Preserving the Integrity of the Electric Power Markets: Why States Should Be Indispensable Parties in Federal Enforcement Actions Against Market Manipulation

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Report No. 14–02
February 2014
National Regulatory Research Institute

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Acknowledgments

I would like to especially thank William Chambliss, General Counsel at the Virginia State Corporation Commission; Asya Staevska, Assistant Counsel for the Pennsylvania Public Utilities Commission; and Charles Hyneman, Regulatory Auditor for the Missouri Public Service Commission, for their careful review and edits to drafts of this paper. I would also like to thank Bishu Chatterjee, Ph.D., Senior Economist, and Jason Zeller, Assistant Chief Counsel, both of the California Public Utilities Commission; and William Smith, Executive Director of the Organization of MISO States for their helpful insights and suggestions. Finally, I would like to thank Ken Costello, Principal Researcher for Natural Gas, and Sherry Lichtenberg, Ph.D., Principal Researcher for Telecommunications, both of NRRI, for their close readings and helpful comments on early drafts of the paper.
# Table of Contents

**Executive Summary** .................................................................................................................. vi

**I. Introduction** .......................................................................................................................... 1

**II. Development of Electric Energy and Derivative Markets** ..................................................... 6

   A. Formation of the electric markets .......................................................................................... 6

   B. Formation of the electricity derivative markets and competing value judgments ................. 8

      1. Background on electricity derivative market formation ...................................................... 8

      2. Electricity derivatives market value judgments ................................................................. 9

**III. Development of FERC Anti-Manipulation Authority and Its Recent Application** .................. 13

   A. The Western Energy Crisis .................................................................................................... 13

      1. Sub-optimal enabling market conditions ........................................................................... 13

      2. Manipulation attributed to Enron Corporation .................................................................. 14

   B. Development of FERC anti-manipulation authority .............................................................. 16

   C. FERC’s application of anti-manipulation authority in recent enforcement actions ............. 19

      1. Deutsche Bank Energy Trading, LLC .................................................................................. 19

      2. Constellation Energy Commodities Group ........................................................................ 20

      3. JP Morgan Ventures Energy Corporation ......................................................................... 21

      4. Barclays Bank, PLC ............................................................................................................ 22

      5. Amaranth Natural Gas Commodities ............................................................................... 23

      6. Brian Hunter ....................................................................................................................... 24

      7. Rumford Paper Company .................................................................................................... 25

   D. FERC approach to enforcement actions and unresolved matters ........................................ 26
IV. Deficiencies in the Existing Legal Framework and Limitations on States

A. Challenges in defining manipulation and manipulative practices .......................... 28
B. Limitations in statutory frameworks ........................................................................ 29
C. Limitations in court decisions .................................................................................. 32
D. Shortcomings in agency applications of enforcement rules .................................... 33
  1. CFTC enforcement ................................................................................................... 33
  2. FERC enforcement .................................................................................................. 33
     a. FERC’s approach to address market power ......................................................... 34
     b. A challenge to FERC’s market-based rate framework ........................................ 36

V. The Case for a Regulatory Pathway for States in Federal Enforcement Actions

A. Attempts for recourse in bilateral markets ................................................................. 37
B. State attempts at recourse in organized markets ......................................................... 39
C. FERC’s case against state intervention in federal enforcement actions ................... 42
D. State and federal coordination is well-founded when confronting market failure .......................................................................................................................... 43

VI. Potential Reforms that May Aid in State Participation

A. Tariff-based reforms .................................................................................................. 45
B. Reforms to FERC disclosures in enforcement actions ................................................. 46
C. Opportunities for state participation pursuant to compliance plans ......................... 48

VII. Jurisdiction, Pending Matters, and Future Implications

A. FERC and CFTC Memorandum of Understanding .................................................... 48
B. Multi-jurisdictional federal enforcement .................................................................... 50
C. Barclay’s motion to dismiss FERC petition to Federal District Court ....................... 52

VIII. Recommendations .................................................................................................. 55

IX. Conclusions ................................................................................................................. 57
Executive Summary

This research paper examines the challenges associated with prosecuting acts that artificially inflate wholesale electric power market prices, following a series of high-profile federal enforcement actions against large financial power market participants. Those challenges include statutory and regulatory shortcomings, unresolved questions about jurisdiction, and, most importantly for the purposes of this paper, limitations on the role that state public utility commissions (PUCs) could play in representing the interests of retail ratepayers in federal enforcement actions. The paper concludes that, given that retail ratepayers are the ultimate victims of artificially inflated wholesale market prices, state PUCs, as their representatives, are indispensable parties in federal enforcement actions; and that such a status necessitates a series of reforms to clarify statutory intent, relax unattainable legal standards, and otherwise accommodate state participation in federal enforcement actions.

The introduction to this paper begins by asserting that state PUCs are the best representatives of retail ratepayers, the ultimate victims of artificially inflated electric wholesale prices, in federal enforcement actions given their unique relationships with retail customers. The introduction also summarizes a panel discussion that occurred at the National Association of Regulatory Utility Commissioner (NARUC) 2013 Annual Meeting in Orlando, Florida, in which industry experts and regulators raised fundamental questions regarding the prosecution of electric power market manipulation, such as (1) the proper interpretation of statutory enforcement authority, (2) the proper definition of manipulation, (3) the consequences of recent federal enforcement actions, (4) opportunities for reform, and (5) future impacts of currently pending matters. These questions are analyzed in turn throughout the remainder of the paper.

Section II offers a brief history of the formations of the wholesale electric power markets and the electric power derivative markets, as well as a discussion of differing value judgments that industry experts have attributed to financial marketer participation in physical electric power markets. Section III outlines the development of the Federal Energy Regulatory Commission’s (FERC) anti-manipulation enforcement authority in the aftermath of the Western Energy Crisis and the application of that authority in seven recent FERC enforcement cases. This discussion attempts both to surmise FERC’s approach to identifying manipulation and to highlight matters, such as jurisdiction, definitions, and application of authority, which the existing regulatory enforcement framework leaves unresolved.

Section IV discusses the difficulty in congressional attempts at defining electric power market manipulation and shortcomings in court and enforcement agency interpretations of notably unclear statutory language. The exclusion of market power from manipulation actions and FERC’s market-based rate regime are noted as specific shortcomings. Section V offers two examples of cases in which parties’ and states’ abilities to address manipulation were compromised due, in part, to the shortcomings identified in Section IV. It also discusses FERC’s hostility to greater state participation in enforcement proceedings through its Order 718 proceedings and concludes that, despite such present hostility, state–federal coordination has a well-founded basis when confronting market failure.
Section VI explores potential reforms to the existing federal enforcement framework for consideration by the state regulatory community. The section considers statutory, regulatory and tariff-based reforms for the purpose of aiding state participation in federal enforcement actions against wholesale electric power market acts which artificially inflate prices.

Section VII discusses a series of pending matters including (1) the respective jurisdictional authority of competing federal agencies, (2) the consequences of multiple federal agencies pursuing electric power market participants, and (3) FERC’s petition to a federal district court to affirm a penalty assessment against Barclays Bank, PLC—an opportunity for a competent court to rule for the first time on many of the fundamental questions raised by this paper.

Section VIII offers a series of recommendations for consideration by the state regulatory community. These are summarized in the following table, which lists the identified deficiency with the existing framework, the proposed reform, and the section of the paper where the topic is discussed:

<table>
<thead>
<tr>
<th>Table VIII-1: Summary of Recommendations</th>
</tr>
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<tbody>
<tr>
<td><strong>Deficiency</strong></td>
</tr>
<tr>
<td>In modeling EPACT 2005 (and EISA 2007) after Securities Exchange Act, Congress defined all manipulation as species of fraud.</td>
</tr>
<tr>
<td>The filed-rate doctrine and FERC’s market-based rate regime treats even market rates set under dysfunctional market conditions as approved “filed” rates.</td>
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<tr>
<td>FERC has rejected state arguments based on FPA § 206 just and reasonable principles when pursuing enforcement actions against manipulation</td>
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<td>FERC has rejected state intervention into federal enforcement actions, drawing no distinction between states and other parties.</td>
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<td>FERC’s confidentiality rule, 1b, allows it to disclose nonpublic information only at its discretion.</td>
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<td>Enforcement actions are not coordinated among federal agencies, market monitors, and states.</td>
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<tr>
<td>Opportunities for state participation in various federal enforcement agency actions is unclear.</td>
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Finally, Section IX concludes that due to its lack of clarity, the existing federal enforcement framework impedes states from effectively representing the legitimate interests of their retail electric ratepayers, who are left to pay artificially inflated prices with no meaningful remedy. The reforms discussed throughout the paper would enable coordinated state/federal enforcement actions that focus on the preservation of market integrity rather than ambiguous assertions of manipulation. The reforms attempt to seek for the states enforcement authority similar to what FERC is attempting to acquire for itself with respect to multi-jurisdictional authority. Finally, given their unique relationship with retail ratepayers, state PUCs are the only
parties capable of adequately representing retail ratepayer interests, and as such, should be indispensable parties in federal enforcement actions against wholesale electric power market manipulation.
Preserving the Integrity of the Electric Power Markets:  
Why States Should be Indispensable Parties  
in Federal Enforcement Actions against Market Manipulation

I. Introduction

This paper examines the role that state public utility regulatory commissions (PUCs) could play in federal enforcement actions against wholesale electric power market participant actions that artificially inflate market prices. Existing statutes, court-created legal doctrines, and regulatory enforcement frameworks have infused attempts at prosecution with uncertainty, and in some respects have obstructed the effective representation by states of their jurisdictional retail ratepayers’ interests. This paper suggests that state commissions, due to their unique obligations to retail electric customers, have a vital interest in preserving wholesale electric power market integrity and share the investigative and enforcement concerns of federal regulators.

Yet states lack any clear role for participating in, advising in, or coordinating information sharing in federal enforcement actions, as well as in the distribution of disgorged profits and penalties. This paper discusses a series of potential reforms that could enable states to adequately represent retail electric power ratepayer interests in federal enforcement actions. In addition to tariff-based and regulatory reforms, this paper recommends the adoption of a different legal framework that authorizes states to bring actions against improper wholesale market price increases under a just and reasonableness standard.1

Notwithstanding its limitations, the existing federal enforcement framework has elicited headline-grabbing settlements and profit disgorgements from large financial and commodity-owning institutions. In July 2013 alone, the Federal Energy Regulatory Commission (FERC) ordered nearly $900 million in penalties and disgorgement in cases against trading operations of

1 Based either upon the state statutory standard or the Federal Power Act §§’s 205 and 206 standard:

All rates and charges made, demanded, or received by any public utility for or in connection with the transmission or sale of electric energy subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

F.P.A. §205, 16 U.S.C §824D(a) (emphasis added). See also, for example, Pennsylvania Consolidated Statutes: “Every rate made, demanded, or received by any public utility, or by any two or more public utilities jointly, shall be just and reasonable, and in conformity with regulations or orders of the commission.” 66 Pa. Cons. Stat. Ann. § 1301 (West) (emphasis added); and Illinois Public Utilities Act, 220 ILCS 5/8-101 (“All rules and regulations made by a public utility affecting or pertaining to its charges or service to the public shall be just and reasonable.”) (emphasis added).
two major banks—the largest penalties in FERC’s history.² Recent FERC enforcement actions have focused the industry’s attention on fundamental questions such as (1) whether market rules have been clearly defined to provide notice and certainty to market participants; (2) which federal enforcement agencies possess jurisdiction to pursue market participants; and (3) what the consequences are of federal enforcement actions on the health of the wholesale electric power markets.

These enforcement actions have by and large excluded the state regulatory community from asserting the rights and interests of retail electric ratepayers, who are notably the ultimate victims of market participant acts that artificially inflate wholesale electric power market prices.³ Further, intractable shortcomings in the existing statutory and regulatory enforcement frameworks have impeded state and party attempts to meaningfully represent ratepayer interests. The creation of a regulatory pathway that enables states to coordinate enforcement efforts with federal agencies and to participate in enforcement actions may offer the best method to sufficiently protect retail ratepayer interests, who are otherwise left paying artificially inflated rates without a remedy.

This paper asserts that states should be an indispensable party in federal enforcement actions against potentially manipulative market acts. This introduction next offers a note on why states should be considered indispensable in such actions and follows with a summary of a National Association of Regulatory Utility Commissioners (NARUC) panel discussion from the 2013 NARUC Annual Meeting which sets the stage for this paper’s analysis.

A note on why states should be indispensable parties in federal enforcement actions

State public utility laws generally obligate PUCs to ensure that retail utility rates are just and reasonable,⁴ require some basic right to electric service access,⁵ or guarantee a provider of

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³ FERC has emphasized on multiple occasions that improper payments in the power markets are ultimately borne by households, businesses and government entities that are end users of electricity. Ryan Tracy and Dan Fitzpatrick, “Regulator Outlines JP Morgan Electricity Market Allegations,” Wall Street Journal, July 29, 2013. See also, Testimony of Norman Bay to U.S. Senate Committee on Banking, Housing and Urban Affairs, Subcommittee on Financial Institutions and Consumer Protection, January 15, 2014 (indicating that costs are borne by consumers if there is fraud or manipulation in the wholesale power markets.)

⁴ See note 1, supra.

⁵ See New Jersey Consumer Bill of Rights, N.J.A.C. 14:3-3.3 (“1. You have the right to utility service if you are a qualified applicant. 2. You shall not be asked to pay unreasonably high deposits as a condition of service, nor to make unreasonable payments on past due bills.”)
last resort (POLR). Such obligations protect captive retail ratepayers from unaffordable and/or unreliable electric service. Wholesale electric power markets, however, do not fall under state jurisdiction. Thus, when wholesale market participants take actions that improperly or artificially inflate wholesale electric prices, retail ratepayers, who pay the inflated prices, are left without any remedy or meaningful avenue by which to assert their rights.

State PUCs are the only parties capable of fully representing the interests of retail ratepayers in actions against wholesale electric power market participants that engage in acts that artificially inflate prices. One reason for this is because PUCs uniquely engage in day-to-day experiences with retail ratepayers, many of whom struggle to pay their electric bills. PUCs also regularly adjudicate battles over every dollar of a potential bill increase in retail rate increase petition cases (or retail rate cases). State commissions recognize that for every dollar by which a customer’s bill increases, that customer’s ability to make a payment decreases, which could result in severe hardships, including service termination before the onset of a cold winter or a hot summer.

Conversely, a wholesale market participant such as a hedge fund, who is participating in the physical power markets for the sole purpose of hedging its financial positions, or who is trying to inflate or reduce prices at a derivative exchange based upon “long” or “short” physical positions, is either indifferent to the retail ratepayer or too far removed from the retail ratepayer to contemplate that its trading activities may lead to retail-customer hardships. Federal regulators, while concerned with the preservation of the integrity of the electric power markets, are similarly too far removed from the everyday struggles of retail ratepayers to adequately represent ratepayers’ interests in enforcement actions. It is incongruent that states, who represent the ultimate victims of price-inflating behavior, should be excluded from asserting retail ratepayer interests in enforcement actions and from participating in decisions about the distribution of penalties and profit disgorgements resulting from that behavior.

Setting the stage for analysis: NARUC Panel Discussion, November 2013

Most of the issues addressed in this paper grew out of a panel discussion held at the November 2013 NARUC Annual Meeting in Orlando, Florida. There, Kentucky Public Service (and former FERC) Commissioner Linda Breathitt moderated a panel of economic, legal, and

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6 Texas Administrative Code, Rule 25.43(a), Provider of Last Resort. (“The purpose of this section is to establish the requirements for Provider of Last Resort (POLR) service and ensure that it is available to any requesting retail customer and any retail customer who is transferred to another retail electric provider (REP) by the Electric Reliability Council of Texas (ERCOT) because the customer's REP failed to provide service to the customer or failed to meet its obligations to the independent organization.”)

7 Because the very definition of the term “market manipulation” is in dispute, an issue examined in this paper, this paper uses the term “artificially inflated” rather than “manipulated” so as to not attribute an improper price increase specifically to either deceit/fraud or an exercise of market power, as either could be considered manipulative behavior.

8 For a discussion of types of market manipulation, see Section IV.A of this paper at p. 28.
industry experts on the topics of electric power market manipulation, FERC enforcement authority, and the industry-wide impacts of recent high-profile enforcement actions. Panelists included Joe Kelliher, Larry Gasteiger, William Scherman, William W. Hogan, Ph.D., and Eric Hildebrandt, Ph.D. The discussion that ensued shapes the issues addressed in this paper, and a summary of that discussion will help frame this paper’s analysis.

(A) On the question of the appropriate FERC role in enforcement matters:

Mr. Kelliher recommended that FERC should help compliant market participants rather than focus the majority of its attention on pursuing bad actors; in return, market participants should help to reform ambiguous FERC market rules.

(B) On the question of the impact of FERC’s recent enforcement actions on the industry:

Mr. Scherman expressed concern that FERC enforcement actions have caused market entrants to leave the electric power markets, and that such an exodus is a threat to the functioning of the organized markets. He explained that without enough market participants, liquidity is reduced, and noted that many more participants are prepared to leave. He also expressed concern that FERC’s application of its enforcement power conflated market power and fraudulent conduct.

Dr. Hogan asserted that the electric power wholesale markets were designed to manage physical and financial hedging and expressed concern that opaque settlements (referring to settlements with Constellation Commodities Group and Deutsch Bank) can undermine the root of the markets’ designs.

(C) On the question of the role of the Market Monitoring Unit (MMU or IMM) in the enforcement process:


10 Executive Vice President, NextEra Energy, Inc.

11 Deputy Director, Office of Enforcement, Federal Energy Regulatory Commission

12 Partner, Gibson Dunn, LLP

13 Professor of Global Energy Policy, Harvard Kennedy School

14 Director, Market Monitor, California Independent System Operator

15 No transcript of the panel discussion is available, and therefore the summary does not attribute direct quotes to any panelist, but rather offers paraphrasing of speaker comments and concepts.
Dr. Hildebrandt noted that the MMU can investigate potential manipulation even after a case has been referred to the FERC Office of Enforcement (OE) and that the MMU can continue to share information with FERC throughout the investigation. Mr. Hildebrandt also noted the similarity between certain behaviors of market participants in recent enforcement actions and the activities of Enron during the Western Energy Crisis and commented that certain parties have opted to settle enforcement actions quickly, before too much information about their alleged practices is discovered or disclosed.

(D) On the question of the correct interpretation of FERC’s statutory authority:

Mr. Gasteiger noted that Congress considered whether to specifically define acts of manipulation in the formation of EPACT 2005, but instead decided to provide FERC with broad enforcement authority so it can investigate potential market manipulation on a case-by-case basis.

Mr. Scherman asserted that SEC Rule 10b-5, upon which the FERC enforcement rule (Rule 1c.2) was modeled, is a disclosure requirement, and that FERC is inappropriately applying it to cases of market manipulation.16

Dr. Hildebrandt noted that the vast majority of market participants do not engage in manipulation and that enforcement actions help those compliers and help the markets continue to work well. He also disagreed that there was or would be an exodus of participants from the wholesale electric power markets.

Mr. Gasteiger agreed that market liquidity was not in any danger and that to the extent that firms decided to leave the wholesale electric power markets, their decisions were more likely due to competition from low gas prices and new requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The discussion was compelling in that it raised the following fundamental questions:

1. When is financial and physical hedging appropriate and when is it manipulative?
2. Was Congress’ response to widespread market manipulation appropriate and, if so, was it correctly implemented by the administrative enforcement agencies?
3. If there are shortcomings in the existing statutory and enforcement frameworks, what are the consequences, both for the industry and for the states?

16 Other commenters argue that the SEC’s authority to regulate the use of manipulative devices and contrivances under § 10(b) “extends to all practices that contribute to disorder in the market or that give voice to speculative sentiment there.” As such, while the Court has repeatedly referred to disclosure when discussing the 1934 Act, many provisions reflect a concern with the effect that trading itself has on stock price. See Steve Thel, Regulation of Manipulation Under Section 10(b): Security Prices and the Text of the Securities Exchange Act of 1934, 1988 Colum. Bus. L. Rev. 359 at 438, 376 (1988).
(4) What opportunities within the existing frameworks, if any, enable states to represent retail ratepayer interests, and what reforms are needed?

(5) What will the impact be of currently pending matters and how will their resolutions affect state opportunities to participate in enforcement actions?

The remainder of this paper addresses these five questions in turn. Section II addresses the first question by offering a discussion of the formation of the energy and derivatives markets and a variety of viewpoints on their values. Section III describes the development of FERC’s enforcement authority and examines its recent application. Section IV addresses the second question by discussing challenges of defining the term “manipulation” and resulting shortcomings in the existing statutory and regulatory enforcement frameworks, particularly with respect to limitations imposed on states. Section V addresses the third question by examining specific unsuccessful attempts by private parties and states to pursue remedies for alleged harm due to manipulation in wholesale electric power markets. Section VI addresses the fourth question by exploring opportunities to reform the existing legal framework in a manner that allows the states to sufficiently represent retail ratepayer interests. Section VII addresses the fifth question by examining currently pending matters, which include federal agency cross-jurisdictional concerns and a challenge to FERC’s enforcement authority. Finally, Section VIII offers a series of recommendations to the state regulatory community for its consideration.

II. Development of Electric Energy and Derivative Markets

A. Formation of the electric markets

Wholesale power markets have changed dramatically since the Federal Power Act was enacted in 1935. At that time, there was relatively little interstate commerce in electricity and limited wholesale sales; the transmission system in most cases did not cross state lines, and few utilities were interconnected; and, in effect, electricity markets were neatly confined within state boundaries. The industry remained stable for decades, but in the late 1960s, in response to the 1965 blackout in the Northeast, electric utilities began to significantly expand their interconnections.

While the system of vertically integrated electric utilities charging administratively set rates dominated the electric industry well into the 1990s, competition in wholesale power markets was greatly expanded by the passage of the Public Utilities Regulatory Policies Act


18 Id. at 5. (“The strengthened interconnection made possible the later acceleration of competition in wholesale power markets, since a robust transmission grid was a necessary foundation for effective competition.”) Id.

(PURPA) in 1978. PURPA promoted conservation and alternative forms of electricity production by providing financial incentives to new, nonutility producers of renewable energy and cogeneration, including, most significantly, a purchase obligation that required utilities to purchase generation from qualifying facilities that met certain requirements. The presence of non-utility generators, known as “independent power producers,” in the market created pressure for nondiscriminatory access to the grid, and Congress responded with the Energy Policy Act of 1992 (EPACT 1992), authorizing FERC to order electric utilities to “wheel” power from these producers over utility transmission lines.

FERC then issued Orders 888 and 889, which mandated (1) that electricity transmission from sales in wholesale markets be “unbundled” and (2) that owners of transmission lines act as common carriers providing transmission service on a nondiscriminatory basis. As a consequence of this unbundling of generation from transmission, FERC began to authorize wholesale sellers of electricity to charge market-based rates on a broad scale, conditioning those grants of authority on the seller’s lack of market power. As a result, some states adopted legislation deregulating the power generation sector, prompting electric utilities to sell or transfer their generating assets to affiliates operating under FERC’s new regime.

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21 See Spense, 53 B.C.L Rev. at 147. See also, Kelliher, 26 Energy L.J. at 6.

22 Spense, supra note 21. Wheeling involves transmitting power for third parties.


24 See id. (Citing, as an example, Entergy Services, Inc., 58 F.E.R.C. ¶61,234 (1992) (authorizing electricity sales at market based rates)). For a discussion of amendments to and limitations to FERC’s market-based rates program up until the passage of EPACT 2005, see Kelliher, supra note 17. See also Section IV.D.2.b of this paper for a discussion of a challenge to FERC’s market-based rate order, infra.

25 Marc D. Machlin, esq. and Min Choi, Esq. This is Not Your Father’s FERC: Understanding the New, Central Role of FERC’s Enforcement Division – Part I, Pepper Hamilton LLP, July 22 2013, http://www.mondaq.com/unitedstates/x/252646/Energy+Law/This+Is+Not+Your+Fathers+FERC+Understanding+The+New+Central+Role+Of+FERCs+Enforcement+Division+Part+II

Many states chose to preserve vertically integrated utilities and limited or prohibited direct competition for generation.
B. Formation of the electricity derivative markets and competing value judgments

1. Background on electricity derivative market formation

Energy derivatives markets emerged as a response to increased price risk, i.e., formerly dominant market participants turned to energy derivatives (such as energy futures contracts) to hedge their new exposure to price risks, due to competition, in energy commodity markets. Traders in energy derivative markets may be energy companies interested in the physical delivery of the commodity or banks or other financial speculators interested purely in making money by speculating in the market.

Derivatives are bets based on projections of the future price of a commodity. Some derivatives, like futures or options contracts, are standardized contracts traded on exchanges like the New York Mercantile Exchange (NYMEX) and have traditionally been regulated by the U.S. Commodity Futures Trading Commission (CFTC). Other “over-the-counter” (OTC) energy derivatives, like forward contracts or swaps, may or may not be standardized and have traditionally been less closely regulated.

Exchange-traded derivatives are settled daily; that is, as the market price of the commodity moves relative to the futures contract price, the parties’ accounts are debited or credited to account for the difference. Most futures contracts do not contemplate delivery of the commodity at expiration, and in general, the parties settle only their financial differences. If one party was hedging and needs to buy or sell the underlying commodity, it can do so in the spot or cash markets. OTC energy derivatives, on the other hand, arose outside of CFTC jurisdiction and typically involve greater risk.

26 Spense, 53 B.C.L. Rev. at 150. “Increasingly competitive energy markets meant increased risk for energy companies, which turned to energy derivatives as a way to hedge that risk.” Id.

27 See id.

28 See id.

29 Unlike futures contracts, swaps do not contemplate delivery of the underlying commodity. Rather, in a typical commodity swap, the buyer agrees to pay the seller a fixed amount of money and the seller agrees to pay the buyer the price of an underlying commodity. See Amaranth Natural Gas Commodities Litigation v. J.P. Morgan et al., 730 F.3d 170, 175 (2nd Cir. 2013).

30 Spense, 53 B.C.L. Rev. at 150.

31 See id. at 151.

32 See id. at 152.

33 See id.
The Commodity Futures Modernization Act (CFMA)\textsuperscript{34} excluded most OTC derivative transactions from the Commodity Exchange Act (CEA)\textsuperscript{35} and essentially divided commodities into three categories. The first category consisted of agricultural commodities; the second, known as “excluded commodities,” included interest rates, exchange rates, currencies, securities and other indices; and the third, known as “exempt commodities,” covered commodities that are not agricultural or “exempt,” including oil, gas, and electricity.\textsuperscript{36}

2. **Electricity derivatives market value judgments**

The D.C. Court of Appeals offered a description of certain electricity derivative market participants in *Black Oak Energy, LLC v. FERC*:

Variously referred to as “virtual marketers,” “financial marketers,” and “arbitrageurs,” the salient factor that distinguishes them from all others who participate in the electric markets is that they never actually transmit or take delivery of electricity. Rather, their trades are offsetting: when they are done trading, they neither owe, nor are they owed, any electricity. Instead, they have either profited or lost based on price fluctuations in the time between their purchases and their sales.\textsuperscript{37}

The court continued by noting that these virtual marketers buy and sell contracts for electricity like all other market participants, and that even though their trades are purely financial, they depend on the existence of a market for actual electricity.\textsuperscript{38} Further, their activities, though “virtual,” contribute to the fluctuations of the market price, which in turn influences whether load-serving entities (market participants who actually traffic in electricity) will purchase electricity at a given time.\textsuperscript{39} Their trades must be treated as if they impose costs on the system, just like the trades of all other participants.\textsuperscript{40}

\begin{itemize}
\item \textsuperscript{34} Pub.L. 106–554, § 1(a)(5)
\item \textsuperscript{35} 7 U.S.C.A §1
\item \textsuperscript{37} *Black Oak Energy v. FERC*, 725 F.3d 230, 236 (DC Cir. 2013). (Concerning the disbursal of a monetary surplus that excluded virtual traders).
\item \textsuperscript{38} See id. at 238.
\item \textsuperscript{39} See id. “Just as a wheat-trading arbitrageur must trade wheat at the market price even though she does not take delivery of the wheat, an electricity-trading arbitrageur must trade electricity at the locational marginal price even though she, in some cases, does not ‘cause the physical flow of power over transmission lines.’” Id.
\item \textsuperscript{40} See id.
\end{itemize}
In *Black Oak*, the court accepted FERC’s proposal to treat disparately virtual traders and other market participants in the PJM market on the grounds that virtual traders are not similarly situated, and to facilitate the achievement of permissible policy goals, namely limiting virtual marketers’ incentives to engage in market manipulation.\(^1\)

FERC has pointed out both pros and cons of virtual-trader participation in the markets, offering, for example, that virtual traders do not participate as producers or distributors of electricity, “but rather as speculators and risk-takers.”\(^2\) According to FERC, virtual traders serve a useful purpose in spotting and exploiting inefficiencies and driving prices closer to an accurate reflection of fundamental value; but their unique position within the marketplace animates the concern over whether virtual marketers will have a beneficial effect on the functioning of the markets.\(^3\) Since their business interests are purely speculative, FERC asserted, virtual marketers pose a threat as potential market manipulators.\(^4\)

For clarity, it is important to distinguish among virtual traders, speculators, and hedgers. Virtual traders attempt to profit from differences between day-ahead and real-time prices. The quantity of MWs purchased or sold by the trader in the day-ahead market is exactly offset by a sale or purchase of an identical quantity of MW in the real-time market, so that the net effect on the market quantity traded is zero. A competitive virtual market should cause day-ahead and real-time prices to converge in each hour, and this convergence is intended to mitigate market power and improve the efficiency of serving load.\(^5\)

A speculator enters the market to make a profit from the buying and selling of a commodity or a financial instrument associated with the commodity.\(^6\) The Commodity Futures Trading Commission (CFTC) defines a speculator as “an individual who does not hedge, but who trades with the objective of achieving profits through the successful anticipation of price

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\(^1\) See id. at 239.

\(^2\) Id.

\(^3\) See id.

\(^4\) See id. FERC explained, in regard to this case, that any formula that disburses surplus to the virtual marketers according to trading volume will create incentives for them to focus on increasing their surplus disbursements by increasing their trading volume. FERC contended that paying excess loss charges to virtual marketers is inconsistent with the concept of arbitrage itself, which is supposed to spot divergences between markets. Enabling profit from the volume of trades would cause virtual traders to make trades based on price differentials alone rather than reacting to price differentials in LMP or congestion. See id.


movements.” A speculator takes on risk that a hedger would want to shed and only benefits when correctly predicting the direction of price changes.

The court in *Black Oak* held that providing an incentive for arbitrageurs to conduct trades simply to receive a larger surplus allocation could distort prices and destabilize the electricity markets (through increased trading), placing virtual marketers far afield of their intended role within a competitive energy system. On the other hand, other commenters believe speculation can improve the efficiency of markets by reallocating market risk and stabilizing prices. Speculation can also provide the market with more liquidity, which facilitates hedging by market participants who wish to reduce price risk; excessive constraints on speculation could reduce market liquidity, limit the ability of hedgers to manage risks, and restrict information for price discovery.

It is clear that regulators are concerned that the rapidly growing markets for complex energy derivatives provide additional opportunities for traders to enrich themselves at the expense of consumers. However, as noted in the summary of the NARUC panel discussion provided above, the very act of hedging—and whether, in some cases, it should constitute market manipulation—remains a contested question among commenters. One such commenter, critical of FERC’s enforcement activities, stated:

> The theme appears to be: market manipulation involves activity that either involves what FERC considers outright misrepresentation or appears to FERC to be traditionally “uneconomic” but that still ends up resulting in profits for your firm, which in some way is viewed by the Commission as

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47 Id. (citing CFTC, *Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations*, September 2008).

48 See id. at 4. Costello also notes that a clear demarcation thus does not exist between hedgers and speculators. See id. at footnote 9.

49 See *Black Oak Energy*, 725 F.3d at 239.

50 Costello, NRRI 08-11 at 11.

51 Liquidity refers to how quickly, and at what cost, buyers and sellers are able to consummate trades in a specific market. Speculators increase liquidity in financial markets, for example, by allowing hedgers to purchase and sell financial derivatives frequently and in a timely manner. Speculators help to achieve this objective by acting as counterparties to those transactions. See id. at fn. 1.

52 See id.

53 Spence, 53 B.C.L. Rev. at 150. See also, Testimony of Norman Bay to U.S. Senate Committee on Banking, Housing & Urban Affairs, *supra* note 3 (indicating that physical markets used to be larger than financial markets but the inverse is true now).
manipulative or false—whether or not such activity is permitted by the governing tariff.\textsuperscript{54}

Mr. McEachran describes FERC’s approach to identifying market manipulation as “a ‘we know it when we see it’ sort of a violation which can make compliance difficult for even the most well-intentioned market participants.”\textsuperscript{55} Kelly notes this concern as well, stating that the risk that market losses might be seen as market manipulation presents challenges for companies that simultaneously hold positions in related markets, because it is inevitable that some trades will settle “out of the money.”\textsuperscript{56} “If those out-of-the-money trades benefit a related position in another market, which may naturally result from normal and lawful hedging, then it is possible that ordinary trading behavior might look like market manipulation.”\textsuperscript{57}

The value of numerous participants in a marketplace is well-documented. By submitting a very large order, a trader can cause a large price movement, especially in an illiquid market where the quantities of bids and offers are small.\textsuperscript{58} Thus, liquidity in the markets is vital to blunting the ability of one participant to cause a large price movement. However, the interplay between the physical and financial markets can create opportunities for market-participant actions that can have the effect of inflating wholesale electric power prices. Thus regulator concern about potential abuse is equally well-founded.

While this section introduced some industry and regulator viewpoints on the value of financial participants in the physical energy commodity markets, distinguishing manipulative from legitimate acts is both challenging and hotly contested. The next sections discuss the development of FERC enforcement authority in the wake of the Western Energy Crisis, and the recent application of that authority in a series of cases. An examination of these cases will elucidate, to some degree, how FERC determines that behavior is improper, as well as a number of enforcement matters that remain unresolved.


\textsuperscript{55} See id. But as Dr. Hildebrandt noted during the aforementioned November 2013 NARUC Panel Discussion, approximately 95\% of market participants comply with FERC rules. See \textit{supra} Introduction.

\textsuperscript{56} See Kelly, \textit{supra} note 2, at 4.

\textsuperscript{57} Id.

III. Development of FERC Anti-Manipulation Authority and Its Recent Application

A. The Western Energy Crisis

1. Suboptimal enabling market conditions

Following a study by the California Public Utilities Commission (Cal PUC) and extensive negotiations in the state legislature, California enacted AB 1890 in 1996, moving from a system of regulated monopolies to a competitive wholesale electricity market. The move required most electricity sales to be conducted through a Power Exchange (PX), which operated under federal authority removed from state jurisdiction. The system appeared to work well between 1998 and 2000 as prices hovered around $35/MWh. Then, in the winter of 2000–2001, market prices forced wholesale buyers, who were used to paying less than $50/MWh, to pay monthly average wholesale prices exceeding $350/MWh during certain months.

Commenters offer a diversity of underlying forces that contributed to these price spikes. One commenter listed: (1) insufficient generating capacity to meet peak demand, (2) short-term supply restrictions, (3) a rapid rise in generator costs, (4) transmission bottlenecks, (5) retail price caps (which kept demand high despite exorbitant wholesale prices), and (6) market manipulation by sellers. Another commenter identified: (1) clumsy deregulation of the wholesale markets, (2) a shortage of new generation, (3) increased demand for energy due to strong economic growth, (4) a drought that limited the availability of hydropower from the Pacific Northwest, (5) reduced natural gas pipeline capacity because of a pipeline rupture, (6) transmission congestion, and a (7) very hot summer. Suffice it to say, the causes were diverse and numerous.

The environment was ripe for manipulators due to very low supply margins during peak periods, enabling sellers to charge very high rates during the peaks and resulting in a windfall to


60 See id.

61 See id. at 16.

62 Spence, 53 B.C.L. Rev. at 155. The new structure caused 80% of transactions to be made in the spot market – the converse of most other markets in which more than 80% of the transactions are made through long-term forward contracts, which lend stability to the markets. See Public Util. Comm’n of Cal v. FERC, 462 F.3d 1027, 1039 (2006).

63 Spense, 53 B.C.L Rev. at 155. All sellers benefited because in California’s centralized power exchange, all sellers were paid the price bid by the marginal seller. See note 209, infra.

64 Kelly, Aspatore at 1.
all sellers during those periods. Wholesale buyers—mainly large incumbent utilities—had to provide electric service to their customers, who were taking service at prices capped below wholesale prices. Due to these caps, the wholesale price spikes were not passed through and so did not act to reduce consumer demand, providing sellers with an incentive to charge even higher prices.

2. Manipulation attributed to Enron Corporation

According to the U.S. Court of Appeals for the Ninth Circuit, it became clear in hindsight that even those who controlled a relatively small percentage of the market had sufficient market power to skew markets artificially. These sellers quickly learned that the California spot market could be manipulated by withholding power from the market to create scarcity and then demanding high prices when scarcity was probable.

Specific manipulative acts attributed to sellers, in addition to those noted above, included scheduling fraudulent transactions that created congestion on the grid in order to claim compensation under California’s grid-congestion relief rules when those transactions were cancelled; and scheduling multiple, high-volume wash trades whereby each party to the transaction agreed to sell the other an identical amount of electricity at unusually high or low prices. Sellers utilized anomalous bidding practices, such as “hockey-stick bidding” (in which an exorbitant price is demanded for a small portion of the market) and “round-trip trades” (in which an entity artificially creates the appearance of increased revenue and demand through continuous sales and purchases).

Enron Corporation engaged in trading designed to increase congestion over transmission lines and then engaged in transactions, for which it was paid by the California Independent System Operator (Cal ISO), that relieved the same congestion. Investigations uncovered the following conduct specific to Enron Corporation during the crisis:

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65 Spense, 53 B.C.L. Rev. at 156
66 See id.
67 Pub. Util. Comm’n of State of Cal., 462 F.3d at 1039
68 Id.
69 Spense, 53 B.C.L. Rev. at 156-157. The purpose of the wash trades was to influence spot-market prices on published indices, which in turn were used to settle obligations under futures or other derivatives contracts that the parties held. See id.
70 See id.
71 AB 1890 also created the Cal ISO, also under FERC jurisdiction, to manage the day-to-day operations of the electricity grid, the elaborate system of transmission lines, towers and equipment that carries electricity throughout the state. See Lockyer Report at 14.
72 Horwich, 27 Energy L.J. at 368. (Citing Price Manipulation in Western Markets, FERC Staff Report, FERC Docket No PA02-2-000 (March 26, 2003) (hereinafter, “Price Manipulation Report”)).
“Death Star” – A practice in which the company sought payment for moving energy to relieve congestion without actually moving any energy or relieving any congestion—rather, all of the demand was created artificially, creating the appearance of congestion, and then satisfied artificially, without any energy being moved.

“Fatboy” – A practice in which the company withheld previously agreed-to deliveries of power to the forward market so that it could sell the energy at higher prices on the spot market—by overscheduling its load, and supplying only enough power to cover the inflated schedule, it would leave extra supply in the physical market, for which the Cal ISO would pay the company.

“Get Shorty” – A practice in which traders would fabricate and sell operating reserves to the Cal ISO, receive payments, and then cancel the schedules and cover their commitments by purchasing energy through a cheaper market closer to the time of delivery.73

“Ricochet” – A strategy to export power to a friendly out-of-state entity, then re-import power at a much higher price.74

Enron also exploited what came to be known as “the Enron Loophole,” a Commodities Exchange Act provision that exempted certain hybrid financial products from CFTC oversight and allowed Enron to trade substantial volumes of physical energy and derivatives contracts on OTC electronic markets.75 Congress purported to close the “Enron Loophole” with the passage of the CFTC Reauthorization Act of 2008.76

FERC issued a staff report in March 2003 finding that many trading strategies employed by Enron and other companies violated anti-gaming provisions of the companies’ own FERC-approved tariffs.77 The staff report found that EnronOnline (EOL) gave Enron knowledge of market conditions unavailable to its competitors and that this trading advantage enabled Enron to absorb losses in physical markets because of profits it earned in the financial markets. It also found that electricity prices in California’s spot markets were affected by economic withholding and inflated price bidding in violation of FERC-approved tariffs and recommended profit disgorgement associated with the violations.78

74 Lockyer Report at 18.
77 Price Manipulation Report, supra note 65.
78 See id. Though not discussed in this paper, the consequences of the Western Energy Crisis for California retail ratepayers persist to this day. See California Investigation No. 02-04-026, Direct Testimony of Paul Clanon in Support of the Settlement Agreement Sponsored by PG&E and PUC Staff,
However, FERC was prohibited from retroactively penalizing electricity sellers who charged market rates that had been properly “filed” with FERC\(^\text{79}\) (discussed in more detail in Sections IV.D.2 and V.A). Thus, in the event that a seller authorized to charge market-based rates acquired market power, FERC’s options to respond were limited to revoking the seller’s authority to charge market-based rates prospectively by either re-imposing cost-based rates for that seller or imposing rate caps for that seller in the relevant market (also known as “mitigation”).\(^\text{80}\)

**B. Development of FERC anti-manipulation authority**

In the wake of the Western Energy Crisis, FERC issued a Market Behavior Rules order in November 2003 to protect wholesale power customers from market abuses by (a) providing effective remedies in the event of market abuses, (b) providing clear rules for sellers with market-based rate authority, and (c) defining reasonable bounds within which market activity could be conducted.\(^\text{81}\) The order conditioned market-based rate authorization on compliance with the behavior rules; deviation from the rules constituted tariff violations.\(^\text{82}\) Market Behavior Rule 2 prohibited “actions or transactions that are without a legitimate business purpose…[which] foreseeably could manipulate market prices.”\(^\text{83}\)

Kelliher notes that while the Market Behavior Rules represented a vigorous bid by the commission to prevent market manipulation, they proved inadequate in that they did not sanction instances when the manipulative practice was unsuccessful or when it produced a foregone loss rather than a profit.\(^\text{84}\) In 2004, FERC adopted market-power screens to assess generator and seller market power and required sellers to report changes in their market-power status, revoking authority to charge market-based rates from sellers who could not satisfy the market-power screens.\(^\text{85}\)

April 22, 2002 at 6. (“The ratepayers have seen the State forced to issue $11.3 billion in bonds just to pay for a few months’ purchases by the Department of Water Resources (DWR), and now face higher rates for twenty years to pay bondholders back.”) Available at: [ftp://ftp.cpuc.ca.gov/static/energy/electric/pge+bankruptcy/paulclanondirecttestimony.pdf](ftp://ftp.cpuc.ca.gov/static/energy/electric/pge+bankruptcy/paulclanondirecttestimony.pdf)

\(^{79}\) See Spence, 53 B.C.L. Rev. at 159. This is called the “Filed Rate Doctrine” and is discussed in greater detail in Section V.A, infra. See also, *Keogh v. Chi. & Nw. Ry. Co.*, 260 US 156, 161-165 (1922).

\(^{80}\) See Spence, 53 B.C.L. Rev. at 160.


\(^{82}\) Kelliher, 26 Energy L.J. at 16.

\(^{83}\) Spence, 53 B.C.L. Rev. at 160. See also, Market Behavior Rule Order at ¶142.

\(^{84}\) Kelliher, 26 Energy L.J. at 22.

\(^{85}\) Spence, 53 B.C.L. Rev. at 161.
In 2005, Congress passed the Energy Policy Act of 2005 (EPACT 2005), which amended the Federal Power Act (FPA) to give FERC broad authority to prosecute 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) from $10,000/day to $1 million/day for each day the violation continued. 86 This section lists the relevant statutory and regulatory language in EPACT 2005 for use as a reference throughout this paper:

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. 87

Congress modeled FERC’s new enforcement authority after Rule 10(b)-5, promulgated pursuant to §10(b) of the Securities Exchange Act of 1934. 88 FERC implemented the statute in 2006 by issuing Rule 1c.2:

It shall be unlawful for any 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,


87 16 U.S.C. §824v(a)


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.

(1) To use or employ any device, scheme, or artifice to defraud,

(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.\(^{89}\)

In January 2006, FERC issued an Order 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.”\(^{90}\) The final rule included a statement that SEC case law amassed over the past decades would provide guidance to FERC’s own enforcement actions, as Congress deliberately modeled portions of the EPACT 2005 on §10(b) of the Exchange Act.\(^{91}\)

The Order also defined 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;

(2) with the requisite scienter;\(^{92}\)

(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.\(^{93}\)

\(^{89}\) 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 note 88).


\(^{91}\) See id at ¶31.

\(^{92}\) 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. Black’s Law Dictionary, Third Pocket Edition. Thomson West, 1996.

\(^{93}\) FERC Order 670 at ¶49.
FERC interpreted scienter, in the context of rule 10b-5, to encompass both intentional and reckless conduct, which means “highly unreasonable [conduct] involving...an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.”

In implementing EPACT 2005, FERC rescinded Market Behavior Rules 2 (generally prohibiting manipulation) and 6 (directing sellers not to violate market-based rate codes of conduct), and codified Rule 1 (obligating sellers to participate in accordance with Commission rules and regulations), Rule 3 (sellers will provide factual information to Commission), Rule 4 (sellers will report factual information to publishers of price indexes), and Rule 5 (sellers shall retain records for three years).

The following section examines FERC’s application of its EPACT 2005 authority in seven recent cases in order to surmise FERC’s approach to identifying manipulation as well as outstanding, unresolved issues with the existing enforcement framework.

C. FERC’s application of anti-manipulation authority in recent enforcement actions

1. Deutsche Bank Energy Trading, LLC

In a September 2012 Order to Show Cause against Deutsche Bank Energy Trading, LLC (DBET), FERC alleged violations of Rule 1c.2 (Anti-Manipulation) and rules on accurate and factual communications as well as parallel provisions of the Cal ISO tariff. Specifically, FERC alleged that DBET traders had executed a scheme called “Export Strategy,” in which DBET scheduled uneconomic physical transactions (exports at Silver Peak that lost money for forty-four straight days) in order to benefit its financial congestion revenue right (CRR) positions at Silver Peak. FERC alleged that DBET had scheduled power to alter pricing in a manner that

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95 See id. (Citing Sundstrand Corp. v. Sun Chem Corp., 553 F.2d 1033, 1045 (7th Cir. 1977)).

96 See id. at 373. (Citing FERC Order 674, Conditions for Public Utility Market Base Rate Authorizations, 114 FERC ¶61,163 at ¶21 (2006)).

97 This section provides a brief overview of seven cases. For a broader discussion of the first four cases, see Rishi Garg, Federal Energy Regulatory Commission Anti-Manipulation Authority and its Recent Application, National Regulatory Research Institute (NRRI) Briefing Paper No. 13-11, (November 2013) at 7-18.

98 See FERC Enforcement Staff Report and Recommendation, Deutsche Bank Energy Trading, LLC, Docket No. IN12-4-000, September 5, 2012, at 13 (hereinafter, “Deutsche Bank Staff Report”).

99 See id. Congestion Revenue Rights are financial instruments that enable holders to manage variability in congestion costs on location marginal pricing and are acquired primarily to offset forward
benefited its financial position rather than trading based on supply-and-demand fundamentals, and that DBET had injected false and deceptive information into the marketplace by submitting transactions at wheeling through when they were not wheeling.

FERC approved a stipulation and consent agreement in January 2013, noting that DBET, without admitting fault, had stipulated that it had engaged in market behavior that benefited its financial CRR positions at the expense of its physical positions. In finding the requisite scienter, FERC stated that while DBET’s physical transactions were not profitable, even if they had been profitable, “profitability is not determinative on the question of manipulation and does not inoculate trading from any potential manipulation claim.”

2. Constellation Energy Commodities Group

FERC issued an order approving a stipulation and consent agreement with Constellation Energy Commodities Group, Inc. (CCG) in March 2012. FERC alleged a scheme in which CCG had traded in the New York Independent System Operator (NY ISO) virtual market to move day-ahead prices in a direction that would benefit its financial contract for differences (CFD) positions in violation of FERC’s Anti-Manipulation Rule and accuracy requirements. Moreover, FERC alleged that CCG had engaged in virtual trading and entered day-ahead physical schedules in the New York ISO that were routinely unprofitable to impact day-ahead market congestion costs that occur in the day-ahead market. See “Congestion Revenue Rights,” California ISO, https://www.caiso.com/market/Pages/ProductsServices/CongestionRevenueRights/Default.aspx

100 See Deutsche Bank Staff Report at 14.

101 See id at 19. When a wheeling transaction takes place, the ISO receives electric energy into its control area from one party and then transmits it to a third party either outside the control area or off of the ISO-controlled grid. “California ISO Settlement Guide, May 2, 2005, http://www.caiso.com/Documents/WheelingCharges.pdf.

102 See Order Approving Stipulation and Consent Agreement, Deutsche Bank Energy Trading, LLC, Docket No IN12-4-000, ¶¶8-23, January 22, 2013.

103 Id at 20.


105 See id at ¶2. 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.

106 See id at ¶1.
prices in other markets in a manner that would benefit financial CFD positions, including swaps, financial transmission rights (FTRs), and transmission congestion contracts (TCCs) it held.107

FERC’s Office of Enforcement (OE) determined that (1) CCG’s trading activity during the months of interest constituted a fraudulent device; (2) CCG intended to manipulate the New York ISO and New England ISO day-ahead markets; and (3) CCG’s manipulative scheme was in connection with transactions subject to Commission jurisdiction;108 and that these actions resulted in widespread economic loss to market participants who bought and sold energy in those markets.109

Notably, the Stipulation and Consent Agreement carved out an exclusive role for state agencies to request apportionment of the $110 million profit disgorgement “for the benefit of electric energy consumers.”110 As noted later in this paper, such invitations have not been consistently extended.

3. JP Morgan Ventures Energy Corporation

FERC issued an Order Approving Stipulation and Consent Agreement with JP Morgan Ventures Energy Corporation (JVEC) in which FERC alleged that JVEC engaged in a series of strategies intentionally submitting bids that falsely appeared economic to the California ISO and Midwest ISO regional operators, but that were intended to pay JVEC rates far above market prices.111

FERC alleged that JVEC engaged in 12 strategies to manipulate the electric markets in California and MISO, and that those strategies included the use of energy-market processes such as ancillary services, self-schedules, operating constraints, and day-ahead bidding to receive

107 Garg, supra, note 97 at 11-12. 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 and settle the difference from the agreed-upon price after the fact. Swaps are financial contracts in which two counterparties agree to exchange payments with each other as a result of such things as changes in a stock price, interest rate or commodity price. 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 markets. Transmission congestion contracts enable energy buyers and sellers to hedge transmission price fluctuations; a TCC holder has the right to collect or obligation to pay congestion rents in the day-ahead market for energy associated with transmission between specified points of injection and withdrawal. Id, fns 59, 61-63.

108 See Constellation Energy Commodities Group Order, supra note 104 at ¶16.

109 See id. at ¶17.


millions of dollars in make-whole payments at above-market rates.\textsuperscript{112} FERC alleged further that JVEC’s trading activities were not grounded in economic fundamentals; rather, JVEC submitted losing bids in day-ahead and real-time markets to trigger out-of-market compensation systems that distorted well-functioning markets.\textsuperscript{113}

Notably, FERC held that Rule 1c.2 does not limit market manipulation to specific tariff violations, but rather, the breadth of Congress’ authorization and the anti-manipulation rule responds to the impossibility of foreseeing the wide array of misconduct in which market participants may engage.\textsuperscript{114} Because “no list of prohibited activities could be all-inclusive,” conduct, as opposed to a specific false oral or written statement, is sufficient to establish a violation of Rule 1c.2.\textsuperscript{115}

4. Barclays Bank, PLC

FERC issued an Order to Show Cause and Notice of Proposed Penalty against Barclays Bank PLC in October 2012.\textsuperscript{116} FERC alleged that the bank and certain of its employees had engaged in a coordinated scheme to manipulate trading at four trading points in the Western United States by engaging in loss-generating trading of next-day fixed-price physical electricity on the Intercontinental Exchange (ICE) at the four locations to benefit its financial swap positions in those markets.\textsuperscript{117}

\textsuperscript{112} See id. at ¶¶49-52. Make-whole payments compensate generators when market revenues do not cover the “bid cost” of a unit that the ISO has committed. See id. at ¶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 its lowest operating level. See id. A self-schedule is the action of a market participant to commit or schedule its resource at a determined output level to provide generation within an hour, regardless of price or whether the ISO could have scheduled or dispatched the resource to provide the service. See ISO New England Glossary & Acronyms. Available at: http://www.iso-ne.com/support/training/glossary/index-p7.html

\textsuperscript{113} See id. at ¶¶76-81.

\textsuperscript{114} See id. at ¶83 (citing Cargill v. Hardin, 452 F.2d 1154, 1163 (8th Cir. 1971)).

\textsuperscript{115} See id. at ¶¶83-84. (citing Amendments to Blanket Sales Certificate, FERC Order 644, 105 FERC ¶61,217 at ¶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.”)

\textsuperscript{116} See Barclays Bank PLC, Order to Show Cause and Notice of Proposed Penalty, FERC Docket No. IN08-000, October 31, 2012.

\textsuperscript{117} See id. at ¶2. 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 day-ahead 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 day-ahead fixed-price physical markets, often called the “cash” or “dailies” market. See FERC Petition for an Order Affirming July 16, 2013 Order Assessing Civil Penalties, (E. Dist. Cal., October 9, 2013) at ¶22-24 (hereinafter “FERC Petition”)}
Allegedly, Barclay’s scheme involved (1) setting up a financial position, (2) building a physical position that was in the opposite direction to the financial position, and (3) flattening the physical position through trading dailies to benefit the financial positions. The act of flattening impacted the ICE daily index settlements and benefited Barclays’ related financial positions, which either paid or received the ICE daily index.

FERC concluded that Barclays’ scheme was serious and complex, requiring coordinated trading of multiple products over a long period of time; widespread, involving trading of more than 35 monthly products on more than 655 product days at four significant trading points; and significant, because Barclays traded large volumes of electricity to affect index settlements. Moreover, the practices affected wholesale electricity prices in the Western United States paid by load-serving entities, which in turn affected the retail rates paid by tens of millions of consumers in California and elsewhere.

Notably, once FERC issues an assessment of penalties, as it did in July 2013, the FPA provides that if the penalty is not paid within 60 days, FERC may commence an action in a U.S. district court for an order affirming the penalty and the court may review the penalty assessment de novo. Barclays did not pay the civil penalty, and on October 9, 2013, FERC petitioned the federal district court for the Eastern District of California for an order affirming its penalty assessment. On December 16, 2013, Barclays filed a motion to dismiss FERC’s petition, and on January 17, 2014, a judge granted a motion to stay the penalty assessment filed by the bank until he rules on the Barclay’s motion to dismiss the case or transfer it to another jurisdiction. Potential consequences of the motion and the resolution of the case are considered in Section VII.

5. Amaranth Natural Gas Commodities

Because many homes and businesses use natural gas for indoor heating, this resource has a highly seasonal price, which rises in the colder winter months and falls in the warmer summer

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118 See FERC Order Assessing Civil Penalties, Barclays Bank, PLC, FERC Docket No IN08-000 at ¶2-4 (July 16, 2013). 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. See FERC Petition at ¶56.

119 FERC Petition at ¶58

120 See id at ¶¶120-121.

121 See id.


123 See FERC Petition, supra note 108.
months. Amaranth, a hedge fund, acquired spreads between natural gas futures for different months. By taking large spread positions, the company was betting that the difference between the winter and summer prices would increase.\textsuperscript{124}

The court found that Amaranth engaged in “slamming the close” trades. In these trades, the company would simultaneously acquire a long position in the future and a short position in the corresponding swap on the ICE exchange.\textsuperscript{125} Then, during the final settlement period, Amaranth would sell most or all of its long position, lowering the future’s final settlement price and lowering the price of the corresponding ICE swap. This enabled Amaranth to profit from its short position in that swap.\textsuperscript{126}

In conducting these trades, Amaranth violated NYMEX position limits and accountability levels, prompting investigations from NYMEX and the CFTC. A subsequent investigation by the U.S. Senate Subcommittee on Investigations concluded that Amaranth dominated the domestic natural gas market in 2006 and increased price volatility in the natural gas market.\textsuperscript{127}

\textbf{6. Brian Hunter}

Both FERC and the CFTC brought enforcement actions against Brian Hunter, an employee of Amaranth.\textsuperscript{128} Within a day of each other, the CFTC filed an enforcement action alleging price manipulation of natural gas future contracts under the CEA and FERC filed an enforcement action alleging price manipulation in violation of the Natural Gas Act.\textsuperscript{129} Hunter petitioned the DC Circuit for review asserting that FERC lacked jurisdiction, while the CFTC intervened in support of Hunter’s petition.\textsuperscript{130}

The court concluded that while EPACT 05 required FERC and the CFTC to enter into a memorandum of understanding (MOU) about information sharing, it had no effect on the CFTC’s exclusive jurisdiction with respect to manipulation of natural gas futures contracts.\textsuperscript{131}

\textsuperscript{124} \textit{Amaranth v. JP Morgan et al.}, 730 F. 3d. 170, 176 (2nd Cir. 2013).

\textsuperscript{125} In a “long” manipulation, a large buyer, or “large long,” accumulates a futures position allowing him to demand delivery of more of the commodity than is available in the delivery markets at the competitive price. In a “short” market power situation, on the other hand, the “large short” makes excessive deliveries of the commodity in order to drive down the futures’ price, thereby allowing him to repurchase his futures’ positions for less than the competitive price. See Section IVA, \textit{infra}.

\textsuperscript{126} See id at 177.

\textsuperscript{127} See id at 177. Amaranth settled enforcement actions with both the CFTC and the FERC.

\textsuperscript{128} \textit{Hunter v FERC}, 711 F.3d 155 (DC Cir. 2013).

\textsuperscript{129} See id. at 156.

\textsuperscript{130} See id. at 156-157.

\textsuperscript{131} See id. at 158.
The court found that FERC fined Hunter for trading natural gas futures contracts with the intent to manipulate the price of gas in the electric power markets, but nonetheless involved transactions of a commodity futures contract.\textsuperscript{132}

FERC argued that where there is manipulation in one market that directly or indirectly affects the other market, both agencies have an enforcement role.\textsuperscript{133} CFTC countered that such a jurisdictional test would allow any agency with authority to prosecute manipulation of the spot price of a commodity to exercise jurisdiction over the trading of futures contracts in that commodity, thereby eviscerating the CFTC’s exclusive jurisdiction over commodity futures contracts.\textsuperscript{134} The court rejected FERC’s argument that there is complementary jurisdiction when the manipulation “coincides with” or is “in connection with” FERC jurisdictional gas transactions,” and ruled that FERC may not intrude upon the CFTC’s exclusive jurisdiction.\textsuperscript{135}

One commenter notes that Hunter is indicative of how oil, gas, and electricity prices have become inextricably intertwined with the trading of financial products, and how FERC intends to focus on uneconomic trading of products related to oil, gas, and electricity when traders lose money in one market in order to benefit positions in another market.\textsuperscript{136} This case may well have significant ramifications for the proper assertion of jurisdiction in market-manipulation enforcement actions, including FERC’s pending petition before the Eastern District of California to enforce penalties against Barclays.

7. Rumford Paper Company

In March 2013, FERC assessed a civil penalty against Rumford Paper Co., alleging market manipulation for payments the company had received as part of ISO New England’s Day-Ahead Load Response Program (DALRP), which pays customers for reducing the amount of electric power they use from the wholesale electrical grid.\textsuperscript{137} FERC concluded that by intentionally ramping down their generator and purchasing energy instead of producing it onsite,

\textsuperscript{132} See id.

\textsuperscript{133} See id. (citing Respondent’s Brief at 22).

\textsuperscript{134} See id. (Citing CTC Reply Brief at 3).

\textsuperscript{135} See id. at 160.

\textsuperscript{136} See Marc Machlin and Min Choi, \textit{This Is Not Your Father’s FERC: Understanding the New Central Role of FERC’s Enforcement Division – Part II}, July 16, 2013. Available at: http://www.mondaq.com/unitedstates/x/252646/Energy+Law/This+Is+Not+Your+Fathers+FERC+Understanding+The+New+Central+Role+Of+FERCs+Enforcement+Division+Part+II

Rumford established a false and inflated baseline, inducing payments for load reductions that never occurred.\(^\text{138}\)

One commenter argues that while Rumford may have gamed the system, it is the fault of the market rule, which authorized a static baseline (which does not reflect the most recent operating conditions and would likely produce phantom reductions) rather than a dynamic baseline; as such, Rumford did not break the rules of ISO-NE’s DALRP program.\(^\text{139}\)

The Rumford case provides a stark example of a statutory standard requiring a showing of manipulation, when in fact Rumford’s conduct may have been both legal (not in violation of the ISO’s tariff) and damaging to the integrity of the New England electric market. As noted in the conclusion, this paper asserts that in cases such as this, a cause of action should be available, based upon a justice-and-reasonableness standard, that enables enforcement authorities to address the bad acts without having to make a showing of manipulation.

**D. FERC approach to enforcement actions and unresolved matters**

The cases discussed above offer some insight into FERC’s application of its enforcement authority. They demonstrate (1) the ongoing challenge of defining the alleged bad behavior appropriately, (2) the interplay between physical and financial markets, and (3) unresolved matters requiring resolution.

In the first four cases discussed above, the OE actions seem to focus on:

1. Physical trades apparently uneconomic to the trading organization but that benefit financial positions the organization held in other markets;
2. Physical trades made without respect to the economic fundamentals of supply and demand;
3. Organization training manuals and other resources that prohibit uneconomic behavior that benefit positions in other markets; and
4. Widespread economic loss to market participants or distortion of well-functioning markets.

These cases also suggest that (1) profitability is not determinative on the question of manipulation; (2) violations of Rule 1.c.2 can be based on conduct rather than any specific tariff violation; and (3) FERC may invite states to intervene in disbursement decisions at its discretion.

\(^\text{138}\) See id at ¶28. See also, William Pentland, *Federal Energy Regulator Burns the Barn to Roast the Pig; Steep Penalty on Distributed Power Provider May Have Unintended Consequences*, Forbes, November 29, 2013.

\(^\text{139}\) See Pentland, supra note 138.
The final three enforcement actions discussed raise yet unresolved matters such as (1) distinguishing manipulative from legitimate market behavior; (2) federal agency jurisdiction; and (3) properly defining market manipulation. Taken together, the cases demonstrate the vital importance of defining the alleged bad behavior appropriately. FERC has offered further insight into why it defines manipulation broadly and its concern about the interplay between physical and financial markets.

A footnote included in FERC’s Order concerning JP Morgan states:

Enron (and others) would demand that a regulatory agency have the prescience to include in a rate schedule all specific misconduct in which a particular market participant could conceivably engage. That standard is unrealistic and would render regulatory agencies impotent to address newly conceived misconduct and allow them only to pursue…last year’s misconduct—essentially, to continually fight the last war and deny the capability to fight the present or next one.\(^{140}\)

In addition, regulators believe that the interplay between the physical commodity and financial derivatives markets in electric energy can open up opportunities for abuse. As OE Director Norman Bay stated in recent testimony to a U.S. Senate committee,

A fundamental point necessary to understanding many of our manipulation cases is that financial and physical energy markets are interrelated: physical natural gas or electric transmission can help set energy prices on which financial products are based, so that a manipulator can use physical trades (or other energy transactions that affect physical prices) to move prices in a way that benefits his overall financial position…. Increasing the value of the benefitting position is the goal or motive of the manipulative scheme. The manipulator may lose money in its physical trades, but the scheme is profitable because the financial positions are benefited above and beyond the physical losses.\(^{141}\)

This interaction is relevant for both the regulator of the physical commodity markets and the derivative financial products markets. For example, interaction between the markets for physical commodities and related derivatives arose in *CFTC v. Enron*\(^{142}\) in which the CFTC alleged that Enron and an employee, Hunter Shively, engaged in a scheme to “bid up” the next-

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\(^{140}\) See JP Morgan Order, *supra* note 102 (citing *Order Denying Rehearing (AEP)*, 106 FERC ¶61,020 at ¶45 (2004)).


day spot price for natural gas at a major trading hub, and eventually unwound Enron's position in the market with a resultant price decline, causing prices in the NYMEX Henry Hub futures market to become artificial.\textsuperscript{143}

Inconsistency in the manner in which FERC applies its enforcement authority, with respect to both defining manipulation and distinguishing between manipulative and legitimate market behavior, may be most aptly attributed to uncertain congressional intent and an unworkable statutory framework. The next section explores the deficiencies in the existing statutory, legal, and regulatory enforcement framework and the impact of those limitations on state enforcement opportunities.

IV. Deficiencies in the Existing Legal Framework and Limitations on States

A. Challenges in defining manipulation and manipulative practices

This section offers different commenter definitions of manipulation in the energy-commodity and derivatives contexts, and defines the most prevalent market manipulation schemes. According to Kelly, at its heart, market manipulation “involves conduct intended to undermine a competitive market by creating a market price that does not reflect supply and demand fundamentals.”\textsuperscript{144} Further, in cases of cross-market manipulation, the focus of FERC’s recent actions, FERC has found that uneconomic trading can satisfy the “fraud or deceit” element of its Anti-Manipulation Rule because deliberately engaging in uneconomic trades is a form of transactional fraud.\textsuperscript{145}

According to Pirrong, the most common type of market-power manipulation is “long” market-power manipulation, executed by a trader who has purchased a large number of futures contracts, sometimes called a “corner” or “squeeze.”\textsuperscript{146} In a “long” manipulation, the large buyer, or “large long,” accumulates a futures position allowing him to demand delivery of more of the commodity than is available in the delivery markets at the competitive price. The large long can then demand of those who have sold him futures contracts (the “shorts”) to either pay the exceptional cost of delivery or buy back their futures positions at a super-competitive price.\textsuperscript{147} In a “short” market-power situation, on the other hand, the “large short” makes excessive deliveries of the commodity in order to drive down the futures’ price, thereby allowing him to repurchase his futures’ positions for less than the competitive price.\textsuperscript{148}

\textsuperscript{143} Id.

\textsuperscript{144} See Kelly, Aspatore, p. 3.

\textsuperscript{145} See id.

\textsuperscript{146} See Pirrong, 31 Energy L.J. at 3.

\textsuperscript{147} See id at 4.

\textsuperscript{148} See id.
According to Pirrong, the other type of manipulation involves deceit or fraud—for instance, when a trader spreads a false rumor that causes prices to move in a way that benefits his position (called “pump and dump”). A trader can also misrepresent prices of transactions when price reports are used to determine the settlement price of a derivatives contract. Further, a trader may engage in a wash trade that gives a misleading impression of actual buying or selling interest in the market.  

Examples of false trades include (1) “bearding,” whereby traders disguise their true interest in a security or create the appearance of heightened interest in the marketplace by using third parties to make trades on their behalf while hiding their involvement; (2) wash sales; (3) “matched trades,” whereby manipulators either trade shares amongst themselves at escalating prices or instigate two other parties to act as contra-parties to a trade to create the false appearance that there is real interest in the stock; (4) rigged prices; and (5) “painting the tape” or “painting the close” which involves intensive trading near the end of the trading day for the purpose of setting the stock’s ending price at an artificial level.

In a “wash trade,” a seller sells a party a specified amount of power to be delivered at a specified point for a specified period; that buyer then almost immediately resells exactly the same power back to the first seller. Wash trades can inflate the sales volumes in the markets as a whole and the volume for the specific traders who report inflated sales, which gives the appearance of greater total market volume as well as overstating the significance of the misrepresenting traders as market participants.

Pirrong notes that power manipulations and fraud-based manipulations are quite distinct: a large trader can corner a market without making any false or misleading statements; and a trader can spread a false rumor that moves prices even if his position is not large enough to permit the exercise of market power. As seen in the next section, legal frameworks that confuse these concepts infuse uncertainty into the enforcement process and inhibit proper prosecution.

B. Limitations on statutory frameworks

Some commenters believe that the securities model that Congress adopted to empower FERC to address market manipulation (discussed in Section II of this paper) is “a bad fit for energy markets,” because the model is focused less on controlling market power and more on

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149 See id at 5.

150 Spense, 53 B.C.L. Rev at 178.

151 Horwich, 27 Energy L.J. at 368. (Referring to Price Manipulation Report, supra note 55).

152 Pirrong, 31 Energy L. J. at 5.

153 See id.
market manipulation based upon fraud and deceit.\textsuperscript{154} As noted immediately above, it is possible to execute a market-power manipulation without engaging in deceit, and those without market power can engage in fraud-based manipulations.\textsuperscript{155}

Pirrong asserts that courts and commissions have gone astray in their enforcement of manipulation because Congress has failed to define and describe manipulation with sufficient specificity to permit those tasked with enforcing and interpreting the law to apply it reliably to the types of conduct most damaging to the market.\textsuperscript{156} He notes that, whereas the CEA distinguishes between market power and fraud-based manipulations, EPACT 2005 and the Energy Independence and Security Act of 2007 (EISA 2007), both based on Section 10b-5 of the Securities and Exchange Act, focus only on fraud-based manipulations and are ill suited to address market-power manipulation.\textsuperscript{157}

The CEA also specifically proscribes corners and makes manipulation a felony;\textsuperscript{158} in addition, it separately bans fraud in commodity markets.\textsuperscript{159} On the other hand, EPACT 2005 and EISA 2007 are misguided because while market-power manipulation is a serious concern in commodity markets, such manipulation does not require any “deceptive device or contrivance,” as required by those laws.\textsuperscript{160}

However, CFTC enforcement authority is not without its own flaws. While a 1974 amendment to the CEA required all futures trading to be done on regulated exchanges, it neglected to define “futures contracts,” leaving uncertain the status of trading in “forward contracts,” a less standardized OTC substitute for futures.\textsuperscript{161} In 1992, Congress amended the CEA by authorizing the CFTC to exempt energy-forward contracts from its regulations. Congress went further and exempted most CFTC regulation of OTC trading of energy derivatives by sophisticated or institutional parties in the Commodities Futures Modernization Act of 2000 (CMFA).\textsuperscript{162} The CMFA’s passage sparked rapid expansion of OTC trading,

\textsuperscript{154} Spense, 53 B.C.L. Rev. at 131.
\textsuperscript{155} Pirrong, 31 Energy L.J at 1.
\textsuperscript{156} See id at 13.
\textsuperscript{159} See id. See also CEA, 7 U.S.C. §6b.
\textsuperscript{160} Pirrong, Energy L. J. at 7.
\textsuperscript{161} Spense, 53 B.C.L. Rev at 152-153.
\textsuperscript{162} See id. at 154.
particularly on the ICE. For example, the U.S. Government Accountability Office reported a more than fourfold increase of energy derivatives on the ICE between 2003 and 2006.\footnote{163}{See id.}

Spense argues that the security-regulation model misses ways in which sellers of energy in physical markets can exercise market power at the expense of buyers, even in the absence of fraudulent or deceptive conduct.\footnote{164}{See id at 133.} By requiring all enforcement actions to be brought under the guise of deception or fraud, the statutory schemes have left a major source of artificial price inflation—market power—unaddressed.

According to Pirrong, it would only have been sensible to model the anti-manipulation provisions of EPACT 2005 and EISA 2007 after the Securities Exchange Act if the kinds of manipulation in commodities and securities markets were similar, but that is not the case.\footnote{165}{Pirrong, 31 Energy L. J at 11.} Pirrong notes that while fraud and deceit can be used to manipulate commodity markets, it is the frictions arising from transportation and other costs that make market power a chronic concern in commodities markets, amplified by the ability of large commercial and financial firms to amass large derivatives positions that can be used to exploit those frictions.\footnote{166}{See id.}

In contrast, while exercises of market power can exploit frictions in securities markets, many manipulation strategies rely extensively on fraud and deceit, due primarily to the fact that prices of securities are highly information sensitive.\footnote{167}{See id.} Thus, it makes sense to emphasize fraud and deceit in a securities-market context, whereas commodities—more sensitive to transportation costs—ought to emphasize market power. Yet EPACT 2005 and EISA 2007 do the opposite; they explicitly note fraud and deceit but are silent on market power and related concerns (such as corners).\footnote{168}{See id at 12.}

Thus, the harm caused by the existing statutory frameworks of EPACT 2005 or EISA 2007 is that in pursuit of market-power manipulation, the statutory language compels FERC or the Federal Trade Commission (FTC)\footnote{169}{EISA 2007 authorized the FTC to promulgate regulations to define and prohibit manipulative or deceptive conduct in wholesale petroleum markets. 42 U.S.C. §§ 17301-17386 (2006).} to make arguments in a context of fraud and deceit—a high bar that does not quite address the action alleged.\footnote{170}{Pirrong, 31 Energy L.J. at13.} That these statutes identify
manipulation as a species of fraud leaves regulators with a difficult course to chart in their pursuit of manipulators.

Spense concurs with Pirrong’s concerns, stating that in energy markets traders are fully informed about the characteristics of the commodity, and therefore, what matters more is the commodities’ relative scarcity. Thus, the focus of enforcement should be on market power rather than deception. Spense states that the current legal framework seems to offer buyers less protection than do traditional public utility rate regulations or antitrust principles.\textsuperscript{171}

The harm imposed on states from the statutory deficiency described herein is significant. To the extent that Congress has limited FERC’s ability to preserve the integrity of the physical energy markets by requiring showings of deception and fraud in all enforcement actions, it has also limited opportunities for the state to assert theories of harm under the just-and-reasonable rate standard. The implications of this limitation will be discussed in Section V.B.

C. Limitations in court decisions

The Supreme Court has repeatedly held that in order to be manipulative, statements and conduct must be deceptive.\textsuperscript{172} In \textit{Ernst & Ernst v. Hochfelder}, the Court stated that manipulation “connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.”\textsuperscript{173} The lower courts have followed suit, with the Seventh Circuit Court of Appeals holding that “manipulation is a kind of fraud; deceit remains essential.”\textsuperscript{174} Due to this tie between manipulation and deception, virtually all Rule 10b-5 manipulation cases have involved either false statements or false trading.\textsuperscript{175}

Spense argues that the courts have failed to appropriately apply statutory interpretation. The language of §10(b) of the 1934 Securities and Exchange Act distinguishes deception from manipulation (“manipulative or deceptive devices”). While the Supreme Court often states that matters of statutory interpretation start with the language of the statute, the Court has seemingly ignored that legal canon in this case.\textsuperscript{176} In fact, by requiring that acts be deceptive in order to be manipulative, the Court has functionally collapsed the two terms.\textsuperscript{177}

\textsuperscript{171} Spense, 53 B.C.L Rev. at 189. Spense is likely referring to just and reasonable principles contained in state public utility acts.


\textsuperscript{173} Spense, 53 B.C.L. Rev. at 177.

\textsuperscript{174} See \textit{Foss v. Bear, Stearns & Co.}, 394, F.3d 540, 542 (7th Cir 2005).

\textsuperscript{175} Spense, 53 B.C.L. rev. at 177.

\textsuperscript{176} See id. at 180.

\textsuperscript{177} See id.
Some commenters believe that the statutory construct does not limit FERC’s ability to pursue market power as market manipulation. Kelly, for example, notes that the abuse of market power can constitute market manipulation when, for example, economic withholding of generation is used to raise electric market prices.\(^{178}\)

**D. Shortcomings in agency applications of enforcement rules**

1. **CFTC enforcement**

Pirrong compiles a list of agency missteps in defining the scope of illegal manipulative behavior. Recent CFTC decisions, for example, have rejected processes for comparing futures prices to determine whether manipulation has occurred. In *In re Indiana Farm Bureau Cooperative Association*, the Commission held that prices were not artificial despite evidence of massive distortions of futures prices, holding instead that it is necessary to “search for those factors that are extraneous to the pricing system.”\(^{179}\) In *In re Cox*, the Commission dismissed price comparisons, asserting that the “prospective behavior of a normal market is not bounded by the market’s historical experiences.”\(^{180}\) According to Pirrong, these rulings demonstrate a lack of understanding of market manipulation and make it difficult to use economic tools to determine whether manipulation has in fact occurred.\(^{181}\)

Pointing to *In re Cox*, in which the CFTC found that the traders had not cornered the market, Pirrong suggests that the CFTC provided manipulators with substantial power to inflate market prices artificially without facing any risk of being found to have the ability to cause the increased prices.\(^{182}\) He also faulted the CFTC’s holding in *Indiana Farm Bureau* for ignoring the act of market power and holding instead that a large long has a contractual right to stand for delivery or exact whatever price for its long position that a short is willing to pay to avoid having to make delivery.\(^{183}\)

2. **FERC enforcement**

   a. **FERC’s approach to address market power**

To implement its new enforcement authority post EPACT 2005, FERC issued Order 670 making it illegal to “use or employ any device, scheme, or artifice to defraud” or to engage in

\(^{178}\) See Kelly, Aspatore at 3.

\(^{179}\) Pirrong, 31 Energy L. J. at 9 (citing *In re Indiana Farm Bureau Cooperative Association*, Commodity Futures Law Reporter ¶21,796, 27,287 (CFTC 1982)).

\(^{180}\) See id. (Citing *In re Cox*, Commodity Futures Law Reporter ¶23,786, 34,064 (CFTC 1987)).

\(^{181}\) See id.

\(^{182}\) See id. at 10.

\(^{183}\) See id. at 9 (citing *Indian Farm Bureau*, ¶¶'s 27,285-27,286).
“any act, practice or course of business that operates or would operate as a fraud or deceit upon any entity” in connection with the purchase or sale of energy subject to FERC jurisdiction.\textsuperscript{184} Order 670 purposefully excluded coverage of exercises of market power, which FERC instead characterized as:

\begin{quote}
    a structural issue to be remedied, not by behavioral prohibitions, but by processes to identify and, where necessary, mitigate market power that a tariff application may possess or acquire. This occurs in the screening process before the Commission grants an application for market-based rate authority, on consideration of changes in the seller’s status or operations, and in the triennial review of market-based rate authorization.\textsuperscript{185}
\end{quote}

This ruling crystallized FERC’s focus on fraud or deceit in enforcement actions, while addressing market power as a front-end structural matter to be determined before authorizing grants of market power. In doing so, the regulatory model may be diverting attention away from market participants who might corner or squeeze markets at the expense of consumers, or pivotal suppliers who might acquire market power and capture scarcity rents over a sustained period of time.\textsuperscript{186}

Even FERC’s market-based rate-authorization power and market-power screens are further limited by the “filed rate doctrine,” which limits FERC ability to retroactively penalize sellers who charge market rates that had been “filed” with FERC.\textsuperscript{187} Thus, while FERC may revoke a seller’s authority to charge market-based rates prospectively by either re-imposing cost-based rates for that seller or imposing rate caps for that seller in the relevant market, its opportunities to apply these remedies appear severely limited.\textsuperscript{188} FERC’s application of the filed rate doctrine—its assertion that its market power determination creates authority for a generator to charge a market rate and that approval precludes retroactive challenge to the price charged—resulted, in the case of the Western Energy Crisis, in no refunds for consumers in California for

\begin{footnotes}
\item[184] Spense, 53 B.C.L. Rev. at 161. See also 18 C.F.R § 1c2 (2011)
\item[185] Spense, 53 B.C.L. Rev. at 162 (citing FERC Docket No. EL06-16-000, Order Revising Market Based Rate Tariffs and Authorizations (2006)).
\item[186] See id. at 175.
\item[187] See id. at 159. (See, for example, Keogh v. Chi. & Nw. Ry. Co., 260 US 156, 161-165 (1922) in which the Court held that “the legal rights of shipper as against carrier in respect to a rate are measured by the published tariff. Unless and until suspended or set aside, this rate is made, for all purposes, the legal rate, as between carrier and shipper. The rights as defined by the tariff cannot be varied or enlarged by either contract or tort of the carrier.”) Id. at 163.
\item[188] See id. at 160.
\end{footnotes}
overcharges between May and October 2000, even though FERC itself determined that those prices were unjust and unreasonable.¹⁸⁹

Some commenters have asserted that FERC’s solution to market power—to mitigate it after the fact by imposing price caps—suffers from the theoretical deficiency that it is unreasonable to assume that high electricity prices will invite entry into the energy markets. Even when price caps are set at levels designed to invite new entry, if they do not in fact result in new entry, then consumers may be stuck paying prices (set at rate caps) considerably in excess of competitive levels for extended periods of time.¹⁹⁰

A prime example of this regulatory shortcoming involves the FERC Office of Enforcement’s 2008 investigation into abuse of market power in the New York City market.¹⁹¹ In that case, despite finding no evidence that the alleged bidding behavior “involved fraud or deceit and, therefore, constituted market manipulation,” the FERC OE noted that: (1) Some sellers had market power and operated under a FERC-imposed bidding cap; (2) despite setting prices at a level intended to invite entry, entry had not occurred in the market; and (3) sellers who were subject to caps consistently offered capacity at those caps and sellers not subject to caps offered their capacity at rates exceeding those caps.¹⁹²

According to Spence, energy regulators are reticent about punishing the mere exercise of market power in energy markets because they fear that doing so will discourage entry, and correspondingly, they assume that high prices will invite entry, which, by reducing prices, will encourage consumption.¹⁹³ Ironically, they note, the current regulatory framework simultaneously permits the exercise of market power and insulates offenders charging supra-competitive prices from challenges based upon traditional public utility law, such as just-and-reasonable-rate or anti-trust standards.¹⁹⁴

b. A challenge to FERC’s market-based rate framework

¹⁸⁹ See Lockyer Report, supra note 52, at 29. (Stating that “FERC’s position, based on its initial market power decision, is that even unjust and unreasonable prices must stand because all pre-October 2000 prices are “filed rates” not subject to retroactive attack.”) Id.


¹⁹² See FERC NYC Staff Report at 2-16.

¹⁹³ Spense, 53 B.C.L. Rev. at 201.

¹⁹⁴ See id.
In June 2007, FERC issued Order 697, revising certain standards and streamlining the administration of its market-based rates program.\textsuperscript{195} FERC stated that specific components of this rule were designed to ensure that market-based rates charged by public utilities are just and reasonable.\textsuperscript{196} FERC described the three major aspects of its market-based regulatory regime as follows:

(1) Analysis of whether a market-based rate seller or any of its affiliates has market power in generation or transmission and, if so, whether such market power has been mitigated;

(2) Assurance that wholesale sellers that have market-based rate authority and sell into day-ahead or real-time organized markets administered by RTOs and ISOs do not exercise market power; and

(3) FERC, through its ongoing oversight of market-based rate authorizations and market conditions, may take steps to address seller market power or modify rates.\textsuperscript{197}

In \textit{Montana Consumer Counsel v. FERC}, a coalition of state and private entities challenged Order 697, arguing that it violated the FPA.\textsuperscript{198} The coalition argued that (1) by relying on the market to regulate rates, FERC violated its statutory obligation to ensure just and reasonable rates; (2) FERC needed to provide evidence that competition would produce just and reasonable prices; and (3) FERC did not intend to review rates for justness and reasonableness—rather, it intended only to check for evidence of market power or manipulation.\textsuperscript{199}

The 9\textsuperscript{th} Circuit rejected each argument in turn, noting first that, in a competitive market, where neither buyer nor seller has significant market power, “it is rational to assume that the terms of the voluntary exchange are reasonable…and to infer that the price is close to marginal cost.”\textsuperscript{200} Second, the court noted that empirical evidence was not necessary because, due to FERC’s market-power screening process, “distorted markets could not control the reins of the


\textsuperscript{196} See id. at ¶2.

\textsuperscript{197} See id. at ¶¶ 3-5.

\textsuperscript{198} \textit{Mont. Consumer Counsel v. FERC}, 659 F.3d 910, 914 (9\textsuperscript{th} Cir. 2011).


\textsuperscript{200} \textit{Montana}, 659 F.3d at 916 (Citing \textit{Tejas Power Corp. v. FERC}, 908 F.2d 998, 1013 (D.C. Cir. 1990).
policy.”  

Third, the court found that FERC had broad discretion to interpret the FPA’s notice requirement. According to Laquet, the court’s holding results in FERC being immune from judicial review in its ratemaking, especially with respect to market-based rates.

This section underscores the shortcomings of the current statutory enforcement framework, court interpretations of the statutory framework, and agency attempts at implementation. The next section provides concrete examples of instances in which these shortcomings imposed real and significant harm on states’ and other parties’ abilities to represent their interests. It highlights the need for a regulatory pathway for the states into federal enforcement actions. Without such a pathway, retail ratepayers will continue paying artificially inflated electric power prices with no available meaningful remedy.

V. The Case for a Regulatory Pathway for States in Federal Enforcement Actions

The uncertainties in the existing legal framework have impacted legal actions that parties and states have taken against market participants. This section offers two examples of the limitations states and private parties can encounter when pursuing actions against artificially inflated electric power-market prices under the existing legal framework.

A. Attempts for recourse in bilateral markets

In states that opted not to adopt retail restructuring, some public utilities continued to generate most of the electricity they sold to customers, while others satisfied most of their electricity needs from wholesale markets. Because electric demand is highly variable, most electricity retailers must participate in the open markets in order to balance supply with demand. Thus, even in vertically integrated regions, prices paid by customers can be influenced by market prices.

In the case of Puget Sound Energy Inc. v. All Jurisdictional Sellers of Energy, FERC examined whether the rates for bilateral spot market sales between December 2000 and June 2001 may have been unjust and unreasonable. Puget requested caps on wholesale prices, arguing that California and the Pacific Northwest were part of a substantially integrated

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201 Laquet, 37 S. Ill. U. L.J at 406 (citing Montana, 659 F.3d at 917).

202 See id. (Citing Montana, 659 F.3d at 921).


204 Spense, 53 B.C.L. Rev. at 148.

wholesale power market of the Western Interconnection; thus, they argued, market conditions in California during the relevant period influenced market conditions in the Pacific Northwest. FERC found that while California energy prices affected energy prices in the Pacific Northwest, prices in the region were driven up by a combination of factors, including reduced availability of hydroelectric power due to drought, increased demand, and relatively high natural gas prices, and determined that prices were not unjust and unreasonable, denying Puget’s request.

The U.S. Court of Appeals for the 9th Circuit remanded the case to FERC, stating that new evidence indicated that the Pacific Northwest spot market was involved in and affected by Enron’s manipulation of the California market and that the Commission had erred in failing to consider the effects on the Pacific Northwest. On remand, the Commission again denied Puget relief. The Commission’s decision was based on differences between the California spot market, “which operated through a centralized power exchange pursuant to the terms and conditions of a Commission-jurisdictional tariff,” and the Pacific Northwest spot market, which “operated through bilateral contracts negotiated independently between buyers and sellers, without a central clearing price.”

Finding that the contracts at issue were short-term bilateral sales contracts, FERC applied the Supreme Court’s Mobile-Sierra doctrine, which presumes that the rates set forth in such contracts are just and reasonable except where certain criteria are met, e.g., one party to a contract engaged in such extensive unlawful market manipulation as to alter the playing field for contract negotiations. Under Mobile-Sierra, the Supreme Court has held that “the mere fact of a party’s engaging in unlawful activity in the spot market does not deprive its forward contracts of the benefit of the Mobile-Sierra presumption,” unless causality has been established.

Applying this precedent, the Commission stated that Puget, in seeking a refund, would have to demonstrate that the seller’s behavior directly affected contract negotiations, i.e., that a particular seller engaged in unlawful market activity in the spot market and that such unlawful

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206 See id. at ¶5 (citing Puget Complaint, October 26, 2000).


208 See id. at ¶14 (citing Port of Seattle, Washington v. FERC, 499 F.3d 1016, 1035 (9th Cir. 2007).

209 See id. at ¶18 (citing Port of Seattle, 499 F.3d at 1023). In California’s centralized power exchange, all sellers are paid the price bid by the marginal seller. In contrast, in bilaterally negotiated contracts, each seller receives only what a specific buyer agrees to pay for a given transaction and each buyer has the opportunity to attempt to negotiate a lower price. See id. at ¶24.


activity directly affected the particular contract or contracts to which the seller was a party.\textsuperscript{212} The Commission held that a general link between the dysfunction in spot markets in California and the Pacific Northwest was inadequate to establish a causal connection and insufficient to overcome the Mobile-Sierra presumption.\textsuperscript{213}

\textit{Puget} demonstrates the difficulty in attaining a favorable judgment at FERC for bilateral market participants, even in cases of extreme market manipulation, such as was the case in the Western Energy Crisis. Many vertically integrated utilities purchase power in the organized wholesale markets and are therefore impacted by manipulated prices. In addition, where contract prices are pegged to prices from an exchange, such as ICE, manipulation of the exchange prices (e.g., as alleged against Barclays Bank, PLC) will impact the bilateral contract price.

In another 9\textsuperscript{th} Circuit case, \textit{California ex rel. Lockyer v. FERC}, the court held that market-based rates are just and reasonable, in part, because FERC conditions market-based rate authority on the absence of market power and monitors markets to regulate the exercise of market power when it does arise, concluding that market rates are filed rates.\textsuperscript{214} Coupled with \textit{Mobile-Sierra} and the Filed Rate doctrines, this reasoning poses significant barriers for parties and states to overcome when attempting to pursue actions that artificially inflate wholesale power market prices. “With the FERC certification in hand, a generator could charge anything the market allowed.”\textsuperscript{215}

Notably, the Supreme Court in \textit{Morgan Stanley} declined to rule on the question of whether market-based rates were consistent with the FPA’s just and reasonable rate standard, stating, “We do not address the lawfulness of FERC’s market-based-rate scheme…[b]ut any needed revision in that scheme is properly addressed in a challenge to the scheme itself, not through a disfigurement of the venerable \textit{Mobile-Sierra} doctrine.”\textsuperscript{216} Therefore, as discussed in the next section, it can be argued that the FPA’s “just and reasonable” language signals congressional intent to protect consumers against the supra-competitive prices that can arise in energy markets.\textsuperscript{217}

\textbf{B. State attempts at recourse in organized markets}

\textsuperscript{212} See \textit{Puget Sound} at ¶21.

\textsuperscript{213} See id.

\textsuperscript{214} \textit{California ex rel. Lockyer v. FERC}, 383 F.3d 1006, 1013 (9\textsuperscript{th} Cir. 2004).

\textsuperscript{215} \textit{Lockyer}, supra note 52 (referring to market-based rate authority).

\textsuperscript{216} \textit{Morgan Stanley}, 554 US at 538. See also, \textit{Fed. Power Comm’n v. Texaco Inc.}, 417 U.S. 380, 399 (1974). (“In subjecting producers to regulation because of anticompetitive conditions in the industry, Congress could not have assumed that ‘just and reasonable’ rates could conclusively be determined by reference to market price.”) Id.

\textsuperscript{217} Spense, 53 B.C.L. Rev. at 200.

Blumenthal argued that certain parties received substantial payments for making capacity-backed energy offers at prices approaching a $1,000/MWh price cap that the parties never intended to be accepted and for energy they never intended to deliver. Further, by offering and receiving payment for capacity-backed energy at prices that would rarely be accepted, those suppliers caused energy prices in New England to be higher and less competitive than they would have been if suppliers had submitted reasonable offers.

In affirming its initial decision denying the relief requested, FERC held that the suppliers fully intended to deliver their capacity-backed energy in the unlikely event that ISO-New England called on it, and that submitting bids at the price cap was exactly what the Commission-approved tariff allowed; thus complainants were unable to make a sufficient showing of scienter.

This case presents an interesting study for this paper in its demonstration of existing enforcement framework limitations imposed on the state. First, the record in the case established that the sellers submitted New York energy bids at prices designed to ensure that they would not be accepted under normal circumstances. Blumenthal asserted that Congress granted the Commission authority to prosecute conduct that interferes with well-functioning markets to further its ability to ensure just and reasonable rates. However, FERC required a showing of scienter, and neither the seller’s conduct nor the adverse impact on the well-functioning of the markets met that high threshold.

Second, even though FERC held that the sellers were prepared to ensure that the energy would be delivered if ISO New England called upon it, FERC rejected Blumenthal’s argument that the FPA “just and reasonable” standard imbued a “reasonable price” threshold into the

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219 See id. at ¶8. The alleged conduct took place during the transition period (December 1, 2006 – June 30, 2009) leading up to the implementation of ISO New England’s Forward Capacity Market. During this period, capacity payments in ISO New England were higher than those made in the New York ISO market, making it attractive for capacity suppliers to export capacity from New York to New England and receive New England capacity prices. See id. at ¶2.

220 See id. at ¶3.

221 See id. at ¶¶’s 13, 15, 24.

222 See id. at ¶16.

223 See id. at ¶21.
Notably, the decision stated that while the FPA requires jurisdictional tariffs to be just, reasonable, and not unduly discriminatory, “the reasonableness inquiry is not probative in resolving allegations of market manipulation against an entity.”

By disallowing FPA §206 arguments and instead requiring that actions be brought under the FPA’s anti-manipulation provisions, FERC effectively disadvantages any party not in possession of sensitive, confidential data generally available only to the offending parties themselves, the FERC OE, and perhaps the ISO Market Monitor. For example, the ISO amended its filing, withdrawing allegations of non-delivery during the transition period based upon a re-reading of the data by the market monitor. Further, the FERC OE sided with the suppliers, asserting, among other things, that (1) suppliers did not engage in wrongdoing, (2) suppliers’ offers were consistent with their obligations, (3) sellers offers were rational responses to risks, and (4) sellers offers were transparent and not concealed.

That is not to suggest that the FERC OE was incorrect in its assertions. Rather, this case demonstrates how difficult it is for a state to navigate an anti-manipulation action when it possesses such imperfect and incomplete information. Furthermore, the existing framework limits the states’ abilities to make meaningful arguments based upon the FPA’s §§ 205 and 206 just-and-reasonable standard because states lack adequate information. According to FERC, whereas the requisite elements of market manipulation in FPA §222 and the Commission’s regulations assess conduct, the just-and-reasonable standard in FPA §§’s 205 and 206 apply to tariff rates:

Complainants blur these two discrete standards together by arguing that Respondents engaged in market manipulation, which interfered with the well-functioning and competitiveness of ISO-NE’s markets, which in turn, resulted in customers paying unjust and unreasonable rates. Fraud, however, is not measured by whether, in fact, unjust and unreasonable rates resulted.

Contrary to the agency’s reasoning above, this paper encourages states to contemplate a different standard, based upon traditional just-and-reasonableness principles, for pursuing actions that artificially inflate wholesale electric power market prices. Such a standard could provide a meaningful cause of action, without requiring a showing of fraud or deceit which may be outside a state’s ability, only if the state has adequate information to develop its cause of action. States

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224 See id. at ¶17.
225 Id.
226 See id. at ¶5. No other party, including the state, had access to this data.
227 See id. at ¶¶’s 31-35.
228 Id. at ¶37.
should be allowed to intervene in enforcement actions and coordinate the sharing of nonpublic information in their enforcement role of protecting retail ratepayers from harm.

C. FERC’s case against state intervention in federal enforcement actions

In October 2008, FERC issued a Final Rule on Ex Parte Contact and Separation of Functions in the context of investigations under Part 1b of FERC regulations. During the rulemaking, FERC proposed that intervention should not be available as a matter of right in a proceeding arising from a Part 1b investigation and noted that it would retain the ability to permit intervention in cases where it might be appropriate.

In issuing Order 718, FERC adopted its proposal to abolish intervention as a matter of right, explaining that allowing parties to intervene would be contrary to the public interest and interfere with consideration of issues in a timely and judicious manner. Instead, the Rule purports to allow third parties to participate in proceedings that directly implicate their interests, “where those interests can be addressed in a manner that does not unduly hamper the Commission’s enforcement efforts.”

During the rulemaking, NARUC offered many of the arguments contained in this paper in favor of a regulatory opportunity for states to participate in enforcement proceedings. Their arguments included the following: (1) States should be able to intervene, given their unique position as regulators charged with serving the public interest; (2) states have a direct interest in enforcement proceedings due to the impact on their ratepayers; and (3) collaboration will enhance enforcement efforts by avoiding duplicative efforts and inconsistent outcomes.

NARUC also argued that the proposed rule was inconsistent with FPA §308, which authorizes FERC to admit interested state and local entities as parties without any qualifiers as to the type of FERC proceeding. In addition to allowing states to intervene as a matter of right, it

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229 Ex Parte Contact and Separation of Functions, Order No. 718, 125 FERC ¶61,063, October 16, 2008 (hereinafter, “Ex Parte Order”).

230 See id., ¶2. It is notable that EPACT 2005 stated explicitly that nothing shall be construed to create a private right of action. See EPACT 2005, §1283. This means that EPACT 2005 remedies are available only to federal government enforcement agencies.

231 See Ex Parte Order, ¶8.

232 Id. at ¶10. See Williams Gas Pipeline Central Inc., 94 FERC ¶61285 (2001) where a state public utility commission sought to clarify the impact of a settlement on state interests. See also, Energy Transfer Partners, 121 FERC ¶61,282, where parties were allowed to participate in the allocation of disgorged profits.

233 See id. at ¶11 (citing NARUC Comments, pp. 5-6).

234 See id. See also 16 USC 825g(a). FPA §308 states: “In any proceeding before it, the Commission, in accordance with such rules and regulations as it may prescribe, may admit as a party any interested State, State commission, municipality, or any representative of interested consumers or security

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proposed a process requiring “specific notification of parties that could have an interest in these determinations, including affected State Commissions.”

FERC determined that while there is no right to intervene in Part 1b investigations, it retained the discretion to take into account specific circumstances that might favor intervention, “although such circumstances would be uncommon and the participation by interveners may be limited to specific matters.” It rejected NARUC’s “expansive view” of state participation in enforcement proceedings, stating that FPA §308 does not draw a distinction between states and other interested parties and that the use of “may” rather than “shall” preserved the Commission’s discretion in making determinations about when interventions may be in the public interest. Ultimately, FERC rejected suggestions that it solicit participation in investigations and enforcement proceedings, finding that such participation “will in most cases result in delay and distraction from the central issues.”

**D. State and federal coordination is well-founded when confronting market failure**

In the 1877 case of *Munn v. Illinois*, the Supreme Court recognized that when an economic activity becomes “affected with a public interest,” it may become a proper subject for regulation, including price regulation. Electricity is of vital importance to the welfare, safety, and economies of the states. Regulation of the electricity industry has been historically grounded in safeguarding the public welfare, and courts have noted that the regulation of utilities is one of the most important functions traditionally associated with the police power of the states.

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235 See Ex Parte Order at ¶11. (Citing NARUC Comments, p. 8). In addition to NARUC’s comments, the Maryland PSC asserted that states should be allowed to intervene as of right in order to request rehearing of enforcement decisions and the Indiana Utility Regulatory Commission (IURC) asserted that the market monitor should be allowed to intervene and stay informed of the status of ongoing investigations. Ex Parte Order at ¶11.

236 Ex Parte Order at ¶13.

237 See id. at ¶16.

238 See id. at ¶20.


241 Id.

On the other hand, the courts have recognized that the production and transmission of energy is likely to affect more than one state, “and its effect on interstate commerce is often significant enough that uncontrolled regulation by the states can patently interfere with broader national interests.” Congress has addressed this duality in the past by crafting a regulatory scheme that preserves the historic state role of administering the regulatory compact between investor-owned utilities, ratepayers, and investors (approving retail rates, making siting and need, etc.), while empowering federal agencies to regulate wholesale rates in interstate commerce.

Given both the state’s historic role in protecting retail electric ratepayers and the history of state–federal cooperation in U.S. electricity regulation, it should follow that in cases of wholesale market failure impacting state retail ratepayers, the federal government ought not to impede a state’s ability to intervene to ensure reliable service at reasonable rates for its citizens in accordance with the state’s respective laws. As discussed in this paper, the current enforcement framework poses such impediments.

VI. Potential Reforms that May Aid in State Participation

Pirrong asserts that existing laws should be revised to distinguish market power from fraud-based manipulation and provide more specific guidance on what constitutes market-power manipulation, including what types of evidence are sufficient to prove it. For example, he suggests that EPACT 2005 and EISA 2007, which conflate market power and deceit/fraud, should be supplemented by additional language. States may want to consider pursuing

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244 See id. at 582.

245 One example of a cooperative state-federal statutory framework is the Public Utilities Regulatory Policies Act of 1978 (“PURPA”), which required utilities to purchase power from qualified facilities (QF) at the full avoided cost, and in which the Federal Energy Regulatory Commission (FERC) determined whether a facility qualified as a QF and the state commission decided what constituted avoided cost. See id. at 586. The Supreme Court found that PURPA established a program of cooperative federalism that allowed States to enact and administer their own regulatory programs within limits established by federal minimum standards. FERC v. Mississippi, 456 U.S. at 767.

246 Schmidt, 65 Rutgers L. Rev. at 632. While Schmidt’s article discusses the state’s right to intervene to correct market failures that lead to insufficient capacity, this paper contends that any and all market failures, including market manipulation and exertion of market power, should contemplate state intervention.


248 See id. at 14.
Pirrong’s suggestion to include market power as a type of manipulation in the enforcement statutes. However, Pirrong’s recommendation of greater specificity with respect to conduct may conflict with both the courts’ and FERC’s legitimate concerns expressed in Cargill Inc. and FERC’s rulemakings that defining manipulation too specifically will invariably create loopholes that will be exploited.\textsuperscript{249} This section discusses potential reforms that could enable states to participate in regulatory enforcement actions. All such reforms would likely require legislative or regulatory action and collective state action.

A. Tariff-based reforms

In April 2010, FERC accepted new tariff provisions from the New York ISO that clarified that violations of the Commission’s rules against electric-energy-market manipulation also violate the ISO’s tariffs and provided for notification of such market manipulation.\textsuperscript{250}

Specifically, new section 4.1.6a2 required that if NYISO becomes aware that a customer may engage in manipulation, it shall promptly inform the market monitoring unit (MMU); the MMU’s obligation, in turn, is to inform the Commission.\textsuperscript{251} The same section provides the ISO with discretion to go directly to the Commission’s OE without being required to wait for action by the MMU, when a violation appears clear and the facts warrant immediate action.\textsuperscript{252} New section 4.1.6a3 provides that the tariff does not grant the ISO or MMU with authority to remedy violations, as remedial authority rests with the Commission.\textsuperscript{253}

One reform that states could consider pursuing is ISO tariff language that includes a provision that states, or affected states, should also be informed when the ISO or MMU detects that a market participant may be engaging in or had engaged in market manipulation. Further, NYISO insists in its tariff filing that it be made clear that the ISO lacks legal authority to remedy violations of the Commission’s regulations.\textsuperscript{254} Tariff language could indicate that states, as competent enforcement agencies, can attempt to remedy violations of the FPA or relevant state statutes if they are provided with sufficient information about violations to develop a cause of action. Such a clarification could encourage other market participants to work with states to bring enforcement actions against those who artificially inflate wholesale electric power markets.

Notably, FERC rejected the third sentence of proposed new section 4.1.6a2, which stated that the ISO shall request that FERC “determine whether a violation has occurred and, if so, that

\textsuperscript{249} See Section III.C.3 and notes 114-115.

\textsuperscript{250} See Order Accepting Tariff Sheets Subject to Condition, 131 FERC ¶ 61,064 (April 23, 2010).

\textsuperscript{251} See id. at ¶6.

\textsuperscript{252} See id.

\textsuperscript{253} See id.

\textsuperscript{254} See id. at ¶10.
FERC impose appropriate remedies.”255 In rejecting this language, FERC stated that the ISO cannot expect FERC to release to the ISO, or to any other member of the public, any information about its investigations, including whether an investigation is ongoing, except under certain circumstances.256

In the absence of a settlement, show cause order, notice of violation, or other appropriate Commission action, OE cannot without authorization or direction from the Commission provide the public…a determination of whether or not a violation has occurred or an investigation has been initiated because its investigations are nonpublic under 18. CFR §1b (2009), unless the Commission orders otherwise.257

Given the stringency of the confidentiality rule, another reform states could pursue is an amendment to 18 C.F.R. §1b.9 to enable the sharing of nonpublic information with the states. Such an approach would necessitate a challenge to the blanket confidentiality protection afforded companies under investigation. While confidentiality is vital to protecting market-participant reputation, the case could be made that a FERC order authorizing the issuance of Staff’s Preliminary Notice of Violations (see Section B immediately below) strikes the balance between the company’s and the public’s interest in a light too favorable to the company. In any case, a tariff amendment requiring comparable disclosure of manipulation to affected states—or, at the very least, an amendment that requires better coordination among the ISO, MMU, and affected states—may be an achievable first step toward retail ratepayer representation in matters of inflated wholesale prices.

**B. Reforms to FERC disclosures in enforcement actions**

On June 8, 2009, the U.S. Court of Appeals for the District of Columbia granted a motion to dismiss, denying the American Public Power Association and National Rural Electric Cooperative Association’s request to intervene in a case involving a settlement agreement between Edison Mission Energy and FERC.258

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255 See id, ¶18.

256 See id.

257 See id. See also, 18 C.F. R. §1b(9) which states: “All information and documents obtained during the course of an investigation…and all investigative proceedings shall be treated as nonpublic by the Commission and its staff except to the extent that (a) the Commission directs or authorizes the public disclosure of the investigation; (b) the information or documents are made a matter of public record during the course of an adjudicatory proceeding; or (c) disclosure is required by the Freedom of Information Act…A request for confidential treatment of information for purposes of Freedom of Information Act disclosure shall not, however, prevent disclosure for law enforcement purposes or when disclosure is otherwise found appropriate in the public interest and permitted by law.”

258 Order No. 09-1051, APPA and NRECA v. FERC (D.C. Cir. 2008).
In denying the intervention, the court cited 18.C.F.R. §1b.11, which states, “There are no parties, as that term is used in adjudicative proceedings, in an investigation under this part and no person may intervene or participate as a matter of right in any investigation under this part.” However, in December 2009, FERC issued an order designed to increase the transparency of OE staff’s nonpublic investigations conducted under Part 1b.

Pursuant to the 2009 Order, the notices will identify (1) the entity or entities that are the subject of the investigation; (2) the time and place of the alleged conduct; (3) the rules, regulations, statutes, or orders that staff alleges were violated; and (4) a concise description of the alleged wrongful conduct. In issuing the order, FERC noted that the timing of any public disclosure prior to the conclusion of the investigation is important because premature disclosure could adversely affect the reputation of the subject.

In striking a balance between transparency for the public and confidentiality for the subject, the order notes that the absence of disclosure mean that a greater amount of time passes before the public becomes aware of potential violations; on the other hand, public disclosure after the subject has had an opportunity to respond balances the need to protect the subject’s confidentiality in the early stages of an investigation with the public interest of promoting additional transparency during investigations.

Importantly, the notices will not confer a right on third parties to intervene in investigations or confer any other right with respect to the noticed investigation, in accordance with 18 C.F.R. §1b.11. While greater transparency is a welcome development from the state perspective, the order does not confer the right to intervene and represent retail ratepayer interests. These developments pose a challenge to the states to contemplate how they can utilize earlier disclosure to pursue enforcement actions more effectively.

In generally excluding state participation, as noted in the discussion of Order 718 above, it is clear that FERC does not apply its discretion to invite state interventions into enforcement proceedings in any consistent manner. As discussed in Section II, the Commission invited state agencies to intervene in the case against CCG to request apportionment of the profit disgorgement “for the benefit of electric energy consumers.” But FERC’s order against

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259 See id. See also, 18 C.F.R. §1b.11.

260 Order Authorizing Secretary to Issue Staff’s Preliminary Notice of Violations, 129 FERC ¶61,247, December 17, 2009.

261 Id.

262 See id. at ¶5. Public disclosure at the outset of an investigation would risk exposing the subject to undue public suspicion without staff having conducted sufficient discovery to reach a preliminary finding that the subject may have violated a Commission requirement. See id.

263 See id. at ¶6.

264 See Section II.C.2 of this paper.
Barclays included $34.9 million in disgorged profits that FERC determined, *sua sponte*, should be divided amongst the Low Income Home Energy Assistance Programs (LIHEAP) of four Western states.\(^{265}\)

This paper also takes exception to the notion that the states are not distinguishable from other parties, when in fact state enforcement concerns regarding the integrity of the wholesale power markets are equal (if not superior) to federal enforcement interests, given the states’ unique obligations to retail ratepayers. In addition, while FERC does not contemplate any impact of Order 718 on the ability of states to pursue remedies for wrongdoings that were the subject of a Part 1b investigation,\(^{266}\) it is clear that the ability of states to pursue such actions is severely limited (re: *Blumenthal*) due to both the lack of complete information and coordination with system operators, market monitors, and the FERC OE and FERC’s refusal to consider arguments based upon FPA §§’ 205 and 206 just-and-reasonableness principles. Finally, given the uncertainty and shortcomings in FERC’s own application of its enforcement authority, it is very likely in the public interest to enable state participation so that efficiencies can be realized and enforcement actions can result in the preservation of the integrity of the wholesale electric power markets.

C. Opportunities for state participation pursuant to compliance plans

FERC has authority, in its assessment of penalties, to impose a compliance plan on the company, either in lieu of or in addition to a civil penalty.\(^{267}\) According to Kelly, FERC can impose or approve a comprehensive compliance program designed to cover a wide range of regulatory requirements and not just those involved in the relevant violations.\(^{268}\) It stands to reason that a FERC-imposed compliance plan can include disclosure requirements to FERC, the relevant system operator, the market monitoring unit, and the state commission or commissions whose retail customers were or could be affected. Pursuing a rule that requires coordination with states in company compliance plans may result in, at the very least, greater coordination among OE, MMUs and states.

VII. Jurisdiction, Pending Matters, and Future Implications

A. FERC and CFTC Memorandum of Understanding

On January 2, 2014, FERC and the CFTC entered an MOU agreeing to share nonpublic information relating to markets within their jurisdictions that may be relevant to the other agency’s market surveillance and investigations into potential manipulation, fraud, or market

\(^{265}\) Barclays Bank, PLC, *FERC Order Assessing Civil Penalties* at ¶152(F).

\(^{266}\) See Order 718 at ¶18.

\(^{267}\) See Kelly, Aspatore at 9.

\(^{268}\) See id. “Comprehensive programs are appropriate for companies that have multiple, diverse violations, repeat offenders, and companies that lack a compliance culture.” Id.
power abuse. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) required the CFTC and FERC to negotiate the MOU addressing information sharing, in response to a request by one commission of the other pursuant to an investigation into potential manipulation, fraud, or market abuse in markets subject to such commission’s regulations or oversight.

Notably, the MOU was executed without any apparent compromise by either agency as to their respective enforcement jurisdiction. As such, uncertainty remains regarding which agency can properly prosecute enforcement actions against traders who undertake actions that adversely affect the electric power markets. In addition, Dodd-Frank did not limit either agency’s authority over what it already regulated, nor did it expand either agency’s pre-existing authority. While Hunter offers some clarity on the CFTC’s exclusive jurisdiction when the manipulative acts occur in the futures markets, the resolution of the reverse case—at issue in Barclays before a federal district court—may significantly change the current framework.

There is precedent to support competing federal agencies’ reaching agreements about jurisdictional boundaries. The CFTC and SEC argued about jurisdiction over futures contracts based on Government National Mortgage Association (Ginnie Mae) securities, which resulted in litigation and, ultimately, the “Shad-Johnson Accords,” which confirmed the CFTC’s authority to approve futures and options on futures contracts on broad-based indexes, and allowed index options to be traded on the Chicago Board of Exchange and other option exchanges regulated by the SEC. Congress can also be explicit about jurisdictional boundaries. For example, the CEA carves out an exemption for the SEC to exert jurisdiction over non-retail foreign currency transactions.

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269 Memorandum of Understanding Between the CFTC and the FERC Regarding Information Sharing and Treatment of Proprietary Trading and Other Information, January 2, 2014 (hereinafter, “FERC-CFTC MOU”).


272 In which traders allegedly engaged in uneconomic conduct in physical energy products to move price indices for the benefit of their positions in energy futures contracts that settled against those indices. See Mark Perlis, The CFTC and FERC Agree to Disagree on the Reach of Each Agency’s Jurisdiction to Police Energy Markets, Energy and Environmental Law Blog, David Write & Tremaine LLP, January 6, 2014. Available at: http://www.lexology.com/library/detail.aspx?g=7d5ab4d5-1dc3-49c2-bed0-d6285b66b91c


274 Commodities Exchange Act, 7 U.S.C.A §2(a)(1)(D)
B. Multi-jurisdictional federal enforcement

Because a number of federal agencies pursue enforcement actions against market manipulation, the jurisdictional landscape is complex. This section briefly discusses consequences of multi-jurisdictional enforcement actions upon market participants and the state regulatory community. Horwich provides the example of a hedge fund that is largely unregulated by the SEC and concerned primarily with oversight from the CFTC, but which may also need to consider FERC if it engaged in transactions in derivatives that affected physical markets in natural gas or electricity; conversely, a utility may be exposed to CFTC enforcement if its transactions in energy markets have a manipulative effect on CFTC-regulated derivative markets.\footnote{275 Horwich, 27 Energy L.J. at 365.}

Horwich states that the most powerful federal antitrust law is §1 of the Sherman Act, which covers conduct in the electric energy, natural gas, and petroleum markets.\footnote{276 Horwich, 27 Energy L.J. at 381 (referring to 15 U.S.C. §1 (2004)). “Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal. Every person who shall make any contract or engage in any combination or conspiracy hereby declared to be illegal shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding $100,000,000 if a corporation, or, if any other person, $1,000,000, or by imprisonment not exceeding 10 years, or by both said punishments, in the discretion of the court.”} Violations of the Sherman Act are felonies, and the U.S. Attorney General may bring either criminal or civil actions to redress the violation.\footnote{277 See id. Price fixing and market allocation are among the serious violations of Sherman Act §1 and can be prosecuted criminally.} The U.S. Department of Justice (DOJ) has prosecuted crimes related to energy trading;\footnote{278 See id. at 384. See, for example, U.S. v. Reliant Energy Serv., Inc., 420 F. Supp. 2d 1043 (N.D. Cal. 2006).} in addition to substantive offenses, the DOJ can prosecute misconduct in connection with a regulatory investigation, such as providing false information to a federal investigator or obstruction of an investigation.\footnote{279 See id.} In addition, the Federal Trade Commission (FTC) may seek civil relief for a violation of antitrust laws, including administrative cease-and-desist orders and injunctive relief, as well as payment of restitution or damages to victims.\footnote{280 See id (referring to Federal Trade Commission Act, 15 U.S.C. §§’s 45(b), 57(b) (2000)).}

Horwich also provides the example of an employee of an electric utility operating outside an organized market who learns that the utility is about to take a large unit off line for unplanned maintenance and then discloses that information to a trader, who trades on the spot market for electricity in that region; in that case, both the employee and the trader would have engaged in
unlawful deceptive conduct, and in either case, SEC Rule 10b-5 could apply.\footnote{281} Manipulation of the market for physical energy by engaging in extraordinary transactions with a manipulative purpose to affect the financial markets can also violate the FPA and CEA.\footnote{282} If an effort to fix prices in the energy markets had the intended effect of manipulating the market price for energy, then both FERC and CFTC rules could apply.\footnote{283}

The number of federal agencies that could pursue electric-market manipulation raises questions about the fairness of multi-jurisdictional enforcement actions against market participants. One federal district court has responded:

[i]t is well established that more than one governmental agency may investigate the same conduct simultaneously and bring simultaneous civil and criminal actions based on such conduct so long as the respective remedies are not mutually exclusive and there is an otherwise rational basis for their individual proceedings.\footnote{284}

The importance of multi-jurisdictional enforcement is made apparent by the U.S. DOJ complaint against Keyspan Corporation for violations of §1 of the Sherman Act in February 2010 for manipulative acts that increased capacity prices in the New York City market.\footnote{285} As noted in Section IV.D.2(b) of this paper (pp.35-36), FERC found no evidence of market manipulation even though its Staff Report noted that some sellers had market power.\footnote{286} The Pennsylvania PUC stated in comments that FERC was “unable to detect or deter the behavior recited in the instant [DOJ] Complaint.”\footnote{287} Even so, the DOJ assessed a civil penalty against Keyspan for its anticompetitive conduct.\footnote{288}

\footnote{281} Horwich, 27 Energy L.J. at 390.
\footnote{282} See id. at 398 (citing 7 U.S.C. §§’a 9, 4b and 6b (2000)).
\footnote{283} Horwich, 27 Energy L.J. at 397-398.
\footnote{284} See id. at 393 (citing SEC v. Joe. Schlitz Brewing Co., 452 F. Supp. 824, 828 (E.D. Wis. 1978)).
\footnote{286} See supra notes 191-192.
\footnote{287} Pennsylvania PUC Comments on U.S. v. Keyspan, Case No. 10-cv-1415 (S.D. NY May 17, 2010) at 2. Keyspan executed a swap agreement that ensured it would withhold substantial output from the NY City capacity market with the likely effect of increased prices for retail electricity supplier who must purchase capacity. See U.S. DOJ Complaint, supra note 285 at 1-2.
Multi-jurisdictional enforcement is also relevant to ongoing investigations that stem from enforcement actions described in this paper. Barclays Bank, for example, is challenging FERC’s petition to affirm its assessment of penalties based upon the court’s holding in *Hunter*, which awarded exclusive jurisdiction to the CFTC. In addition, multiple entities continue to investigate JP Morgan Chase for alleged actions taken during FERC’s enforcement proceedings.

In July 2013, Senators Elizabeth Warren and Edward Markey of Massachusetts sent a letter to FERC Chairman Jon Wellinghoff questioning whether the JP Morgan settlement adequately refunded defrauded ratepayers and why certain JP Morgan executives who sought to impede the investigation faced no penalties. Further, the U.S. Senate Permanent Subcommittee on Investigations asked FERC to provide information about the investigation, and to include an outline of the investigators’ findings. U.S. DOJ has also initiated an investigation into whether certain bank employees misled FERC regulators during the OE investigation, and has purportedly alleged false representations under oath about energy trading schemes and strategies.

In cases of cross-jurisdictional enforcements actions, it is important for states to know whether the respective federal agency offers opportunities for state input during the investigation process, enforcement action or settlement proceeding. It may be that states will encounter a more transparent and inclusive enforcement environment before other enforcement agencies than it currently experiences at FERC. This paper recommends that the states, through NARUC or in some other collective manner, organize a panel of federal enforcement authorities (which may include FERC, the CFTC, the FTC, the DOJ, the SEC and the new Consumer Financial Protection Bureau (CFPB)), and request information on procedures, either needed or in place, that enable sharing and coordination of information, interventions into enforcement actions, and participation in disbursements of penalties and disgorged profits to ensure that retail ratepayer interests are sufficiently protected.

C. **Barclay’s motion to dismiss FERC petition to Federal District Court**

On December 16, 2013, Barclays filed a motion to dismiss FERC’s petition to the U.S. District Court for the Eastern District of California requesting an order affirming its assessment of $435 million in penalties and disgorgement of unjust profits. In their article for the

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290 See id.


292 Robert Pease, DavidPerlman and Jennifer Lias, *Barclays Motion to Dismiss Claims Raises Significant Issues About FERC Jurisdiction*, The National Law Review, January 6, 2014. Available at:
National Law Review, Pease, Perlman and Lias (“the authors”) characterize the arguments contained in Barclays’ Motion as follows:

(1) The CEA grants the CFTC exclusive jurisdiction over transactions involving commodity futures contracts;

(2) FERC has no jurisdiction over the transactions under the FPA unless physical energy was actually transmitted or delivered;

(3) Individuals are not entities, so FERC lacks jurisdiction to bring claims against the individual traders; and

(4) FERC failed to allege inherently manipulative, false, or deceptive trades, and instead focused on legitimate trading activity.293

Regarding the CFTC exclusive jurisdiction argument, Barclays refers to the decision in Hunter (see earlier section), in which the court found FERC to be without jurisdiction over a manipulative scheme involving future contracts but affecting FERC jurisdictional natural gas contracts. According to the authors, if Barclays were to prevail on this argument, FERC authority would be limited solely to activities within physical markets, while cross-market actions would be solely within the CFTC’s jurisdiction.294

Regarding Barclays’s argument that FERC jurisdiction is conditioned upon physical transmission or delivery, the authors suggest that the power markets currently contain a variety of physical contracts that may not result in delivery, including: (1) forward power transactions, (2) dispatchable power purchase agreements in which the plant is not dispatched, (3) options on the physical sale/delivery of power that will not deliver power unless exercised; (4) capacity products that represent the ability to generate power but not actual delivery; and (5) virtual markets and trading. According to the authors, if Barclays were to prevail, FERC’s existing rate authority would be eviscerated and limited only to instances where power flowed over a transmission line or was delivered under a contract.295

Regarding Barclays’s argument that individuals are not entities, FERC has maintained that individuals are subject to prosecution. Finally, Barclays’s claim that no manipulation occurred because the trades were between competent market participants in an open and transparent market suggests that Barclays’s view is that a scheme that loses money in open-


293 See id.

294 See id.

295 See id.
market transactions with willing counterparties to benefit other positions in other markets is not actionable by FERC. 296

The impact that the DC Court of Appeals decision in Hunter will have on the Barclays Motion to Dismiss is unclear, and the recently reached MOU between FERC and the CFTC does not address any of the issues raised in the Motion. In addition, FERC could attempt to distinguish its case against Barclays from Hunter by arguing that the manipulative trading by Barclays took place in the physical electric power commodity markets, clearly under FERC’s jurisdiction, rather than in the futures markets. 297

This paper offers no opinion on the outcome of FERC’s petition before the Eastern District of California. However, because the resolution of the case may have widespread consequences, it is important to articulate FERC’s basic allegations to which Barclays filed its Motion to Dismiss. FERC has alleged that a series of physical transactions were made to affect the ICE index, which sets the price for both jurisdictional and non-jurisdictional transactions. 298 Further, Barclays purchased and sold either long or short physical positions that have physical delivery operations, and because Barclays could not meet its physical delivery operations, it traded dailies to flatten out its net physical position. 299 According to FERC, this amounts to uneconomic physical trading with an intention to benefit financial swap positions that Barclays held. 300 Although the bank profited from its financial swap positions, FERC may argue that the manipulative trading was done “in connection with” a transaction subject to its jurisdiction in support of FERC enforcement in cross-market manipulation actions. 301

One commenter counters by analogy that as the CFTC has exclusive jurisdiction over futures markets, the SEC has jurisdiction over securities markets, 302 and that illegal or manipulative securities short sales adversely impacting energy market prices does not empower FERC to exercise jurisdiction over securities trades. 303 However, even if jurisdiction to pursue the wrongdoer may rest with another agency, the commenter notes that FERC would still be

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296 See id.


298 Id. (citing Barclays Bank PLC, 144 FERC ¶61,041 at ¶116).

299 See id.

300 See id.

301 See id.


303 See Ghee, 18 Fordham J. Corp. & Fin. L at 400-401. Ghee argues for limited FERC jurisdiction over transactions pertaining only to physical energy commodities.
empowered to “correct the pricing anomalies to ensure that rates within its jurisdiction are ‘just and reasonable.’”  

As FERC’s petition to the federal district court raises many of the unresolved matters addressed in this paper—(1) jurisdiction, (2) defining manipulation, (3) FERC’s application of its statutory authority and (4) the physical/financial market interplay—the petition’s resolution will undoubtedly impact any reforms that state may undertake to effectuate their participation in federal enforcement actions. Thus, states are encouraged to track the developments in the case.  

VIII. Recommendations

The following table summarizes the recommendations made in this paper:

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<tr>
<th>Deficiency</th>
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<tr>
<td>In modeling EPACT 2005 (and EISA 2007) after Securities Exchange Act, Congress defined all manipulation as species of fraud.</td>
<td>Supplement EPACT 2005 (and EISA 2007) with language that defines exercises of market power as a form of manipulation separate from deceit/fraud.</td>
<td>IV.B VI</td>
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<tr>
<td>The filed-rate doctrine and FERC’s market-based rate regime treats even market rates set under dysfunctional market conditions as approved “filed” rates.</td>
<td>Challenge FERC’s market-based rate regime as a violation of the FPA’s just and reasonable rate standard before a competent court.</td>
<td>IV.D V.A</td>
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<td>FERC has rejected state arguments based on FPA § 206 just and reasonable principles when pursuing enforcement actions against manipulation</td>
<td>Enable states to pursue meaningful actions that address price-inflating conduct under a just and reasonableness standard.</td>
<td>V.B.</td>
</tr>
<tr>
<td>FERC has rejected state intervention into federal enforcement actions, drawing no distinction between states and other parties.</td>
<td>Seek clarification of FERC Order 718 citing the states’ unique enforcement interests and likely benefits to the public interest.</td>
<td>V.C VI.B</td>
</tr>
<tr>
<td>FERC’s confidentiality rule, 1b, allows it to disclose nonpublic information only at its discretion.</td>
<td>Seek clarification of FERC’s Preliminary Notice of Violations order on consistent FERC disclosure policy</td>
<td>VI.A VI.B</td>
</tr>
<tr>
<td>Enforcement actions are not coordinated among federal agencies, market monitors, and states.</td>
<td>Pursue tariff reform agreements/compliance plan orders that require coordination.</td>
<td>VI.A VI.C</td>
</tr>
<tr>
<td>Opportunities for state participation in various federal enforcement agency actions is unclear.</td>
<td>Collectively convene a federal enforcement agency panel (FERC, CFTC, SEC, FTC, DOJ, CFPB) to discern opportunities.</td>
<td>VII.B</td>
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The existing legal framework in federal enforcement statutes may be based upon incorrect assumptions, e.g., competitive prices will result in market entry or market power can be

304 Id.

addressed prior to a grant of market-based rate authority. To the extent that these assumptions are false, they have resulted in inadequate statutory language that, according to some commenters, penalizes fraud and deceit (which is less prevalent in physical commodity markets) while ignoring exercises of market power (which may be more widespread).

Court-developed legal doctrines, such as the Filed-Rate doctrine and the *Mobile-Sierra* doctrine, as well as statutory interpretations that require all enforcement actions to demonstrate deceit or fraud, severely limit state options to pursue price-inflating behavior. This is due in large part to the fact that states do not currently have access to the information concerning manipulative acts that federal enforcement agencies and market monitors possess, and in turn reflects a fallacy in federal agency views on state competency to handle confidential information and protect the well-functioning of the physical energy markets.

State arguments to intervene in federal enforcement actions, such as FERC Order 718, have been met with hostility, even as (1) FERC’s own tools to pursue market manipulation are demonstrably limited, (2) state participation is very likely in the public interest, and (3) coordination among state and federal actions would achieve efficiencies.

The reforms promoted in this paper echo certain reforms offered by the California Attorney General in a 2004 white paper which recounted its investigation of the Western Energy Crisis. These particular reforms are worth listing here:

Recommendation 1 - Amend the FPA and NGA to ensure that in a market-based rate system, unjust and unreasonable rates are subject to refund regardless of when a complaint is filed before FERC (limited to a certain time period);

Recommendation 2 - Amend the FPA to prescribe that bilateral contracts entered into during a period of market dysfunction are subject refund for that portion of the rate that exceeds a just and reasonable price;

Recommendation 5 - Give states explicit authority to enforce compliance with the FPA to ensure a FERC/state partnership in policing the operation of electricity and natural gas markets

Recommendation 11 – Amend the FPA and NGA to state specifically that the filed rate doctrine does not apply to market-based rates;

Recommendation 19 – In situations involving market dysfunction, the PUC (through federal legislation) should be given a status different from that of regulated entities to enable the PUC to work with FERC to re-establish market functionality; and

Recommendation 27 – Consider the creation of a multi-jurisdictional interagency energy task force. U.S. DOJ, Attorney Generals, FERC, the CFTC, the SEC, the

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state PUCs, the FBI and other regional, state and local agencies have a strong interest in ongoing coordination of enforcement policies and actions.\textsuperscript{307}

Given the severe consequences of the Western Energy Crisis on retail ratepayers, and the difficulty in extracting refunds for retail consumers after the crisis, states are encouraged to consider pursuing the reforms presented in this paper, as well as those in the Lockyer Report, to best protect their customers against similar consequences should market conditions arise that mirror those of California in the early 2000s.

\textbf{IX. Conclusions}

Free and competitive energy markets cannot realize the benefits of competition if they are being manipulated at the expense of consumers.\textsuperscript{308} FERC’s role, it seems, should be to preserve the integrity of the physical commodity markets. This paper suggests that whether hedging behavior of private companies is legitimate should not factor into the state enforcement calculus; rather, if an action disrupts the well-functioning of the physical markets, an investigation should ensue. To the extent that FERC is inhibited from investigating price-inflating conduct due to its existing statutory mandate, there should be a procedure or pathway for states to address the market failure under a different legal standard, such as a just-and-reasonable standard, as state-jurisdictional retail ratepayers will ultimately bear the inflated costs.

An examination of recent enforcement actions reveals that offenders often settle actions by admitting to price-inflating conduct while neither admitting to nor denying manipulative behavior.\textsuperscript{309} These scenarios leave retail ratepayers without a remedy for the artificially inflated prices they pay and beg for the creation of a legal standard that seeks simply to preserve the integrity of the physical wholesale markets. From the states’ perspective, inflated wholesale prices are harmful, whether they are due to “illegal” manipulation or “legal” market participant maneuvering. Therefore, a legal standard that focuses on preserving the integrity of the physical markets, such as the just-and-reasonable standard contained in FPA §§ 205 and 206 and many state public utility acts, could be sufficient to protect retail ratepayer interests if states are provided adequate information to develop causes of action. Such a reform might also disrupt the ability of market manipulators to admit to actions that artificially inflate wholesale electric power market prices without admitting to breaking the law.

\textsuperscript{307} Id. at 65-68.

\textsuperscript{308} Spense, 53 B.C.L. Rev. at 175.

\textsuperscript{309} JP Morgan admitted to engaging in bidding strategies that were aimed at capturing make-whole payments, those payments established by tariff to compensate generators when market revenues were insufficient to cover the cost of the bid. See McEachran, supra note 47; see also note 93, supra (Deutsche Bank, without admitting fault, stipulated that it engaged in market behavior that benefited its financial CRR positions at the expense of its physical positions).
Just as former FERC Chairman Joseph Kelliher publicly called for legislative action to empower his agency to respond to rampant manipulation in the electric markets,\textsuperscript{310} so too are the states encouraged to pursue legislative action to remedy barriers to their participation in federal enforcement actions. In effect, the states would be making the same argument that FERC made in \textit{Hunter} and continues to make in its petition concerning Barclays Bank before the federal district court in California with respect to its jurisdiction: Where a manipulative action in a non-jurisdictional market adversely impacts market prices or conditions in a FERC-jurisdictional market, the power to bring an enforcement action should be concurrent or joint.

The same logic can be applied to state participation in federal enforcement actions—where a manipulative action takes place in the federally regulated wholesale markets, but retail customers under the jurisdiction of the states are impacted, there should similarly be joint jurisdiction to investigate. Keeping states out of enforcement actions deprives them of the information they need to sufficiently represent retail ratepayer interests. Ironically, FERC has objected to state participation in enforcement actions as a matter of right, even as it seeks jurisdiction to pursue improper conduct in non-jurisdictional markets.

Underlying the disconnection between retail electric customers and price-inflating activities in wholesale markets are the very real consequences upon the retail customer. As noted in the introduction to this paper, state commissions uniquely engage in day-to-day experiences with retail ratepayers, many of whom struggle to pay their electric bills. PSCs also regularly administer persistent battles over every dollar of a potential bill increase in retail rate increase petition cases. State commissions recognize that for every dollar a customer's bill increases, that customer may be less able to make a payment. Market participants, concerned primarily with hedging financial and physical positions and federal regulators, whose main concern should be the preservation of the physical markets, are too far removed from the everyday struggles of retail ratepayer to adequately represent their interests in enforcement actions. It is therefore incongruent that states, who represent the ultimate victims of price-inflating behavior, should be excluded from asserting retail ratepayer interests in enforcement actions. That is why this paper asserts that states should be an indispensable party in federal enforcement actions against market manipulation.

\textsuperscript{310}“Congress does not write a law on a mountaintop; it looks at the world that surrounds it. In a perfect world, it considers that the world may change, and provides flexibility in the law. While electricity markets and the industry have changed, the Federal Power Act remains largely the same. In my view, the time has come to make fundamental reforms to the statute.” Kelliher, 26 Energy L.J at 29.
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