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ALERT

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May 2015 Brings a Crop of FERC 'Loophole' Manipulation Civil Penalty Assessments

In May, two "loophole" penalty orders were issued regarding recent fraud and manipulation investigations conducted by the Federal Energy Regulatory Commission's (FERC) Office of Enforcement (OE), which are discussed below. What will June bring? To start, on June 3, the House of Representatives Energy and Commerce Subcommittee on Energy and Power heard testimony, including from new OE Director Larry R. Parkinson, reviewing draft legislation designed to revamp FERC's enforcement program to ensure that FERC's actions are fair and transparent. Parkinson said that FERC's investigative process is "one of the most transparent, if not the most transparent, in the federal government." At the same time, as requested by several senators last year, the U.S. Department of Energy's Inspector General is investigating the fairness of recent FERC enforcement efforts.

FERC Issues Order Assessing Civil Penalties to Powhatan, et al.

On May 29, 2015, FERC issued an Order Assessing Civil Penalties against Powhatan Energy Fund, LLC and its affiliates as well as against Dr. Houlian Chen, Powhatan's chief trader, for violating FERC's anti-manipulation rule. Specifically, FERC found Powhatan violated section 222 of the Federal Power Act (FPA) and section 1c.2 of the Commission's regulations by designing and implementing a scheme to engage in fraudulent up-to congestion (UTC) transactions in PJM Interconnection LLC's (PJM) energy markets to garner excessive amounts of certain credit payments to transmission customers, known as marginal loss surplus allocation (MLSA). FERC found that from June 1 to August 3, 2010, Powhatan implemented its fraudulent trading scheme by intentionally placing a high volume of "round-trip" UTC trades that canceled each other out by placing the first leg of the trade from locations A to B, and simultaneously placing a second leg of equal volume from locations B to A. This OE investigation was initiated after PJM referred a market participant's complaint to OE regarding the unusually high volumes of transmission reservations on PJM's OASIS. PJM's independent market monitor submitted a similar referral to OE.

FERC determined that the evidence proved that Powhatan artificially created these round-trip UTC trades solely to reserve transmission service to enable them to collect excessive MLSA payments during the period of manipulation. Accordingly, FERC ordered Powhatan to pay $28.8 million in civil penalties and over $4.7 million in disgorgement, and ordered Powhatan's chief trader, Dr. Houlian, who allegedly designed and implemented the fraudulent scheme, to pay $1 million. The civil penalties are high, especially when compared to the amount of unjust gains and market losses alleged by FERC. This investigative process culminating in a FERC "show cause" order in December 2014 and responses in early 2015, has been on-going for nearly five years.

Powhatan argued that its UTC transactions were "legal, permissible, not fraudulent, and executed for a legitimate economic purpose." Moreover, Powhatan argued that the trades were permitted under the PJM tariff. Powhatan further argued that exploiting loopholes is a "time-honored tradition," and that market participants do the "market and rule makers a service" by exposing inefficiencies. Powhatan noted the Commission did not exclude round-trip UTC trades from receiving MLSA payments in *Black Oak.*[1]

FERC rejected Powhatan's arguments. FERC found that Powhatan's trades were contrary to the market design purposes for which PJM offered the UTC product. The Commission stated that when used appropriately, UTC trades in PJM benefit PJM's market by encouraging convergence between day-ahead and real-time market prices and permit financial traders to profit by arbitraging market prices between two locations in the day-ahead and real-time markets. According to FERC, Powhatan's gaming, however, did not promote market efficiency by converging the day-ahead and real-time prices, but rather intentionally subverted the allocation of payments provided by PJM's tariff. FERC found Powhatan fraudulently placed high-volume, round-trip UTC trades without regard to market fundamentals and with the intent to benefit not from the spread on UTC trades, but solely from the improper allocation of MLSA payments. Moreover, FERC also found that Powhatan's round-trip UTC trades were wash trades, which the Commission has long-recognized are *per se* fraudulent and manipulative.

In addition, FERC stated the *Black Oak* orders cannot be read to authorize Powhatan fraudulent round-trip UTC trades because the Commission did not explicitly contemplate trading UTCs for the purpose of capturing MLSA revenues. Moreover, FERC stated "the fact that the PJM tariff does not explicitly prohibit round-trip UTC trades does not create a loophole or otherwise render [the] transactions lawful… Powhatan's roundtrip UTC transactions were deceptive and manipulative." The Commission rejected Powhatan's "legitimate business purpose" argument noting that its trades were routinely uneconomic and that having "legitimate business purpose" is not an affirmative defense to manipulation.

Powhatan continues to respond "publicly and forcefully" before FERC, in the press, and before lawmakers regarding the inherent unfairness of the investigatory process – a process, according to Powhatan, that resulted in an incorrect determination of wrongdoing and assessment of penalty.

These investigations (and others like it, including Maxim Power highlighted below) represent an important expansion of OE's recent interests to include tariff "loopholes" in addition to "relational trading" enforcement matters. Powhatan followed the tariff rules and received a MLSA payment by virtue of what some say is a loophole. FERC, on the other hand, essentially says that simply following the rules is insufficient. Ostensibly, based on these recent orders, market participants also must discern the purpose and intent behind the market design – an intent and purpose that may vary depending on whether you are FERC, the market monitor, market operator or a market participant – and avoid undercutting that purpose and intent, which may not be clearly articulated in the marketplace.

FERC Issues Order Assessing Civil Penalties to Maxim Power, et al.

In another example of a "loophole" type investigation, on May 1, 2015, the FERC issued an Order Assessing Civil Penalties of $5 million against Maxim Power Corporation and its named subsidiaries (Maxim)[2], as well as $50,000 against Maxim Energy Marketing Analyst Kyle Mitton for violating the Commission's Anti-Manipulation and Market Behavior rules. The Commission did not order disgorgement of profits because the $2.99 million in overpayments at issue in the matter already were returned through ISO-New England tariff processes.

With the significant exception of dissenting Commissioner Tony Clark, FERC found Maxim and Mitton violated the anti-manipulation rules in section 222 of the FPA and section 1c.2 of the Commission's regulations by engaging in a fraudulent scheme to obtain payments for electric reliability dispatches utilizing offers based on the expensive price of fuel oil, when Maxim, in fact, burned much less costly natural gas. In addition, the Commission concluded Mitton violated 18 C.F.R. § 35.41(b) (2014) of the Commission's rules, which, in relevant part, prohibits a seller, like Maxim, from submitting false or misleading information or omitting information to Commission-approved independent system operators or market monitors.

According to the market rules in effect at the time, Maxim's generating plant would receive more money for reliability dispatches if the grid operator believed Maxim was burning fuel oil rather than natural gas based on Maxim's offers. When questioned by the market monitor, FERC concluded Maxim and Mitton

responded with intentional evasion, misleading questioners by implying that the Pittsfield plant was physically unable to obtain natural gas due natural gas pipeline restrictions. FERC found Maxim was indeed able to procure natural gas, often in advance of submitting day-ahead offers based on oil-based prices.

Commissioner Clark dissented from the Order Assessing Civil Penalties. Commissioner Clark argued that Enforcement had not met its burden of proving by a preponderance of the evidence that Maxim and Mitton had intended to engage in a deceptive course of business. While acknowledging that the evidence cast Maxim's behavior in a suspicious light, Commissioner Clark nevertheless stated that "such a fact pattern does not a $5 million penalty make." Commissioner Clark found it persuasive that natural gas pipeline restrictions were in place during the time in question and that Mitton's characterization of Maxim's bidding activity as "conservative[]" could easily have been interpreted as a truthful response. Moreover, Commissioner Clark acknowledged that offering based on oil, though typically burning gas, was a "way to play it safe given pipeline restrictions." Finally, Commissioner Clark was reluctant to assess a penalty against Mitton. Commissioner Clark explained that, while there are some cases where it would be appropriate to hold individuals accountable, he could not support "holding only the front-line employee culpable when management itself embraces and takes ownership of the actions."

The Commission's penalty assessment against Maxim Power is significant because it injects uncertainty regarding what information market participants must volunteer when they communicate with the Commission, RTOs/ISOs, and market monitors. The result of the Maxim proceeding appears to indicate that at least in some circumstances responding in a technically accurate manner to a potentially poorly phrased question posed by a market monitor is insufficient to protect oneself from liability under the Anti-Manipulation Rule. If FERC can base a determination of manipulation on "subjective impressions" of bad intent even when the tariff rules are followed, then there is little guidance to the marketplace as to when conducting business is transformed into fraud. Caution is advised: FERC's broad interpretation of Rule 35.41(b) can serve as a predicate for manipulative intent. Furthermore, Commissioner Clark's dissent reveals a significant rift among the Commissioners with respect to what facts sufficiently evidence market manipulation to merit a multi-million dollar civil penalty assessment.

Next Stop – Likely Federal Court

Assuming that the penalty will not be paid by the Powhatan or Maxim Power defendants and the matters do not settle at this time, then pursuant to FPA section 31(d)(3)(A) the defendants will have the option to have an administrative hearing before an administrative law judge or have FERC, pursuant to 16 U.S.C. § 823b(d)(3)(B), commence an action in U.S. district court for an order, in which the district court reviews the assessment of the civil penalty de novo ("the court shall have the authority to review de novo the law and facts involved . . .").

The Powhatan and Maxim Power defendants may or may not argue that FERC lacks jurisdiction over UTCs as financial transactions and individuals. As seen in May, however, this may be no easy task, given the U.S. District Court for the Eastern District of California ruling upholding FERC's determination that it had jurisdiction over a global financial institution and four of its energy traders and FERC's corresponding assessment of civil penalties for allegedly manipulating electricity markets and prices through arguably purely financial trading in the West. That court concluded that section 222 of the FPA, which prohibits market manipulation by "any entity" in violation of FERC rules, applies to natural persons as well as organizations.

The Powhatan and Maxim defendants could fight on or attempt to settle the matter. Another threshold issue will be a determination of the scope of review regarding the assessment of the civil penalty de novo, as mandated by section 31(d)(3)(A) of the FPA. Is the scope a simple review of the FERC investigative materials or de novo trial? This issue is being litigated in the Eastern District of California proceeding and in *FERC v. Silkman et al.*, No. 1:13-cv-13054 and *FERC v. Lincoln Paper & Tissue, LLC*, No. 1:13-cv-13056 in the District of Massachusetts.

FERC has taken the view in various forums that courts should apply a deferential standard; no trial is required. FERC asserts that under de novo review, the court can affirm the penalty assessment based on FERC's order assessing civil penalties and the existing investigatory record – no discovery or cross examination of that record is warranted. Defendants assert that a de novo trial is warranted and that a non-public investigation without discovery available to the defendants is an insufficient administrative

record to be the subject of a review de novo as mandated by law.

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[1] *Black Oak Energy, L.L.C., et al. v. PJM Interconnection, L.L.C., 122 FERC ¶ 61,208 (2008); Black Oak Energy, L.L.C., et al. v. PJM Interconnection, L.L.C., 125 FERC ¶ 61,042 (2008) (Black Oak).*

[2] The Commission assessed a $5 million penalty against the following Maxim companies: Maxim Power Corporation, Maxim

Power (USA), Inc., Maxim Power (USA) Holding Company Inc., Pawtucket Power Holding Co., LLC and Pittsfield Generating Company, LP.