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Energy**FERC Enforcement**

The Federal Energy Regulatory Commission, in recent years, has taken on an expanded regulatory role with vigorous enforcement of energy market manipulation. In doing so, FERC has attempted to stretch the parameters of its statutory jurisdiction and targeted large players in the energy markets, resulting in record settlements in recent years.

Authors Zach Brez, Jon Daniels and Megan McEntee of Ropes & Gray analyze FERC's aggressive approach and attempts by industry to resist, as the Supreme Court and other courts move toward resolution of key legal challenges.

**FERC Enforcement Update:
Increased Attention to Market Manipulation is Coming to a Head**

By ZACH BREZ, JON DANIELS AND MEGAN
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**1. Introduction: FERC Stretches its
Jurisdiction**

The Federal Energy Regulatory Commission ("FERC" or the "Commission") is an independent government agency that regulates the interstate transmission of electricity, natural gas, and oil, and reviews proposals to build natural gas terminals and pipe-

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lines. In recent years, FERC¹ has taken on an expanded regulatory role with its vigorous enforcement of energy market manipulation. As part of its aggressive approach, FERC has attempted to stretch the parameters of its statutory jurisdiction and targeted large players in the energy markets, resulting in record settlements in recent years. This expanded regulatory role for the Commission will have significant implications for individuals and entities involved in the energy and swap markets.

2. Background of FERC

FERC was created in 1977 when the now-defunct Federal Power Commission was reorganized by Congress in the wake of the oil crisis in 1973. This began a period of gradual deregulation, as the agency's direct oversight of utilities was eliminated, and rules were issued that made it easier for consumers to negotiate di-

¹ The agency is generally referred to as "FERC," rather than "the FERC," in Commission filings and on the Commission's website, as well as in public articles regarding the Commission.

rectly with producers of natural gas. Beginning in the 1990s, FERC issued a series of orders that restructured the wholesale electric power and natural gas industries so that their services were unbundled. This forced the agency's Enforcement staff to begin to address challenges caused by the creation of new financial products related to the energy industry that were traded by sophisticated market players.²

In 2005, following revelations in the earlier part of the decade that Enron had manipulated energy markets in the western United States, Congress enacted the Energy Policy Act, which gave FERC expansive new regulatory authority and responsibility.³ Most significantly, the Act authorized FERC to issue rules prohibiting manipulation of energy markets by any entity in "in connection with the purchase or sale of natural gas or the purchase or sale of transportation services subject to the jurisdiction of [FERC]." Pursuant to this authority, FERC subsequently enacted an anti-manipulation rule in 2006 that broadly 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."⁴

Despite this broad new authority, the early results from this expanded regulatory authority were limited. Perhaps the main reason for the insignificant enforcement impact was that the Staff of FERC relied primarily upon self-disclosed conduct as a basis for conducting investigations, as opposed to performing their own independent inquiries. In 2007, FERC reported that more than 70 percent of its investigations did not even result in penalties.⁵ After this slow start, however, enforcement actions have picked up speed in the following years. This more robust enforcement approach was driven in part by the appointment of a new Director of the Office of Enforcement—Norman Bay—in 2009,⁶ as well as the creation of a Strategic Plan that focused on enhancing competition in the energy markets and ensuring that energy rates were reasonable. The Plan specifically called for deterring market manipulation by promoting internal compliance programs and self-reporting, and conducting risk-based audits.⁸

² Allison Murphy, Todd Hettenbach, and Thomas Olson, *The FERC Enforcement Process*, Energy Law Journal, p. 283 (Nov. 18, 2014).

³ Clark, Tony, Ensuring Reliability and a Fair Energy Marketplace, Col. Nat. Resources, Energy & Env'tl. L. Rev. Vol 25:2, p. 339, available at <http://www.ferc.gov/media/statements-speeches/clark/2014/07-02-14-clark.pdf>.

⁴ Natural Gas Act, § 4A, 15 U.S.C.A. § 717c-1; 18 CFR § 1c.1. The agency chose to model its anti-manipulation rule after SEC Rule 10b-5 in an attempt to utilize the precedent surrounding securities fraud litigation, and provide market participants with a sense of the agency's expectations regarding actionable conduct.

⁵ 18 CFR § 1c.1 (2006).

⁶ FERC Report on Enforcement, Nov. 14, 2007, p.21-22 and Appendix A, available at <http://www.ferc.gov/EventCalendar/Files/20071114084824-Staff-report-11-14-07%20.pdf>.

⁷ Bay has since been appointed as Chairman of FERC.

⁸ Federal Energy Regulatory Commission, *The Strategic Plan FY 2009-2014* (revised March 2013) pg. 17-19; <http://tinyurl.com/npz5oph>.

3. FERC's Recent Enforcement Efforts

FERC's recent efforts to strengthen its enforcement activities have been marked by three main features. First, the Commission has attempted to test the boundaries of its authority in recent years by asserting its jurisdiction over a wide range of markets that have not traditionally been regulated by FERC. Second, the Commission has taken a hard-line approach to market manipulation by targeting actions that do not constitute technical violations of market rules but nonetheless may be considered unscrupulous. Third, the agency has focused its attention on bigger players in the energy markets, thereby leading to higher penalties from enforcement actions.

A. Expanding Jurisdiction. One of the most notable aspects of FERC's recent enforcement efforts has been its attempt to expand its statutory jurisdiction. This approach has included investigating conduct in markets typically regulated by other government agencies; attempting to regulate intrastate conduct; and prosecuting actions involving so-called "non-sales" in the energy market.

The first example of FERC's attempt to expand its jurisdictional reach came in 2011 when the Commission tried to impose penalties on a hedge fund trader, Brian Hunter, for alleged manipulation of natural gas futures contracts.⁹ Hunter appealed FERC's jurisdiction over the conduct, and the Commodity Futures Trading Commission ("CFTC") intervened to argue that it possessed exclusive jurisdiction over manipulative behavior in the futures markets. In 2013, the D.C. Circuit Court of Appeals agreed with Hunter and the CFTC, and precluded FERC from regulating this market.¹⁰

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The *Hunter* decision appears to have been only a minor impediment to FERC's enforcement progress: rather than tread carefully with respect to its authority, the Commission instead has interpreted the decision narrowly and continued to assert broad jurisdiction under the anti-manipulation rule. Only a few months after the *Hunter* decision, for example, FERC accused BP of manipulating natural gas markets by making uneconomical physical gas sales at the Houston Ship Channel ("HSC") to suppress prices and make its financial position more profitable.¹¹ The conduct in this case involved gas sales and transportation that occurred within a single state, and BP argued that the states themselves had exclusive jurisdiction over intrastate

⁹ Zachary Brez, Jon Daniels, and Joe Harrington, *FERC Strikes Back on Financial Market Jurisdiction in BP Manipulation Case*, Bloomberg BNA Daily Report for Executives (Jul. 15, 2014).

¹⁰ *Hunter v. FERC*, 711 F.3d 155, 158 (D.C. Cir. 2013).

¹¹ 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/>.

distribution of natural gas. In response, FERC asserted a narrow construction of *Hunter's* jurisdictional analysis and claimed that it had jurisdiction over what was arguably intrastate conduct because the activity was **connected** to interstate conduct. The Commission found that daily physical gas sales at HSC involved both intrastate and interstate transactions, meaning that BP's manipulative behavior occurred "in connection with" interstate transactions that included a drop in price.

FERC has also proposed regulations that would give it jurisdiction over a greater range of behavior in the market. In 2011, FERC proposed Order 745, which the agency believed would address problems with the compensation of demand response in the wholesale market. Demand response allows system operators to reduce the overall cost of electricity by paying groups of consumers for reducing their energy consumption during periods of high power prices. Order 745 would require that system operators pay consumers the same price for non-consumption of energy that they would have paid to a generator to produce that same energy on the wholesale market. Power companies brought actions challenging the order, arguing that demand response does not constitute a "sale" of electricity such that it would fall within FERC's statutory jurisdiction.

The D.C. Circuit agreed, finding in *Electric Power Supply Association v. FERC* that the agency did not have jurisdiction to implement this rule under Section 201(b)(1) because demand response is specifically a "non-sale."¹² The court also found that FERC's interpretation of its ability to regulate practices "directly affect[ing] wholesale rates" would give FERC enormous powers to regulate "the steel, fuel, and labor markets" as long as they were "affecting" wholesale energy rates. A final answer on the issue is pendent, with the Supreme Court granting certiorari and environmental advocates such as the National Resource Defense Counsel supporting the appeal. However the proposed Order makes clear that FERC believes its jurisdiction should encompass a wider range of market activities.

B. Loophole Prosecutions. A second major development in recent enforcement actions is FERC's assertion that actions that do not strictly violate market rules can still be misleading and manipulative and therefore the target of investigation. This broad interpretation of the Commission's statutory authority can be found in FERC filings asserting that schemes that disrupt the general market "design" can violate the anti-manipulation rule, even if the trading scheme is technically compliant with specific market rules.

This debate over market loopholes is front and center in a long-running enforcement action against Powhatan Energy Fund. In 2010, FERC accused Powhatan of manipulating a wholesale electricity market. The Commission alleged that Powhatan made up-to-congestion ("UTC") trades in opposite directions that inflated transaction volumes, and allowed Powhatan to capture transmission credits that made these transactions profitable. FERC stated that standing alone, these actions were the equivalent of riskless wash trades that created "no economic value" in the market, and sought \$29 mil-

lion in civil penalties and \$4.7 million in disgorged profits.¹³

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Powhatan has mounted a legal and media campaign against the charges, arguing that its actions cannot constitute active deception since these types of trades were permissible under a "loophole" in PJM's market rules.¹⁴ In its Order Assessing Civil Penalties in May 2015, FERC rejected that argument, citing its previous guidance that "[a]n entity need not violate a tariff, rule or regulation to commit fraud."¹⁵ In July 2015, FERC filed a petition in federal court to affirm the penalties, which will give the Eastern District of Virginia an opportunity to analyze the loophole issue in the near future.

Another example of a so-called "loophole" prosecution occurred in 2012 when FERC alleged that Ventures Energy Corporation, an energy-trading unit of a major U.S. bank, engaged in bidding strategies in the California independent system operator ("ISO") market that created artificial conditions that forced the ISOs to pay Ventures Energy premium rates for electricity.¹⁶ The California ISO market was operating under a system in which bids from energy suppliers were judged and accepted by computer software. FERC found that Ventures Energy was deliberately alternating low and high bids in a scheme they knew would cause the software to pay their facilities at a rate high above market. Ventures Energy disputed the idea that its conduct was illegal and instead argued that the bidding strategy at issue was both transparent and in full compliance with market rules. Nonetheless, Ventures Energy ultimately settled with the agency for roughly \$400 million.

C. Larger Actions. Another significant consequence of FERC's expanded enforcement efforts is a drastic increase in the monetary penalties that the agency has sought from defendants in recent enforcement actions. In 2007, for example, the largest penalty sought by the agency was a \$9 million civil fine levied against SCANA Corporation. Since then, FERC has issued multiple civil penalties in the hundreds of millions of dollars.

¹³ Order Assessing Civil Penalties, 151 FERC ¶ 61,179 (May 29, 2015).

¹⁴ In their filings, Powhatan has reserved the issue of whether these trades actually utilized a "loophole," and argued that regardless the trades did not constitute fraud. See <http://ferclitigation.com/>.

¹⁵ Order Assessing Civil Penalties, 151 FERC ¶ 61,179 (May 29, 2015) (citing Competitive Energy Services, LLC, 144 FERC ¶ 61,163, at P 50 (2013)).

¹⁶ Order Approving Stipulation and Consent Agreement, 144 FERC ¶ 61,068 (July 30, 2013).

¹² *Electric Power Supply Association v. FERC*, 753 F.3d 216 (D.C. Cir. 2014).

The most noteworthy penalty occurred in the *Barclays* enforcement action. In October 2012, FERC alleged that Barclays and four of its traders violated the anti-manipulation rule through trading in Commission-regulated physical markets “with the fraudulent purpose of moving the physical Index price at a particular point so that Barclays’ financial swap positions at that same trading point would benefit.”¹⁷ The Commission assessed \$435 million in civil penalties and demanded that the defendants disgorge \$34.9 million in unjust profits. Barclays petitioned its record civil penalty in the Eastern District of California, arguing in part that the agency didn’t have jurisdiction under *Hunter*. The District Court sided with FERC, and found that the Commission’s jurisdiction in the case stemmed from the fact that physical transfers of electricity took place, and that the defendants did not show “why swaps, as the benefiting position, are relevant to jurisdiction, as opposed to the trades involving physical products, from which the swaps were priced.”¹⁸

The size of the penalty in *Barclays* was not an isolated occurrence.

The size of the penalty in *Barclays* was not an isolated occurrence. As noted above, FERC settled in 2012 with Ventures Energy over its alleged manipulation of California ISOs, levying a \$285 million civil penalty and forcing Ventures Energy to return \$125 million in ill-gotten profits to electricity ratepayers.¹⁹ Earlier that year, FERC also brought an action against Constellation Energy Commodities Group for allegedly manipulating New York energy markets by entering virtual transactions without regard for their profitability in an attempt to affect energy prices and benefit their financial positions in the market.²⁰ Constellation ultimately paid a penalty of \$135 million, and was forced to disgorge profits of \$110 million.

4. Media/Government Responses

FERC’s new approach to enforcement has met with mixed approval by government officials and the popular press. FERC has generally been praised by industry groups such as the American Public Power Association, along with government leaders who feel the agency serves as an important safeguard against corporate

¹⁷ Order to Show Cause and Notice of Proposed Penalty, 141 FERC ¶ 61,084 (Oct. 31, 2012).

¹⁸ *Federal Energy Regulatory Commission v. Barclays Bank PLC et al.*, No. 2:13-cv-2093-TLN-DAD (E.D.C.A. 2015). The court also found that a definition of the term entity in the anti-manipulation statute at FPA § 222 that includes natural persons was “more consistent with the goals of FPA 222 and the surrounding statutory scheme.”

¹⁹ Order Approving Stipulation and Consent Agreement, 144 FERC ¶ 61,068 (July 30, 2013).

²⁰ Order Approving Stipulation and Consent Agreement, 138 FERC ¶ 61,168 (Mar. 9, 2012).

abuse of the energy markets. At a recent hearing, for example, Sen. Maria Cantwell (D-Wash.), ranking member of the Senate’s Energy & Natural Resources Committee, praised FERC for being a “shining light” in protecting consumers from market manipulation.

However, lawmakers have been critical of FERC’s aggressive new approach to enforcement.²¹ Rep. Ed Whitfield (R-Ky.), Chairman of the House Subcommittee on Energy and Power, raised concerns during testimony in June 2015 about the “fairness, consistency, transparency, and due process” afforded by FERC’s Office of Enforcement, and asked “whether FERC enforcement actions are counterproductive and actually impede the proper functioning of electricity markets.” Rep. Gene Green (D-Texas) said in July 2014 that FERC needed additional transparency on enforcement, so that market actors could better understand the market rules at issue. FERC has also been subject to media criticism, with an opinion article in the *Wall Street Journal* describing it as “a fearsome scourge of Wall Street and U.S. business,” and stating that recent cases “raise troubling questions about [Chairman] Mr. Bay’s fitness and competence.”²²

6. Conclusions

FERC’s invigorated enforcement efforts have demonstrated in recent years that it is a major regulatory player. The Commission has been aggressive in pursuing the outer boundaries of its enforcement authority, and FERC has also shown that it is willing to target bigger participants in the energy markets. Despite these recent successes, it remains unclear how the limited resources of the Commission’s enforcement division will be affected by the increasing scope of the agency’s current matters – especially in light of the fact that a growing number of cases are in active litigation.

Fortunately, market participants will likely get some additional clarity in the near future from the courts on the relatively untested anti-manipulation rule. This may include additional analysis of how FERC’s regulations interact with state statutes, discussion of the due process defendants should receive in FERC investigations, and debates over FERC’s ability to prosecute actions that do not violate any market rules.

While the full impact of FERC’s enhanced enforcement activity remains to be seen, actors in the energy market should be wary of the increased attention that the Commission is focusing on market manipulation.

²¹ The Energy Department’s Office of Inspector General released a report in June 2015 detailing breaches of confidentiality by Jon Wellinghoff, former Commission Chairman from 2009-2013. Wellinghoff moderated a panel discussion in March 2015 in which he played a video excerpt of a non-public deposition taken during a major investigation. The IG stated that the behavior “could threaten the integrity of FERC’s regulatory and enforcement processes.” <http://www.forbes.com/sites/williampentland/2015/06/09/inspector-general-accuses-former-federal-energy-regulator-of-gross-ethical-violation/>.

²² Rago, Joseph, *The Investors at War with Political Power* (May 2, 2014) available at <http://www.wsj.com/articles/SB10001424052702304178104579533693554509288>.