of HQ Energy's TCCs, DC Energy was obligated to pay this price differential (payments estimated by DC Energy of approximately $2 million over the time period covered by its complaint).[47]

HQ002-00000128); Brosseau Aff. at ¶ 5.

[44] Brosseau Aff. at ¶¶ 34-35; HQP Strategic Plan 2006-2010 Backup Data (Bates Range HQ003-0000295 to HQ003-0000298).

[45] Brosseau Aff. at ¶ 34.

[46] TCC authorization and analysis documents (Bates Range HQ001-0005351 to HQ001-0005371); Authorization for hedging transactions 2006 (Bates Range HQ002-0000001 to HQ002-0000058); Authorization for hedging transactions 2007 (Bates Range HQ003-0000775 to HQ003-0000783); Bates Number HQ002-00000128; Brosseau Aff. at ¶ 7.

[47] DC Energy Complaint at p. 5. HQ Energy estimates DC Energy's total payments for its TCCs sinking at Zone M for the period April 1 to June 23 to be $2.66 million. Supplemental Affidavit of Paul Kevin Wellenius, Aug. 31, 2007, Docket EL07-67, Exh. No. HQ-38 ("Wellenius Supp. Aff.") at ¶ 34.

DC Energy's allegation that HQ Energy's price-taker offers are evidence of a manipulative scheme is misplaced. Given the nature of the NYISO LBMP, HQ Energy could expect to receive the clearing price irrespective of the price it offered at Zone M. Thus, in these circumstances, offering power as a price taker is not evidence of acting against one's economic interest, or of manipulation.

Similarly, DC Energy's allegation that HQ Energy undertook economically irrational actions in the NYISO energy market (*i.e.*, exporting energy from NYISO off-peak at prices lower than it sold energy "on-peak," on the same days, so as to benefit its TCC positions) is not established by the facts. There is no evidence that the on-peak sales and off-peak purchases on the same days were related.[48] Further, if HQ Energy had wanted to congest the line to collect TCC revenues, it had ample resources to do so in every hour, something it did not do. In fact, HQ Energy's actual transactions had only a de minimis effect on its TCC portfolio, which supports HQ Energy's arguments that the six days highlighted by DC Energy where HQ Energy exported energy from NYISO off-peak at prices lower than it sold energy "on-peak," were not part of a scheme to manipulate.

The amount HQ Energy offered into the NYISO day-ahead market followed the amount of MWs HQ Energy had to deliver in bilateral contracts.[49] HQP earns the great majority of its revenue from physical sales, not from payments it receives from TCCs. As Christian Brosseau, Vice President, Wholesale Markets, for HQP, put it:

> It is important to realize that by "going physical" with export sales, one would realize, as revenue, the entire amount of the transaction (minus costs); whereas by settling forward bilateral transactions financially, one would only receive the amount of the "spread," if any, between the "hedged" sales price and the cost of buying back said position.[50]

As a physical player, HQ Energy's revenues are calculated by the difference between its cost of production and the price it receives for its power. HQ Energy's financial statements support Brosseau's statements. In the NYISO in 2007, HQ Energy's power sales were roughly ten times that of its income from

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[48] Shanker Aff. at ¶ 43.

[49] HQ Energy delivered on the vast majority (85-100 percent) of its contracts. Brosseau Supp. Aff. at ¶¶ 4-5.

[50] Brosseau Supp. Aff. at ¶ 2.

TCCs, or $247,434,305 from power sales as compared with $21,158,798 from TCCs. Similarly, in 2006, HQ Energy received $5,670,550 in revenue from TCCs, but over $283,088,577 from energy sales.[51]

Next DC Energy alleges that HQ Energy was "over-hedged." Dr. Peter Cramton's affidavit for DC Energy describes HQ Energy as being over-hedged when its TCC quantity is greater than the day-ahead energy offered and scheduled. In Cramton's hypothetical, rather than a one-to-one MW to TCC hedge, there may be circumstances where HQ Energy offers and has scheduled by NYISO less power than its TCC holdings, but other actors at the interface still cause congestion. Under such a circumstance, HQ Energy could theoretically profit from all 1500 MW of TCCs, even if it offers less than 1500 MW of energy into the day-ahead market.[52] DC Energy asserts such "over-hedging" provides the financial leverage and incentive for HQ Energy to increase congestion.

DC Energy's argument ignores the fact that TCCs are bought months in advance of the day-ahead market scheduling.[53] Therefore, when acquired, it is unknowable whether all of the 1500 MW of TCCs will be needed on any given day. As such, HQ Energy acquired a full hedge because it was possible that on any given day, it could sell the 1500 MW into New York. Staff finds nothing unusual about a market participate fully hedging their risk of congestion.

According to HQ Energy's expert, Paul Kevin Wellenius of CRA International, HQ Energy was not "over-hedged" as alleged by DC Energy. Wellenius's analysis shows that HQ Energy's "perfect hedge" quantity would have been 1,266 MW for April; 1,388 MW for May; and 1,585 MW for June 1-23. When compared to HQ Energy's actual TCC holdings, Wellenius' analysis shows that HQ Energy was under-hedged by 39% during April; over-hedged by 8%

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[51] Spreadsheet on Income, Expenses, Profit, and Loss in NYISO for 2007 and 2006, HQ001-0005702-0005705.

[52] Affidavit of Professor Peter Cramton, Aug. 16, 2007, Attachment A to DC Energy Answer at ¶ 10.

[53] *See, e.g.*, TCC Authorization and analysis documents (Bates Range HQ001-0005351 to HQ001-0005371); Authorization for purchase TCCs IESO April 2005 to June 2008 (Bates Range HQ001-0005550 to HQ001-0005553); Authorization to sell UCAP—NY market-2005-08 (Bates Range HQ001-0005567 to HQ001-0005596); Authorization to sell UCAP—NE market-2006-07 (Bates Range HQ001-0005554 to HQ001-0005566); HQD Hedging authorizations (Bates Range HQ003-0000662 to HQ003-0000666).

during May; and under-hedged by 5% for June 1 to 23. And since HQ Energy acquired TCCs covering May and June through multi-month TCCs, Wellenius also calculated the "perfect hedge" quantity for the May 1 to June 23 period (requiring the TCC quantity to be constant). Under this approach, Wellenius determined the "perfect hedge" TCC quantity to be 1,461 MW, meaning HQ Energy was over-hedged during this period by 3%.[54] As can be seen, the facts do not support a claim that HQ Energy perpetrated a fraud by way of "over-hedging."

The final part of DC Energy's alleged manipulative scheme requires other actors, enticed by the high returns of TCCs, to acquire TCCs in the direction of the NYISO Reference Bus. DC Energy then asserts that, once HQ Energy no longer holds TCCs, HQ Energy would revert to its prior behavior pattern of offering enough energy to approximate the Reference price, easing congestion and reducing the TCCs' value.[55] In this way, DC Energy argues, HQ Energy would complete its alleged manipulative scheme. This step in the alleged scheme has no basis in fact; HQ Energy never reverted to "price-discovery" bidding.

c. HQ Energy's Possession of Market Power at Zone M Does Not Equal Market Manipulation Under These Facts

DC Energy alleges that: (1) HQ Energy has market power at Zone M and can dictate the clearing price there at will and (2) HQ Energy used its market power to manipulate the value of TCCs.[56]

HQ Energy disputes that it exercised market power, but argues that, if it had, this alone does not establish manipulation. Staff agrees with this position. There is a difference between engaging in (1) market manipulation in violation of section 1c.2, which includes fraud or deceit as discussed above and (2) a party exercising market power. Of course, an exercise of market power may be a factor to consider in examining whether Part 1c was violated. However, it is not the only relevant factor. Here, however, Enforcement staff found no evidence that HQ Energy's behavior satisfied the elements of a violation of section 1c.2. For instance, Enforcement staff did not find any evidence that HQ Energy engaged in fraud or deception. In addition, Enforcement staff did not find

[54] Wellenius Supp. Aff. at ¶ 26.

[55] DC Energy Answer at pp. 21, 30-31.

[56] *Id.* at p. 18.

any evidence that HQ Energy engaged in any activity that lacked a legitimate business purpose, was not economically rational, or that it possessed the requisite scienter.

DC Energy's first allegation that HQ Energy has market power at Zone M and can dictate the clearing price there at will is not supported by the facts of this case. According to David Patton, any market power that HQ Energy has at Zone M is "effectively similar to the locational market power that a supplier has when its generator is connected to the transmission system by a radial line."[57] According to Patton, the internal prices paid by New York consumers are "not substantially affected" by HQ Energy's activity at Zone M.[58] The prices paid by New York consumers are determined by the marginal cost of supply in New York as a whole, and when power is imported from HQ Energy, it replaces more expensive generation in New York. Therefore, when, as here, HQ Energy acts as a price taker, this would either have no effect or reduce the prices for power paid by New York consumers. This is so because the maximum amount HQ Energy can import or export on any given day is 1500 MW (the physical constraint of the transmission line) yet the total MW supply of installed capacity for NYISO is 43,862 MW. As such, HQ Energy's 1500 MW represents a mere 3.4% of the total installed capacity. In any event, HQ Energy's transactions in the NYISO energy and TCC markets did not raise prices paid by consumers in New York.

Staff also found no evidence to support DC Energy's allegation that HQ Energy used its market power to manipulate the value of TCCs. Unlike the allegation in *ETP*, under these circumstances, HQ Energy did not use a combination of market power and trading activity to act against its economic interest in one market in order to benefit its position in another market by artificially moving the market price.[59] There is no evidence that HQ Energy acted against its economic interest in any market. Rather, the facts of this case show that HQ Energy made price-taker bids and used TCCs to hedge congestion risk in a manner explicitly contemplated by the Commission. Under these facts, HQ Energy did not artificially move the price of energy in NYISO. As discussed *supra*, in this case, any market power HQ Energy has at Zone M did not function to raise the NYISO Reference Price.

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[57] *Comments of the New York Independent System Operator, Inc.*, Docket No. EL07-67 (July 23, 2007), Attachment I: Affidavit of Dr. David Patton at ¶ 17.

[58] *Id.* at ¶ 23.

[59] *Energy Trading Partners, L.P.*, 120 FERC ¶ 61,086 at P 41 (2007).

d. NYISO's TCC Auctions Were Fair

As a general matter, the fact that energy bidding may affect congestion, which in turn may affect the value of TCCs, is known and unsurprising. DC Energy does not allege any fraud in connection with the auctions where it and HQ Energy acquired TCCs. DC Energy's complaint is not that HQ Energy somehow defrauded them in their acquisition of TCCs, but that HQ Energy's bidding affected the value of the TCCs they had already acquired. As discussed above, however, staff does not believe HQ Energy's NYISO energy market bidding operated as a fraud.

Staff's view is that DC Energy took a knowingly speculative trading position on TCCs. HQ Energy did not use or employ a fraudulent device, scheme or artifice in its acquisitions of TCCs.

2. Scienter

As to the second element, staff found no evidence that HQ Energy intended, or acted recklessly, to defeat a well-functioning market. Furthermore, there is no behavior in this case sufficient to raise a strong inference of scienter.[60]

HQ Energy's transactions evidence the conduct staff would expect of a rational actor executing a legitimate commercial strategy. Staff's investigation found no documents from which an intent to manipulate could be inferred. In fact, the documents discovered support HQ Energy's argument that it was not, as DC Energy alleges, engaging in transactions for the purpose of affecting congestion. For example, an e-mail from an HQ Energy trader captures the fact that HQ Energy's traders were instructed to sell power into NYISO, within a threshold price range; the trader was not instructed to sell power into NYISO for the purpose of affecting congestion.

As part of our investigation, staff deposed both Christian Brosseau, President of HQ Energy, and Normand Lamothe, its Director of Trading. Both men were straight-forward in their demeanor and responses to questions, and staff found them to be credible. They viewed TCCs as a hedging tool, and the nearest equivalent to firm transmission in NIYSO.[61] Below (and in Appendix A) are excerpts from the deposition of Brosseau:

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[60] Order No. 670 at P 53 fn. 109.

[61] Brosseau Dep. at pp. 28, 57-58, 70, Jan. 25, 2008; Lamothe Dep. at pp. 11-12, Jan. 25, 2008.

> Q Was it ever HQ's intent to price power in such a way to decrease competition?
> A No.
>
> * * *
>
> Q . . . Did at anytime around April 17th HQUS employ a strategy designed to displace competition?
> A No.
>
> * * *
>
> Q And when you're conceiving [the] hedge bidding strategy, do you consider the TCC revenues?
> A I don't know the revenues ahead of time. The only thing I know with the TCCs is that I will have the equivalent of firm transmission into New York.
>
> Q So you don't count on or expect the revenues that may derive from TCC contracts in your planning?
> A No.[62]

Brosseau and Lamothe stated that they sold most of HQP's power for export into ISO-NE, where transmission entitlements or their financial equivalent, FTRs, are available. According to Brosseau, ISO-NE has "always been [HQ Energy's] primary market in terms of volume and prices."[63] However, around the time covered by DC Energy's complaint, HQ Energy determined that it had more power to export but was unable to purchase additional entitlements into ISO-NE.[64] Therefore, the only other market with "enough depth to accept that kind of volume" was NYISO,[65] and the closest thing to a firm transmission right in NYISO is a TCC.

Far from acting with an intent to defraud, as can be seen in Appendix A, Brosseau's recitation of what was happening at HQ Energy in April 2007 evidences

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[62] Brosseau Dep. at pp. 70, 85.

[63] *Id.* at p. 47.

[64] *Id.*

[65] *Id.* at pp. 47, 49-50.

legitimate business conduct one would expect of a rational market participant.

As mentioned above, HQ Energy uses financial derivatives "almost solely to mitigate price risk and volatility."[66] HQ Energy states that it "does not want to put the revenues generated by market activities at risk."[67] Staff found no evidence that contradicts this statement.

3. In connection with

The NYISO TCC and energy market transactions at issue in this matter are in connection with the purchase or sale of electric energy or transmission of electric energy subject to the jurisdiction of the Commission.[68] However, as discussed above, staff's investigation determined that the first two elements of a claim under 18 C.F.R. § 1c.2 are not satisfied.

VI. Conclusion

Enforcement staff concludes that, based on all the facts and circumstances surrounding HQ Energy's transactions in the NYISO energy and TCC markets, HQ Energy did not violate section 1c.2. In particular, we found: (1) HQ Energy's NYISO energy and TCC markets transactions did not constitute a fraud or fraudulent practice; (2) HQ Energy's change in bidding strategies were legitimate and economically rational considering its improved hydro conditions and the increased competition at Zone M due, in part, to the Canadian authorities decision to require HQD to sell 600 MW via a competitive process. This decision, beyond the control of HQ Energy, increased the likelihood of congestion at Zone M; (3) HQ Energy's energy offers were not motivated by the profit the revenue derived from their TCCs; and (4) HQ Energy did not engage in predatory pricing; rather, HQ Energy bid as a price-taker and employed TCCs to hedge the risk of congestion into NYISO.

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[66] *Id.* at p. 2.

[67] *Id.*

[68] Order No. 670 at P 49.

Appendix A (Brosseau Dep. at pp. 45-48)

Q: Let's talk about the strategy generally in April of 2007. What was going on at HQ at the time?

A: In April 2007, what was going on is, if you allow me to go back a bit in time, just to have a better understanding of what's happening in April, in early January 2007, HQD, the load serving entity in Quebec, was forecasting to be long for the year 2007. And when I say "long," they were forecasting to be long about 4 to 5 [TWh] annually.

And as I mentioned earlier, we have two contracts with the load serving entity, representing roughly 600 megawatt on which they can call on a baseload basis. So that represents approximately 4 to 5 [TWh] also. So the HQD was forecasting to be long.

So they came to us in order to see if it was possible to reach an agreement in order to suspend the deliveries on these contracts for the year 2007. So we had some discussions with the LSE for several days, several weeks, and we have reached an agreement at the end to suspend the deliveries over this contract for a year.

The LSE had to present this agreement to the Regie de l'energie, how do you say that in English, the energy board of Quebec to get final approval to suspend this contract. The Regie did not approve the contract. They said no, we want the LSE to sell back this power into the market. And if my recollection is right, that decision was made toward the end of February 2007.

Therefore, it was clear that the LSE would be long for the balance of the year of roughly 4 to 5 [TWh], as I said. Knowing that and the market knowing that, too because a decision of the Regie is publicly known, and there were some public hearings on this debate. So many people assisted to these hearing. We did not. Knowing that and knowing that we had some goals to meet and we had some volumes to sell over the years, it was decided at that time to sell, keep on selling the power that we had over the transmission lines. We knew, because once again that was public information, that there were no entitlements available over the DC line that goes into New York.

The entitlements, it's a right of way that you have to purchase in order to be able to sell power in New England over that line. It's a privately held line. So you have to negotiate and acquire some entitlements. And those entitlements, you have to purchase them almost a year in advance before the delivery.

And we've done since New England has always been our primary market in terms

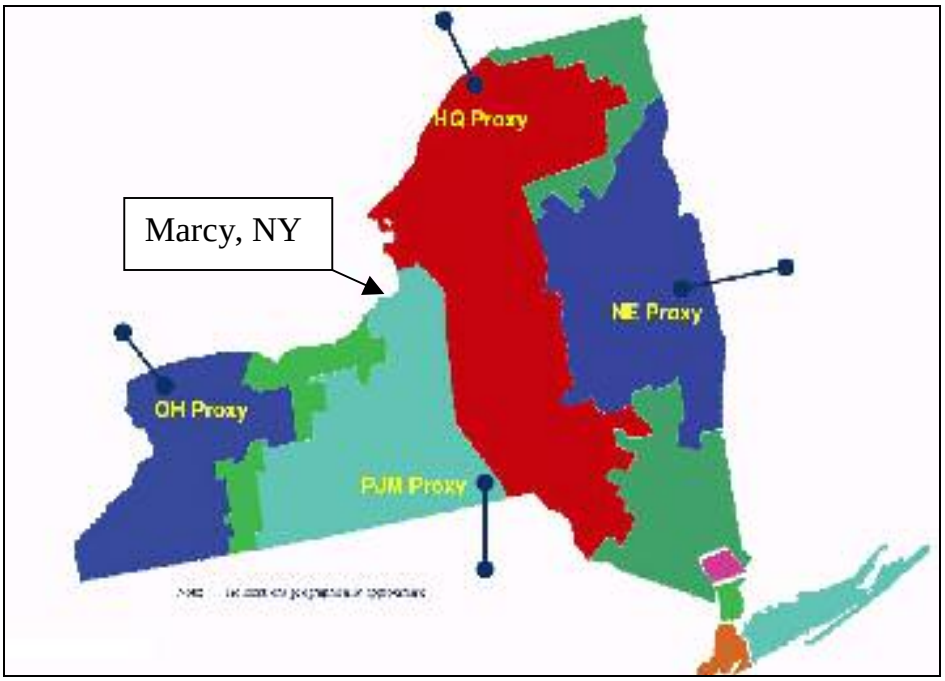
of volume and prices, we did buy some entitlements, and other market participants also bought entitlements over phase II at that time. So we knew that there was no entitlements available over phase II. So if somebody was long 600 megawatts, they could not flow this power over phase II into New England.

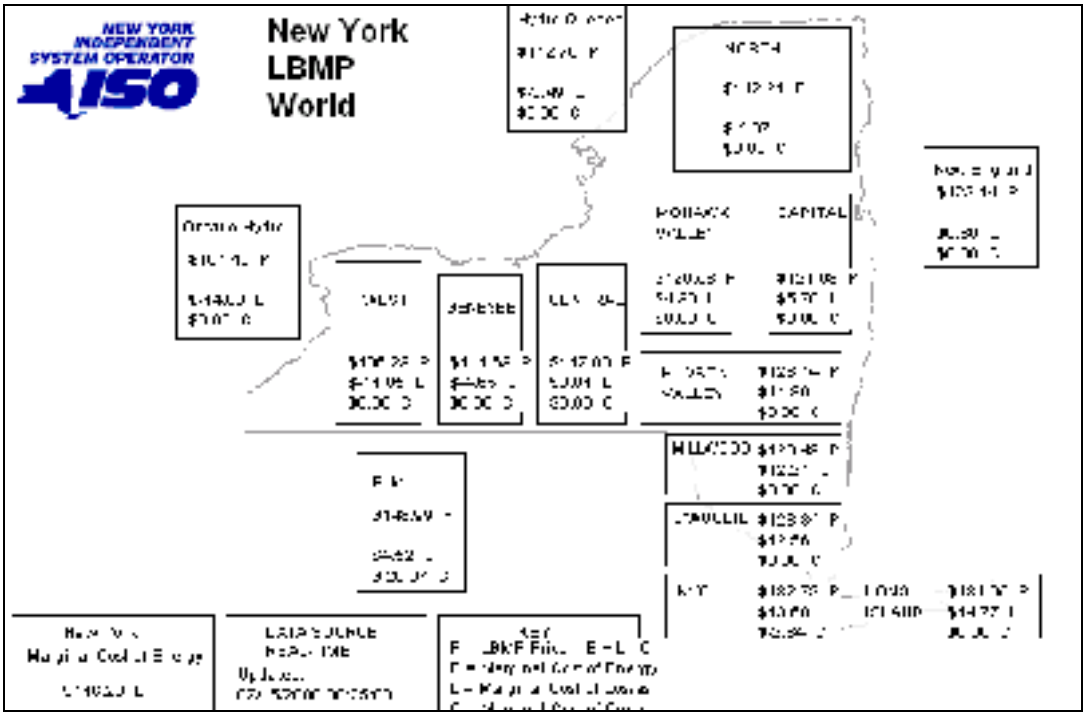
[attorney colloquy]

THE WITNESS: So the other markets that were then available was New Brunswick, so flowing north toward New Brunswick, which is a market that is, at times, interesting, but it's not our primary market. And where the other market that has enough depth to accept that kind of volume eventually potentially, I should say, is New York. And with the volumes that we had and the budget that we had, it was decided at that time to buy more TCCs in the public auction of New York ISO and to buy as much TCCs that were available in order for us to cover to hedge our deliveries into New York for the balance of the year 2007, knowing that there were already some market participant, there was already competition in that market. But knowing that the LSE will have to sell this power somewhere, we knew, we suspected that the LSE would like to sell or the way it would like to sell, is to sell to flow this power eventually into New York. And I had some volumes to sell, too.

So in April, what happened is we weren't fully hedged on the TCC side. We had, if I remember well, 799 megawatts of TCCs. And I gave instruction to Normand [Lamothe] to carry on with the commercial strategy that was put forward and based on the modeling that we had in front of us saying that carry on with our same strategy even though we're not fully hedged. We know that we will be able to meet our budget, our goals at the end of the year. Even though we were not fully hedged for the month of April, but we knew that the following months, we were hedged also. So at the end of the day for us, it was a matter of flowing the volumes, and it was a strategy that was put forward, and it was carried out that way.

Appendix B (source: http://www.nyiso.com/public/market_data/zone_maps/index.jsp) (locations are geographically approximate).





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