

The Myth of “Deregulated Gas Sales”— Federal Regulation of Gas Marketers

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In 1989, Congress passed the Natural Gas Wellhead Decontrol Act (“Decontrol Act”), which became fully effective as of January 1, 1993.² This, combined with Federal Energy Regulatory Commission (“FERC”) initiatives in the early 1990’s to inject competition into interstate natural gas wholesale sales markets,³

¹ This paper does not constitute legal advice and should not be used as a substitute for advice of competent counsel. Further, the views expressed in this paper represent solely those of the author, and do not reflect the views of Vinson & Elkins L.L.P., any of its other attorneys, or any of its clients. The author would like to acknowledge the assistance of Vinson & Elkins’ associate Elizabeth Barnidge and Vinson & Elkins’ legal assistant Helen Bonhomme in preparing this paper.

² Natural Gas Wellhead Decontrol Act of 1989, PL101-60, 103 Stat. 157 (1989).

³ *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, 59 F.E.R.C. ¶ 61,030 (Order No. 636), *order on reh’g*, 60 F.E.R.C. ¶ 61,102 (1992) (Order No. 636-A), *order on reh’g*, 61 F.E.R.C. ¶ 61,272 (1992) (Order No. 636-B), *reh’g denied*, 62 F.E.R.C. ¶ 61,007 (1993), *aff’d in part and remanded in part sub. nom, United Distrib. Cos. v. FERC*, 88 F.3d 1105 (D.C. Cir. 1996), *cert. denied, Associated Gas Dist. v. FERC*, 117 S.Ct. 1723 (1997); Cont’d

precipitated development of a robust new wholesale gas trading industry. Developments over the last year have re-emphasized to participants in the wholesale gas trading business that many sales for resale of natural gas in interstate commerce are not fully deregulated. Instead, to the apparent surprise of some unsuspecting market participants, such sales can be subject to broad regulatory authority on the part of the FERC, both under traditional Natural Gas Act⁴ (“NGA”) regulation, as well as the FERC’s new market monitoring authorities conveyed by the Energy Policy Act of 2005 (“EPAct”).⁵ This paper focuses solely on FERC regulation of marketers; it should be noted however, that the activities of gas marketers may be subject to other extensive regulation at the federal level, including for example, regulation by the Commodities Futures Trading Commission.⁶

I. A Brief History of Relevant Gas Regulation

A. All Gas Sales Are Not Created Equal—NGPA “First Sales”

To understand how gas marketers remain subject in many respects to

order on remand, Order No. 636-C, 78 F.E.R.C. ¶ 61,186 (1997); *order on reh’g*, Order No. 636-D, 83 F.E.R.C. ¶ 61,210 (1998); Regulations Governing Blanket Marketer Sales Certificates, 61 F.E.R.C. ¶ 61,281 (1992) (Order No. 547, *order on reh’g*, Order No. 547-A, 62 F.E.R.C. ¶ 61,239 (1993).

⁴ 15 U.S.C. 717, *et seq.* (2006).

⁵ Energy Policy Act of 2005, Pub.L. No. 109-58, 119 Stat. 594 (2005).

⁶ A discussion of the authority of the CFTC is outside this scope of this presentation.

continuing FERC regulation under the NGA requires some historical context. In 1954, the Supreme Court's decision in *Phillips Petroleum Co. v. Wisconsin*⁷ determined that producer wellhead sales for resale of natural gas in interstate commerce were among the sales subject to regulation under the NGA. It is outside the scope of this paper to address the details of the wellhead regulation that developed over the two and a half decades following this decision. Suffice it to say that the regulator's attempts to apply full-blown cost of service ratemaking and other NGA pipeline regulation, such as requirements to receive authorization prior to initiation or termination/abandonment of transactions, to producer sales for resale precipitated numerous problems in interstate natural gas markets that culminated in the passage of the Natural Gas Policy Act of 1978 ("NGPA").⁸

The NGPA tackled a variety of now arcane regulatory areas, including, for example, incremental pricing of natural gas used for industrial purposes.⁹ Thus, much of the NGPA has lost its relevance to practitioners today by virtue of the fact that the vast majority of its provisions have either been repealed or gradually eliminated as the result of subsequent legislation. This includes the extensive framework for statutory wellhead price ceilings established in Title I of the NGPA, the last pricing vestiges of which were eliminated on January 1, 1993 pursuant to the Decontrol Act.¹⁰ One aspect of this statutory pricing scheme remains effective today, however,

⁷ 347 U.S. 672 (1954).

⁸ Natural Gas Policy Act of 1978, Pub. L. 95-621, 92 Stat. 3350 (1978).

⁹ 15 U.S.C. §§ 3341 – 3348 (repealed 1987).

¹⁰ Decontrol Act, § 2(b).

which can precipitate confusion among industry participants about whether, and what, wholesale gas sales by marketers remain subject to FERC regulation under the NGA.

Because Congress intended NGPA price controls to address the ills flowing from the *Phillips* decision, but not to affect the existing pervasive NGA regulation of interstate pipelines at the federal level, or intrastate pipeline and local distribution company regulation by the states, the NGPA price ceilings did not apply to all sales of gas. Instead, the NGPA established a subset of non-pipeline sales of gas—"first sales"—that remains highly relevant today. Contrary to the plain meaning of its name, this subset category of gas sales is *not* limited only to the first sale in a chain of sales from source to ultimate consumer of a particular quantity of gas. Rather, the NGPA defines a "first sale" as:

(21) FIRST SALE.—

(A) GENERAL

RULE.—The term "first sale" means any sale of any volume of natural gas—

(i) to any interstate pipeline or intrastate pipeline;

(ii) to any local distribution company;

(iii) to any person for use by such person;

(iv) which precedes any sale described in clauses (i), (ii), or (iii); and

(v) which precedes or follows any sale described in clauses (i), (ii), (iii), or (iv) and is defined by the Commission as a first sale in order to prevent circumvention of any maximum lawful price

established under this Act.¹¹

Thus, the defined term “first sale” includes, inter alia, producer wellhead sales, and any other sale within the chain of sales from the producer to the ultimate consumer, until the gas is sold to a pipeline, local distribution company or retail customer.¹² Importantly, the term excludes any sale of natural gas by an interstate pipeline, intrastate pipeline, local distribution company, or affiliate of any of the foregoing, unless the sale is of production owned in the ground by one of the foregoing entities.¹³ The term also excludes any sale

¹¹ 15 U.S.C. § 3301(21)(A).

¹² FERC determined pursuant to its circumvention authority that all non-pipeline sales that follow a first sale are also to be considered “first sales.” See, e.g., *Amendments to Blanket Sales Certificates*, 105 FERC ¶ 61,217 (2003), *reh’g denied* 107 FERC ¶ 61,174, (2003) (Order No. 644), *appeal docketed*, No. 04-1168 (D.C. Cir. May 28, 2004), *appeal voluntarily dismissed*.

¹³ 15 U.S.C. § 3301(21)(B). The full text of the NGPA’s exclusion reads as follows:

(B) CERTAIN SALES NOT INCLUDED.—Clauses (i), (ii), (iii), or (iv) of subparagraph (A) shall not include the sale of any volume of natural gas by any interstate pipeline, intrastate pipeline, or local distribution company, or any affiliate thereof, unless such sale is attributable to volumes of natural gas produced by such interstate pipeline, intrastate pipeline, or local distribution company, or any affiliate thereof.

The FERC has determined that the phrase “attributable to” used in the exclusion meant that the gas volumes had to be owned when in the ground. *Amendments to Blanket Sales Certificates*, Regulations Preambles 105 FERC ¶ 61,217 at P 14.

that follows the non-first sale of gas by a pipeline, local distribution company, or retail customer.¹⁴ The insertion of a pipeline, local distribution company, or retail customer into the chain of transactions “breaks” the chain of “first sale” transactions such that no subsequent sale can so qualify.¹⁵

II. Catch-22—Jurisdictional Gas Sales

All of this “first sales” and “non-first sales” arcana is relevant today because of the manner in which the Decontrol Act operates. Since it was not intended to affect federal or state regulation of pipelines and local distribution companies, the Decontrol Act removed from FERC’s jurisdiction under the NGA, only those sales of gas that constituted “first sales” of natural gas, effective for all such sales on January 1, 1993.¹⁶ Thus, the Decontrol Act had no effect on the FERC’s jurisdiction under the NGA over those sales—principally most sales by pipelines, local distribution companies, and their affiliates—excluded under the NGPA from the “first sale” category. Nor did deregulation under the Decontrol Act apply to sales of gas made after the “first sale” chain had been broken by insertion of a sale by a pipeline, local distribution company, or retail customer.

A. Blanket Sales Certificate and Code of Conduct

The FERC recognized the limitations on deregulation under the Decontrol Act.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ Decontrol Act, 103 Stat. 157 (1989), section 3(b)(7)(A). Some categories of first sales were removed from FERC’s NGA jurisdiction on earlier dates.

Thus, in conjunction with its efforts to promote a competitive wholesale gas market, FERC issued certain blanket NGA certificates that pre-authorized under the NGA various sales for resale in interstate commerce.¹⁷ First issued in a series of orders commencing in 1992 in conjunction with FERC's open access initiatives regarding interstate pipeline transportation, these blanket certificates pre-authorized interstate sales for resale automatically, without the need to apply for the certificate, and without any conditions as to the price, purchaser, volume, term or other economic conditions of the sale.¹⁸ The blanket certificates also pre-authorized abandonment of the sale under the NGA upon expiration of the contract term or termination of the individualized sales arrangement.¹⁹ Thus from an industry participant point of view, a blanket certificate functioned precisely as though the sales made under its authority were not subject to any federal regulation by the FERC, with one crucial exception—the FERC retained NGA jurisdiction over all blanket certificate sales.

One important consequence of FERC's retained NGA jurisdiction over blanket certificate sales, is that the FERC has the ability to add prospective terms and conditions to such certificates as future conditions warrant. FERC first exercised this authority in 2003, when in the wake of the market upheavals in California, FERC established a gas marketing "code of conduct" applicable to all blanket certificate sellers.²⁰ Originally, the code of conduct

contained extensive prohibitions against transactions without a legitimate business purpose, or that are intended to or could foreseeably manipulate market prices or conditions, such as "wash trades"²¹ or collusion with another person for the purpose of manipulating market prices or conditions.²² The code of conduct also provided remedies for violations of it, including disgorgement of unjust profits, and suspension or revocation of the certificate. It also required that complaints or the initiation of Commission enforcement action be brought within 90 days after knowledge of the wrongful conduct.²³

In addition to these provisions, the code of conduct for blanket certificate sellers also included price reporting provisions²⁴ intended to address the problems that surfaced in gas markets concerning false transaction reports designed to manipulate price indices

(Order No. 644), *appeal docketed*, No. 04-1168 (D.C. Cir. May 28, 2004), *appeal voluntarily dismissed*.

²¹ Pre-arranged offsetting trades of the same product among the same parties, which involve no economic risk and no net change in beneficial ownership.

²² See 18 C.F.R. § 284.403 (2005).

²³ *Id.* In light of the authorities FERC gained through EPCRA 2005, discussed in more detail below, the FERC recently revised the blanket certificate code of conduct to delete the anti-manipulation provisions, the remedial provisions, and the time limits for bringing action. See, *Amendments to Code of Conduct for Unbundled Sales Service and for Persons Holding Blanket Market Certificates*, 114 F.E.R.C. ¶ 61,166 (2006) (Order No. 673).

²⁴ 18 C.F.R. § 284.403(a) (2007).

¹⁷ See, e.g., 18 C.F.R. 284.402 (2007).

¹⁸ See 18 C.F.R. § 284.402(a) (2007).

¹⁹ See 18 C.F.R. § 284.402(d) (2007).

²⁰ See *Amendments to Blanket Sales Certificates*, 105 FERC ¶ 61,217 (2003), *reh'g denied* 107 FERC ¶ 61,174, (2003)
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published by various publications.²⁵ This aspect of the code of conduct remains in effect today. The code of conduct's price reporting provision does not require any seller to report transactions to a publisher of natural gas price indices, but requires that any seller who chooses to do so must provide accurate information, not knowingly submit false or misleading information, or omit material information, by reporting such transactions in accordance with the Commission's Policy Statement on Natural Gas and Electric Price Indices ("Reporting Policy").²⁶

B. Policy on Reporting Gas Prices to Index Publishers

The Reporting Policy requires that any sellers who report transactions to publishers of price indices must adopt and follow a number of standards. They must adopt and make public²⁷ a clear code of conduct for employees to follow in buying or selling gas and in reporting data from such transactions. Further, data reported must be reported by a department or personnel of

²⁵ See Final Report on Price Manipulation in Western Markets, Docket No. PA02-2, Ch. III (March 2003).

²⁶ *Policy Statement on Natural Gas and Electric Price Indices*, 104 FERC ¶ 61,121 (2003); *order on clarification*, 105 FERC ¶ 61,282 (2003); *order regarding future monitoring*, 109 F.E.R.C. ¶ 61,184 (2004); *order on clarification*, 112 FERC ¶ 61,040 (2005).

²⁷ The FERC takes the position that a code of conduct must be posted on a website available to the public in order to be "public"; it is not sufficient to publicize the code of conduct among company employees. See, e.g., Docket No. PA06-13, *Audit of Price Index Reporting Compliance of Marathon Oil Co.*, p. 2 (Apr. 5, 2007).

the company independent of the department or personnel responsible for trading, and which should verify the accuracy and completeness of the data before submitting it. A data provider must report all bilateral transactions between non-affiliated parties in the physical markets at all trading locations, shall not include data for financial hedges or swaps, and shall include specified information reported separately for each transaction.²⁸ This requirement is intended to provide index publishers with sufficient information to verify data accuracy. Further, to the extent any errors are subsequently discovered in data reported, the provider must correct the error as soon as possible, and must cooperate with the process and timeline for submitting corrections and responding to inquiries established by the publisher.²⁹ The Reporting Policy also requires all parties that submit transaction data to have an independent auditor review annually the data gathering and submission process adopted by the data provider. The audit results must be made available to any index developer to whom the data provider submits information.³⁰ In addition, all blanket certificate sellers must retain for five³¹ years all data and information upon

²⁸ The specified information required is (a) price, (b) volume, (c) buy/sell indicator, (d) delivery/receipt location, (e) transaction date and time, and (f) term. *Policy Statement on Natural Gas and Electric Price Indices*, 104 F.E.R.C. ¶ 61,121, at P 34 (2003); *order on clarification*, 105 F.E.R.C. ¶ 61,282 (2003); *order regarding future monitoring*, 109 F.E.R.C. ¶ 61,184 (2004); *order on clarification*, 112 F.E.R.C. ¶ 61,040 (2005).

²⁹ 104 F.E.R.C. ¶ 61,121 at P 34.

³⁰ *Id.*

³¹ 18 C.F.R. § 284.403(b) (2007). The original three-year data retention requirement was increased to five years in Cont'd

which it billed the prices it charged for gas sold under the blanket certificate. Finally, a blanket certificate seller must timely notify the FERC if such seller intends to engage in price reporting and of any change in its price reporting status.³²

Under the Reporting Policy, a safe harbor exists under which the FERC will presume that information is accurate, timely and submitted in good faith by any data provider that can demonstrate it has adopted and is following the Reporting Policy standards described above. As noted, these price reporting and record retention requirements continue in effect today for all blanket certificate sellers.

C. FERC Enforcement

Although reduced in scope from its original incarnation containing anti-manipulation and remedy provisions, the blanket certificate code of conduct retains vitality as an FERC enforcement tool. Three non-pipeline marketers discovered this in connection with FERC's Office of Enforcement audits performed during the last twelve-months.

BG Energy Merchants, Marathon Oil Company, and Anadarko Energy Services Company, were each the subject of price reporting audits initiated by the Office of Enforcement in late August 2006.³³ Audit

May 2006. *Revisions to Record Retention Requirements for Unbundled Sales Service, Persons Holding Blanket Marketing Certificates, and Public Utility Market-Based Rate Authorization Holders*, 115 FERC ¶ 61,212 (2006) (Order No. 677).

³² 18 C.F.R. § 284.403(a) (2007).

³³ *Letter Order, Marathon Oil Company*, Docket No. PA06-13 (April 5, 2007); *Letter Order, Anadarko Energy Services* Cont'd

reports and letter orders were issued in these proceedings in early April 2007, some seven months later. The audits covered price reporting of wholesale energy transactions for two-year periods commencing January 1, 2005,³⁴ through December 31, 2006. It does not appear from the letter orders that any of the marketers audited took the position with FERC Staff that FERC did not have jurisdiction to perform the audit.³⁵ Though no fines or penalties were assessed, each of BG Energy and Marathon³⁶ were required to take several corrective actions to come into compliance with the code of conduct and the Reporting Policy provisions incorporated by reference therein.³⁷

Company, Docket No. PA06-11 (April 5, 2007); *Letter Order, BG Energy Merchants, LLC*, Docket No. PA06-12 (April 5, 2007). Other non-public audits may be pending, but these three are the only ones with respect to which public orders have yet issued.

³⁴ In minor conflict with the audit letter order, the BG Energy audit report describes the audit period as concluding January 31, 2007, Docket No. PA06-12, *Audit of Price Index Reporting Compliance at BG Energy Merchants LLC*, p. 1 (Apr. 5, 2007).

³⁵ As noted above in the discussion on "first sales," such a position would have to be based on the argument that the marketer conducted only non-jurisdictional "first sales" and no sales under the FERC's blanket certificate.

³⁶ Anadarko had a clean audit and no further action was required for it.

³⁷ For example, Marathon was required to prepare a new code of conduct for blanket marketing certificate holders that clearly discussed the procedures its employees would follow in conducting and reporting upon such transactions, and to post such Cont'd

Perhaps as important, note that even in circumstances in which no penalties are assessed, or no corrective actions are required, the conduct of the audit itself can be disruptive and distracting to company staff for some months—in these cases seven months. Such audits can also require a company to devote substantial resources to responding to data requests, requests for interviews, and the like, or risk appearing uncooperative or recalcitrant.

In addition to enforcement audits, blanket certificate holders who violate the certificate conditions are subject to potential suspension or revocation of the certificate.³⁸ For example, in one of the cases resulting from alleged market manipulation in conjunction with the California market upheavals in 2000-2002, FERC ultimately revoked the blanket certificate authorizations of several affiliated marketers.³⁹ More recently, in a July 2007

code on its public website. *Letter Order, Marathon Oil Company*, Docket No. PA06-13, P 3 (April 5, 2007).

³⁸ Effective as of August 8, 2005, blanket certificate violations are also subject to FERC's enhanced penalty authorities under EP Act, as described in part III.B below.

³⁹ See *Enron Power Marketing*, 103 FERC ¶ 61,343 (2003), *reh'g denied*, 106 F.E.R.C. 61,024 (2004). All but one of the Enron entities subject to this remedy was in bankruptcy at the time of the order revoking the certificates, and was either engaged in liquidating or had liquidated its physical positions. 103 F.E.R.C. ¶ 61,343 P 82. Given this, and FERC's decision to grant limited jurisdiction certificates as needed to complete the ongoing liquidation process, *id.* at PP 91, 93, 95, 97, this remedy was not as disruptive as might otherwise have been the case.

show cause order initiating a formal enforcement proceeding against several affiliated gas marketers, the FERC has proposed to revoke the marketers' blanket certificate authorizations for a period of one year, in addition to other proposed remedies discussed in more detail below.⁴⁰ A marketer who is unable to use the blanket sales certificate must receive prior Commission approval under the NGA for each individual sale for resale that does not qualify as a "first sale," as described earlier. Given the realities of the likely regulatory delays associated with such a review process, a certificate revocation remedy would likely render anything but long-term marketing impracticable.

Finally, all blanket certificate sellers are subject to the regulatory risk associated with future FERC action to prescribe new conditions that attach to transactions conducted under the certificate. For example, in April 2007, the FERC initiated a proposed rulemaking that would require blanket certificate sellers (and other marketer participants with more than de minimis purchases and sales) to report annually on physical natural gas transactions for the previous year.⁴¹ The FERC proposes the reports include information such as total physical transactions, the breakdown between purchases and sales, the number and volume of transactions conducted in monthly and daily spot markets, and a breakdown of transactions by type of pricing, *e.g.*, fixed or indexed.⁴² In addition,

⁴⁰ See, *Energy Transfer Partners, L.P. et al.*, 120 FERC ¶ 61,086 (2007).

⁴¹ *Transparency Provisions of Section 23 of the Natural Gas Act; Transparency Provisions of the Energy Policy Act, Notice of Proposed Rulemaking*, 119 FERC ¶ 61,068 (2007).

⁴² *Id.* PP 44-45.

under the proposed rule sellers would be required to state whether they operate under blanket certificate authority, whether they report prices to price index publishers, and whether such reporting complies with the FERC's requirements, discussed above.⁴³ While perhaps these conditions may seem fairly innocuous to some, any such reporting requirements increase administrative burdens for marketers, as well as clearly identifying additional audit targets for the FERC, and creating the potential for regulatory violations.

As happened with the old code of conduct "anti-manipulation" rules,⁴⁴ FERC's authority to condition blanket certificates can result in the imposition of significant substantive requirements. Although the

⁴³ *Id.* P 46.

⁴⁴ Before its change to the current text, the anti-manipulation provisions of section 284.403 read in pertinent part as follows:

(a) Any person making natural gas sales for resale in interstate commerce pursuant to § 284.402 is prohibited from engaging in 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 natural gas. Prohibited actions and transactions include but are not limited to:

(1) 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 "was trades"); and

(2) collusion with another party for the purpose of manipulating market prices, market conditions, or market rules for natural gas.

See 18 C.F.R. § 284.403(a) (2005).

FERC never acted on them, various parties urged FERC to impose price controls on jurisdictional gas sales at the time of the California market upheavals.⁴⁵ Such an option respecting jurisdictional blanket certificate sales remains available to FERC in the appropriate circumstances.

III. FERC's Brave New World— Enhanced EAct Authorities

A. Prohibition on Market Manipulation

The newest, and perhaps most expansive weapon in the FERC's regulatory arsenal applicable to gas marketers is the anti-manipulation provision added to the NGA pursuant to the Energy Policy Act of 2005 ("EAct")⁴⁶. Enacted effective as of August 8, 2005, EAct adds section 4A of the NGA, which prohibits market manipulation as follows:

"SEC. 4A. It shall be unlawful for any entity, directly or indirectly, to use or employ, in connection with the purchase or sale of natural gas or the purchase or sale of transportation services subject to the jurisdiction of the Commission, any manipulative or deceptive device or contrivance (as those terms are used in section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b))) in contravention of such rules

⁴⁵ *No Clear Justification for Setting Benchmark Gas Price, FERC Told*, INSIDE FERC, March 12, 2001.

⁴⁶ Energy Policy Act of 2005, P.L. No. 109-58, 119 Stat. 594 at pp 979-80 (2005).

and regulations as the Commission may prescribe as necessary in the public interest or for the protection of natural gas ratepayers. Nothing in this section shall be construed to create a private right of action.”⁴⁷

In January 2006, the FERC adopted rules implementing this new authority.⁴⁸ These new regulations, codified in Section 1c.1,⁴⁹ are patterned after the Securities Exchange Commission’s rule 10b-5.⁵⁰ Section 1c.1 makes it unlawful for any entity, directly or indirectly, in connection with the purchase or sale of natural gas or the purchase or sale of transportation subject to the Commission’s jurisdiction, (1) to use or employ any device, scheme, or artifice to defraud, (2) to make any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made, in 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.⁵¹ As is apparent from the foregoing, this rule is not a model of clarity or precision.

⁴⁷ A similar provision, applicable to electric energy markets, was added as new section 222 of the Federal Power Act.

⁴⁸ See Order No. 670, 114 FERC ¶ 61,047 (2006); *reh’g denied* 114 FERC ¶ 61,300 (2006) (Order No. 670).

⁴⁹ 18 C.F.R. § 1c.1 (2007). New Section 1c.2 contains a parallel provision prohibiting governing electric energy market manipulation.

⁵⁰ 17 C.F.R. 240.10b-5 (2007).

⁵¹ 18 C.F.R. § 1c.1 (2007).

The preamble to the final rule discusses several interpretive matters relevant to its understanding, which reflect the breadth of its potential scope. According to FERC, the rule applies to any entity, not just regulated interstate gas pipelines, regardless of the entity’s legal status, function or activities.⁵² The phrase “subject to the Commission’s jurisdiction” as used in the rule modifies both “purchases or sales of gas” and “purchases or sales of transportation,” such that actions taken solely in connection with non-jurisdictional activities, such as retail sales, or intrastate activities, are not covered.⁵³ The phrase “in connection with” is to be construed broadly, but not so broadly as to capture every case of common law fraud; rather, there must be a nexus between the fraudulent or deceptive conduct and the jurisdictional transaction.⁵⁴ In committing the fraud, the entity must have intended to affect, or have acted recklessly to affect, a jurisdictional transaction.⁵⁵ The terms “contrivance or manipulative or deceptive device” are intended to be understood as used in securities law rules; the Commission will look to case law interpreting rule 10b-5 for guidance in applying the new anti-manipulation rules.⁵⁶

FERC has clarified that the “no material omission” language of the new rule creates no new affirmative duty of disclosure.⁵⁷ Thus, absent a tariff requirement or other Commission order directing disclosure, there is no violation simply because non-public information is

⁵² Order no. 670, P 16.

⁵³ Order No. 670, P 20.

⁵⁴ Order No. 670, P 22.

⁵⁵ Order No. 670, PP 52-53.

⁵⁶ Order No. 670, P 30.

⁵⁷ Order No. 670, P 35.

not disclosed, for example, in the context of contract negotiations. When a party voluntarily provides information or is required to do so, then omission of information necessary to make the material provided not misleading can be a violation if other required elements are present. Mere “puffery,” however, is not a violation.⁵⁸ The rule does not apply to simple negligence; instead a party must act with intent or scienter. Notwithstanding implementation of the new rule, the Commission expects the parties to continue to resolve most contract disputes such as fraud in the inducement, without Commission involvement.⁵⁹

In summary, the elements of a violation include (1) an entity engages in a prohibited act, *i.e.*, uses a fraudulent device, scheme or artifice; makes a material misrepresentation or material omission as to which there is a duty to speak under a Commission tariff, 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, and (3) in connection with the jurisdictional purchase or sale of natural gas or transportation.⁶⁰ The Commission defines fraud generally, to include any action, transaction, or conspiracy for the purpose of impairing, obstructing, or defeating a well-functioning market.⁶¹ Whether or not fraud exists is a question of fact. With respect to the disclosure requirements, a fact is material if there is a substantial likelihood that a reasonable market participant would consider it in making its decision to transact, because the fact significantly altered the total mix of information available; materiality

⁵⁸ Order No. 670, P 39.

⁵⁹ Order No. 670, P 37.

⁶⁰ Order No. 670, P 49.

⁶¹ Order No. 670, P 50.

will be determined on a case-by-case basis. The element of scienter required for violation of the rule includes knowing or intentional misconduct, as well as recklessness. Importantly, a showing of reliance, loss causation or damage from the actions in question is not necessary to establish a violation.⁶² The behaviors previously prohibited under the Commission’s blanket certificate code of conduct (wash trades, transactions predicated on submitting false information, and collusion for the purpose of market manipulation) are all examples of manipulative or deceptive devices.⁶³

The Commission did not agree to commenters’ requests to impose a statute of limitations or other time limit on enforcement actions under the anti-manipulation rules, such as the ninety-day period previously imposed for bringing a claim under the anti-manipulation provisions of the blanket certificate code of conduct.⁶⁴ The Commission will, however, observe the five-year statute of limitations (which runs from the time the claim accrues) generally applicable under Federal law⁶⁵ in situations in which the Commission seeks to impose civil penalties. In this connection, and contrary to the manner in which the FERC implements its authority respecting complaints under NGA section 5,⁶⁶ the Commission does not view remedies under Section 4A as required to be prospective from the time of a FERC order only. Instead, penalties may be applied respecting past action found to have

⁶² Order No. 670, P 48, fn 102. These elements will inform the nature of the remedy imposed, however. *Id.*

⁶³ Order No. 670, P 59.

⁶⁴ Order No. 670, P 63.

⁶⁵ 28 U.S.C. § 2462 (2000).

⁶⁶ 15 U.S.C. 717e.

violated the rules.⁶⁷ Penalties may only be assessed by the FERC after notice and hearing.

B. Civil Penalty Authority

In addition to the anti-manipulation provisions, EAct gave FERC enhanced authority to levy civil penalties for violations of its rules, including for the first time in FERC's history the authority to levy civil penalties for violations of the NGA and FERC's rules and orders issued thereunder. Under the civil penalty authority granted by EAct, FERC now has the ability to levy penalties on any person that violates the NGA, or any rule, regulation, restriction, condition, or order made or imposed by the FERC under the NGA, of up to \$1,000,000 per day per violation, for as long as the violation continues.⁶⁸

Subsequently, FERC issued a policy statement on enforcement, in which it set forth factors it would consider in assessing penalties under its enhanced authority.⁶⁹ Briefly, the FERC outlined three major areas it would consider in pursuing enforcement penalties. The first consideration generally involves the seriousness of the action,

⁶⁷ Order No. 670, P 72.

⁶⁸ See, 15 U.S.C. § 717t-1, *added by* EAct, § 314(b)(1)(B). Note that Section 314(a) of the EAct amends the NGA to (1) increase criminal penalties for knowing violations of the statute from \$5000 to \$1,000,000, (2) increase possible prison sentences from a maximum of two years in jail to five years, and (3) increase the fine payable for violation of a FERC order upon conviction from \$500 to \$50,000 for each day on which the violation occurs.

⁶⁹ *Enforcement of Statutes, Orders, Rules, and Regulations*, 113 FERC ¶ 61,068 (2005) ("Enforcement Policy").

including issues such as whether or not the alleged violation involved fraud, willful activity, or the active participation of senior management.⁷⁰ Second, the Enforcement Policy emphasizes the importance of a "culture of compliance,"⁷¹ and notes the FERC will consider compliance-related circumstances, such as the existence of formal, well-documented compliance programs and senior management involvement in compliance activities.⁷² Last, the Enforcement Policy urges self-reporting of violations and full cooperation with investigations.⁷³

C. A Tale of Two Enforcement Orders

⁷⁰ *Id.* at P 20.

⁷¹ *Id.* at P 2.

⁷² *Id.* at P 22.

⁷³ *Id.* at P 24. On November 16, 2007, the FERC held a conference on its enforcement policies, at which each of the Commissioners presented their thoughts before listening to and questioning a series of panelists on issues and concerns regarding the FERC's enforcement policies. In conjunction with the conference, FERC Staff issued a report on November 14, 2007 that contains the first overall description of its actual enforcement program to date, including generic descriptions of dispositions of non-public investigations. It remains to be seen what, if any, actions result from the conference. Written materials from the conference are posted in the FERC's eLibrary in Docket No. AD07-13, www.ferc.gov/docs-filing/elibrary.asp. In addition, a video of the conference will be archived for three months and is available by clicking on "Conferences" at www.ferc.gov/news/webcast.asp, and selecting the November 16, 2007 "Conference on Enforcement."

FERC kept the industry in suspense for over a year regarding further details about how it would apply its anti-manipulation rules and enhanced penalty authority. Recently, however, FERC issued two proposed enforcement orders that provide an initial view of FERC's thinking.⁷⁴ In *Energy Transfer Partners, L.P.*, FERC proposes to assess penalties in the amount of \$82,000,000, and to require disgorgement of unjust profits equal to \$69,866,966, plus interest for alleged illegal market manipulation on several occasions.⁷⁵ In addition to the proposed monetary remedies, FERC also proposes to revoke the marketers' blanket certificate authorizations for a period of one year.⁷⁶ Briefly, FERC accuses several affiliated gas marketers of manipulation of wholesale gas prices at two market hubs on several occasions allegedly by making physical sales of gas for resale at below market prices to drive down the price, thereby increasing the value of certain of the sellers'

⁷⁴ Technically, one of these orders, *Energy Transfer Partners, L.P.*, et al., 120 FERC ¶ 61,086 (2007), involves interpretation of the former anti-manipulation provisions of the FERC's blanket certificate marketing code of conduct, not new NGA section 4A, but the discussion on market manipulation is relevant to an understanding of the latter.

⁷⁵ *Energy Transfer Partners, L.P.*, et al., Order to Show Cause and Notice of Proposed Penalties, 120 FERC ¶ 61,086, at P 19 (2007) ("*Energy Transfer*"). The FERC also proposed assessment of additional penalties of \$15,500,000 and disgorgement of unjust profits of \$267,122, plus interest, for alleged violations by an intrastate pipeline affiliate in connection with the performance of NGPA section 311 transportation. *Id.* at PP 21-22.

⁷⁶ *Id.* P 16.

other physical or financial positions in gas markets.⁷⁷

In the other order, *Amaranth Advisors L.L.C., et al.*,⁷⁸ FERC proposes to assess civil penalties of \$200,000,000 against the Amaranth entities involved, civil penalties of \$30,000,000 and \$2,000,000, respectively, against two individual traders, plus disgorgement by the Amaranth entities of unjust profits of over \$59,000,000, plus interest.⁷⁹ These truly eye-popping proposed penalties are based on FERC's assertions that alleged attempts to manipulate certain prices for gas futures contracts violated NGA 4A and FERC's anti-manipulation rules because of the alleged effect on prices for interstate physical gas sales. Perhaps the most remarkable aspect of this order, apart from the astronomical proposed penalty, is that the alleged perpetrators did not even engage in any physical sales for resale of natural gas in interstate commerce, *i.e.* sales subject to FERC jurisdiction under the NGA. Rather, the FERC asserts its anti-manipulation authority applies because of the direct nexus between prices in futures markets and prices in jurisdictional physical markets—alleged manipulative activity has transpired "in connection with" jurisdictional sales.⁸⁰

A thorough review of FERC's detailed factual allegations contained in these lengthy orders is beyond the scope of this paper. There are certain particularly noteworthy points that bear emphasis,

⁷⁷ *Id.* at PP 5-12.

⁷⁸ *Amaranth Advisors L.L.C., et al.*, Order to Show Cause and Notice of Proposed Penalties, 120 FERC ¶ 61,085 (2007) ("*Amaranth*").

⁷⁹ *Id.* at P 8.

⁸⁰ *Id.* at P 110.

however. First, the investigation in *Energy Transfer*, which encompassed a two-year period from December 2003 through December 2005 and culminated in the order proposing a seven-figure civil penalty, was precipitated by a call to the FERC's Enforcement Hotline alleging manipulation of the market for prompt month (next month) fixed price gas on a single day, September 28, 2005.⁸¹ Two lessons can be drawn from this. First, the ease and anonymity of reporting available with the Hotline gives a broad constituency—including high-minded whistle blowers, disgruntled employees, and unhappy competitors—a ready forum. Thus, as a practical matter, market participants today can generally assume that misconduct cannot necessarily simply be corrected, but is likely to come to regulators' attention, whether or not the actor self-reports to the FERC. Second, once FERC's interest is piqued, a relatively narrow inquiry can expand quickly and to largely unrelated issues.⁸²

Another point of interest relates to the nature of the alleged misconduct and the resulting scope of the anti-manipulation authority FERC asserts. In contrast to the California market controversies, which involved allegations of attempts to drive up prices, the alleged manipulation at issue in the *Energy Transfer* case involved sales at below market prices. Somewhat counter-intuitively, given the NGA's roots as a

⁸¹ *Energy Transfer*, at P 4. The Amaranth case arose as the result of the real time observations and subsequent investigation of the FERC's Office of Enforcement's Division of Energy Market Oversight. *Amaranth* at PP 52-53.

⁸² As noted, in *Energy Transfer*, the initial allegation about manipulating Houston Ship Channel gas prices, ultimately led to proposed penalties for violation of section 311 transportation laws and related rules.

consumer protection statute, the FERC essentially alleges that driving down prices can be just as harmful to competitive markets as driving them up, resulting in "distortions in consumption, production, storage, and transportation, as well as a reduction in hedging effectiveness, and a decline in market liquidity."⁸³ The *Amaranth* case also involves allegations of trading intended to drive down the natural gas futures contract settlement price.⁸⁴ More interesting, in the *Amaranth* case, the alleged violative conduct takes place in a market not directly subject to FERC jurisdiction.⁸⁵ These allegations reflect an extremely broad view of FERC's authority under NGA 4A.

Last, the civil penalties proposed in both cases reflected the maximum potential penalty. In both cases, FERC cited alleged willful action that implicated important FERC regulatory policy supporting free markets, was condoned by senior management, and caused significant harm to the market.⁸⁶ Further, the FERC notes the conduct was not self-reported in either case, and no credit was available under the Enforcement Policy for exemplary cooperation with the investigation.⁸⁷

It is uncertain how either of these proceedings will conclude, or whether the FERC's broad interpretations of its anti-manipulation authority will survive intact. The alleged perpetrators have strongly

⁸³ *Id.* at P 31.

⁸⁴ *Amaranth* at P 58.

⁸⁵ *Id.* at P 48.

⁸⁶ *Energy Transfer*, at P 126; *Amaranth* at PP 122-131.

⁸⁷ *Amaranth* at P 133; *Energy Transfer* at P 126.

denied any wrong-doing,⁸⁸ as well as requesting rehearing based, in part, on arguments attacking FERC's jurisdiction to issue the orders in the first instance.⁸⁹

Regardless of how these proceedings conclude, however, simply the issuance of the orders gives cause for heightened concern about regulatory risks for gas marketers under FERC's broad views of its new authorities. Given the lack of FERC precedent interpreting its new authority, one can conceive of many scenarios that might give rise to claims of manipulation. Indeed, earlier this month, Connecticut Governor Jodi Rell urged an investigation of whether domestic gas producers were trying to manipulate prices upward by choosing to shut in production.⁹⁰ Certainly it is appropriate for all gas marketers to reassess their trading practices and compliance programs in light

⁸⁸ "Energy Transfer Partners Denies Validity of Government Charges," Press Release, July 26, 2007, www.energytransfer.com/PressReleases.asp?idPressRelease=181; Amaranth and Hunter are already maneuvering to derail FERC action. See, e.g. Complaint, Hunter v. Fed. Energy Regulatory Comm'n., No. 1:07-CV-01307 (D.D.C. July 23, 2007).

⁸⁹ Expedited Request for Rehearing and Request for Stay of Energy Transfer Partners, L.P., Docket No. IN06-3, p. 4 (Aug. 27 2007); Request of Amaranth Advisors L.L.C., Amaranth Advisors (Calgary) ULC, Amaranth Management Limited Partnership, and Amaranth Group Inc. For Expedited Rehearing to Terminate Show Cause Order for Lack of Subject Matter Jurisdiction, Docket No. IN07-26 (Aug. 27, 2007).

⁹⁰ "Connecticut Governor asks Congress to probe natgas price" *Rueters*, (Sept. 13, 2007).

of these orders, and to make sure that policies are widely disseminated among, and well understood by affected employees.

IV. Concluding Thoughts—How to Stop Worrying and Love FERC

For over a decade, the FERC has sought to create a free and open, competitive wholesale natural gas market. After a decline in the immediate aftermath of the Enron bankruptcy, today's wholesale gas market is more robust than ever,⁹¹ and continues to attract new market entrants.⁹²

No market participant should make the mistake, however, of assuming that a free, competitive wholesale gas market equates to an *unregulated* wholesale gas market. The FERC retains NGA authority over a significant segment of the wholesale gas market. Moreover, the very openness of the market exacerbates the difficulties of attempting to maintain clear distinctions between NGA jurisdictional gas and deregulated "first sale" gas. As a result, many gas marketers make some or all of their gas sales for resale pursuant to FERC blanket certificates issued under the NGA. These gas marketers transact their business subject to existing requirements established by the certificates, such as the current code of conduct on price reporting to

⁹¹ Sales volumes reported for the three-months ending June 30, 2007 by the largest 25 marketers in the latest Platt's survey increased 3.5% from the same period last year, even though BP, once the largest trader in North America is not included in the survey. "Gas marketing sector called 'stronger than ever.'" *GAS DAILY* p. 1 (Sept. 12, 2007).

⁹² *Bear Sterns Forges Ahead to Establish Gas, Power Trading Desk Without Calpine*, *INSIDE FERC GAS MARKET REPORT*, April 21, 2006.

index publishers. They also face continued risk that future market conditions may prompt FERC to attach additional requirements. Although unlikely, given the right confluence of future events, history teaches that these could include price caps, prohibitions on certain uses of gas, and restrictions on the ability to terminate certain transactions. An even more expanded universe of market participants is potentially subject to FERC's authority under the NGA's new anti-manipulation rules. Moreover, violation of FERC rules now, more than ever before, can result in imposition of very material remedies. Gas marketers ignore these regulatory realities at their peril.

Given this regulatory regime, what can a prudent gas marketer do, short of exiting the business, to reduce and manage FERC regulatory risk? First, to perhaps state the obvious, regulatory risk mitigation begins with establishment of an effective compliance program. This is easier said than done, however. Effective compliance requires the devotion of substantial resources that do not translate directly into revenue-producing activity. It requires emphatic top-down leadership, access to expert advice, and effective employee education, to name just a few important elements.

Establishment of a good compliance program is a necessary, but not a sufficient, predicate for regulatory risk mitigation. Consistent, universal implementation of that compliance program is at least as important. Indeed, a compliance program observed only in the breach is arguably worse from the regulator's perspective than no program at all. Compliance implementation requires sustained executive leadership, constant vigilance, regular supplemental employee training, periodic implementation audits to assess the program's efficacy, regular reassessments and modifications to account for identified shortcomings and regulatory developments, and meaningful

internal sanctions for repeated or willful failures.

FERC regulation is highly complex, technical, and often may appear counter-intuitive, especially in the for-profit setting of gas marketing companies. As a result, FERC regulation presents a particular compliance challenge, because employee commitments to act with common sense and integrity will likely not suffice to achieve compliance. Employees should thus be encouraged to seek advice from superiors and regulatory experts both early and often. This may not be welcome advice for gas marketers hoping to maintain lean legal budgets. With the potential for multi-million dollar penalties for NGA violations, however, effective FERC regulatory compliance really does illustrate the veracity of the old adage that "an ounce of prevention is worth a pound of cure."