

# FERC Show Cause Orders and Proposed Market-Based Rate Conditions

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# FERC Show Cause Orders

*Practices Defined and Scope of  
Penalties Set Forth*

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## *Show Cause Orders*

- FERC issued show cause orders to over 60 power trading companies that are alleged to have engaged in manipulative practices in western energy markets. 103 FERC ¶ 61,345.
  - The show cause orders cover the time period January 1, 2000 to June 20, 2001, with certain exceptions.
  - Potential disgorgement would be in addition to refunds owed in the California proceeding.
  - Hearings set before a FERC ALJ.

## *Show Cause Orders*

- If a company is found to have violated the CAISO or PX tariffs, it may be ordered to disgorge profits gained from the transactions.
- The ALJ may also determine if additional remedies are warranted, such as revocation of market-based rate authority or revisions to codes of conduct.
- ISO must submit transaction data by July 16.

## ***Show Cause Orders***

- Commission Authority:
  - *Period Prior to October 2, 2000.* FERC states that it can order refund of monies prior to October 2, 2000 if it finds violations of the ISO and PX tariffs.
    - Market Monitoring and Information Protocol (MMIP) put market participants on notice regarding their rights and obligations in the marketplace, including notice of possible enforcement action.
    - MMIP served as “the rules of the road.”
    - MMIP contemplated enforcement of these rules by FERC even if procedures set forth in MMIP were not followed.

## ***MMIP - "Rules of the Road"***

- FERC describes MMIP as the "rules of the road" but really a vague description of what constitutes gaming and anomalous behavior.
  - Gaming: "taking unfair advantage of the rules and procedures or of transmission constraints in periods in which substantial congestion exists."
  - Anomalous behavior: "departs significantly from the normal behavior in competitive markets leading to unusual or unexplained market outcomes."

## *Show Cause Orders*

- Commission Authority (cont'd):
  - *Authority over Governmental Entities.*
    - FERC states that its jurisdiction extends to the “affected transactions” including those of non-jurisdictional entities.
    - FERC recognizes the significant number of transactions by non-jurisdictional entities (up to 30 percent of all sales in the California centralized ISO and PX spot markets).

## ***Gaming Practices - Disgorgement Required***

- Gaming Practices:
  - *False Import*. Practice (also known as “ricochet” or “megawatt laundering”) took advantage of price differentials that existed between the day-ahead or day-of markets and out-of-market sales in the real-time market.
    - FERC states that market participants engaging in False Import deceived the ISO by falsely representing that their available power had been imported in order to receive a price above the cap.

## ***Gaming Practices - Disgorgement Required***

- Gaming Practices (cont'd):
  - *Congestion-Related Practices*. Practices involved false scheduling of load or counterflow energy that appeared to relieve congestion in real-time.
    - Non-Firm Export;
    - Circular Scheduling;
    - Wheel Out; and
    - Load Shift.
  - Disgorgement for these practices will only apply to transactions between May 2000 and the start of the refund period on October 2, 2000.

## ***Gaming Practices - Disgorgement Required***

- Gaming Practices (cont'd):
  - *Ancillary Services-Related Practices.*
    - *Paper Trading.* Practice involved selling ancillary services in the day-ahead market even though the market participant did not have required resources. Market participant then bought back these ancillary services in the hour-ahead market or real-time market.
    - *Double Selling.* Practice involved selling ancillary services in the day-ahead market from resources that were initially available but later selling those same resources as energy in the hour-ahead or real-time markets.

## ***Gaming Practices - Disgorgement Required***

- *Selling Non-Firm Energy as Firm.* Practice, engaged in by Enron, involved buying non-firm energy from outside California and then selling it to the ISO as firm energy. FERC characterized practice as a “flagrant false representation.”
  - FERC notes that in the 100 days of discovery, parties alleged that others engaged in selling non-firm energy as firm, but FERC finds no evidence that anyone other than Enron engaged in such behavior.

## ***Gaming Practices - Disgorgement Not Required***

- *Underscheduling Load.* Practice engaged in primarily by the three California IOUs to reduce overall price paid for generation.
  - Violation of MMIP.
  - Disgorgement not required because it was a price-reducing strategy.

## ***Gaming Practices - Disgorgement Not Required***

- *Overscheduling Load.* An entity with more generation than load falsely overstates its scheduled load to correspond with scheduled generation.
  - Also referred to as “Inc-ing” or “Fat Boy.”
  - Ensured that generation would not go unsold in the real-time market.
  - No disgorgement because practice balanced out underscheduling problem and participants did not set the market clearing price.

## ***Show Cause Orders - Possible Remedies***

- Disgorgement required if engaged in certain practices as set forth in the show cause orders.
- ALJ can propose additional remedies, including revocation of market-based rate authority or revisions to codes of conduct.
- *De Minimis* threshold set at \$10,000 or less.

## ***Docket IN03-10-000***

- Commission finds that all bids in the CAISO and CalPX markets above \$250 per MW are *prima facie* excessive.
- Order applies to the period May 1, 2000 to October 2, 2000.
- Price caps at the time:
  - \$750/MW through July 1, 2000.
  - \$500/MW through August 7, 2000.
  - \$250/MW thereafter.

## ***Docket IN03-10-000***

- FERC directs OMOI to investigate all parties who bid in the CAISO and the CalPX above the *prima facie* level.
- Parties identified must demonstrate to OMOI why their bidding behavior and practices did not violate the MMIP.
- OMOI must report to Commission regarding its findings.

## ***Show Cause Orders - Enron Partnerships***

- FERC finds evidence that Enron and a number of entities worked in concert through partnerships, alliances or other arrangements to engage in activities that constitute gaming or anomalous behavior.
- ALJ appointed.
- ALJ may recommend disgorgement or other appropriate remedies.

# FERC's Show Cause Orders

*How to Respond and Minimize Future  
Litigation Risk*

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## *Implications*

- Recent Show Cause Orders -- Implications and Repercussions:
  - review of preparation and response protocol.
  - possible related litigation: minimizing risks.

## *Implications (cont.)*

- Responding To Show-Cause Orders And Cal ISO Issues May Not Be The End Of This.
  - lawsuits alleging creative theories (e.g., RICO) may follow administrative processes. Antitrust analogy: private litigation following DOJ consent decrees.
  - "success" can be defined as continued avoidance of adverse publicity, further inquiries, penalties, and follow-on litigation.
  - continued importance of not letting the response become the "story." E.g., Martha Stewart, Watergate, Arthur Anderson

## *Preparing and Responding*

- The basics of a threshold response protocol:
  - Freeze electronic and hard copy document destruction with an appropriately drafted bulletin to employees.
  - Also, confirm and understand information system procedures.
  - Focus first on collection of documents and data.

## *Preparing and Responding*

- Assess protecting communications with attorney-client and work product protections.
- Assign company point person.
- Consider early retention and involvement of counsel (this itself can buy credibility, just like with an SEC, DOJ, or other analogous investigation).

## *Preparing and Responding*

- Dynamics and challenges of the response:
  - Collection of documents and materials. Create an auditable and reconstructable paper trail.
  - Interviews. Protect with attorney-client privilege, memorialize, make clear purpose and roles.

## *Preparing and Responding*

- Preparation of written responses to FERC. Again, credibility: what will other parties disclose? Important to strike the right balance between appropriate vs. over-qualification of responses.
- Post-response. It is not safe to assume that you can rest easy after the response is submitted.

## ***Minimize Future Litigation Risks***

- Document Retention:
  - reminders for electronic and hard copy preservation;
  - review/update categories of retained materials; and
  - accommodate changing personnel, organizations.

## ***Minimize Future Litigation Risks***

- Preservation Of Privileges:
  - continue to protect draft responses to agencies and associated work product;
  - be aware of potential of "selective disclosure" of privileged materials to agency. (E.g., SEC case law.)

## ***Minimize Future Litigation Risks***

- Settlement:
  - Payment to FERC is not necessarily end of all problems.
  - Pay attention to release: what exactly are you buying?
    - Inter-agency issues
  - “no admission of liability”
    - At least consider practical effect on potential future plaintiffs.
    - At least consider practical impact in future litigation.

## ***Minimize Future Litigation Risks***

- Other Proactive Steps:
  - consider possible necessity of internal audits or investigations
  - assess compliance program and formalized procedures; role of counsel in compliance matters
  - continue to be alert to possible criminal implications of government investigations, e.g., trade data reporting to industry publications

# FERC's Proposed MBR Conditions

*FERC's Proposal and What it Means*

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## ***FERC's Proposed MBR Conditions***

*"If you don't make it illegal, you can't  
prosecute it."*

Richard O'Neill,  
FERC Office of Economic Policy

## ***FERC's MBR Conditions***

### **The Model - Securities Regulation - Rule 10b-5:**

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- a. To employ any device, scheme, or artifice to defraud,
- b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

## ***FERC's MBR Conditions***

- In November 20, 2001, FERC proposed to condition all market-based rate (MBR) tariffs to include condition prohibiting the seller from engaging in anti-competitive behavior or the exercise of market power.
  - FERC states its intention to establish a clear benchmark governing market participant conduct with penalties for violations clearly spelled out.

## ***FERC's MBR Conditions***

- What will be deemed illegal behavior?
  - Illegal behavior will be determined after the fact.
  - The condition outlaws anticompetitive behavior and the exercise of market power without specifying what that entails.
  - This is FERC's version of the SEC's Rule 10b-5 – a catchall provision, although one that targets less specific behavior than 10b-5.

## ***FERC's MBR Conditions***

- FERC states that since the November 20 order, it has been informed by comments received and by what it has learned about types of behavior that occurred in Western markets during 2000 and 2001.
- FERC's findings in this area led to the order issued on June 26, 2003. 103 FERC ¶ 61,349.

## ***FERC's Goals***

- FERC states that proposed MBR conditions attempt to balance three goals:
  - provide effective remedies on behalf of customers in the event that market abuse occurs;
  - provide clearly delineated rules of the road; and
  - provide regulatory certainty.
- FERC acknowledges that balancing these goals requires trade-offs: broad rights to allege violations vs. transaction finality.

## ***FERC's Proposed MBR Conditions***

- FERC proposes six specific rules relating to:
  - unit operation;
  - market manipulation;
  - communications;
  - reporting;
  - record retention; and
  - related tariffs.
- Proposed conditions would apply to bilateral sales or sales in an organized market.

## ***Unit Operation***

- Commission proposes to require Sellers to operate and schedule generating facilities, undertake maintenance, declare outages, and commit or otherwise bid supply in a manner that complies with the rules and regulations of the applicable power markets.
- FERC asserts condition is consistent with its view that *ex ante* rules are superior to *ex post* regulatory action.

## ***Market Manipulation***

- FERC proposed condition designed to prohibit activities that adversely affect competitive outcomes and result in rates that do not reflect legitimate market forces.
- Condition includes non-exclusive list of prohibited activities.
- FERC states that some cases may require remedial action while others may require clarification of market rules.

## *Communications*

- Proposed condition prohibits submission of false information or omission of material information.
- Include information related to: maintenance and outage data; bid data; price and transaction information; and load and resource data.
- Does this mean load forecasts are subject to enforcement actions?

## *Reporting*

- Proposed condition would require that sellers provide complete, accurate and honest information to any entity that publishes price indices.
- Information must be provided by company's risk management office and certified by the chief risk officer.
- Reporting requirement subject to outcome in Docket No. AD03-7-000.

## ***Record Retention***

- Proposed condition would require sellers to retain data and information needed to reconstruct a published price index for a period of three years.
- In Western Markets Report, FERC Staff found that companies had little, if any, formal procedures in place to ensure accuracy of data reported to trade press.

## ***Related Tariffs***

- Proposed condition would prohibit seller from violating, or colluding with another party, in actions that violate seller's code of conduct or standards of conduct.
- In Western Markets Report, FERC Staff found that sellers had failed to abide by their codes of conduct and standards of conduct.

# FERC of the Future

*FERC's OMOI, RTOs  
and Market Monitors*

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## ***The OMOI Model***

- FERC has acknowledged that OMOI will conduct investigations “of the sort that are routine at agencies such as the CFTC.”
- CFTC model based upon the SEC model.
- Basic investigation: Informal at first, *i.e.* call and a follow-up letter. If SEC does not sense that the company is cooperating, it becomes a formal investigation.

## *Why OMOI?*

- FERC trying to restructure the industry but also attempting to restructure itself as well.
  - Industry restructuring through formation of RTOs and establishment of regional markets.
  - FERC restructuring through market investigations by OMOI and MMUs. FERC has already begun discussions with MMUs to try and coordinate action.

## ***FERC's White Paper***

- On April 28, 2003, FERC released its white paper on Wholesale Power Market Platform
- Key elements reflect a retreat from some elements contained in the SMD NOPR.
- White Paper does not retreat from FERC's firm belief that market monitoring and mitigation are necessary elements of the wholesale market platform.

## ***Federal Legislation***

- Senate Energy Committee approved energy bill on April 30 on a 13-10 vote.
  - No SMD Final Rule before July 1, 2005.
  - Energy bill still before the full Senate. Passage before the end of the session increasingly unlikely.
- House passed Energy Policy Act on April 6 by a vote of 247-175.
- Even if Senate passes an energy bill, House and Senate must still conference.

## ***What does it mean for OMOI?***

- Congressional debate has delayed SMD.
- FERC has shifted away from SMD toward regional RTO development.
- Although regional flexibility is allowed, FERC sees market monitoring and mitigation as key in the formation of regional power markets.

## ***Other Examples of OMOI Enforcement Action***

- On May 16, FERC issued order approving stipulation and consent agreement executed by OMOI and Idaho Power Company.
  - IP will pay \$203,318 to entities harmed by IP's incorrect use of the native load priority;
  - IDACORP Energy to transfer to Idaho Power the net revenue derived relative to certain contract that were not filed with FERC (\$5.8 million);
  - IP will pay \$118,200 to address § 203 violations.

## ***Other Examples of OMOI Enforcement Action***

- In addition to the financial sanctions, IP must also:
  - appoint compliance officers; and
  - retain an independent firm to audit compliance with its standards of conduct and to file an audit report with the Commission.

## ***Other Examples of OMOI Enforcement Action***

- OMOI has already begun to audit a number of utilities to determine compliance with FERC regulations.
- Possible areas of compliance review include:
  - OASIS compliance;
  - Standards of Conduct compliance;
  - OATT implementation; and
  - adherence to Codes of Conduct.

## ***Steps to Lessen Likelihood of OMOI Investigation***

- Steps Companies can take to lessen the likelihood of an OMOI investigation:
  - Internal Compliance Assessments.
  - Establish internal controls, such as compliance manuals.
  - Designate a compliance officer.
  - Adhere to codes of conduct and FERC affiliate rules.

## ***Conclusion***

- FERC has not retreated from its goal of creating regional energy markets.
- In fact, these show cause orders represent FERC's determination to federalize energy markets so that all generation will play by FERC's rules.
- Show cause orders are the beginning of a trend. Companies should act accordingly.

## ***Conclusion***

- Companies should think carefully about the ramifications and implications of settlement in these proceedings.
- Companies should take proactive steps to protect themselves going forward:
  - Establish process for submitting and reviewing communications.
  - Appoint a compliance officer.