The Federal Energy Regulatory Commission (FERC) finds itself in the public eye only so often, and the attention is almost always unwanted. Most recently, the Commission has come under fire for its prosecution of Powhatan Energy Fund, an electricity trading firm that has assembled a glittering case of consultants and representatives in defense of a trading scheme that Powhatan said the traders could not have known was prohibited. The case is being litigated in a public setting, with editorial support for the traders from the Wall Street Journal and intense criticism of the Commission in Congress.

FERC finds itself in the public eye only so often, and the attention is almost always unwanted.

One could forgive FERC for thinking the situation is a little ironic, because the last occasion on which the Commission found itself in so public a spotlight was when it was understood to have failed to prevent widespread market manipulation in connection with the Western Energy

Jonathan D. Schneider and Jonathan P. Trotta

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Jonathan D. Schneider (jonathan.schneider@stinsonleonard.com) is a partner with Stinson Leonard Street, Washington, D.C. Jonathan P. Trotta (jonathan.trotta@stinsonleonard.com) is an associate at Stinson Leonard Street.
Crisis of 2000–01. Recognizing that FERC lacked the tools to address rampant behavior in the marketplace, Congress gave FERC enhanced authority with the Energy Policy Act of 2005 (EPAct 2005) to police market manipulation—precisely the authority FERC is now being attacked for exercising.

Answering FERC’s December 2014 Order to Show Cause laying out the allegations of FERC enforcement staff, Powhatan and its principal trader, Houlian Chen, argue that the targeted activity was permitted by FERC-approved tariffs, and that neither FERC regulation nor precedent gave Powhatan and Chen fair notice the conduct was prohibited. In papers filed in March 2015, FERC staff replied that a trading strategy designed not to make money in itself, but instead to take advantage of a revenue stream to which the traders should have known they were not entitled, is manipulative conduct. Whatever the outcome or one’s feeling about the assertion of unfairness at the root of Powhatan’s defense, the prosecution establishes guideposts that market players cannot afford to ignore.

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HOW DID WE GET HERE?

Section 222 of the Federal Power Act (FPA) and Section 4A of the Natural Gas Act (NGA) have their roots in the 2000–01 Western Energy Crisis. Then, as the story is told by the Supreme Court in Morgan Stanley Capital Group, Inc. v. Public Util. District No. 1 of Snohomish County, Washington, a perfect storm of events unfolded—including a regional drought triggering a substantial loss in critical hydropower, the rupture of a major natural gas pipeline, load growth, unusually high temperatures, and unplanned generation outages. These triggered a massive increase in average electric spot market prices, from an average $24 per megawatt-hour in the Pacific Northwest to a peak of $3,300 per megawatt-hour.

Capitalizing on an unhappy situation, and the inexperience of state and federal regulators in dealing with such conditions, electricity traders extracted windfall profits by taking advantage of rules designed for less turbulent times. Among the more notorious schemes were those under which traders moved power out of California and back into the state to avoid price caps on in-state resources, and those that remunerated traders moving power in a direction that relieved transmission congestion, even though they themselves had scheduled the transactions that caused the congestion in the first place.

The cumulative impact of natural conditions and the behavior of certain market participants led to rolling blackouts and saddled utilities with mounting debt.

Reaction to Western Power Crisis

Responding, FERC took such action as was within its authority by, among other things, encouraging price-taking utilities to enter into long-term contracts and imposing regional price caps. Market-based rate (MBR) tariffs, enabling eligible sellers to sell power at market rates, were modified to reflect a list of specifically prohibited practices, including wash trades, the creation of artificial transmission congestion, and transactions premised on the submission of false information. But FERC itself concluded, and Congress ultimately agreed, that the Commission lacked the tools needed to police hard-charging players in organized markets whose creation FERC had facilitated. As a direct consequence, EPAct 2005 amended the FPA and the NGA to include provisions expressly prohibiting market manipulation, while civil penalties were increased from a maximum of $10,000 per day under the FPA to $1 million per day per violation under both the FPA and the NGA.

FPA Section 222(a) provides (in language echoed in the NGA) that

[i]t shall be unlawful for any entity (including an entity described in section...
held that the practices specifically prohibited in the MBR tariffs (i.e., wash trades, transactions predicated on submitting false information, transactions creating and relieving artificial congestion, and collusion for the purpose of market manipulation) would all be incorporated into the broad anti-manipulation provision. FERC further specified that it would refrain from promulgating an exclusive list of transgressions, commenting that "the permutations [of fraud] are limited only by the imagination of the perpetrator."

The Commission also rejected calls to include in the new rule a provision specifying as an affirmative defense to a charge of manipulation the fact that the questioned activity was undertaken for a "legitimate business purpose," holding that intent would be judged in view of the totality of circumstances.

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**Similar Manipulation Cases**

Directly relevant to the situation in Powhatan, a good deal of the Commission’s high-profile enforcement activity over the past several years has focused on “cross-product manipulation”—that is, the practice of uneconomic trading in one market with the aim of advantaging a position in another. This was the situation in Amaranth Advisors, LLC, and Energy Transfer Partners, LP, involving instances of alleged gas market manipulation. The FERC staff report underlying the Commission’s Order to Show Cause in Amaranth detailed a strategy by which Amaranth traders unloaded gas supply in the physical market with the aim of depressing gas futures prices, in which Amaranth traders had taken a short position.

Similarly, in its Order to Show Cause in ETP, FERC tentatively concluded that ETP manipulated physical wholesale gas prices at the Houston Ship Channel (HSC) by suppressing these prices to increase the value of its financial derivative positions and other phys-
stances revealing the motivation for conduct. Closely related, the Commission dismissed the claim that establishing a legitimate business purpose for trades alleged to trigger a manipulative scheme is in itself complete defense.

The fact that the relevant transactions took place in an open market, and were in some sense transparent, did not mitigate the inference of manipulative intent.

WHICH BRINGS US TO POWHATAN

In the enforcement staff report underlying the Commission’s Order to Show Cause and Notice of Proposed Penalty in Powhatan, FERC staff alleges that Powhatan and trader Chen engaged in a series of virtual (nonphysical) trades in PJM for the purpose of accessing a stream of revenues (refunds of excess funds collected to compensate utilities for transmission-line losses) to which FERC says Powhatan and Chen should have known that they were not entitled. The trades giving Chen access to that revenue stream were swaps of the difference between the price of electricity at two points in PJM’s Day-Ahead market (reflecting the cost of transmission congestion) and the same two points in the Real-Time market.

These trades, referred to by PJM as “Up-To Congestion” (UTC) trades, were designed as hedges for transmission customers against transmission congestion charges, are permitted under PJM’s tariff, and became a specialty among financial traders expert in predicting directions in nodal price differences between the Day-Ahead and Real-Time markets. The UTC trades became eligible for the distribution of funds overcollected for transmission-line losses pursuant to a FERC order specifying that all market participants in PJM, including virtual traders, who reserved
paid transmission service on OASIS, would receive refunds. Virtual traders were later excluded from this revenue stream. Analyzing the pattern of Chen’s trading, the Commission tentatively concluded that Chen’s UTC trades were executed not as a profitable exercise in their own right, but in order to take advantage of the distribution of the refunds of surplus loss revenues.

Drawing on Order No. 670, FERC staff argued, and the Commission tentatively agreed, that Chen’s fraud lay in a strategy designed to give the false appearance that he was accepting risk (as a party offering a hedge would naturally do), while instead shedding it in order to use the transactions for ulterior purposes. Citing Barclays Bank, FERC staff alleged that the UTC trades lacked “legitimate purpose” because they were not “an attempt to profit from the relationship between the market fundamentals of supply and demand” and would not have occurred “in the absence of some ulterior purpose.” Staff further likened the risk-cancelling countervailing hedges into which Chen entered as “wash-like” trades, designed to cancel one another out from an economic standpoint, invoking the specific prohibition previously listed in FERC’s erstwhile Market Rule 2 and incorporated implicitly into the anti-market-manipulation rule, as discussed earlier. Staff also invoked Enron’s “Deathstar” scheme—a set of circular transmission transactions designed to create congestion and resolve it, in order to establish eligibility for congestion relief payments—in partial response to which FPA Section 222 was passed, as discussed earlier.

Powhatan and Chen responded to the Order to Show Cause in separate pleadings emphasizing many of the same points. The traders emphasize that FERC, PJM, and its market monitor were aware that UTC traders were eligible for loss refunds under PJM’s tariff at the time the trading in Powhatan took place. And while that eligibility was later rescinded in view of perceived abuses, the traders argue that the Commission’s approval of PJM’s mechanism for distributing loss refunds, knowing that the mechanism provided distribution to UTC traders, prevents FERC from now maintaining that the traders had fair notice that their activity was prohibited, in violation of their right to due process of law.

Powhatan further argues that the very idea that Chen exploited what FERC staff pejoratively terms a “loophole” in PJM’s tariff underscores the fact that the activity was permitted. Additionally, Powhatan contends that there can be no finding of deception or fraud where the trading and evident financial incentives associated with the distribution of loss revenues were in plain sight. Both Powhatan and Chen argue at some length that Chen’s UTC trading was guided by legitimate economic motives independent of the associated entitlement to the loss revenues, and that the trades often made money independent of those revenues.

In a reply filed March 3, 2014, FERC enforcement staff argues that the fact Chen’s trading strategy was not specifically prohibited by PJM’s tariff is no defense to the manipulation charge. Staff notes that Enron had argued similarly in the context of charges laid against it in connection with the Western Energy Crisis and, in response to this, FERC was given broad new authority under FPA Section 222, unconfined by the specific requirements of a tariff—similar in scope to the Sherman Act (outlawing contracts in restraint of trade) and the Federal Trade Commission Act (outlawing unfair trade practices). Addressing the claim that Chen’s activity was neither “deceptive” nor fraudulent insofar as no effort was made to conceal it, FERC staff argues that the deception lies in the fact that Chen’s countervailing trades were of no value to the grid, and designed as an economic nullity, save for the value of the loss revenue refunds Powhatan received.

Chen’s countervailing trades were of no value to the grid and designed as an economic nullity, save for the value of the loss revenue refunds.

Staff rejects the argument that the potential profitability of certain of Chen’s trades absent loss revenue refunds negates that there was unlawful intent, commenting that intent
involves a “holistic determination” judged as a function of overall strategy. 47

WHERE IS POWHATAN HEADED AND WHAT CAN WE LEARN IN THE MEANTIME?

It seems a near certainty that the *Powhatan* case is headed into the courts.

Powhatan has waged a high-profile, take-no-prisoners defense and public relations campaign that strongly suggests Powhatan has taken aim at a higher authority than the Commission. FERC’s Order to Show Cause was issued after that strategy was well under way, and it seems improbable that FERC will back down.

What might be the outcome then? The most telling factor may lie in the traders’ contention that FERC understood that virtual UTC traders were eligible for refunds of loss revenues before Chen undertook his trades. Drawing a cute analogy, Chen’s attorneys score points in arguing that the allegation of fraud is akin to accusing a child of deception in pressing for a McDonald’s Happy Meal in order to snag the toy, knowing his parents have been buying the meals with full disclosure for years.

Chen’s attorneys argue that the allegation of fraud is akin to accusing a child of deception in pressing for a McDonald’s Happy Meal in order to snag the toy.

On the other hand, FERC staff is not wrong in asserting that FERC likely did not contemplate a trading strategy designed exclusively to secure the toy. And the traders are surely wrong in asking to confine claims of manipulation to instances in which tariff violations have occurred. Pretty clearly, the anti-manipulation provisions of the FPA and NGA were designed to provide FERC with broad authority that it did not previously possess, and FERC staff seems right to argue that requiring all manipulative schemes to be expressly prohibited in stated rules or tariffs would rob the Commission of essential flexibility, condemning it, in so many words, to an enforcement strategy limited to fighting the last war on each occasion. In fact, when many of the traders in the Western Energy Crisis argued that their conduct was permitted under existing tariffs, Congress responded with the broad grant of antimanipulation authority to FERC under FPA Section 222.

Requiring all manipulative schemes to be expressly prohibited in stated rules or tariffs would rob the Commission of essential flexibility, condemning it, in so many words, to an enforcement strategy limited to fighting the last war.

What can we learn? Dating back to the Commission’s early prosecution of Amaranth, students of the Commission’s anti-manipulation activity have understood that an activity with no legitimate business purpose in and of itself, designed in order to take advantage of a market affected by that activity, or to secure a benefit under tariff, would be the target of the Commission’s unwanted attention.

The *Powhatan* case dramatically underscores that message, and the framework the Commission used for understanding manipulation in *Powhatan* is likely to continue to serve as a focal point for FERC’s enforcement activity whether or not the traders ultimately prevail.

Market participants and advisors would ignore it at their peril.

NOTES


18. See Order No. 670, at p. 49. See also implementing regulations at 18 C.F.R. §§ 1c.1, 1c.2.


21. Ibid., at p. 24. Includes those under 18 C.F.R. § 1c.

22. Ibid.

23. Amaranth Advisors, LLC, 120 FERC ¶ 61,085 (2007). FERC, in its Show Cause Order, sought $300 million in civil penalties and disgorged profits from Amaranth. The case was eventually settled through an uncontested Stipulation and Consent Agreement in which Amaranth agreed to pay $7.5 million in civil penalties. Amaranth Advisors, LLC, 128 FERC ¶ 61,154 at p. 2 (2009). Amaranth’s lead gas trader, Brian Hunter, was not a party to this settlement.


25. Amaranth, 120 FERC ¶ 61,085, at p. 5.

26. ETP, 120 FERC ¶ 61,086, at p. 4. The Commission also tentatively determined that ETP’s intrastate pipeline subsidiary, Oasis Pipeline, L.P., engaged in preferential and unduly discriminatory conduct by favoring affiliated shippers, charging nonaffiliates more than the maximum FERC-approved rate for interstate transportation service, and failing to file an amended operating statement. Ibid.

27. Ibid., at p. 5.

28. Energy Transfer Partners, LP, 128 FERC ¶ 61,269, at pp. 10–11 (2009). The settled-upon penalties were substantially below the alleged penalty assessments outlined in FERC’s Order to Show Cause, which proposed civil penalties of $82 million, and nearly $70 million in disgorged profits. ETP, 120 FERC ¶ 61,086, at p. 1.


32. Ibid., at pp. 42–44, 62–64.

33. Ibid., at p. 61.

34. Ibid., at p. 51. FERC petitioned the Eastern District of CA for an order affirming its penalty assessment against Barclays (Case No. 2:13-CV-02093-TLN-DAD), an action that enables Barclays to trigger de novo review of the case in court. That enforcement action is in the motion stages as of this writing.

35. This stream of revenues under the PJM tariff is known as Margin Loss Surplus Allocation.

36. Powhatan, 149 FERC ¶ 61,261 at Appendix A (Enforcement Staff Report and Recommendations), pp. 1, 9–10.

37. Ibid., at Appendix A, pp. 11–12.

38. Ibid., at Appendix A, pp. 31–32.

39. FERC staff concluded that the offsetting nature of Chen’s multiple Up-To Congestion trades revealed that they were not designed to yield a profit in their own right. Powhatan, 149 FERC ¶ 61,261, at pp. 37–38.


41. Ibid., at Appendix A, pp. 38–39.

42. Ibid., at Appendix A, pp. 42–43, 50–53.


44. Powhatan Answer, at pp. 4–8. Chen adds FERC’s application of the definition given to fraud in Order No. 670 (discussed above to mean interference with what would otherwise be the natural outcome of a well-functioning market) is flawed insofar as it fails to include an element of deception or dishonesty. Chen Answer, at pp. 36–37.

45. Shen Answer, at pp. 8–9.


47. FERC Staff Reply, at 77, n. 246.