

There's a New Sheriff in Town:

Energy Derivatives and Ferc

By Catherine Krupka and Athena Velie

Traders, brokers and clearing firms in the U.S. energy derivatives business today face a new type of regulatory risk. The Federal Energy Regulatory Commission, a government agency traditionally more familiar with utilities than markets, has been asked by Congress to act more aggressively to prevent manipulation in power and natural gas markets, as well as related derivatives markets. In the following article, two lawyers familiar with Ferc describe the agency's expanded jurisdiction, the potential overlap with the Commodity Futures Trading Commission, and the implications for financial institutions.

A Forced Introduction? Meet Ferc

Companies that trade energy derivatives, such as futures or swaps, know that the Commodity Futures Trading Commission is the principal watchdog against fraud and manipulation in those markets. What they may not know is that another federal agency also has the power to investigate energy trading.

For most of its history, the Federal Energy Regulatory Commission concerned itself primarily with issues related to the interstate transmission of electricity and natural gas, and the entities it regulated were mainly electric utilities, hydroelectric projects, oil and gas pipelines, and various companies

involved in the production and distribution of natural gas. As the energy markets have changed, however, Ferc has begun to define its jurisdiction more broadly.

In 2000, if you looked at the screens on any energy desk, you would see power marketers bearing familiar names like Duke, Southern and AEP. Today, many of these companies have returned to their retail utility roots. In their place on the top power marketer lists, you see names of investment banks and hedge funds like Goldman Sachs' subsidiary J. Aron, Citadel, D.E. Shaw, Merrill Lynch, and Morgan Stanley. Indeed, more than 50 financial services companies have secured Ferc authority to be power marketers and thus are public utilities subject to Ferc's jurisdiction.

So it should come as no surprise that Ferc is trying to increase its expertise regarding financial services companies and the role they play in the physical and financial energy markets. But what might be surprising is that Ferc is not limiting its oversight activities to financial services companies that have subjected themselves voluntarily to the agency's jurisdiction. Nor is Ferc focusing only on the physical wholesale energy markets. Instead, Ferc is interested in the interplay between the physical and financial markets and the effect that trading in the futures and OTC markets may have on physical energy prices. Ferc's recently released 2006 State of the Markets Report, an important window into the agency's thinking, dedicates an entire section to the growth of financial trading in

energy commodities and explicitly addresses concerns about the effect that speculation may have on physical energy prices.

The bottom line is that financial services companies of all types, and their affiliates, may be subject to the increasingly long arm of Ferc's jurisdiction, based on both their proprietary trading activities and the services they provide as futures commission merchants or foreign brokers. The agency's head of enforcement, Susan Court, recently told industry lawyers at an FIA-sponsored event in New York that energy traders working for financial institutions fall within her jurisdiction, even when they do not trade physical gas or power. Ferc staffers already are visiting financial services companies and quizzing representatives on their trading activities. Moreover, since 2006, Ferc has been monitoring in real time the trading of natural gas futures contracts on the New York Mercantile Exchange during the last half hour before settlement, as well as natural gas swaps traded on the Intercontinental-Exchange that are based on the Nymex contracts. The agency cited the relationship between futures prices and physical gas transactions as the rationale for this oversight, explaining that Nymex settlement prices often are used in the gas markets as the basis for setting prices, especially in the Eastern and Gulf coast regions.

Some may say that this heightened scrutiny is just a phase that will pass once natural gas prices drop. Current political trends suggest otherwise. Members of Congress, state regulators, state attorneys general and consumer advocates are pressing Ferc to use its enforcement powers to prevent "excessive" speculation in the energy markets, which often is blamed for volatility in natural gas prices. The collapse of two hedge funds last year—Amaranth Advisors and MotherRock—has contributed to the pressure on Ferc to demonstrate that it is fully exercising its authority.

For example, Senator Jeff Bingaman, chairman of the Senate Committee on Energy and Natural Resources, posed a series of detailed questions to the CFTC and Ferc in February 2007 asking what they are doing to oversee the natural gas markets. Bingaman specifically asked Ferc for more information on how the agency is using its authority under the 2005 Act to protect consumers and signaled that he will continue to monitor the issue as the year goes forward.

Manipulation Standards: Comparing Apples to Oranges

Combating price manipulation has long been a concern for Ferc, but its powers in this area were greatly expanded two years ago when Congress, reacting to the Western power crisis, passed the Energy Policy Act of 2005. Among other things, it broadened Ferc's jurisdiction over energy trading and gave it new enforcement tools to prevent manipulation. In the last two years, Ferc has responded by creating a new Office of Enforcement, currently staffed by nearly 130 employees and projected to grow to more than 150 employees by 2008. The 2005 Act also increased Ferc's civil and criminal penalty authority to \$1,000,000 per day, per violation.

Ferc's new manipulation rule, which was finalized in January 2006, is the cornerstone of its enforcement efforts. According to Ferc, the rule applies to "any entity" regardless of whether it is a public utility or otherwise subject to Ferc's jurisdiction. All the rule requires is that the entity have engaged in some behavior "in connection with" a Ferc-jurisdictional transaction. Because of the perceived inter-relationship between financial transactions and wholesale and retail physical energy transactions, Ferc believes it can monitor financial transactions at least insofar as the trading activity may affect Ferc-jurisdictional transactions and markets.

Ferc's manipulation rule, which was modeled on the Securities and Exchange Commission's Rule 10b(5), differs considerably from the CFTC's manipulation standard. In particular, the rule does not expressly require Ferc to prove deceptive conduct or price artificiality in order to find manipulation. Rather, Ferc has said that it will act in cases where an entity: "(1) uses a fraudulent device, scheme or artifice, or makes a material misrepresentation or a material omission ... 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 (i.e., reckless disregard); (3) in connection with a jurisdictional transaction." The threat of enforcement actions based on this rule could chill legitimate trading activities critical for hedging and price discovery. A brief comparison of the two manipulation rules highlights the problem.

Courts and the CFTC historically have required exacting proof to find commodities manipulation. Thus, in order to prosecute a manipulation claim under the Commodity Exchange Act, the government must prove each of the following elements by a preponderance of the evidence: 1) ability to influence prices, 2) specific intent to create an artificial price, 3) existence of an artificial price, and 4) causation.

Manipulation under the CEA is very difficult to prove. It requires a complex review of market fundamentals, available cash supplies, the role of other traders in the market and complicated price relationships. In addition to having to muster evidence of ability and specific intent, the government also must prove the actual existence of an artificial price (i.e., a price that does not reflect supply and demand fundamentals). Because of these difficulties, the enforcement staff often makes an alternative claim for attempted manipulation, which only requires proof of specific intent to create an artificial price and an overt act. However, the CFTC has never found either actual or attempted manipulation in a litigated case.

In contrast to the high standard of proof required to find manipulation under the CEA, Ferc defines fraud broadly to include "any action, transaction, or conspiracy for the purpose of impairing, obstructing or defeating a well-functioning market." This standard potentially redefines fraud to reach conduct that Ferc may consider to be unfair or abusive, even if it is not deceptive. Adding to concerns about the vagaries inherent in the manipulation rule, Ferc staff have been quoted as saying that while they think the manipulation rule is clear, "it will have more meaning when the commission actually applies it in a concrete case." Ferc's know-it-when-it-sees-it approach does not provide much regulatory guidance for market participants. Moreover, the real scope of Ferc's authority may not be known until a U.S. Court of Appeals has a chance to opine on Ferc's own interpretation of its manipulation rule.

Ferc's Enforcement Cache

In addition to its manipulation rule, Ferc has other enforcement tools.

The CFTC/Ferc Memorandum of Understanding—To address the interplay between the physical and financial energy markets, Congress ordered the CFTC and

Ferc to adopt procedures to allow the agencies to coordinate their oversight activities. In October 2005, the CFTC and Ferc entered into a memorandum of understanding on information sharing. According to the MOU, if one agency, in the course of its oversight activities, discovers potential violations that are within the purview of the other agency, the matter is referred. In addition, if Ferc wishes to investigate the impact of the financial markets on the physical energy markets and needs information from entities like Nymex, Ferc can access the information by requesting it through the CFTC.

The CFTC and Ferc responses to Senator Bingaman's questions indicate that the MOU is not just a symbolic document. Rather, the agency staffs are in regular contact and "routinely" advise each other on investigations and other important matters. Furthermore, the CFTC regularly invites Ferc staff to attend its enforcement and surveillance meetings and meets with Ferc enforcement staff on a quarterly basis to share information on topics of mutual interest. In fact, both regulators can and are using each other's resources to expand their own oversight activities, thereby increasing the likelihood that problematic market behavior will at least be discovered.

The Market Transparency Proposal—In the 2005 Act, Congress directed Ferc to "facilitate price transparency in markets for the sale or transportation of physical natural gas in interstate commerce." In furtherance of Congress' intent, Ferc issued a notice of proposed rule-making in April 2007 proposing measures to increase the transparency of natural gas transactions through some form of mandatory reporting.

One of the measures in this proposal would require all buyers and sellers of physical natural gas to submit annual reports summarizing their natural gas trading activity. This requirement would apply to the trading of natural gas futures contracts only if the contracts settled by physical delivery.

Another measure would require intrastate pipelines, which are not within the Ferc's jurisdiction, to report daily flow data. This raises an interesting question about Ferc's jurisdictional restraint. Ferc apparently believes that the market transparency provisions in EPA05 give it authority to require intrastate pipelines—which are non-jurisdic-

tional—to report daily natural gas flow data. If Ferc adopts the proposed rule and a court upholds the agency's view of the scope of its authority vis-à-vis non-jurisdictional activities, Ferc could rely on the precedent created to require reporting of a broader array of market activity, including all related futures transactions, in the name of facilitating transparency.

While a new reporting requirement may be inconvenient at best, the real cause for concern is how Ferc may use the information it obtains (e.g., in connection with a possible manipulation investigation). An enforcement action under Ferc's manipulation rule could result in inconsistent standards regarding what is permissible in markets previously overseen exclusively by the CFTC.

Audits and Investigations—Ferc routinely has audited traditional public utilities and natural gas pipelines to ensure that they comply with accounting, open transmission/transportation access, and affiliate abuse rules. For example, according to the Government Accounting Office, Ferc conducted 39 such audits in 2004. The initiation of a Ferc audit is not an indication that the agency believes the audit subject has violated the law. It is merely one of the ways that Ferc ensures that jurisdictional companies are complying with its regulations. However, if Ferc uncovers significant violations during the course of an audit, it may initiate an enforcement proceeding (e.g., an investigation or complaint case).

Ferc recently has expanded its audits to include more companies with market-based rate authority, including financial services companies. The stated scope of Ferc's audits is to verify that the financial services company is complying with a limited set of reporting and approval requirements applicable to all public utilities that trade physical power pursuant to Ferc's market-based rate authority. In practice, according to public accounts of the audits, Ferc's staff have used the opportunity to ask financial services companies about:

- The activities of the financial services company's energy businesses, offshore as well as onshore, including not only energy production, generation, distribution, transmission and transportation, but also any physical and financial trading of energy products or derivatives and other instruments based upon energy products (such as hedges, swaps, forwards and options).

- The energy business activities of affiliates related to financial trading, investment banking, capital markets, equities and retail financial services.
- The company's investment banking, asset management, and financing relationships with any unaffiliated companies engaged in the energy business, including detailed information on all transactions engaged in by the energy business and the types of advice and services provided to the companies listed.
- Employment agreements and bonus plan descriptions for energy business employees.
- A floor plan of the energy desk and a description of all products traded by the desks surrounding the energy desk.
- A list of all equities traders who also trade energy equities and a list of all equities they trade.

If this sampling of audit topics is any indication of the shape of things to come, financial services companies should prepare now to address Ferc's likely attempts to review business functions that fall outside the scope of its traditional jurisdiction.

Conclusion: Double the Regulators, Double the Cost?

The potential breadth of Ferc's manipulation rule, coupled with Ferc's extensive enforcement tools, makes it difficult to anticipate where, when and why Ferc will come knocking. One thing is for sure: as long as consumers and members of Congress continue to complain about energy prices, companies that participate in the financial energy markets are likely to find themselves fielding regulatory inquiries from both the CFTC and Ferc, either as a target or as someone with information related to the target. Despite the press of other business, companies should try to prepare in advance to deal with Ferc audits and joint Ferc-CFTC oversight and investigations. ■

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