Federal Energy Regulatory Commission Anti-Manipulation Authority And Its Recent Application

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About the Author

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Executive Summary

Recent federal enforcement actions against large financial participants in the U.S. electric power markets have gained national media attention, as well as the attention of the U.S. Senate and Department of Justice. The ultimate victims of market prices distorted due to manipulation are the end-user customers who purchase electricity from public utilities regulated by the state.

Yet the state's role in protecting the end users' interests in federal actions against market manipulation is unclear. Given the number of actions and the dollar amounts of recent penalty assessments (totaling over $1 billion), it seems clear that the manipulation taking place is having significant impacts on the market, and that states ought to have a forum to ensure that end-use ratepayer interests are adequately represented in both the enforcement actions and the allocations of recovered amounts.

This briefing paper represents the first part of a two-part study that will outline for the state regulatory community (1) opportunities for and barriers to their participation in federal enforcement matters, (2) whether it is worth their while to engage in enforcement actions, and (3) what benefits could accrue to end-use ratepayers if state regulators were to engage in anti-manipulation actions.

The briefing paper offers a brief history of Federal Energy Regulatory Commission (FERC) enforcement authority up to the passage of the Energy Policy Act of 2005. It discusses the 2005 reforms and the series of administrative policies FERC has since adopted in order to effectuate its enhanced enforcement authority.

The briefing paper then examines four recent actions brought by the FERC Office of Enforcement against (1) Deutsche Bank Energy Trading, LLC; (2) Constellation Energy Commodities Group, Inc.; (3) JPMorgan Ventures Energy Corporation; and (4) Barclays Bank, PLC. This section discusses the federal allegations of market manipulation, penalties, and profit disgorgements that have been assessed, and the procedural postures of cases yet to be resolved.

Finally, the briefing paper introduces some of the topics that will be examined in the second phase of the report. The forthcoming report (February 2014) will examine power-marketer participation in the electric power markets and the impacts of market manipulation on end-use ratepayers. It will examine more closely the strategies employed to manipulate electric power markets. It will also describe the various federal agencies that bring enforcement actions in electric-market manipulation cases in order to determine which forums may be open for state participation. It will analyze the jurisdictional boundaries, both among the federal enforcement agencies and between federal and state agencies that may have interests in pursuing enforcement actions against electric-power-market participants. Finally, it will inform the state regulatory community what enforcement options exist and what ratepayer benefits can accrue from their participation in such actions.

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Federal Energy Regulatory Commission Anti-Manipulation Authority And Its Recent Application

I. Introduction

Over the past two-plus years, the public and media have taken notice of robust Federal Energy Regulatory Commission (FERC) Office of Enforcement (OE) actions and settlements brought against large U.S. banks and power marketers for manipulative behavior in the U.S. power markets. The magnitude of these actions—both the size of the imposed penalties and the particulars of the manipulative behavior—have gained the attention of the U.S. Senate Permanent Subcommittee on Investigations, which recently requested documents related to FERC's investigation of JPMorgan Chase & Co.[1] FERC has stated that improper payments in the power markets are ultimately borne by the households, business, and government entities that are end users of electricity.[2] End-user purchases of electricity, made from public utility distribution companies, fall under the jurisdiction of state public utility commissions.

Yet the state regulatory commission's role in the ongoing enforcement matters is unclear if not undefined. FERC's high-profile actions against large banks and power marketers include recent settlements with Constellation Commodities Group LLC, Deutsche Bank, and JPMorgan Chase & Co., as well as an assessment of civil penalties against Barclays PLC. Taken together, these actions have totaled over $1 billion in penalties and profit disgorgements.

These amounts appear to have been ascertained and distributed to compensate end-use ratepayers via top-down decisions ordered by FERC; the amounts may also have been left to the internal accounting practices of the impacted regional transmission organizations (RTOs). It is unclear whether the amounts ascertained and the manners of distribution sufficiently account for the interests of end-use ratepayers; in turn, it is unclear whether ratepayer interests are adequately represented in federal enforcement actions.

Therefore, an examination into barriers to—and opportunities for state regulatory commission participation in—federal enforcement actions may help determine whether harm to a particular state's end users is adequately accounted for and whether it is worthwhile for states to expend scarce resources to ensure proper representation of ratepayer interests.

This research paper will be completed in two phases. Phase I, the current document, is a Briefing Paper that will (1) examine FERC's recently enhanced authority to pursue market manipulation actions against power-market participants since the passage of the Energy Policy

[1] Ryan Tracy, "Senate Joins Probes of JPMorgan Energy Trading," *Wall Street Journal*, August 28, 2013.

[2] Ryan Tracy and Dan Fitzpatrick, "Regulator Outlines JPMorgan Electricity-Market Allegations," *Wall Street Journal*, July 29, 2013.

Act of 2005,[3] and (2) examine the types of manipulation alleged and actions taken against the four parties noted above.

The topics covered in this briefing paper raise a number of "central" and "secondary" questions that will be the focus of a comprehensive Phase II report that will be issued in February 2014. At the heart of the Phase II report are the following central questions:

1) Which avenues exist for state participation in federal enforcement actions?

2) Is it in a state's interest to participate in enforcement-related matters?

3) What benefits can accrue to ratepayers if states were to engage in enforcement proceedings?

Answers to these questions depend on an examination of underlying or secondary questions related to market participation, manipulation, and jurisdiction. Such questions include:

(A) What are the impacts of power-market manipulation on jurisdictional ratepayers in both organized electric markets and vertically integrated regions?

(B) What roles do power marketers and banks play in the functioning of the electric power markets?

(C) What are the jurisdictional mandates of the various federal enforcement agencies as they relate to electric markets, and what are the jurisdictional boundaries between federal and state agencies in pursuing actions?

The goal of the Phase II report will be to recommend to the state regulatory community what steps it may take to ensure that the interests of its ratepayers are adequately represented in ongoing and future enforcement actions. Ultimately, greater coordination and communication among federal enforcement agencies (including the FERC Office of Enforcement, the Commodity Futures Trading Commission, and others) and state agencies such as state attorneys general and public utility regulatory commissions may lead to better information about market-manipulation practices and could help to curve such practices in the future.

II. FERC Enforcement Authority

A. A brief history of FERC enforcement authority

FERC traces its history back to the Federal Power Commission (FPC), created in 1920 by the Federal Water Power Act.[4] In response to the Great Depression, President Franklin

[3] Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594 (2005).

[4] Federal Water Power Act, 16 U.S.C. 791-828c, Chapter 285, June 10, 1920, 41 Stat. 1063.

Roosevelt signed the Federal Power Act in 1935, transforming the FPC into an independent agency whose mission was to ensure "just and reasonable" wholesale electricity prices.[5] In September 1977, the FPC was renamed FERC under §4 of the Department of Energy Reorganization Act,[6] and in December of that year, FERC created the Office of Enforcement to assist in implementing the agency's regulatory goals.[7]

FERC's enforcement role was rather limited prior to the deregulation of major industries that occurred throughout the 1980s. After Congress passed the Energy Policy Act of 1992 (EPACT 1992)—which initiated a transition in the electric industry from full regulation of power sales to partial deregulation and competition for energy producers and suppliers—FERC acquired oversight authority. Also during the 1990s, some states adopted legislation deregulating the power-generation sector, and electric utilities either sold off their generation assets or transferred the assets to market-based affiliates. Many other states chose to preserve their vertically integrated utilities and limited or prohibited direct competition in their generation sectors.[8]

By the early 2000s, energy-commodity prices were determined more than previously by the trading of financial instruments, such as futures and derivatives, and the value of these instruments was tied to the prices of the underlying oil, gas, and energy commodities.[9] Electricity deregulation created new trading possibilities by permitting companies that owned power plants and their intermediaries to sell electricity in regional auctions, which were envisioned as a way to reduce prices by creating a competitive market among suppliers—but the trading rules were complex, and traders found ways to exploit the rules for profit.[10]

B. FERC enforcement authority post-EPACT 2005

In response to the California Energy Crisis, and in the wake of Enron Corporation's manipulative schemes in the western U.S. electricity markets, Congress passed the Energy Policy Act of 2005 (EPACT 2005),[11] which amended the Federal Power Act (FPA) to give FERC the

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[5] Federal Power Act, 16 U.S.C.A. § 791a (1935).

[6] Pub. L. No. 95-91, §2-1002, 91 Stat. 565 (1977) (amended 1978).

[7] William Scherman, John Shepherd, and Jason Fleischer, "The New FERC Enforcement: Due Process Issues in the Post-EPACT 2005 Enforcement Cases," *31 Energy L.J.* 55, 57 (2010).

[8] Marc D. Machlin, Esq. and Min Choi, Esq., "This Is Not Your Father's FERC: Understanding the New, Control Role of FERC's Enforcement Division—Part I," Pepper Hamilton Sustainability Counsel, July 2, 2013.

[9] Ibid.

[10] Rebecca Smith and Christian Berthelsen, "Deutsche Bank Fined Over Energy Trading Scheme," *Wall Street Journal*, January 22, 2013.

[11] Energy Policy Act of 2005, 16 U.S.C. §824 (2000) (Enacted as Pub. L. No. 109-58, Title Xii, Subsection A, 1119 Stat. 594, 941). *See also,* fn. 3.

broad authority to prohibit energy-market manipulation and increased FERC's civil penalty authority for violations under the FPA, Natural Gas Policy Act (NGPA), and Natural Gas Act (NGA) to $1 million per day for each day the violation continues.[12]

In relevant part, FPA §222, 16 U.S.C. §824v(a) makes it

> unlawful for any entity…directly or indirectly, to use or employ, in connection with the purchase or sale of electric energy…any manipulative or deceptive device or contrivance…in contravention of such rules and regulations as the Commission may prescribe as necessary and appropriate in the public interest or for the protection of electric ratepayers.[13]

Congress modeled FERC's new enforcement authority after Rule 10(b)-5, promulgated pursuant to §10(b) of the Securities Exchange Act of 1934.[14] FERC implemented the statute in 2006 by issuing Rule 1c.2:

> It shall be unlawful for an entity, directly or indirectly, in connection with the purchase or sale of electric energy or the purchase or sale of transmission services subject to the jurisdiction of the Commission,
>
> (1) To use or employ any device, scheme, or artifice to defraud,

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[12] Respectively, EPACT 2005 §1284(e)(2); §314(b)(2) and §13(b)(1). *See also 31 Energy L.J.* 55, 58.

[13] 16 U.S.C. §824v(a)

[14] Securities Exchange Act of 1934, 15 U.S.C.A. § 78j-2. Rule 10(b)-5 states:

> 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.

"Employment of Manipulative and Deceptive Devices," 17 C.F.R. § 240.10b–5.

> (2) 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
>
> (3) To engage in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity.[15]

C. Subsequent FERC statements on enforcement and penalties

In January 2006, FERC issued a Final Rule on the Prohibition of Energy Market Manipulation, permitting the Commission to "police all forms of fraud and manipulation that affect natural gas and electric energy transactions and activities the Commission is charged with protecting."[16] FERC included in the final rule the affirmation that SEC case law amassed over the past decades would provide guidance to its own enforcement actions, as Congress deliberately modeled portions of the EPACT 2005 on §10(b) of the Exchange Act.[17]

The Final Rule broadly defined fraud to include "any action, transaction or conspiracy for the purpose of impairing, obstructing or defeating a well-functioning market."[18] A transaction is covered by FERC rules if "in committing fraud, the entity…intended to affect, or have acted recklessly to affect, a jurisdictional transaction" as long as there is a nexus between the conduct and a jurisdictional transaction.[19]

The Order also defined the elements of FERC's Anti-Manipulation Rule, indicating that the Commission will act in cases where an entity

> (1) uses a fraudulent device, scheme or artifice, or makes a material misrepresentation or a material omission as to which there is a duty to speak under a Commission-filed tariff, Commission order, rule or regulation, or engages in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity;

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[15] "Prohibition of Electric Energy Market Manipulation," 18 C.F.R. 1c.2. For a comparison with the Securities Exchange Commission Rule, *See* 17 C.F.R. §240.10b-5 or fn. 14.

[16] FERC Order 670 (2006), "Prohibition of Energy Market Manipulation," 114 F.E.R.C. ¶61,047, ¶25. *See also 31 Energy L.J.* 55, 59.

[17] Ibid., ¶31.

[18] FERC Order 670, ¶50. *See also* Lawrence, Gregory K. and Terence T. Healey, "United States: FERC Enforcement: The Pit and the Pendulum," Cadwalader, Wickersham & Taft LLP, May 7, 2013.

[19] Ibid., ¶22.

(2) with the requisite scienter;[20]

(3) in connection with the purchase or sale of natural gas or electric energy or transportation of natural gas or transmission of electric energy subject to the jurisdiction of the Commission.[21]

FERC issued a May 2008 Revised Policy Statement on Enforcement in response to concerns about the application of its penalty authority.[22] The Revised Policy Statement set forth the factors the Commission takes into account when assessing a penalty, offering greater detail than it had provided in the 2005 Policy Statement. It also described the steps involved in an audit and the steps involved in an investigation, including a description of the types of matters regarding which enforcement staff either determine not to open an investigation, or close an investigation without a finding of a violation or recommendation of sanction.[23]

On October 16, 2008, FERC issued a Policy Statement on Compliance that offered additional guidance on the key elements of internal compliance programs that FERC will consider in deciding whether to reduce or forego potential civil penalties for violations.[24] The new Policy Statement listed four key elements that FERC will consider when evaluating its response to a violation of its regulations: (1) actions of senior management; (2) effective preventive measures; (3) prompt detection, cessation, and reporting of the offense; and (4) remediation efforts.[25]

Finally, in March 2010, FERC issued a Policy Statement on Penalty Guidelines and a Revised Statement in September 2010.[26] While the Revised Statement emphasized that compliance, rather than assessment of penalties, is FERC's ultimate goal, FERC noted the importance of penalties in prompting compliance.[27] Importantly, the Revised Statement affirmed

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[20] Black's Law Dictionary defines Scienter as: 1. A degree of knowledge that makes a person legally responsible for the consequences of his her act or omission; the fact of an act's having been done knowingly, especially as a ground for civil damages or criminal punishment. 2. A mental state consisting in an intent to deceive, manipulate, or defraud. In this sense, the term is used most often in the context of securities fraud. Garner, Bryan A. <u>Black's Law Dictionary, Third Pocket Edition</u>. Thomson West, 1996.

[21] Id, FERC Order 670, ¶49.

[22] *See* FERC Revised Policy Statement on Enforcement, 123 FERC ¶61.156, ¶4. May 15, 2008.

[23] Ibid., ¶13. *See also 31 Energy L.J.* 55, 59.

[24] FERC Policy Statement on Compliance, 125 FERC ¶ 61,058, October 16, 2008.

[25] Ibid.

[26] FERC Revised Policy Statement on Penalty Guidelines, 132 FERC ¶61,216, September 17, 2010

[27] Ibid, ¶112.

FERC's March 2010 decision to include a settlement in the definition of "prior adjudication" regardless of whether the settlement included an admission of the violation.[28] Thus, organizations are on notice that a settlement could be used to bolster a penalty hat is assessed for future misconduct.

III. Examinations of Recent FERC Enforcement Actions

Prior to its investigation of large banks, manipulation investigations settled by OE almost exclusively involved entities whose primary business was energy related.[29] These companies had continuing relationships with FERC—their primary regulator—and a substantial portion of the companies' revenues were tied to conduct regulated directly by FERC.[30] In the case of the big banks, FERC is not the primary regulator, and the banks' energy-trading operations are less essential to their businesses.[31]

This section will briefly examine the enforcement actions OE has brought against three large banks and an energy marketer within the past two-plus years.

A. Deutsche Bank Energy Trading, LLC

1. Order to Show Cause

In its September 5, 2012 Order to Show Cause and Notice of Proposed Penalty,[32] FERC alleged that Deutsche Bank Energy Trading (DBET) had violated FERC's Anti-Manipulation Rule[33] and market-behavior rules on accurate and factual communications,[34] as well as parallel provisions of the California Independent System Operator (CAISO) tariff.[35] EO further alleged

[28] Ibid. FERC Penalty Guidelines, Chapter 1, Part A, p. 91.

[29] Mark Robeck and Brooksany Barrows, "FERC Takes Aim at Big Banks," *Baker Botts Compliance and Enforcement Report*, Vol. II, Issue 2, June 2013.

[30] Ibid.

[31] Ibid. This may explain why FERC's expanded authority to prosecute manipulation in energy markets has been directed at banks rather than energy companies. Ibid.

[32] FERC Order to Show Cause and Notice of Proposed Penalty, 140 FERC ¶61,178, ¶2, September 5, 2012.

[33] 18 C.F.R. §1c.2 (2012)

[34] 18 C.F.R. ¶35.41(b)

[35] CAISO Tariff, §§'s 35.7, 35.5.

that DBET conceived and executed a fraudulent scheme of scheduling physical transactions to benefit its financial Congestion Revenue Right (CRR)[36] positions.

Specifically, OE alleged that DBET scheduled exports from CAISO at Silver Peak with the intent to eliminate import congestion and, thereby, benefit its CRR position at Silver Peak. In addition, OE alleged that the bank had falsely designated certain imports and exports as wheeling-through transactions,[37] even though the bank was not wheeling power and those schedules did not meet the CAISO tariff requirements for wheeling-through transactions.[38]

According to FERC, the DBET traders at issue in the case conceived and executed a scheme that they called the “Export Strategy” in response to a de-rating[39] at Silver Peak that caused import congestion and caused DPs CRR position to lose value. The Export Strategy entailed scheduling exports at Silver Peak to eliminate import congestion and pairing those exports with imports at Summit of the same quantity.[40] While DBET scheduled all imports and exports as wheeling-through transactions, in fact, the DBET traders created a circular schedule in which no power flowed to or from California.[41]

However, the Export Strategy increased the value of DBET’s CRR position by eliminating the import congestion that had decreased the value of its CRR position. Taking further advantage of the strategy, the DB traders increased their CRR position for Silver Peak; while the physical transactions at Silver Peak and Summit lost money each day, the benefit to DBET’s CRR position outweighed the loss.[42]

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[36] Congestion revenue rights are financial instruments that enable CRR holders to manage variability in congestion costs based on locational marginal pricing. CRRs are acquired primarily, although not solely, for the purpose of offsetting integrated forward market congestion costs that occur in the day-ahead market. *See* “Congestion Revenue Rights,” California ISO, http://www.caiso.com/market/Pages/ProductsServices/CongestionRevenueRights/Default.aspx

[37] When a wheeling transaction takes place, the ISO receives electric energy into its control area from one party and then transmits this energy to a third party either outside the control area or off the ISO Controlled Grid. For example, an entity like BPA would be outside the ISO Control Area; an entity like a municipality would be within the ISO Control Area, but off the ISO Controlled Grid. In a wheeling transaction, no energy is consumed by entities on the ISO Controlled Grid. “California ISO Settlement Guide,” May 2, 2005, http://www.caiso.com/Documents/WheelingCharges.pdf

[38] Ibid., Order to Show Cause, ¶2.

[39] To de-rate is to lower the rated electrical capability of electrical apparatus.

[40] FERC Enforcement Staff Report and Recommendation, Docket No. IN12-4-000, September 5, 2013, p. 2.

[41] Ibid., p. 3.

[42] Ibid.

OE staff alleged that the scheme was fraudulent because DBET's exports at Silver Peak were entered into without regard to their economics or supply-and-demand fundamentals, but rather to increase the value of its CRRs by altering congestion at Silver Peak.[43] OE concluded that DBET violated FERC's Anti-Manipulation Rule by trading in one product, physical exports at Silver Peak, with the intent to benefit a second product, its CRR position at Silver Peak. In addition, DBET fraudulently labeled its transactions as wheeling-through even though they did not meet the tariff requirements of wheeling-through. Ultimately, OE staff recommended sanctions, including a civil penalty of $1,500,000 and a disgorgement amount of $123,198 plus interest.[44]

2. Order Approving Stipulation and Consent Agreement

In January 2013, FERC issued an Order Approving Stipulation and Consent Agreement, determining that the order was in the public interest because it provided fair and equitable resolution of the Order to Show Cause proceeding.[45]

Without admitting fault, DBET agreed that its CRR traders had exported physical energy at Silver Peak in order to eliminate the import congestion that was causing losses to its CRR positions (i.e., the Export Strategy). DBET also stipulated that its exports at Silver Peak raised prices at Silver Peak and caused its CRR position to gain value.[46]

The Order stated that DBET had falsely designated many of its physical transactions as wheeling-through transactions, even though the CAISO tariff required such transactions to have resources or loads outside of CAISO, and DBET lacked resources or loads outside of CAISO.[47] In addition, the Order stated that since DBET's physical trades were undertaken with the intent to change the values of the CRRs, false and deceptive information was injected into the marketplace that affected the price at Silver Peak and hindered the proper functioning of the physical and CRR market there.[48]

The Commission stated that while DBET's physical transactions were not profitable, even if they had been profitable, "profitability is not determinative on the question of

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[43] Ibid.

[44] Ibid., p. 4.

[45] Order Approving Stipulation and Consent Agreement, 142 FERC ¶61,056, January 22, 2013, ¶1. DBET neither admitted to nor denied the violation and agreed to pay the civil penalty and disgorgement of unjust profits plus interest, while implementing improved compliance training and procedures. Ibid., ¶2.

[46] Ibid., ¶ 12.

[47] Ibid., ¶14 and fn. 4.

[48] Ibid., ¶19.

manipulation and does not inoculate trading from any potential manipulation claim."[49] Rather, the elements of manipulation are determined by all the circumstances of a case.[50] The Order stated that DBET had violated the Anti-Manipulation Rule and FERC's accuracy requirement, which requires it to provide "accurate and factual information and not submit false or misleading information…in any communication with…independent system operators."[51]

FERC directed CAISO to allocate the disgorged funds and interest for the benefit of the market participants harmed by DBET's conduct "as determined by CAISO."[52] After the enforcement action was terminated, Deutsche Bank indicated that it no longer does business in the CAISO market.[53]

B. Constellation Energy Commodities Group, Inc.

In March 2012, FERC issued an Order Approving Stipulation and Consent Agreement resolving an investigation into whether Constellation Energy Commodities Group, Inc. (CCG) had violated the Commission's Anti-Manipulation Rule and its regulation prohibiting the submission of inaccurate information.[54] Pursuant to the Stipulation and Consent Agreement, CCG—while neither admitting nor denying the allegations—agreed to pay a civil penalty of $135 million and to disgorge unjust profits of $110 million, including interest.[55]

1. Office of Enforcement allegations

OE alleged that through its own surveillance, it had observed CGC engage in virtual trading[56] in the New York Independent System Operator (NYISO) that was unprofitable.[57]

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[49] Ibid., ¶20.

[50] Ibid. (citing FERC Order 670, "Prohibition of Energy Market Manipulation," ¶39).

[51] Ibid., ¶23 (citing 18 C.F.R. §35.41(b)).

[52] Ibid., ¶27.

[53] Rebecca Smith and Christian Berthelsen, "Deutsche Bank Fined Over Energy Trading Scheme," *Wall Street Journal*, January 22, 2013.

[54] Order Approving Stipulation and Consent Agreement, 138 FERC ¶61,168, March 9, 2012.

[55] Ibid., ¶1. CCG agreed to additional compliance measures including (1) regular monitoring of profit/loss concentrations in virtual transactions and physical schedules of electric energy and (2) reviewing and documenting the purpose of virtual transactions. Ibid.

[56] Virtual trading is the arbitrage of day-ahead to real-time energy price differences:

- Virtual energy purchases are sold back in real-time by the virtual trader.
- Virtual energy sales are bought back in real-time by the virtual trader.

Bob De Mello and Nicole Bouchez, "Virtual Bidding in the NYISO," September 6, 2006, slide 7.

Around the same time, NYISO informed OE that it would apply mitigation measures against CCG related to its virtual-bidding behavior, which had contributed to an unwarranted divergence of location-based marginal prices between the day-ahead (DA) and real-time (RT) markets.[58] Thereafter, OE opened an investigation to determine whether CCG had employed a scheme of trading in the NYISO virtual market to move DA prices in a direction that would benefit its financial contract for differences (CFD)[59] positions.

OE's investigation focused on the virtual trading practices of CCG's East Power Trading Group (EPTG) in NYISO, Independent System Operator of New England (ISO-NE), PJM Interconnection (PJM), and Ontario Independent Electric System Operator (IESO).[60] Briefly and generally described, EPTG held CFDs that included swaps[61] whose prices were based on the average DA prices in NYISO and ISO-NE, swaps whose prices were based on the RT market in PJM, financial transmission rights (FTRs)[62] in ISO-NE, and PJM and transmission congestion contracts (TCCs)[63] in NYISO.[64]

OE found a repetitive pattern to the virtual and DA physical trading during the months of interest; this trading was routinely unprofitable.[65] FERC noted in its Order that CCG's training manuals recognized that uneconomic behavior that benefited positions in other markets should not be engaged in by traders and that the Commission would likely consider such behavior

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[57] Order Approving Stipulation and Consent Agreement, supra, fn. 53, ¶2.

[58] Ibid.

[59] A contract for differences is a contract between a buyer and seller agreeing upon an energy price at a specific location on the grid. The participants buy and sell at a location-based marginal price (LBMP) and settle the difference from the agreed-upon price after the fact. *See* http://www.nyiso.com/public/markets_operations/services/customer_support/glossary/index.jsp

[60] *See* Order Approving Stipulation and Consent Agreement, ¶¶ 3-5.

[61] Swaps are financial contracts in which two counterparties agree to exchange or "swap" payments with each other as a result of such things as changes in a stock price, interest rate, or commodity price. http://www.sec.gov/swaps-chart/swaps-chart.shtml

[62] Financial Transmission Rights are financial instruments that entitle the holder to a stream of revenues (or charges) based on the hourly congestion price differences across a transmission path in the Day-Ahead Energy Market. *See* http://www.pjm.com/markets-and-operations/ftr.aspx

[63] Transmission Congestion Contracts (TCCs) enable energy buyers and sellers to hedge transmission price fluctuations. A TCC holder has the right to collect or the obligation to pay congestion rents in the day-ahead market for energy associated with transmission between specified points of injection and withdrawal. *See* New York ISO Glossary, http://www.nyiso.com/public/markets_operations/market_data/tcc/index.jsp.

[64] *See* Order Approving Stipulation, ¶5.

[65] Ibid., ¶¶ 7-8.

market manipulation.[66] FERC also noted that when NYISO had investigated CCG's virtual trading activity, CCG stated that its decisions to participate in the NYISO markets were based on market fundamentals, omitting the fact that the virtual trading was directly related to its CFDs.[67]

OE concluded that CCG had violated the Commission's Anti-Manipulation Rule[68] by entering into virtual transactions and DA physical schedules without regard for their profitability, but with the intent of impacting DA prices in the NYISO and ISO-NE to benefit certain CFD positions held by CCG.[69] OE further determined that the manipulation had resulted in widespread economic losses to market participants who had bought and sold energy in the DA markets of ISO-NE and the NYISO, and distorted price discovery for all market participants, which contributes to trading decisions and a variety of other industry-wide determinations.[70]

Finally, OE determined that CCG had violated FERC's Accurate Information Rule because it provided inaccurate and misleading information to NYISO by denying that its virtual transactions were related to its CFD positions and instead asserting that the transactions were based on market fundamentals.[71]

2. Distribution of funds and other remedies

The Agreement required CCG to pay a $135 million civil penalty to the U.S. Treasury and disgorgement and interest of $110 million paid as follows: (a) $ 6 million divided equally among NYISO, ISO-NE, PJM, the Midwest Independent System Operator (MISO), Southwest Power Pool (SPP), and CAISO, to enhance their market-surveillance activities; and (b) a fund set up to benefit electric energy consumers in the affected states divided as follows: (a) $78 million to NYISO, (b) $20 million to ISO-NE, and (c) $6 million to PJM.[72]

CCG also implemented procedures to monitor profit/loss concentrations in virtual transactions and DA physical schedules and to document the purpose of its virtual transactions; retain communications by its traders for at least five years; submit semi-annual compliance

[66] Ibid., ¶ 9.

[67] Ibid., ¶10.

[68] *See* ibid., fn. 20. The rule prohibits entities from (1) using a fraudulent device, scheme, or artifice; or making a material misrepresentation or a material omission as to which there is a duty to speak under a Commission-filed tariff, Commission Order, rule, or regulation; 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; and (3) in connection with a transaction subject to the jurisdiction of the Commission.

[69] *See* Order Approving Stipulation, ¶¶ 12-13.

[70] Ibid., ¶17.

[71] Ibid., ¶¶ 18-20.

[72] Ibid., ¶22. The distribution was based upon OE's assessment of the relative harm imposed on each organized market as a result of CGC's trading practices.

monitoring reports to OE; and prohibit named traders from holding positions involving physical and financial trading going forward.[73]

3. Subsequent enforcement action

In a subsequent order issued recently in a separate case on October 18, 2013, Exelon Corp agreed to pay over $600,000 to settle allegations that CCG had violated FERC rules by submitting bids and improperly designating transactions as wheeling-through transactions between January and March 2010 in the CAISO markets.[74]

C. JPMorgan Ventures Energy Corporation

On July 30, 2012, FERC issued an Order approving Stipulation and Consent Agreement settling a case against JPMorgan Ventures Energy Corporation (JVEC) in which the company agreed to pay a civil penalty of $285 million and the disgorgement of unjust profits of $125 million for actions it took in the CAISO and MISO markets between September and November 2012.[75] FERC directed CAISO to allocate its portion of the disgorgement ($124 million) and directed MISO to allocate its portion of the disgorgement ($1 million) for the benefit of their respective ratepayers through internal accounting procedures.[76]

OE alleged that JVEC had violated the Commission's Anti-Manipulation Rule by engaging in a series of strategies of intentionally submitting bids that falsely appeared economic to CAISO's and MISO's market software but that were intended to pay JVEC at rates far above market prices.[77] Their practices prompted four emergency tariff filings by CAISO or MISO and a fifth expedited request by CAISO to block what it viewed as improper bidding practices.[78] JVEC stipulated to the allegations made in the order.

1. JVEC plants at issue

JVEC acquired the plants at issue in 2008 as part of its parent company's acquisition of the Bear Stearns firm. JVEC inherited rental agreements from Bear Stearns that included several

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[73] Ibid., ¶¶ 23-26.

[74] "Exelon Settles with U.S. FERC Over Power Market Activity," *Thomas Reuters*, October 21, 2013.

[75] FERC Order Approving Stipulation and Consent Agreement, 144 FERC ¶61,068, ¶¶ 1-3, July 30, 2013.

[76] Ibid., ¶88.

[77] Ibid., ¶4. FERC OE stated that it brought the action pursuant to EPACT 2005's directive to combat gaming of energy markets.

[78] Ibid., ¶8. In each case, FERC granted the request.

gas-fired plants owned by AES in Southern California, which totaled approximately 4000 MW and a 545 MW gas-fired plant in Michigan (Kinder Jackson).[79] JVEC subleased most of the AES plants to Southern California Edison but retained control over four of the units. These units have relatively high heat rates, and the marginal costs of running the plants were typically higher than DA market prices in CAISO (which averaged $30-$35/MWh).[80] The Michigan plant also faced competition from lower-price energy sources.[81]

2. Background on energy-market payments

The CAISO and MISO markets generally pay generators market rates that are locational market prices (LMP) multiplied by quantity (in MWhs). The ISOs may also pay uplift or "make-whole" payments to compensate generators when market revenues do not cover the "bid cost" of a unit that the ISO has committed. The bid cost includes the unit's bundled price for running at its lowest operating level (called "Pmin") and its per-MWh price for energy above Pmin.[82]

CAISO's principal make-whole payment is called "Bid Cost Recovery" (BCR), while MISO offers several types of make-whole payments, including Revenue Sufficiency Guarantee (RSG) and Day-Ahead Market Assurance Payments (DAMAP).[83] The CAISO tariff authorizes it to issue "exceptional dispatches," which are manual, out-of-market instructions. Exceptional dispatches can include commitments to Pmin and/or incremental dispatches above Pmin, and energy delivered pursuant to an exceptional dispatch instruction is typically paid the higher of the plant's bid price or market rates.[84]

3. Office of Enforcement allegations

The Commission's order notes that JVEC engaged in 12 strategies to manipulate the electric markets. Strategies A through H are discussed in some detail in FERC's Order Approving Stipulation and Consent Agreement (as well as in the attached Stipulation and Consent Agreement) and demonstrate JVEC's use of the energy-market processes, including ancillary services, self-schedules, and respect for operating constraints, to receive many millions of dollars in BCR, DAMAP, and exceptional dispatch payments at above-market rates.[85]

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[79] Ibid., ¶¶ 14-15.

[80] Ibid., ¶17.

[81] Ibid.

[82] Ibid., ¶21. For example, if a unit's Minimum Load Cost is $100/MWh and the market clearing price comes in at $30/MWh, the tariff obligates the ISO to provide a $70/MWh make-whole payment to the unit for the MWhs it provided up to Pmin.

[83] Ibid., ¶22.

[84] Ibid., ¶23. Such units may receive additional payments for Residual Imbalance Energy.

[85] Ibid., ¶¶ 69-70.

OE determined that JVEC had designed its biding strategies with the intent to obtain the above-market payments.[86] By reviewing how CAISO and MISO market software responded, OE determined that JVEC could predict the make-whole payment awards that the ISOs would make to it. Further, OE determined that JVEC's DA bids falsely appeared economic to the ISOs' automated market software, which led the ISOs to pay JVEC at rates that were far above market prices.[87]

OE also determined that JVEC's bids were not grounded in economic fundamentals and lost money at market rates, and that JVEC's purpose was to create artificial conditions that would cause the ISO to pay it at premium out-of-market rates. Put another way, JVEC submitted losing bids in the DA and RT markets to trigger out-of-market compensation systems, the purpose of which are to ensure fair results to units bid in good faith. Finally, OE determined that OE's DA bids had displaced other generation and altered DA and RT LMPs and congestion values and ultimately distorted well-functioning CAISO and MISO markets.[88]

4. FERC authority to act under EPACT 2005

FERC also noted that commission rules do not limit market manipulation to tariff violations.[89] Instead, both the breadth of Congress's authorization and the Anti-Manipulation Rule are a response to the impossibility of foreseeing the "myriad means" of misconduct in which market participants may engage.[90] In other words, no list of prohibited activities could be all-inclusive.[91] Rather, "conduct" is sufficient to establish a violation of Rule 1c.[92]

5. Related ongoing matters

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[86] Ibid.

[87] Ibid., ¶¶ 73, 75.

[88] Ibid., ¶¶ 76-81.

[89] Ibid., ¶83. Many of the Commission's major enforcement activities under Rule 1c have concerned, either in whole or in part, market manipulation in the absence of a violation of a specific tariff provision or comparable specific market rule (citing *Barclays Bank PLC et al.*, 144 FERC ¶61.041 (2013).

[90] Ibid. (citing *Cargill, Inc. v. Hardin*, 452 F.2d 1154, 1163 (8th Cir. 1971), which stated that the "methods and techniques of manipulation are limited only be the ingenuity of man").

[91] Ibid. (citing *Order Revising Market-Based Rate Tariffs and Authorizations*, 114 FERC ¶61,165, ¶24 (2006). *See also Amendments to Blanket Sales Certificate*, Order No. 644, 105 FERC ¶61,217, ¶33 (2003) ("by requiring regulations to be too specific, [courts] would be opening up large loopholes allowing conduct which should be regulated to escape regulation").

[92] Ibid., ¶84.

While JVEC indicated an intention to transition out of the commodities business completely,[93] the U.S. Department of Justice has initiated an investigation into whether certain bank employees misled FERC regulators during its OE investigation. DOJ has alleged false representations under oath about energy trading schemes and the strategies behind the schemes.[94] In addition, as noted earlier, the U.S. Senate Permanent Subcommittee on Investigations sent FERC a letter in August 2013 seeking documents outlining FERC's charges against JPMorgan.[95]

D. Barclays Bank, PLC

1. Procedural history

On October 31, 2012, FERC issued an Order to Show Cause and Notice of Proposed Penalty against Barclays Bank PLC and certain named Barclays employees (collectively, Barclays), alleging that they had engaged in a coordinated scheme to manipulate trading at four electricity trading points in the Western United States in certain months from November 2006 to December 2008.[96] The order noted FERC OE's allegation that Barclays and its individual traders violated §1c.2 of Commission Rules by engaging in loss-generating trading of next-day fixed-price physical electricity on the Intercontinental Exchange (ICE) at the locations of Mid-Columbia (MIDC), Palo Verde (PV), South Path 15 (SP) and North Path 15 (NP) to benefit Barclay's financial swap positions in those markets.[97] Accordingly, FERC assessed a civil penalty of $435 million and disgorgement of $34.9 million in unjust profits.[98]

Pursuant to FPA §31(d), Barclays had the option of choosing between an administrative hearing before an administrative law judge at the Commission or an immediate penalty assessment without a hearing. Barclays chose the immediate-penalty-assessment path under FPA §31(d)(3)(A). On July 16, 2013, the Commission issued an Order Assessing Civil Penalties.[99] According to the FPA, if the penalty was not paid within 60 days of the assessment, the Commission could commence an action in a United States district court for an order affirming the penalty, in which the district court may review the assessment of the civil penalty

[93] Ryan Tracy and Dan Fitzpatrick, "J.P. Morgan Settles Electricity-Market Case," *Wall Street Journal*, July 30, 2013.

[94] Dan Fitzpatrick and Devlin Barrett, "U.S. Probes Whether J.P. Morgan Employees Misled Regulators," *Wall Street Journal*, September 4, 2013.

[95] *See* fn. 1, supra.

[96] FERC Order to Show Cause and Notice of Proposed Penalty, 141 FERC ¶61,084, ¶ 2, October 31, 2012.

[97] Ibid.

[98] FERC Order Assessing Civil Penalties, 144 FERC ¶61,041, July 16, 2013, ¶8.

[99] Ibid.

de novo.[100] Barclays did not pay the civil penalty within 60 days of the assessment, and on October 9, 2013, FERC petitioned the federal district court for the Eastern District of California for an order affirming the FERC's July 16th Order Assessing Civil Penalties.[101]

2. Office of Enforcement allegations

OE determined that Barclays had manipulated electricity markets in violation of FERC's Anti-Manipulation Rule during 35 product months[102] by engaging in a coordinated scheme to take physical positions and liquidate them in cash markets at a loss in order to impact the ICE daily index[103] settlements to benefit its related financial positions that settled against those indices.[104]

The Commission determined that Barclays' scheme had involved three parts for each month of manipulation: (1) setting up a financial position, (2) building a physical position that was in the opposite direction to the financial position, and (3) flattening[105] the physical position through trading dailies to benefit the financial positions.[106] The act of flattening impacted ICE index settlements and benefited Barclays related financial positions, which either paid or received the ICE daily index.[107] FERC alleged that Barclays had flattened its positions by trading

[100] FPA §31(d)(3)(B), 16 U.S.C. §823b(d)(3)(B) (2006). *See also Process for Assessing Civil Penalties*, 117 FERC ¶61,317, ¶5 (2006).

[101] FERC Petition for an Order Affirming the FERC's July 16, 2013 Order Assessing Civil Penalties, October 9, 2013.

[102] A product month is the trading of a specific product at a specific location for a specific calendar month. Ibid., ¶36.

[103] ICE is an electronic trading platform used to trade electricity products. The ICE daily index is an index published by ICE each day based on the volume-weighted average price (VWAP) of all DA fixed-price physical electricity transactions at a particular trading location. The ICE daily index is set by a methodology that calculates an index price based on the VWAP of all contributing volumes and prices traded on ICE, based on the DA fixed-price physical market, often called the "cash" or "dailies" market. Ibid., ¶¶22-24.

[104] Ibid. Electricity products could be either physical or financial. Physical products involve the obligation to deliver or receive physical electricity at a particular location during a particular time and are typically measured in MW/h. Ibid., ¶21. Financial positions, on the other hand, do not entail physical obligations to deliver or receive electricity, and are financially settled through an exchange of payments. For example, a financial swap buyer paid a fixed price and received a floating price (set in the ICE daily index). Ibid., ¶26.

[105] Because Barclays did not own electricity generation or serve customer load, its physical DA positions had to be liquidated prior to delivery or receipt of the electricity by buying or selling in equal volumes of electricity—the process of purchasing or selling electricity to liquidate the physical DA position is called "flattening" the position. Ibid., ¶56.

[106] Ibid., FERC Order Assessing Civil Penalties, ¶¶2-4.

[107] Ibid., FERC Petition for an Order Affirming Penalties, ¶58.

dailies in order to increase or lower the ICE daily indices at those points, i.e., they traded dailies to impact the ICE daily index price at particular points so that its financial positions would benefit, not in an attempt to profit from market fundamentals of supply and demand.[108] According to FERC, Barclays' flattening of its physical positions in the dailies was uneconomic; the firm knew it was losing money, but it was willing to accept such losses because the scheme benefited its financial positions.[109]

In addition, FERC determined that Barclays had acted with scienter based upon (1) a series of emails and instant messages examined as part of the investigation; (2) the losses associated with the Barclays physical positions, which totaled over $4 million; and (3) Barclays' compliance documents, which emphasized the need to avoid uneconomic trading to benefit another position.[110]

Finally, the Commission concluded that the manipulation had affected the wholesale price of electricity in the western U.S., and that affecting prices paid by load-serving entities such as public utilities had in turn affected the ultimate retail rate paid by tens of millions of consumers in California and elsewhere in the western U.S.[111]

3. Disgorgement of unjust profits

The Commission ordered that the disgorged profit amount of $34.9 million be distributed to the Low Income Home Energy Assistance Program (LIHEAP) of the states of Arizona, California, Oregon, and Washington for the benefits of their respective electric-energy customers in the following manner: California—63%; Arizona—19%; Oregon—9%; and Washington—9%.

As the matter is now before the federal district court in the Eastern District of California, each element of the Assessment of Penalties, including FERC's substantive findings and FERC's proposed allocation of disgorged profits, can be reviewed *de novo*.

IV. An Introduction to the Phase II Research Paper

This Briefing Paper (Phase I) introduced FERC's recently-acquired enforcement authority and described briefly FERC OE actions against four companies that traded in the electric markets. The goal of Phase II will be to document opportunities for and barriers to state-regulatory-commission participation in federal enforcement actions related to electric power-

[108] Ibid., FERC Order Assessing Civil Penalties, ¶3.

[109] Ibid., Petition for an Order Affirming Assessment of Penalties, ¶¶ 60-61.

[110] Ibid., ¶¶ 72-109.

[111] Ibid., ¶121.

market manipulation. To help gauge whether it is in a state regulatory commission's interest to engage in a federal enforcement proceeding, Phase II proposes to examine:

- Power-marketer participation in the electric power markets
- Impacts of power-market manipulation on end-use ratepayers
- Strategies employed to manipulate electric power markets
- Federal enforcement agencies and their actions against power-market manipulation
- Opportunities for state participation in enforcement actions and recovery allocations
- Jurisdictional boundaries between federal agencies and between federal and state agencies

Phase II will conclude by informing the state regulatory community what opportunities, if any, currently exist for participation in enforcement actions and what ratepayer benefits, if any, can accrue due to state participation.

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