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**Energy**

The vexed question of FERC jurisdiction over alleged manipulation of the natural gas futures markets recently bubbled back to the surface, as the commission embraced the aggressive view of FERC anti-manipulation powers asserted by the Office of Enforcement against BP America. Authors Zachary Brez, Jon Daniels and Joe Harrington of Ropes & Gray LLP explain why the commissioners did not think FERC's 2013 defeat in the D.C. Circuit in a futures case pitting it against the CFTC applied to the BP facts.

Industry may prevail again in the courts, they say, but it may take more arguments.

**FERC Strikes Back on Financial Market Jurisdiction in BP Manipulation Case**

ZACHARY BREZ, JON DANIELS AND JOE HARRINGTON

**1. Introduction**

**O**n May 15, 2014, the Federal Energy Regulatory Commission ("FERC" or the "Commission") denied BP's motion to dismiss allegations that it manipulated natural gas markets in 2008.<sup>1</sup> In siding with

<sup>1</sup> BP America Inc., et al., Order Establishing Hearing, 147 FERC ¶ 61,130 (2014). The order is available on FERC's eLibrary at <http://elibrary.ferc.gov/idmws/search/>

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its Office of Enforcement staff's ("OE Staff") opposition to BP's motion, FERC rejected a challenge to its jurisdiction over allegedly manipulative transactions. The challenge was based on a decision 14 months earlier, in *Hunter v. FERC*,<sup>2</sup> in which the D.C. Circuit Court of Appeals held that FERC lacked jurisdiction over allegedly manipulative natural gas futures transactions.

FERC construed *Hunter* narrowly in permitting the case against BP to proceed and asserted a broad understanding of its own jurisdiction. Further administrative proceedings, and perhaps another appeal to the D.C. Circuit, will test that construction's plausibility. An analysis of *Hunter* and the recent BP decision help illuminate the future of FERC's market-policing authority.

**2. FERC's authority to sanction market manipulation**

Assessing BP's challenge to FERC's jurisdiction requires an understanding of the natural gas industry's statutory and regulatory regime. Section 4A of the Natural Gas Act ("NGA") empowers FERC to promulgate rules prohibiting use of "any manipulative or de-

[fercensearch.asp](http://fercensearch.asp). The four entities that moved to dismiss FERC's enforcement action are BP America Inc., BP Corporation North America Inc., BP America Production Company, and BP Energy Company and are collectively referred to herein as "BP."

<sup>2</sup> 711 F.3d 155 (D.C. Cir. 2013).

ceptive device or contrivance.”<sup>3</sup> Pursuant to this authority, FERC enacted the so-called Anti-Manipulation Rule as Section 1c.1 of the Commission’s regulations. This regulation prohibits three types of conduct: (1) using “any device, scheme, or artifice to defraud,” (2) making a misleading statement or omission of a material fact, and (3) engaging in “any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity.”<sup>4</sup> Importantly, both the NGA and the Anti-Manipulation Rule only apply to conduct “in connection with the purchase or sale of natural gas or the purchase or sale of transportation services subject to the jurisdiction of [FERC].”<sup>5</sup> According to Section 1(b) of the NGA, FERC has jurisdiction over the transport or sale for resale of natural gas in interstate commerce.<sup>6</sup> The Commission’s jurisdiction does not extend to intrastate transportation or transactions.<sup>7</sup>

### 3. The allegations against BP

#### a. Physical versus financial positions at the Houston Ship Channel

OE Staff has accused BP of making uneconomical physical gas sales at the Houston Ship Channel (“HSC”) to suppress prices and to make its financial position more profitable. In order to appreciate these allegations, it is important to first understand the nature of the natural gas market in which BP was trading.

HSC is a distribution hub connecting physical natural gas supply to intra- and interstate pipeline systems for eventual downstream consumption. Suppliers’ physical gas holdings, or “physical positions,” at HSC demonstrate their expectations about future prices there. Investors can also speculate on HSC gas prices by buying or selling HSC *Gas Daily* index swaps. The HSC *Gas Daily* index is a monthly average of daily HSC physical gas prices, and index swaps are financial instruments whose value is determined by the price level of the underlying index. An investor who expects HSC gas prices to drop thus sells index swaps to benefit from an expected decline in the HSC index. A buyer, by contrast, expects prices to rise and the instruments’ value to increase. Investors’ holdings of HSC index swaps, reflecting their beliefs about future gas prices, are “financial positions” at HSC.

For either physical or financial participants, a “short” position describes actions indicating expected price decreases, either physical supply reduction or index swap sales. Participants increasing physical holdings or buying index swaps take “long” positions. BP was both a supplier of physical gas at HSC and a trader in HSC *Gas Daily* index swaps, and thus had both a financial and a physical position at the hub.

#### b. BP’s positions September through November 2008

In early 2008, BP sold HSC *Gas Daily* index swaps, acquiring a short financial position at HSC. BP also

bought index swaps at another natural gas hub, Henry Hub in Louisiana. In essence, BP had bet on high prices at Henry Hub coupled with low prices at HSC. In September 2008, Hurricane Ike caused HSC prices to fall behind those at Henry Hub. Disruptions from the storm shut down smaller, intrastate pipeline systems fed by gas from HSC. Halted downstream consumption reduced interstate pipeline flows, leading to an oversupply of natural gas at HSC and therefore depressed prices at the hub. By contrast, Henry Hub’s prices did not drop dramatically after the hurricane. BP’s relative financial positions at the two hubs proved lucrative. From Sept. 18 until the end of November, BP continued to increase its bet that HSC prices would lag behind Henry Hub’s for the near future by selling HSC index swaps and acquiring Henry Hub index swaps.

As HSC-supplied pipeline systems’ demand for natural gas slowly returned to pre-Ike levels, BP increased its supply of physical gas at HSC through purchases and shipments from the nearby Katy Hub for sale at HSC. BP’s increased supply at HSC, OE staff claimed, perpetuated the post-hurricane glut and increased profits on BP’s financial positions at HSC and Henry Hub. OE Staff alleged that BP’s acquisition of natural gas for sale at HSC ran counter to its financial position. Further, BP could have sold its gas supply at Katy Hub at higher margins than it realized by transporting it from Katy to HSC for sale. The apparently contradictory positions and uneconomical sales, according to OE Staff, indicated physical market manipulation designed to increase returns on BP’s financial position.

### 4. Insight from *Hunter* for jurisdictional analysis in BP

FERC issued its show cause order to BP on Aug. 5, 2013, less than five months after the D.C. Circuit issued its *Hunter* opinion. The opinion rejected FERC’s attempt to regulate natural gas futures trading pursuant to its market manipulation authority. *Hunter* did not identify the precise boundaries of FERC’s jurisdiction, however. BP’s challenge to FERC’s jurisdiction required an expansive reading of *Hunter*. FERC rejected that interpretation, along with BP’s motion to dismiss. Examining *Hunter* is necessary to understand the future of FERC’s market manipulation authority in the BP case and beyond.

#### a. The D.C. Circuit opinion

In *Hunter v. FERC*, an employee of the hedge fund Amaranth named Brian Hunter appealed FERC’s penalty for alleged manipulation of natural gas futures contracts on the New York Mercantile Exchange. The Commodities Futures Trading Commission (“CFTC”) regulates that exchange. Hunter sold a significant number of natural gas futures contracts in certain 2006 settlement periods, during which Hunter’s sales constituted between 14.4 percent and 19.4 percent of total market volume. The sales’ volume and timing reduced the settlement price for natural gas, benefiting his short financial position. FERC filed a market manipulation action and imposed a \$30 million penalty. CFTC intervened on Hunter’s behalf, claiming it possessed exclusive jurisdiction to sanction manipulative activity in futures markets.

The court sided with CFTC and Hunter, finding that the Commodity Exchange Act (“CEA”) administered by

<sup>3</sup> Natural Gas Act, § 4A, 15 U.S.C.A. § 717c-1.

<sup>4</sup> 18 CFR § 1c.1. Upon promulgating the Anti-Manipulation Rule, FERC stated that the rule was modeled on the SEC’s Rule 10b-5 and that its interpretation should be consistent with analogous SEC precedent. Order No. 670, FERC Stats. & Regs. ¶ 31,202 (codified at 18 C.F.R. §§ 1c.1, 1c.2).

<sup>5</sup> Natural Gas Act, § 4A, 15 U.S.C.A. § 717c-1; 18 CFR § 1c.1.

<sup>6</sup> Natural Gas Act, § 1(b), 15 U.S.C.A. § 717(b).

<sup>7</sup> Natural Gas Act, § 1(c), 15 U.S.C.A. § 717(c).

CFTC, established CFTC's exclusive jurisdiction over futures markets. To permit FERC to regulate activities in such markets, the court held, would require finding statutory provisions evincing a clear, manifest congressional intent to repeal CEA's grant of exclusive jurisdiction to CFTC. Importantly, CFTC's intervention meant that the court did not review FERC's interpretation of its own jurisdiction for a permissible construction, as established in *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*<sup>8</sup>

### b. Jurisdictional exclusivity

*Hunter's* holding that FERC lacked jurisdiction to regulate natural gas futures markets depended largely on CFTC's exclusive authority to regulate futures markets. Though FERC argued that its jurisdiction overlapped with CFTC's, the statutory basis for CFTC's exclusive jurisdiction is strong. Not only does CEA describe CFTC's jurisdiction as exclusive,<sup>9</sup> but this authority is reinforced by the fact that NGA section 23 states that "[n]othing in this section may be construed to limit or affect the exclusive jurisdiction of [CFTC] under the Commodity Exchange Act."<sup>10</sup>

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### **BP's exclusivity argument lacks the statutory support and agency intervention that benefitted *Hunter's*.**

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BP's exclusivity argument lacks the statutory support and agency intervention that benefitted *Hunter's*. BP argued that NGA section 1(b) prohibits FERC's intervention in intrastate commerce, just as section 23 demands deference to CFTC's exclusive jurisdiction over futures markets. NGA section 1(b) states that the "[NGA] shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas."<sup>11</sup> BP likened NGA's delegation of some energy matters to the states to CFTC's singular authority in futures markets.

A claim of states' exclusive jurisdiction over intrastate conduct will face tougher scrutiny than did CFTC's assertion of exclusive jurisdiction in *Hunter*. There, the court's finding that the Commodities Exchange Act granted exclusive jurisdiction limited its inquiry to whether "Congress clearly and manifestly intend[ed] to impliedly repeal CEA section 2(a)(1)(A) when it enacted the Energy Policy Act of 2005."<sup>12</sup> With

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<sup>8</sup> 467 U.S. 837, 841-42 (1984) (holding that when a "court reviews an agency's construction of the statute which it administers . . . [and] determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.").

<sup>9</sup> Commodity Exchange Act, § 9(a)(2), 7 U.S.C.A. § 13(a)(2).

<sup>10</sup> Natural Gas Act, § 23(c)(2), 15 U.S.C. § 717t-2(c)(2).

<sup>11</sup> Natural Gas Act, § 1(b), 15 U.S.C.A. § 717(b).

<sup>12</sup> *Hunter v. FERC*, 711 F.3d 155, 158 (D.C. Cir. 2013).

no competing government entity asserting authority, FERC's interpretation of its own jurisdiction will be accorded *Chevron* deference.

The *Hunter* court contrasted the two standards of review: "Because the 'premise of *Chevron* deference is that Congress has delegated the administration of a particular statute to an executive branch agency . . . we have never deferred where two competing governmental entities assert conflicting jurisdictional claims."<sup>13</sup> Since BP will need to face this additional hurdle, the argument that FERC is again trespassing on another agency's authority may be available to BP but will prove more difficult than in *Hunter*.

### c. "In connection with" jurisdiction under Natural Gas Act section 4A

In both *Hunter* and BP's case, FERC sought to limit manipulative conduct in markets outside of its jurisdiction based on the effect of this conduct on prices within FERC-regulated markets. In *Hunter*, the non-jurisdictional conduct was the sale of natural gas futures contracts, and the jurisdictional impact was a drop in natural gas prices. In BP's case, the non-jurisdictional conduct was the intrastate sale and transport of physical gas.

In its motion to dismiss, BP contended that its allegedly manipulative conduct—physical gas sales at, and transportation to, HSC—occurred within a single state and was thus exempt from FERC's NGA section 1(b) authority. OE Staff denied that BP engaged only in intrastate commerce at HSC, instead alleging that some of BP's conduct amounted to interstate sales or transportation, so-called "jurisdictional transactions." More important than that factual dispute was OE Staff's argument that NGA section 4A grants FERC jurisdiction over the conduct in question. Daily physical gas sales at HSC include both intrastate (non-jurisdictional) and interstate (jurisdictional) transactions, depending on the parties involved. Thus, even if HSC's efforts to depress prices at HSC manifested in intrastate transactions, OE Staff reasoned, BP's manipulative conduct occurred "in connection with" interstate transactions whose prices dropped.

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### **The *Hunter* court's reaction to FERC's "in connection with" theory of jurisdiction is ambiguous.**

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The *Hunter* court's reaction to FERC's "in connection with" theory of jurisdiction is ambiguous. On the one hand, the court agreed with CFTC's conclusion that FERC's jurisdictional theory "would allow any agency having authority to prosecute manipulation of the spot price of a commodity to lawfully exercise jurisdiction with respect to the trading of futures contracts in that commodity."<sup>14</sup> BP will likely argue that the *Hunter* court highlighted the implications of FERC's section 4A

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<sup>13</sup> *Id.* at 157 (quoting *Salleh v. Christopher*, 85 F.3d 689, 691-92 (D.C. Cir. 1996)).

<sup>14</sup> *Id.* at 158.

jurisdiction to emphasize the limits on FERC's anti-manipulation authority.

On the other hand, the *Hunter* court seemed to endorse FERC's interpretation of section 4A, provided it did not encroach on other agencies' jurisdictions. Summarizing the argument, the court wrote "FERC contends that it is empowered to prohibit manipulation not only in FERC-regulated markets but also when the manipulation coincides with—i.e., is 'in connection with,' 'directly or indirectly'—FERC-jurisdictional gas transactions."<sup>15</sup> The court believed that interpretation indicated that NGA did not seek to repeal CFTC's mandate, "because FERC is free to prohibit manipulative trading in markets outside the CFTC's exclusive jurisdiction."<sup>16</sup>

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<sup>15</sup> *Id.* at 160.

<sup>16</sup> *Id.*

That statement seems to limit *Hunter's* holding to exclusive jurisdiction turf wars, rather than casting it as a broad rebuke of FERC's anti-manipulation authority.

## 5. Conclusion

No matter the course of FERC's enforcement action against BP, the case embodies FERC's expansive and aggressive view of its own anti-manipulation jurisdiction. *Hunter* shed some light on appellate courts' reaction to this interpretation. Nevertheless, CFTC's exclusive jurisdiction over futures markets presented a peculiar set of circumstances that may not apply to the BP matter. Thus, further challenges to FERC's jurisdiction, whether by BP or others, will continue to shape the outer bounds of the FERC's enforcement authority.