

*Complying with FERC's Market Behavior Rules:*

**Making Sellers Responsible for the**

**Integrity of Energy Markets**

## *Introduction*

*This presentation is adapted from ProComply's MBR training materials and our compliance program. We also present a small section on the Commodity Future Trading Commission because of the MBR overlap (conflict) with the Commodities Exchange Act and its rules on energy market behavior.*

- On November 17, 2003, the U.S. Federal Energy Regulatory Commission (FERC or Commission) issued two orders implementing behavioral rules for market-based electricity and natural gas sales.
- FERC has stated that the rules were developed to provide market participants (“Sellers”) with the “rules of the road” covering their expected behavior. The rules only partly achieves the Commission’s intended goal. They do not present Sellers with sufficient guidance that is necessary to comply with all of the new regulations.
- These rules only address seller behavior. They do not apply to entities such as control area operators, independent system operators, regional transmission owners, governmental entities, load-serving entities and others, which also have the ability to adversely impact natural gas, energy, ancillary services or transmission prices.

***Disclaimer:** This presentation provides information designed to help energy companies manage their regulatory compliance. Although we go to great lengths to make sure our information is accurate and useful, we recommend you consult specialists if you want professional assurance that our information, and your interpretation of it, is appropriate to your particular situation.*

## *What FERC Wants to Accomplish*

*FERC's three objectives are:*

1. Provide for effective remedies on behalf of customers in the event of anticompetitive behavior or other market abuses;
2. Provide clearly delineated Rules of the Road to market-based sellers (while giving FERC wide latitude to address future specific abuses);
3. Provide reasonable market conduct boundaries so as not to create unlimited regulatory uncertainty for market participants.

## *Market Behavior Rules: Overview*

- New rules are a response to Western energy market debacle of 2000-2002;
- Rulemaking started in 2001 and finalized last year. Changes continue through today in re-hearing; (but rules are effective now);
- Most dissent to these rules are based on arguments of vagueness (lack of specificity); lack of due process available to market participants, and over-reaching on the part of FERC (lacks authority).
- FERC has shifted the market abuse burden of proof from the accuser to the accused;
- FERC has set a “due diligence” standard as a safe harbor;
- FERC will judge intent of market abusers through a fact-finding investigative process.

## *The New Regulatory Language of Energy Trading*

*Market Manipulation.* FERC introduces new concepts with this rule:

- Actions with/without “**legitimate business purposes**”;
- “**Intent of Seller**” at the time of an alleged violation (“**inadvertent** and **honest errors**”)
- “**Foreseeability**” of the effect of an alleged violation;
- “**Due Diligence Standard**” as a defense to allegations of misconduct;
- “**Manipulation**”, “**collusion**” and “**overt collusion**”.

*“...we decline to add greater specificity to a standard that will and must be relied upon in the future to prohibit manipulative acts or transactions whose precise form and nature cannot be envisioned today”. (FERC Rehearing quote).*

*Communications.* Seller must provide factual and accurate information, and not omit “**material**” information to FERC, MMUs, RTOs, ISOs and Transmission Providers.

## *Organizational Impacts and Risks*

### *Impacts*

- Companies must allocate resources to compliance- “lowballing” may backfire;
- Companies may need to altar long-standing business practices (without running afoul of other regulations- state and federal;
- Market dynamics may be constantly shifting as FERC clears up ambiguities and adds specific definitions of its MBR terminology through future cases and audits;
- Additional rules on traders (sellers) make their job more complex- trading spontaneity is virtually eliminated.

### *Risks*

- Companies can be forced to disgorge profits, refund counterparties or other behavioral remedies;
- In the course of responding to an MBR complaint, FERC may conduct wider-ranging inquiries or audits;
- If found guilty of an MBR violation, company will be scrutinized in that market for some time to come.

### *Interaction of MBR and other Corporate Governance Functions*

- Sarbanes-Oxley requires enhanced internal controls over financial reporting and company compliance with laws and regulations;
- Federal Sentencing Guidelines /DOJ Standards give weight to the adequacy of company's compliance procedures;
- State and regional bodies have imposed affiliate abuse rules, especially in the power markets;
- Integrated Resource Planning issues and the application of the Standards of Conduct to IRP activities.
- The Commodities Exchange Act and the parallel requirements enforced by the CFTC.

*Unit Operation: Seller will operate and schedule generating facilities, undertake maintenance, declare outages, and commit or otherwise bid supply in a manner that complies with the Commission-approved rules and regulations of the applicable power market. Compliance with this Market Behavior Rule 1 does not require Seller to bid or supply electric energy or other electricity products unless such requirement is a part of a separate Commission-approved tariff or requirement applicable to Seller.*

## *Rule One: Unit Operation*

- FERC rules apply to sellers who have been granted market-rate authority. FERC rule defers to rules of the applicable power market for must-offer requirement.
- Rule 1 applies to all Sellers, including those that do not own generation but participate in markets, bid supply and control generation resources through contract rights. Rule 1 does not create a must-offer requirement to bid or supply energy into the market. Instead, the Rule governs a Seller's conduct in the market.
- The Commission clarified that FERC-approved market rules (such as Independent System Operator (ISO) or Regional Transmission Organization (RTO) tariffs) establish the scope of Rule 1. The Commission also clarified that Rule 1 is not applicable to bilateral power sales and other transactions.

## *Rule Two: Market Manipulation (1)*

*Market Manipulation: Actions or transactions that are without a legitimate business purpose and that are intended to or foreseeably could manipulate market prices, market conditions, or market rules for electric energy or electricity products are prohibited. Actions or transactions undertaken by Seller that are explicitly contemplated in Commission-approved rules and regulations of an applicable power market (such as virtual supply or load bidding) or taken at the direction of an ISO or RTO are not in violation of this Market Behavior Rule. Prohibited actions and transactions include, but are not limited to:*

- (a) pre-arranged offsetting trades of the same product among the same parties, which involve no economic risk and no net change in beneficial ownership (sometimes called "wash trades");*
- (b) transactions predicated on submitting false information to transmission providers or other entities responsible for operation of the transmission grid (such as inaccurate load or generation data; or scheduling non-firm service or products sold as firm), unless Seller exercised due diligence to prevent such occurrences;*
- (c) transactions in which an entity first creates artificial congestion and then purports to relieve such artificial congestion (unless Seller exercised due diligence to prevent such an occurrence; and*
- (d) collusion with another party for the purpose of manipulating market prices, market conditions, or market rules for electric energy or electricity products.*

## *Rule Two: Market Manipulation (2)*

- The Market Manipulation Rule is supposed to forbid anticompetitive market behavior, not transactions with “economic substance” or transactions that reflect a “legitimate business purpose”. The Commission declined to define a legitimate versus illegitimate business purpose so the rule is vague. FERC only indicated that it would consider the facts and circumstances associated with the conduct to determine its purpose and intended/foreseeable result.
- FERC rule includes the lack of a “legitimate business purpose”, “intent” and “Foreseeability” as elements of the violation. “Legitimate business purpose” and lack of “Foreseeability” may be raised as affirmative defenses. Lack of improper intent may be raised as a consideration in determining whether to assess an administrative penalty and the amount of any penalty.

## *Rule Two: Market Manipulation (3)*

- By imposing a Foreseeability element FERC has raised concerns about the effectiveness of any given compliance program. Usually, Foreseeability is an impartial legal standard that ascertains whether a reasonable person, acting as the defendant is alleged, would have foreseen the injury, as compared to a subjective standard that considers only what the defendant *intended* when the market behavior occurred.
- Other government agencies involved with energy market manipulation use only the Intent standard, not the Foreseeability test. This makes compliance difficult for companies to develop balanced procedures.
- FERC did not amend the definition of wash trades as energy transactions that occur at the same delivery/receipt point. FERC declared that wash trades could involve multiple locations on the transmission system. However, the Commodity Exchange Act (see later) defines wash trades (in futures contracts) as involving the same receipt point. As the rule stands now, wash trades are a *per se* MBR violation.
- FERC did offer some limited guidance regarding book-out and sleeve transactions by excluding them from the Rule's definition of prohibited wash trades. The Commission also noted that close-out transactions used to cancel or correct a prior erroneous transaction are not prohibited. FERC did exclude some types of transactions from being defined as wash trades.

## *Rule Two: Market Manipulation (4)*

- To violate the false information rule, the Seller must know (or should have known) that the information is false even though FERC does not indicate what constitutes false information. It is also unclear how Rule 2.b differs from Rule 3.
- The Commission did not assimilate an adverse impact element into the Rule (*i.e.* the alleged behavior caused an adverse effect.). Inadvertent or honest mistakes, or submitting information based on good faith approximations that later turn out to be inaccurate (*e.g.* variations between a projection and an eventual outcome), will not violate the rule, as such submissions are not knowingly false.
- Companies must institute policies and procedures to assure the adequacy and truthfulness of any submitted information. The Commission intends to compel companies to pro-actively minimize honest mistakes. Virtual bidding and other Commission-approved activities will not violate the prohibition against submitting false information.
- FERC went on to define “artificial congestion” by including all forms of congestion from scheduling power flows in an uneconomic manner for the purpose of creating real or perceived congestion. The Rule is not calculated to apply when Sellers react to changing conditions between the day-ahead and real-time markets. However, FERC can deem that this rule has been violated if the proscribed conduct occurred without adequate internal controls designed to preclude the conduct.

*Communications: Seller will provide accurate and factual information and not submit false or misleading information, or omit material information, in any communication with the Commission, Commission-approved market monitors, Commission-approved regional transmission organizations, or Commission-approved independent system operators, or jurisdictional transmission providers, unless Seller exercised due diligence to prevent such occurrences.*

## *Rule Three: Communications*

- This rule prohibits submitting false or misleading information, unless the Seller has exercised due diligence to prevent such occurrence (which may be raised as an affirmative defense under FERC rule).
- FERC has not clarified the interaction between Rules 2b and 3. Each rule addresses the need for accurate and precise communication but creates different compliance requirements. Rule 3 uses indistinct terms, including references to “misleading information”, which will make it arduous for market participants to assess whether their communications are satisfactory.
- While the Rule prohibits knowingly providing false or even deceptive information, the Commission will not penalize companies for inadvertently erroneous or misleading submissions. Sellers must have instituted a program to assure the accuracy of submitted data. FERC clarified that jurisdictional entities may not use this Rule to induce others to provide information or to avoid treating information provided to them confidentially.

## *Rule Four: Reporting (1)*

*Reporting: To the extent Seller engages in reporting of transactions to publishers of electricity or natural gas price indices, Seller shall provide accurate and factual information, and not knowingly submit false or misleading information or omit material information to any such publisher, by reporting its transactions in a manner consistent with the procedures set forth in the Policy Statement issued by the Commission in Docket No. PL03-3 and any clarifications thereto. Seller shall notify the Commission within 15 days of the effective date of this tariff provision of whether it engages in such reporting of its transactions and update the Commission within 15 days of any subsequent change to its transaction reporting status. In addition, Seller shall adhere to such other standards and requirements for price reporting as the Commission may order.*

- This rule prohibits knowingly reporting false or misleading information. Lack of knowledge that information was false or misleading may be raised as an affirmative defense under the Commission rule.
- The Commission is not mandating reporting at this time. However, if Sellers report energy or natural gas transactions to index publishers, they are required to provide accurate and factual information, consistent with the procedures set forth in FERC's recent Policy Statement on Natural Gas and Electric Price Indices (104 FERC ¶ 61,121 (2003)).

## *Rule Four: Reporting (2)*

- FERC does not define terms such as “misleading”. Index publishers have not been required to institute explicit and coherent standards for the information they collect from companies, thereby adding to the difficulties that must be considered when attempting to comply with Rule 4.
- To enforce Rule 4, FERC approved the transaction reporting standards set forth in the Policy Statement, as well as the Policy Statement’s “safe harbor” provision related to certain reporting errors. Sellers must inform FERC within 15 days of the effective date of this Order whether they report transactions to indices and must notify FERC within 15 days of any change to their transaction reporting status.

## *Rule Five: Record Retention*

*Record Retention: Seller shall retain, for a period of three years, all data and information upon which it billed the prices it charged for the electric energy or electric energy products it sold pursuant to this tariff or the prices it reported for use in price indices.*

- FERC rule requires Sellers to maintain data and information on prices, enough to substantiate the basis for the prices. FERC does allow companies to submit certain confidential information.
- FERC clarified that companies need not preserve all analytical or cost-of-service data, but they must retain a complete set of the contractual and transaction-related records that formed the basis for bills sent to customers. FERC indicated that it is immaterial whether the records are paper or electronic as long as they are reasonably accessible.

*Related Tariffs: Seller shall not violate or collude with another party in actions that violate Seller's market-based rate code of conduct or Order No. 889 standards of conduct, as they may be revised from time to time. Any violation of these Market Behavior Rules will constitute a tariff violation. Seller will be subject to disgorgement of unjust profits associated with the tariff violation, from the date on which the tariff violation occurred. Seller may also be subject to suspension or revocation of its authority to sell at market-based rates or other appropriate non-monetary remedies.*

## *Rule Six: Related Tariffs*

- Commission does not provide any direction or clarification on their meaning of “collude”.
- Commission rule does not link specific remedies to violations and does not limit or expand the remedies available to the Commission by statute.
- This Rule only applies to Sellers’ codes of conduct contained in their market-based rate tariffs and any "Order No. 889" standards of conduct the Seller may be required to have in place.

## *Complaints and Penalties (1)*

- Commission rule addresses an informal investigation procedure that Commission Staff will use in most cases where expeditious action is not required. No time limits are imposed on Staff's investigation and review.
- FERC rule uses the existing Rules of Practice and Procedures but provides that unless a complaint is filed within 90 days of knowledge of the violation, no liability will be imposed and only prospective relief will be granted.
- The Market Behavior Rules will not supersede parties' rights to file complaints under the Federal Power Act. However, a party seeking contract modification based on an alleged violation of the Rules must demonstrate that there is a direct connection between the alleged Rule violation and contract formation. This latter requirement should eliminate specious, but frequently filed, complaints based on broad allegations of wrongdoing (*e.g.*, market participant X manipulated the market, so the Commission should abrogate market participant A's contract).

## *Complaints and Penalties (2)*

- Anyone bringing complaints to FERC regarding alleged Rule violations has 90 days from the end of the calendar quarter in which the challenged transaction or market action occurred. If a complainant can show that it did not know and should not have known about the behavior that forms the basis of the complaint within that time period, the 90-day period will begin to run from the time when the complainant knew or should have known about the behavior at issue.
- FERC also limited its ability to enforce the Rules. The Commission must act, by initiating an investigation or issuing an order, within 90 days from the date that it knew of an alleged Rule violation or of the potentially manipulative character of an action or transaction.
- Because the Administrative Procedure Act requires FERC to comply with its own regulations, the new complaint procedures will provide finality for power transactions, which should bring much needed certainty to the markets.

## *Initial Compliance Deadline*

- The Order directs Sellers to include the Rules in their tariffs on the earlier of when they: (1) file any amendment to their market-based rates tariff; or (2) seek continued authorization to sell at market-based rates (*e.g.*, the triennial filing). Notwithstanding this time allowance, the tariff revisions approved in the Order are effective on December 17, 2003.
- Additionally, orders approving market-based rate tariffs that were issued after FERC initiated this proceeding included language requiring Sellers to make a compliance filing to amend their tariff to reflect the Rules within 15 days of the issuance of this Order. Thus, Sellers whose market-based rate tariff approvals contain that language are obligated to file their amended tariff by December 2, 2003. Companies should review their market-based rate tariffs to determine whether this requirement is applicable to them.

*Commodity Exchange Act makes it unlawful for a person to “manipulate or attempt to manipulate the price of any commodity in interstate commerce ... or knowingly to deliver or cause to be delivered ... false or misleading or knowingly inaccurate reports concerning ... market information or conditions that affect or tend to affect the price of any commodity in interstate commerce.”*



## *Commodity Futures Trading Commission*

- The mission of the Commodity Futures Trading Commission (CFTC) is to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options.
- What is the Commodity Exchange Act?
  - Commodity Exchange Act gives CFTC exclusive jurisdiction over energy futures contracts
  - Enacted originally to preserve the integrity of the price discovery process by preventing market manipulation and disruption
- CFTC becoming more aggressive in exerting jurisdiction under the Commodity Exchange Act.

### *CFTC: Attention On the Energy Industry*

- Since 2002, the CFTC has investigated over 40 energy companies and numerous individuals.
- Thus far, the CFTC has filed 20 actions and collected over one-quarter billion dollars in penalties; settlements include ongoing obligations to cooperate.
- Cases have dealt primarily with false price reporting to trade publications.

## Commodity Futures Trading Commission: *Cooperation Advisory*

- The Advisory outlines factors that CFTC will weigh when evaluating whether a company has “cooperated” with the CFTC. Factors include:
  - ✓ Self reporting
  - ✓ Privilege waiver
  - ✓ Provide financial analysis of harm
  - ✓ No joint defense agreement
  - ✓ Hire staff to respond to subpoena
  - ✓ Investigate facts

### Commodity Futures Trading Commission: *Criminal Prosecution*

- To date there have been criminal indictments against traders at Duke, Dynegy, El Paso, Enron, Reliant and Williams .
- Majority of these are for false price reporting in violation of the Commodity Exchange Act.
- Most recent charges have alleged conspiracy to manipulate the markets.

### Commodity Futures Trading Commission: *Individual Prosecution*

- Traders from numerous companies have been criminally charged with a felony for violating the Commodities Exchange Act (7 U.S.C. § 13 (a) (2)) and wire fraud -- El Paso, Dynegy, Reliant and Williams.
- In *U.S. v. Valencia*, Dynegy trader argued that CEA is unconstitutionally overbroad, is void for vagueness, only applies to futures transactions and infringes on speech protected by the first amendment.
- On December 17, 2004, the Fifth Circuit concluded that the CEA is not unconstitutionally overbroad; statute requires that person submitting false or misleading information must know that information is false or misleading.

## *Conclusion: What To Do*

- **Create a formal compliance function**
  - Name responsible persons (esp. a Chief Compliance Officer) and duties;
  - Develop a Compliance Policy, Plan and Manual;
- **Conduct training**
  - Include computer-based programs with detailed training records;
  - Cover company-specific scenarios and role-playing.
- **Develop internal monitoring program**
  - Check on data system transaction transparency;
  - Review current document retention policies.
- **Enforce compliance through existing company policies**
  - Establish disciplinary measures and procedures;
  - Adopt new trading practices to address problematic issues;
  - Involve senior management in an annual review of MBR Compliance.

*Don't forget-* Call ProComply for  
Standards of Conduct or  
Market Behavior Rule  
services, including  
training,  
manuals and  
internal compliance audits.