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2014 FERC Enforcement Year In Review

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On the surface, 2014 appeared to be a rather slow year for the Federal Energy Regulatory Commission's Office of Enforcement. Overall, both the number of settlements and penalty assessments were down from previous years and the average value of the settlements that did occur were substantially below the average settlements of previous years.

The OE entered into just 10 enforcement settlements in 2014, five of which related to a joint OE and North American Electric Reliability Corporation investigation into a single event. With total 2014 assessed civil penalties of only about $33 million and less than $4 million in disgorgement, the OE's 2014 numbers lagged significantly behind 2013's totals of nearly $750 million in assessed penalties and almost $175 million in assessed disgorgement. Moreover, of the $33 million in 2014 assessed civil penalties, more than $16 million were not "cash" penalties, but rather were in the form of "offsets" for the completion of "reliability" or "public safety enhancements," and nearly $4 million went to NERC, and not the U.S. Department of the Treasury, for NERC's role in the joint OE and NERC investigation into the Sept. 8, 2011 Arizona-Southern California power outages. In total, the DOT saw slightly more than $13 million from the OE's efforts in 2014.

But, the numbers do not tell the full story. The OE continues to aggressively pursue a number of cases and investigations — some public, some nonpublic. For instance, outside of settlements, the OE continued to seek enforcement of the civil penalties FERC assessed in 2013 against Barclays Bank PLC and four traders in federal district court in California, and the civil penalties FERC assessed in 2013 against Lincoln Paper and Tissue LLC and Competitive Energy Services LLC and its managing partner, Richard Silkman, in federal district court in Massachusetts. Defendants in both sets of cases have moved to dismiss the OE's complaints for a variety of substantive and procedural reasons, and the motions are pending before the two respective courts. The OE also began a hearing before a FERC administrative law judge to determine whether BP America Inc. violated the FERC's anti-manipulation rules while trading next-day, fixed-price natural gas at Houston Ship Channel. FERC has also moved forward its case against the Powhatan Energy Fund and one of its traders, issuing a show cause order after more than three years of investigation.

Due Process Is Everyone's Concern

Beyond these cases, 2014 saw the continuation of the ongoing referendum and debate over whether those subjected to the FERC enforcement process after the Energy Policy Act of 2005 "receive due process," as FERC has promised "both in perception and reality." This is not a new discussion, and has been a growing area of concern since at least 2009/2010, in the aftermath of the first litigated cases under EPAct 2005: Energy Transfer Partners/Oasis Pipeline and Amaranth/Brian Hunter. 2014 saw the debate intensify even further, with congressional interest in the FERC enforcement process at an all-time high.

We expect these discussions to be as robust as ever in 2015; the federal court cases are likely to have significant rulings in 2015 that could shape the debate moving forward. We also expect a variety of articles and congressional hearings on the FERC enforcement process to continue. Indeed, the U.S. Department of Energy's inspector general recently began reviewing the OE's activities at the request of several senators.

Arguably, however, the first shots over due process in 2014 were fired in an Internet public relations campaign by Powhatan Energy Fund. Last February, Powhatan launched a website, to protest what in its view was an unjustified and overly aggressive investigation by the OE. The website, which has since been taken down, revealed much of the nonpublic back-and-forth in that nonpublic investigation, and also included interviews with a number of prominent economists finding fault with the OE's investigation. At heart, Powhatan alleged that the OE's investigation violated their due process rights because, prior to the investigation itself, there was no FERC order or other regulation which put them on notice that their activity might be deemed unlawful and all of their transactions were transparent and fully compliant with the PJM tariff.

Then, in May 2014, we published a peer-reviewed article in the Energy Law Journal, which explored many of the due process issues involving the OE. Among other things, that article addressed the same questions Powhatan raised about the sufficiency of FERC's definition of manipulation and whether it provides fair notice, but also covered other pressing issues of basic fairness, such as the OE's adherence to its disclosure obligations under Brady v. Maryland and its failure to sometimes provide even basic information, such as transcripts of investigative subjects own depositions, and other concerns relating to the OE's aggressiveness and potentially excessive investigative practices.

Congress weighed in later that month, paying the FERC enforcement process a great deal of attention during the confirmation hearings of Cheryl LaFleur and the elevation of former head of FERC Enforcement, Norman Bay, to be one of the five FERC commissioners. (In a deal meant to address concerns over Bay's perceived lack of experience, Congress agreed to keep Cheryl LaFleur as chairman until April 15, 2015, while Bay finds his footing, at which time Bay will become FERC's next chairman.) After the hearings, several senators successfully requested that the DOE's inspector general investigate the OE's investigative practices.

Most recently, three relatively new members of the OE wrote an article allegedly responding to several of these due process concerns. In their article, they admit that the OE's investigations "start with a suspicion of wrongdoing." Then, having discarded the presumption of innocence, the main point of their response to concerns about due process is simple: the OE hasn't violated anyone's due process rights because the entities and individuals subject to OE investigations don't have any due process rights. As they put it, in OE investigations, the investigation subject's due process rights "are not implicated."

Process on Trial

One of the root causes of the due process concerns stems from the fact that FERC has never clearly laid out

the guiding principles FERC wants the OE to enforce. FERC has resisted efforts from industry for clearer guidance on what really constitutes market manipulation. (Chairman LaFleur did recently indicate a willingness to provide more guidance.) Indeed, in their article, the three members of the OE suggest that no guidance is needed because, "[m]ost energy market participants do, in fact, understand the principle of market manipulation and the bounds of permissible market conduct." And, there has been some indication that some commissioners believe the OE should be enforcing "principles" rather than determining whether "rules" have been violated. It is hard to see how such an approach passes constitutional muster.

As the Powhatan public disclosures showed, there are serious questions over whether FERC's general definition of manipulation is sufficiently clear to put market participants on notice of what is, and is not, manipulative activity. For instance, FERC has maintained that some evidence of "improper intent alone" is enough to transform legitimate transactions into manipulation, and has further maintained that even where an otherwise legitimate transaction is expressly contemplated by a FERC-approved tariff, no tariff violation is necessary to prove manipulation.

This issue was actively litigated this year in federal district court in at least two of the OE's cases: Lincoln Paper and Tissue and CES/Silkman. In those cases, FERC alleges that the defendants improperly set baselines during their participation in ISO-NE's Day-Ahead Load Response Program. FERC, however, does not allege and actually agrees that none of the defendants violated any provision of the ISO-NE tariff, let alone one related to setting a baseline. This is decidedly curious, because the so-called baselines do not exist outside of the ISO-NE tariff. If the baselines were in conformance with the tariff, how can that meet FERC's manipulation test?

In fact, during oral argument in those cases, when the presiding judge pressed the OE to explain the market manipulation standard that FERC was trying to enforce, and how the judge could understand what the tariff required, the OE could not provide a specific response. Instead, the OE told the court that "I think it's very much in the lines of the famous pornography quote [by Justice Potter Stewart] that you know it when you see it." The judge responded directly: "I don't think our administrative law depends on that proposition, or it'd better not."

Due Process Requires Fairness and Access to Information

Federal courts, in Brady v. Maryland and its progeny, have long required our government to provide those accused of misdeeds with exculpatory or potentially exculpatory information in the government's possession. Ensuring that the government does not hide such information from the accused is a cornerstone of our system of due process. FERC has adopted a policy requiring disclosure of all "material that would be required to be disclosed under Brady" and the numerous court cases that have expanded and explained those rules. But the OE has a poor, virtually nonexistent, record of producing exculpatory information to the subjects of investigations.

During the Senate confirmation hearings, when asked about the OE's abysmal record in applying Brady, now Commissioner Bay testified that "if those allegations were true, I would be very concerned. I do not believe those allegations are true however." Yet, Bay's written testimony to the Senate confirmed that in the last five years the OE has only identified and produced exculpatory materials under its Brady policy twice in public investigations — twice.

In their article, the three members of the OE suggested that the office "takes very seriously" its Brady obligations. This claim was recently tested when Powhatan sought disclosure of Brady materials. The OE responded that "no materials [were] required to be disclosed" because Powhatan "misapprehend the

scope" of FERC's Brady policy and that only "exculpatory evidence material to guilt or punishment" need be produced. This highlighted the disconnect between the OE and subjects of investigations. As Judge Bruce Levine of the U.S. Commodities Futures Trading Commission explained almost 20 years ago, Brady requires agencies like the CFTC and FERC to disclose information that is "favorable" to the accused's case or that would "undermine" the government's case. Before a trial, the government simply is not in a position to assess what could or might be "material" and so the courts have consistently held that before a trial, the government must err on the side of disclosure. Since the OE has only turned over Brady material twice in more than five years, it suggests that enforcement staff simply does not understand the difference between its pre-trial and post-trial Brady obligations.

This year's BP hearing also highlighted another due process issue related to the disclosure of information: BP challenged the OE's use of certain deposition transcripts because BP had not received them timely and thus had not had the opportunity to review and correct any errors they might contain.

Indeed, the OE and FERC have taken the position that they can deny investigation subjects the ability to review transcripts of their own deposition testimony, let alone receive copies at a time of their own choosing. The three members of the OE disagree that this is a problem, claiming that FERC's rules allow them to withhold immediate copies of transcripts for "good cause." But this ignores the fact that the rules — and the Administrative Procedure Act — also say: "In any event, any witness or his counsel, upon proper identification, shall have the right to inspect the transcript of the witnesses own testimony." That can't be clearer: Immediately upon a showing of identification, a witness or her counsel must be provided access to the witnesses' transcripts. But that just doesn't seem to happen at FERC on a regular basis.

What Will Happen in 2015 and Beyond?

We expect the next few years to be rather turbulent in the world of FERC enforcement. As the courts begin deciding some of these issues — and as the DOE inspector general's investigation picks up steam — we think the landscape will begin to change. But, in the meantime, market participants and other entities need to be prepared to deal with the OE's current model.

—By William Scherman and Jason Fleischer, Gibson Dunn & Crutcher LLP

DISCLOSURE: William Scherman and Jason Fleischer have served as FERC enforcement counsel to several of the entities identified in this article, including Lincoln Tissue and Paper LLC, Energy Transfer Partners, Oasis Pipeline and Barclays Bank PLC. They are also counsel to other entities involved in current, nonpublic FERC investigations and are the authors of the Energy Law Journal article referenced herein.

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