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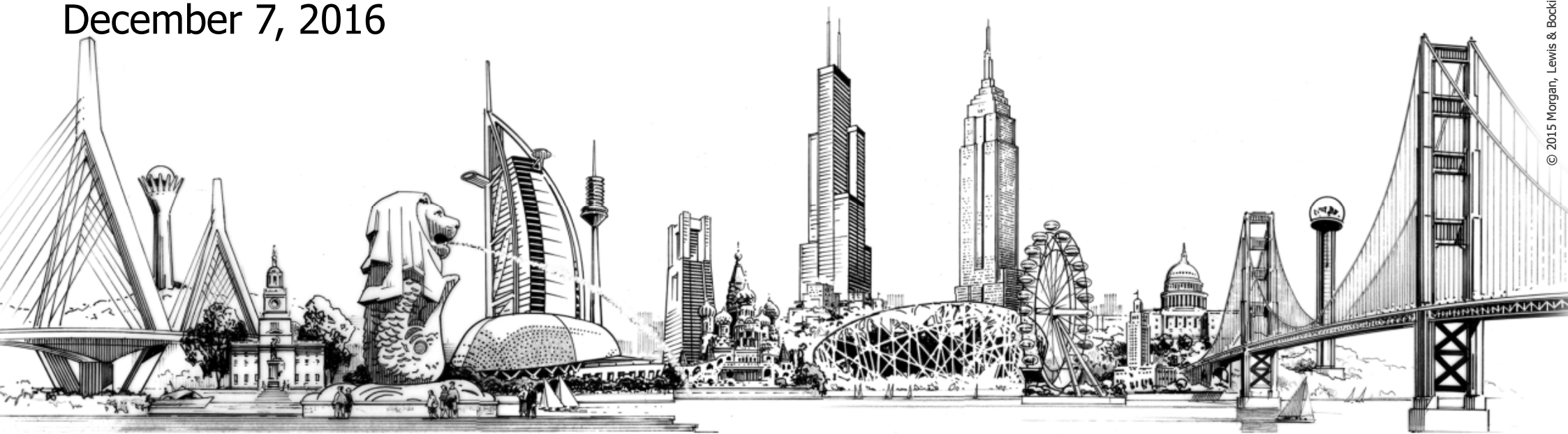
# **2016 FERC ENFORCEMENT YEAR IN REVIEW**

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December 7, 2016



# Agenda

- Federal Court Cases Arising from FERC Enforcement
- FERC's 2016 Enforcement Report
- FERC Guidance on Anti-Market Manipulation Efforts
- FERC Guidance on Trading Compliance Practices
- The Impact of a Trump Administration on FERC Enforcement Policy
- Questions

# **FEDERAL COURT CASES ARISING FROM FERC ENFORCEMENT**

# De novo review of FERC enforcement actions in federal court

- FPA section 316A provides FERC with civil penalty authority for violations of Part II of the FPA (up to \$1 million, per violation, per day)
  - Those civil penalties must be assessed under section 31 of the FPA
- Section 31 allows entities subject to civil penalty action to choose:
  - ALJ hearing at FERC or
  - FERC assessment of penalty, followed by action in federal district court to affirm the assessment of the civil penalty
- Key language: “The court shall have authority to review *de novo* the law and the facts involved, and shall have jurisdiction to enter a judgment enforcing, modifying, and enforcing as so modified, or setting aside in whole or in part, such assessment.”

# *FERC v. Maxim Power Corp et al. (D.Mass)*

- FERC had alleged manipulative actions in power markets, with proposed \$5 million civil penalty for company and \$50,000 civil penalty for individual
- Maxim decided to contest allegations in federal district court
- District court required to resolve issue of the process to use in resolving dispute:
  - FERC argued that the court should only review the materials that the Commission itself relied upon in reaching its decision
  - Maxim argued that the court needed to review and develop the facts in the same manner as an ordinary civil action
- Court held that the *de novo* provision of the FPA requires “treating this case as an ordinary civil action governed by the Federal Rules of Civil Procedure that culminates, if necessary, in a jury trial.”
  - Concerned that anything short of full trial would reduce due process for respondent
  - Concerned that FERC has an inherent bias as both prosecutor and judge in agency actions
- Court also held that discovery may be managed to avoid repetition of FERC’s earlier fact-gathering during the investigation

# *FERC v. City Power Marketing, LLC (D.D.C.)*

- FERC alleged market manipulation by City Power in the PJM market, with proposed civil penalty of \$14 million for City Power, a \$1 million civil penalty for the individual involved, and \$1.2 million in disgorgement
- City Power decided to contest allegations in federal district court
- District court rejected motions to dismiss filed by the respondent, but also addressed the issue of *de novo* review
  - City Power argued for full civil procedures, including discovery and a jury trial, if necessary
  - FERC argued that the court need only examine FERC's own record and the order assessing the civil penalties
- District court decided to treat this as a “standard civil action” governed by the FRCP
  - Explicitly followed the *Maxim Power* decision
  - Expressed concern over City Power's inability to subpoena records or depose witnesses
  - Refused to rule on entitlement to a jury trial

# What does this mean going forward?

- Not *Maxim* and *City Power* are not the last we have heard of this issue
  - Same issue remains pending in *FERC v. Powhatan Energy Fund LLC* (E.D. Va.), *FERC v. Silkman* (D. Maine)
- FERC's enforcement authority has traditionally avoided court review due to:
  - FERC's ability to settle its allegations
  - FERC's ability to pursue market manipulation under statutory authority without *de novo* review
- Court review on a *de novo* basis could have several implications for FERC's enforcement processes
  - Greater reliance on federal courts to resolve allegations of significant non-compliance with the FPA?
  - Revisions to FERC's enforcement processes to streamline proceedings likely to go to district court?
  - Reductions in aggressive interpretations of FERC's anti-manipulation authority?
  - Greater clarity on the scope of FERC's anti-manipulation authority?
  - Different information gathering techniques due to application of Federal Rules of Evidence?

# **FERC'S 2016 ENFORCEMENT REPORT**



# Enforcement Priorities

## Market Behavior

- Fraud and market manipulation
- Anticompetitive conduct
- Conduct that threatens market transparency

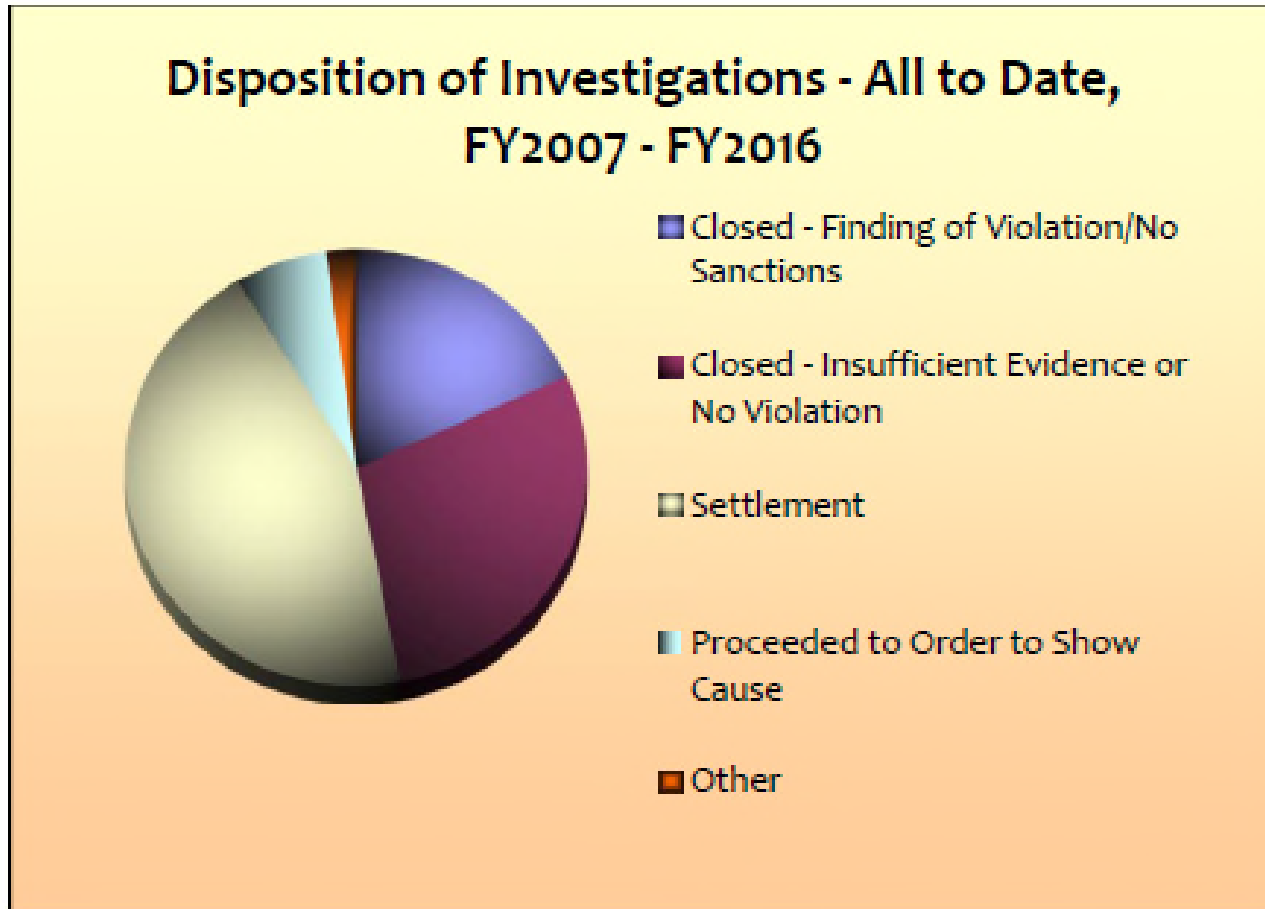
## Reliability

- Serious violations of Reliability Standards

# FY2016 enforcement by-the-numbers

- Analytics and Surveillance
  - Participated in 40+ investigations
  - Reviewed “numerous instances” of possible misconduct
- Investigations
  - 17 new investigations opened
  - 6 investigations closed through settlement
  - 5 investigations closed without action because no violation occurred or lack of evidence
  - Settlements resulted in \$12.25 million in penalties and \$5.7 million in disgorgement
- Audits
  - 14 audits completed of oil pipelines, public utilities, and natural gas companies
  - 214 total audit recommendations
  - Refunds totaling \$5.3 million
- Court proceedings
  - Six actions currently in federal court
  - \$592 million in total penalties and disgorgement sought in court cases
- To-date under its EAct 2005 enforcement authority, FERC has assessed penalties and required disgorgement of amounts totaling more than \$1 billion

# Investigations under EPO Act 2005



# Orders to Show Cause

- *ETRACOM LLC* (Docket No. IN16-2)
  - Allegations of manipulative conduct in violation of the FPA by submitting virtual supply transactions to affect power prices and economically benefits company's congestion revenue rights positions
  - Sought civil penalty of \$2,400,000 against company and \$100,000 against trader
  - Sought disgorgement of \$315,072
  - Currently being litigated in federal court
- *Coaltrain Energy, L.P.* (Docket No. IN16-4)
  - Allegations of manipulative conduct in violation of the FPA by engaging in fraudulent Up-To-Congestion trades
  - Sought civil penalty of \$4,121,894 from company and co-owners
  - Sought civil penalties ranging from \$500,000 to \$5,000,000 from traders
  - Currently being litigated in federal court
- *Total Gas & Power North America, Inc.* (Docket No. IN12-17)
  - Allegations of manipulative conduct in violation of the NGA by trading to affect natural gas index prices to benefit their derivative positions
  - Sought civil penalty of \$213,600 against Total, and \$1,000,000 and \$2,000,000 from implicated traders
  - Sought disgorgement of \$9.18 million
  - District court challenges to the Commission's enforcement actions rejected
  - Currently pending before the Commission

# Settlements

- FERC approved six settlement agreements in 2016 that demonstrated the continued focus on manipulative conduct:
  - *National Energy & Trade, LP* (IN16-5)
    - Violated prohibition on market manipulation by engaging in directional trading at natural gas trading hubs to benefit the company's financial positions.
  - *Saracen Energy Midwest, LP* (IN16-7)
    - Violated the SPP OATT by submitting certain bids for Transmission Congestion Rights where trading in such rights "serves no legitimate purpose"
  - *Berkshire Power Co. and Power Plant Management Services, LLC* (IN16-3)
    - Violated prohibition on market manipulation, market behavior rules, ISO-NE Tariff, and Reliability Standards through concealment of generating plant maintenance outages
      - Power Plant Management Services also pleaded guilty to criminal violation of FPA for this behavior (first criminal conviction in history of FPA)

# Settlements (continued)

- *FERC v. Lincoln Paper & Tissue, Inc.* (case in federal district court)
  - FERC agreed that company could pay penalty as an unsecured claim following Chapter 11 bankruptcy and that civil penalty would be a subordinated claim
    - District court held that the automatic stay in bankruptcy proceedings does not apply to enforcement of FERC civil penalty orders under the FPA
- *FERC v. Maxim Power Corp.* (case in federal district court)
  - In separate investigation from case that went to district court, FERC alleged violations of the prohibition on market manipulation through company's gaming of ISO-NE mitigation procedures to maximize uplift payments when generation dispatched for reliability
  - Maxim agreed to resolve pending district court case along with new allegations in a single settlement

# Self-reports

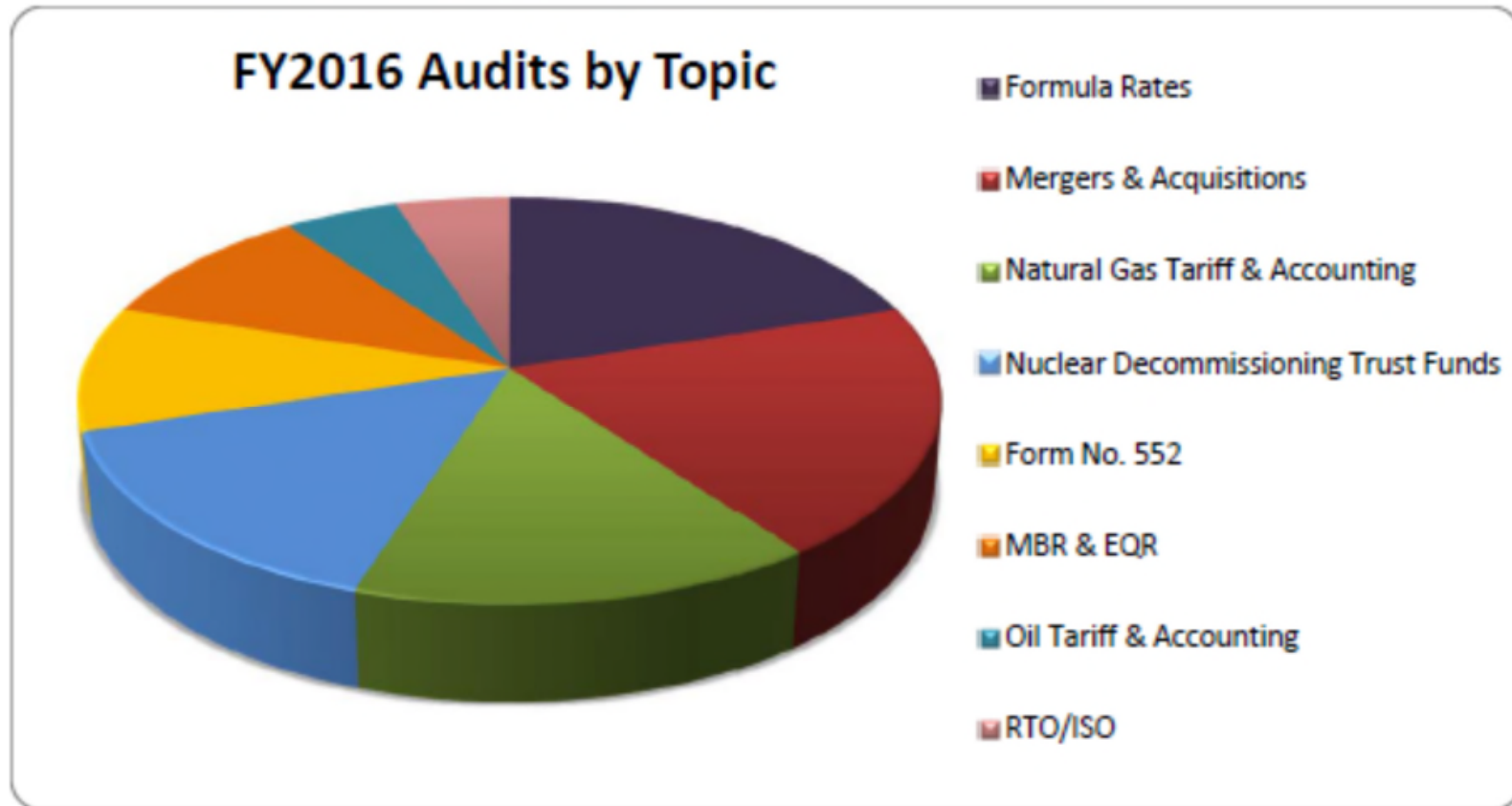
- Self-reports continued to be the largest source of potential allegations of noncompliance
  - 110 new self-reports in 2016
  - 126 self-reports closed in 2016
- Vast majority of self-reports closed without opening an investigation due to “absence of significant harm to the relevant market.” Examples include:
  - RTO/ISO Violations: minor violations of ISO/RTO tariffs resulting from software errors or human errors where harm as relatively small and inadvertent and steps taken to fix issue and avoid recurrence
  - EQR Violations: Errors in a company’s EQRs resulted in 1,100 refiled EQRs but closed without action because (a) company comprehensively reviewed compliance obligations, identified errors, and implemented measures to prevent recurrence, (b) company’s representatives were “thorough and transparent” when dealing with FERC Staff, and (c) there were no allegations of harm from customers

# More self-reports closed without further action

- QF Certification Failure: QF failed to self-certify as a QF; closed without action because QF self-certified and paid time-value refunds
- Trading Violation: Report of inadvertent wash trades closed without action because self-reporting was prompt, company ceased trading products, company lost money on trades, no manipulative intent, and compliance measures implemented to prevent recurrence
- Failure to Report Change-in-Status: Failure to report affiliation with gas lateral pipeline reported upon discovery and change-in-status filed; closed without action because FERC order provided warning and no harm to market
- Interlocking Directorate Violations: After discovery, immediate filings made with FERC and compliance measures implemented to prevent recurrence; also no indication of market harm
- Wholesale Sales without MBR: Company immediately filed for MBR authority and self-reported after discovery of unauthorized sales; FERC approved MBR prospectively and company made time value refunds. Other factors relevant to closing without action were that compliance measures were implemented, a new regulatory manager position created, and unauthorized sales were small and short-lived.
- Violations of Standards of Conduct: Non-public transmission function information available to but not accessed by marketing function employees; closed without action after employees trained, new procedures implemented to avoid similar software problems in the future, notice of disclosure posted to OASIS.



# Division of Audits activities in FY2016



# Division of Audits and Accounting: Focus on Transmission Formula Rates

- Formula rate audits identifying repeated noncompliance related to:
  - Allocation of utility plant in transmission vs. distribution rates
  - Including merger-related costs in rates without FERC approval (typically in violation of hold-harmless commitments)
  - Including merger goodwill in the equity component of capital structure without FERC approval
  - Using state-approved depreciation rates, rather than FERC-approved depreciation rates in transmission rates
  - Including Asset Retirement Obligations in formula rates without FERC approval
  - Inadequate controls for ensuring proper charging and allocation of labor costs
  - Recording nonoperating expenses and functional operating and maintenance expenses in A&G expense accounts

# Division of Audits and Accounting: Focus on Natural Gas Accounting and Tariff Issues

- Gas pipelines failing to (a) use the method required by their tariff for valuing system gas activities, (b) enforce stipulations in Operational Balancing Agreements to manage and monitor gas imbalances between interstate and intrastate pipelines, (c) update reservation credit procedures, and (d) report operational available capacity data as required by NAESB
- Gas pipelines failing to comply with accounting requirements for gas charges and activities such as incorrect derivations of AFUDC and charging donations, fines, penalties, and lobbying activities to customers
- Gas pipelines misclassifying integrity management costs (which should be recorded as maintenance expenses)
- Gas pipelines failing to post available pipeline capacity correctly

# **FERC GUIDANCE ON ANTI-MARKET MANIPULATION EFFORTS**

# Background

- Prior to the Energy Policy Act of 2005 (EPAct 2005), FERC's enforcement action authority for market manipulation activities only applied to electric sellers with market-based rate authority and natural gas sellers with blanket certificates.
  - FERC's powers were limited to revoking either the market-based rate authority or blanket certificate and directing disgorgement of unjust profits.
  - FERC notably lacked the authority to impose significant civil penalties under the Federal Power Act and lacked civil penalty authority altogether under the Natural Gas Act.
- EPAct 2005 changed this. The legislation allowed FERC to impose significant civil penalties for violations of all sections of Part II of the FPA and the NGA, and expressly prohibited manipulative acts in connection with jurisdictional transactions by "any entity."
- The White Paper assesses the impact of the broadening of FERC's authority in the more than ten years since EPAct 2005 was passed.

# Indicia of Fraud Under the Anti-Manipulation Rule

- The White Paper highlights that FERC, in various orders has provided some guidance in identifying key indicia it deems relevant to determining whether fraud has occurred in violation of its Anti-Manipulation Rule. Examples Staff highlights include:
  - *Illicit Purpose* – The purpose underlying market behavior can determine whether that behavior is fraudulent. In three recent orders addressing Up-To Congestion trades in PJM, the Commission found it significant that trades engaged in had no relationship to the purpose of UTC trades. *See, e.g., Houlian Chen*, 151 FERC ¶ 61,179, at P 80 (2015).
  - *Uneconomic Conduct* – When an entity knowingly engages in behavior that loses money on a stand-alone basis (or is indifferent to such losses) but engages in that behavior anyway to serve an ulterior purpose. However, profitability by itself is not dispositive. *See, e.g., BP America, Inc.*, 156 FERC 61,031, at PP 22, 131-34 (2016).
  - *Inconsistency with Market Fundamentals* – Participants in energy markets should have as their price signal supply and demand fundamentals, not ancillary considerations that bear no relation to underlying market fundamentals.

# Types of Market Manipulation

- EAct 2005 granted FERC a flexible and broad statutory framework to prohibit and penalize manipulative conduct.
- *Cross-Market Manipulation Schemes* – Trading in one market with the intent to move prices in a particular direction to benefit positions in a related market.
  - Recent electric cross-market cases have involved:
    - Trading physical or virtual power to influence Financial Transmission Rights (FTR) or Congestion Revenue Rights (CRR). *See, e.g., Barclays*, 144 FERC ¶ 61,041.
    - Financial swap positions.
    - A market participant's overall generation fleet. *Gila*, 141 FERC ¶ 61,136.
  - Recent natural gas cross-market cases have involved:
    - Trading physical gas to affect published index prices that benefit related financial positions tied to those same index prices. *See, e.g., BP*, 156 FERC ¶ 61,031.

# Types of Market Manipulation (continued)

- *Gaming of Market Rules* - Reflected in FERC's broad definition of fraud and includes behavior that circumvents or takes unfair advantage of market rules or conditions in a deceptive manner that harms the proper functioning of the market and potentially other market participants or consumers. Examples include:
  - Riskless transactions executed to receive a collateral benefit. *See, e.g., Chen*, 151 FERC ¶ 61,179 at P 104.
  - Conduct which is inconsistent or interferes with a market design function. *See, e.g., JP Morgan*, 144 FERC ¶ 61,068.
  - Conduct that takes unfair advantage of market rules to the detriment of other market participants and market efficiency. *See, e.g., id.*
- *Misrepresentations and Omissions* – Examples include:
  - In a group of four cases involving ISO-NE's Day-Ahead Load Response Program (DALRP), the Commission found that two entities misrepresented their typical load and their ability to reduce load by adjusting their energy use during an initial "baseline" period. *See, e.g., Rumford Paper Co.*, 142 FERC ¶ 61,218 (2013) (settlement).
  - Two paper mills in Maine misrepresented to ISO-NE that they had a higher load amount when they intentionally reduced their on-site generation and purchased more power from the grid. Then, after the baseline period, the mills resumed normal use of their on-site generation and purchased less energy from the grid, thus creating the illusion that they had reduced electricity consumption. *CES*, 144 FERC ¶ 61,163 at P 43; *Lincoln*, 144 FERC ¶ 61,162 at P 30.



# Mitigating and Aggravating Factors

- Sources of FERC's previously described mitigating and aggravating factors affecting penalties for violations of its rules are its various policy statements and Penalty Guidelines. *See, e.g.,* Revised Policy Statement on Penalty Guidelines, 132 FERC ¶ 61,216 (2010) (attaching FERC Penalty Guidelines).
  - *Commitment to Compliance* – Substantial penalty reductions are afforded to entities that have effective compliance programs. FERC details seven factors that make for an effective compliance program in its Penalty Guidelines. However, FERC has refused to provide any compliance credit to some entities that had documented compliance program but did not follow them.
  - *Self-Reporting* – FERC believes that self-reporting credit adds “significant value to overall industry experience” and serves as an incentive for entities to detect and correct violations early.
  - *Cooperation* – “Great importance” is placed on good-faith and consistent cooperation throughout an investigation. FERC therefore provides credit for cooperation to reduce a company's culpability score under its Penalty Guidelines and has provided guidance on what is required to achieve the credit. This can be achieved by, among other things:
    - Timely producing pertinent information and witnesses. *See Gila River*, 141 FERC ¶ 61,136 at P 16.
    - Disclosing all pertinent information known by the company. *See* FERC Penalty Guidelines, Section 1C2.3(g) App. Note 11.

# Decisions to Close Investigations

- FERC Staff noted that it closes a significant number of market manipulation investigations with no action after finding no violation.
- Examples of investigations resulting in no action:
  - A trader providing a “credible, legitimate” explanation for submitting virtual bids which themselves lost money but caused the value of a firm’s FTR position to rise substantially on one day. *See 2015 FERC Enforcement Report.*
  - Whether a demand response aggregator enrolled a resource in a yearly demand response capacity program knowing the resource’s operating level could vary widely during the delivery year. Staff lacked “sufficient” details regarding the timing and extent of potential changes in the resource’s operating level to draw any concrete conclusions concerning the activity. *See 2015 FERC Enforcement Report.*
  - Whether a financial institution engaged in manipulation by increasing the quantities of Congestion Revenue Rights held at two locations and proceeding to schedule price-taking physical import bids at one of the locations. FERC Staff determined that groups responsible for the CRRs and imports and operated independently and that economic fundamentals supported the behavior. *See 2014 FERC Enforcement Report.*

# **FERC GUIDANCE ON TRADING COMPLIANCE PRACTICES**

# Background

- Since The Energy Policy Act of 2005 broadened FERC's power to enforce prohibition against market manipulation under the Federal Power Act and the Natural Gas Act, the Commission has emphasized its commitment to promoting compliance with its rules and applicable statutes.
- Various FERC issued guidance provides for a number of factors that it considers in determining whether to provide mitigation credit for compliance efforts in any penalty decisions.
- Although FERC's Penalty Guidelines state that an organization must (1) exercise due diligence to prevent and detect violations; and (2) otherwise promote an organizational culture that encourages a commitment to compliance, FERC emphasizes that there is no "one-size-fits-all" approach to compliance.
- Most recently FERC issued a Policy Statement on Penalty Guidelines (revised as of September 2010) which sets forth a guideline-based structure for assessing civil penalties.
- This White Paper supplements FERC's guidance and is meant to respond to requests for additional guidance by industry participants by providing examples of compliance practices that have been effective or ineffective in detecting and deterring market manipulation and other violations of FERC rules.

# Effective Trading Compliance Practices

- An organization and its executive officers must be committed to promoting compliance at all levels by devoting resources, enforcing rules, and ensuring employees understand compliance obligations. The White Paper identifies the following features for an effective compliance program:
  - *Organizational Structure and Composition* – Compliance personnel should have a variety of expertise, including legal, day-to-day operations, risk management, and trading.
  - *Human Resources* – Hire traders that are able and willing to learn and adhere to the rules that apply to their trading activities. And a trader compensation structure should be created which incentivizes compliance, not just profitability.
  - *Training* – Employ a training program that is appropriate for: (1) an organization's size; (2) its trading activities; and (3) the experience level of the traders. Traders should be aware of any changes in rules or requirements to that apply to them on a timely basis.
  - *Information Technology Resources* – Commit sufficient resources to an organization's compliance program to purchase, maintain, and operate IT resources that will make their compliance programs more efficient and effective.

# Implementing and Enforcing Effective Practices to Deter and Detect Misconduct

- FERC Staff identifies that organizations struggle the most in monitoring their traders' activities to identify potential misconduct, FERC Staff suggests the following methods to achieve this:
  - *Establish Appropriate Trading Rules and Restrictions* - Place appropriate restrictions on trading activities which limit the traders' ability and incentives to manipulate or engage in other misconduct. This could include:
    - Maintaining a list of prohibited trading strategies.
    - Documenting trading strategies.
    - Requiring traders to obtain approval from compliance or upper management before trading new products or at new locations
    - Implementing restrictions that discourage or prevent traders from using price-setting instruments to benefit open financial positions.
  - *Monitoring Trading Activity* – Monitoring methods that could prove effective include automated surveillance tools or algorithms that track trading data and communications. Staff notes that whatever monitoring tools are used, it is important that they are used routinely and that all potential issues are taken seriously.
  - *Enforcing Rules and Restrictions* – This could include: (i) following up on all alerts of possible misconduct; (ii) documenting resolution taken in response to alerts; (iii) establishing appropriate disciplinary action; and (iv) disciplining employees for all instances of noncompliance.

# Regularly Assessing Compliance Program Performance

- In accordance with FERC's Penalty Guidelines, Staff suggests that an organization take reasonable steps to periodically evaluate the effectiveness of an organization's compliance program.
- Regular evaluations help to: (1) ensure the program's compliance tools continue to be effective; (2) uncover compliance gaps and failures; and (3) identify where updates are necessary.
- Suggested steps to achieve this include:
  - Performing regular performance audits of an organization's compliance program.
  - Taking action on all issues identified in compliance program's performance program. An organization should document all of the issues identified during its performance audits and take action to improve the compliance program.

# Ineffective Trading Compliance Practices

- Staff also identified ineffective compliance practices it observed as part of its investigative and surveillance efforts which generally reflect an organization's failure, among other things, to (i) tailor compliance programs to the needs of its trading operations; (ii) keep the compliance program up-to-date; (iii) follow through on monitoring for violations and enforcing compliance-related rules.
- Staff recommended that organizations *do not* employ the following ineffective practices:
  - **Heavily relying on standardized and long annual training.** Traders are less likely to absorb pertinent information from standardized trainings that cover too many topics that may or may not be applicable to a trader's responsibilities.
  - **Heavily relying on attorneys for training without including operational staff.**
  - **Providing insufficient funding for an organization's compliance program.**
  - **Allowing commercial trading staff to overrule compliance advice**
  - **Failing to regularly reassess and update compliance practices as circumstances change.**
  - **Failing to monitor for violations or discipline those who violate compliance-related rules in a meaningful way.**
  - **Implementing policies that inhibit or prohibit retention of trader communications.**



# **THE IMPACT OF A TRUMP ADMINISTRATION ON FERC ENFORCEMENT POLICY**

# Changes in Commissioners

- Current commission:
  - Chairman Norman C. Bay (D) (term expires June 30, 2018)
  - Commissioner Cheryl A. LaFleur (D) (term expires June 30, 2019)
  - Commissioner Colette D. Honorable (D) (term expires June 30, 2017)
- Two open Republican seats
  - Commissioner Tony Clark (R) (resigned September 30, 2016)
  - Commissioner Philip D. Moeller (R) (resigned October 30, 2015)
- Filling seats requires presidential appointment and senate confirmation (42 USC 7171(b))
  - No more than three members of any political party
  - President also has ability to designate the Chairman

# Changes in Enforcement Policy

- Room for significant changes given language of statutes and FERC's regulations
  - Much enforcement policy developed through settlement, with supporting guidance
- Appetite for change in enforcement area will depend on eventual picks for Chairman and remaining commissioners
  - Each Chairman's priorities differ and set the agenda for FERC
  - Enforcement actions are inherently an exercise of executive discretion
- Possible areas for change include:
  - What is market manipulation and how should it be policed?
  - What role does discretion play in FERC's enforcement authority?
  - What is the purpose of enforcement activities?
  - How should FERC's limited resources be prioritized?
  - Do past enforcement practices discourage infrastructure investment?

# Questions?

## Competitive Transmission Development

December 7, 2016

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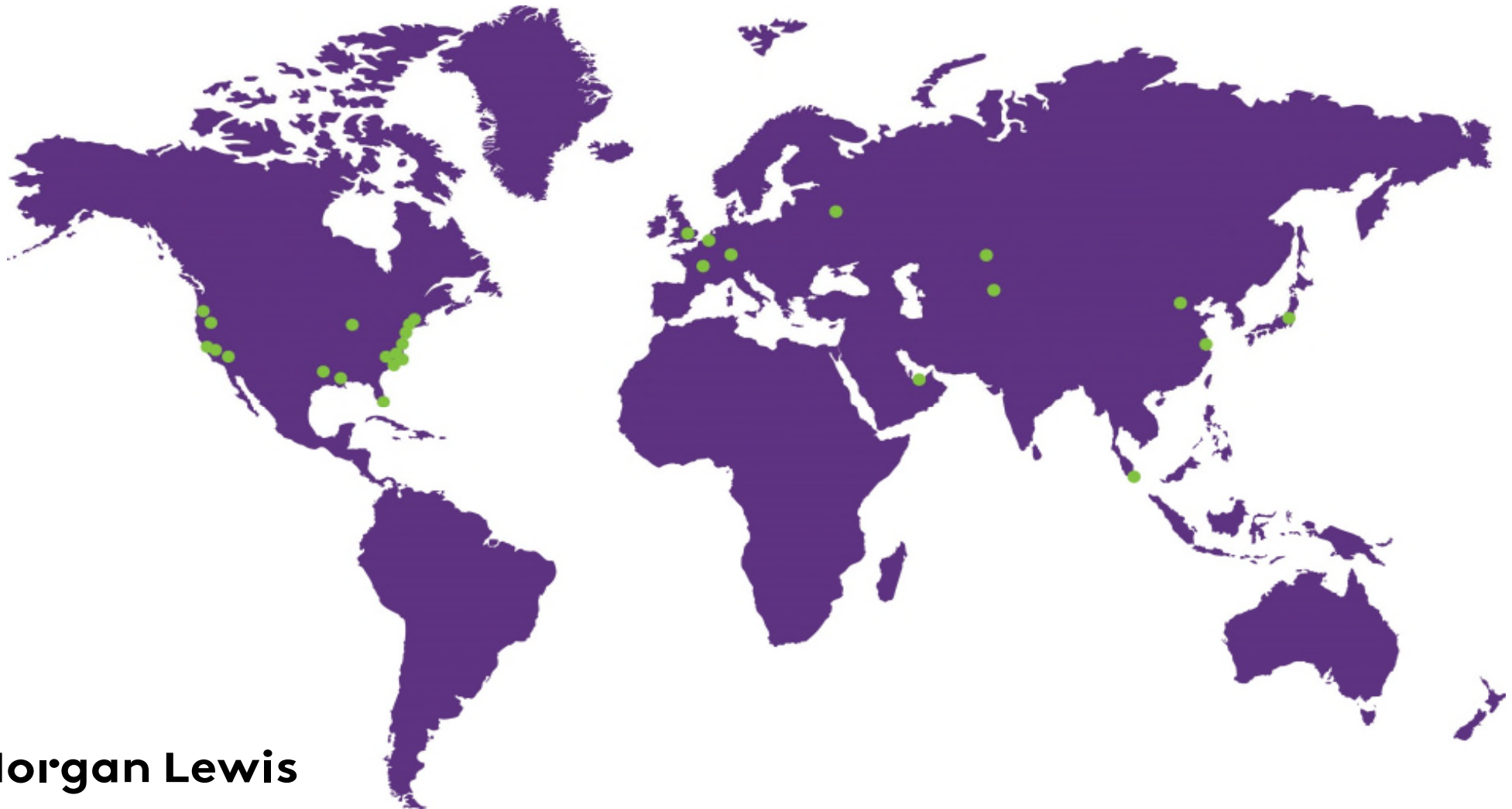
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## Our Global Reach

Africa  
Asia Pacific  
Europe  
Latin America  
Middle East  
North America

## Our Locations

Almaty	Dallas	Los Angeles	Philadelphia	Silicon Valley
Astana	Dubai	Miami	Pittsburgh	Singapore
Beijing	Frankfurt	Moscow	Princeton	Tokyo
Boston	Hartford	New York	San Francisco	Washington, DC
Brussels	Houston	Orange County	Santa Monica	Wilmington
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