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MARKET MANIPULATION, MARKET POWER, AND THE AUTHORITY OF  
THE FEDERAL ENERGY REGULATORY COMMISSION

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## MARKET MANIPULATION, MARKET POWER, AND THE AUTHORITY OF THE FEDERAL ENERGY REGULATORY COMMISSION

*Hon. Joseph T. Kelliher\**

“Of the Commission’s primary task there is no doubt, however, and that is to guard the consumer from exploitation by non-competitive electric power companies.”<sup>1</sup>

“Give us the tools and we will finish the job.”<sup>2</sup>

### I. INTRODUCTION

For years, the Federal Energy Regulatory Commission (Commission) has promoted competition in wholesale power markets subject to its jurisdiction. It has done so in response to dramatic changes that occurred in the electricity industry over the past twenty-five years. Those changes greatly expanded competition in wholesale power markets, and the Commission made a policy decision to rely increasingly on competition to lower wholesale power prices.

Although the Commission’s policy has evolved in response to changes in electricity markets, the goal of Agency policy has remained constant: assuring just and reasonable rates. The Commission has certain legal duties under the Federal Power Act, perhaps the most important of which is assuring that wholesale power rates are just and reasonable. However, the Commission has discretion on what policies it can pursue to assure such rates. The Agency has chosen to rely on competition to achieve that end.

The courts have upheld that approach, in large part, because the Commission has not relied solely on market forces. In fact, the Commission’s policies have relied on both competition and regulation to assure just and reasonable rates. The Commission has struggled to find the right balance between competition and regulation.

As the industry has changed, the Commission’s role has evolved from setting rates for individual sellers to setting rules of general application that govern electricity markets. Among the most important market rules are those that prevent market manipulation. This article reviews the Commission’s

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1. NAACP v. FPC, 520 F.2d 432, 438 (D.C. Cir. 1975).

2. *Sir Winston Churchill* (BBC Radio Broadcast Feb. 9, 1941).

authority to prevent market manipulation and finds it wanting.

This article also reviews the Commission's authority to prevent the accumulation and exercise of generation market power<sup>3</sup> or horizontal market power. The accumulation of generation market power is a greater concern as the Commission relies on competitive forces to assure just and reasonable prices. Under traditional cost-of-service rate regulation, the accumulation of generation market power is a lesser concern, since the exercise of market power can be controlled by setting individual rates. As the Commission has evolved from setting rates to regulating markets, the accumulation of generation market power is more problematic. This article finds the Commission's authority to prevent accumulation of generation market power to be insufficient.

The Federal Power Act was enacted into law nearly seventy years ago. Much has changed since then. It is unremarkable that the passage of time and the nature of the changes that have swept across the industry created the need for fundamental reforms to the Federal Power Act. This article concludes with a call for legislative action by Congress to bolster the Commission's authority in several key areas in order to strengthen the ability of the Commission to discharge its legal duty to assure just and reasonable rates in the context of competitive wholesale electricity markets.

Part II of this Article reviews the legal duties of the Commission with respect to the regulation of wholesale power sales and disposition of jurisdictional facilities. Part III discusses the dramatic changes that have occurred in the electricity industry over the past twenty-five years and how the Commission's policy evolved in response to these changes. Part IV examines the authority of the Commission to prevent market manipulation and the accumulation of generation market power, concluding that the Commission's current legal authority is insufficient in both areas. Finally, Part V discusses the need for legislative reforms to the Federal Power Act and offers some specific recommendations for such reform.

## II. LEGAL DUTIES OF THE FEDERAL ENERGY REGULATORY COMMISSION

### *A. Prevent Unjust and Unreasonable Rates*

The most important legal duties of the Commission with respect to the regulation of wholesale power sales and the transmission of electric energy in interstate commerce are set forth in sections 205 and 206 of the Federal Power Act.<sup>4</sup> Under section 205, all rates charged by a public utility in connection with wholesale power sales and transmission of electric energy in interstate commerce must be just and reasonable.<sup>5</sup> Under section 206, whenever the Commission

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3. This article does not address the related, but distinct, issue of vertical market power arising from ownership of transmission facilities. It therefore does not discuss major Commission initiatives such as Order No. 888, Order No. 2000, and development of independent system operators and regional transmission organizations.

4. Federal Power Act §§ 205–206, 16 U.S.C. §§ 824d–824e (Supp. 2004).

5. Federal Power Act § 205(a), 16 U.S.C. § 824d(a) (Supp. 2004). The just and reasonable standard is a longstanding one, having been established early in the history of government rate regulation, and the standard seeks to provide utilities a fair return on value. *See, e.g.,* *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679, 690 (1923) (holding that governmentally imposed utility rates that are

finds that a wholesale power or transmission rate charged by a public utility is unjust, unreasonable, unduly discriminatory, or preferential, the Commission is obligated to determine the just and reasonable rate and fix the same by order.<sup>6</sup>

The courts have determined that an unjust and unreasonable rate is a rate that falls outside the “zone of reasonableness,” which is bounded by monopoly rents on the high side and confiscatory prices on the low side.<sup>7</sup> Monopoly rents are prices that an unregulated monopoly would charge,<sup>8</sup> and confiscatory prices are prices so low that they effectively guarantee an investor will never recover his investment.

The legal duty of the Commission to prevent unjust and unreasonable rates and undue discrimination or preference in the sale of wholesale power or interstate transmission by jurisdictional sellers<sup>9</sup> is absolute; the Commission does

not sufficient to yield reasonable rates of return are unjust and that public utilities are entitled to earn a return on the value of property employed in the provision of service that is equal to a return earned by other businesses facing similar risks); see also *Smyth v. Ames*, 169 U.S. 466, 546–47 (1898) (ruling that the fair value of property used, costs of construction, improvements, and other expenses should be examined when calculating the reasonableness of rates set by federal government for railroads).

6. Federal Power Act § 206(a), 16 U.S.C. § 824e(a) (Supp. 2004).

7. See *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1177 (D.C. Cir. 1987) (stating that “zone of reasonableness” is “bounded at one end by the investor interest against confiscation and at the other by the consumer interest against exorbitant rates.”) (quoting *Wash. Gas Light Co. v. Baker*, 188 F.2d 11, 15 (D.C. Cir. 1950)); *Farmers Union Cent. Exch., Inc. v. FERC*, 734 F.2d 1486, 1502 (D.C. Cir. 1984) (holding that the Commission may approve rates “that fall within a ‘zone of reasonableness,’ where rates are neither ‘less than compensatory’ nor ‘excessive.’”); *Pac. Gas & Elec. Co. v. FERC*, 306 F.3d 1112, 1116 (D.C. Cir. 2002) (“Absent procedural or methodological flaws, the court may only set aside a rate that is outside a zone of reasonableness, bounded on one end by investor interest and the other by the public interest against excessive rates.”).

8. A monopolist, if unregulated, curtails production in order to raise prices. Higher prices mean less demand, but the monopolist willingly forgoes sales—to the extent that he can more than compensate for the lost revenue (from fewer sales) by gaining revenue through increased price on the units that are still sold.

STEPHEN BREYER, *REGULATION AND ITS REFORM* 15–16 (Harvard Univ. Press 1982) [hereinafter BREYER].

9. The Commission does not have jurisdiction over all wholesale power sellers or transmitting utilities. With respect to wholesale sales and transmission, the Commission’s jurisdiction is limited to “public utilities.” A “public utility” is defined as a “person who owns or operates facilities subject to the jurisdiction of the Commission. . . .” Federal Power Act § 201(e), 16 U.S.C. § 824(e) (Supp. 2004). However, section 201(f) provides that Part II of the Federal Power Act does not apply to “the United States, a State or any political subdivision of a State, or any agency, authority, or instrumentality . . . of the foregoing . . .” Federal Power Act § 201(f), 16 U.S.C. § 824(f) (2000). In 1967, the Commission held in *Dairyland Power Cooperative* that rural electric cooperatives that receive government financing were also exempted from application of Part II of the Federal Power Act. *Dairyland Power Coop.*, 37 F.P.C. 12, 26 (1967). Therefore, the just and reasonable standard in the Federal Power Act, as a general matter, does not apply to wholesale power sales by federal utilities such as the Tennessee Valley Authority and Bonneville Power Administration, state utilities such as New York Power Authority and Lower Colorado River Authority, municipal utilities such as Los Angeles Department of Water and Power, other public power utilities such as irrigation districts like Salt River Project, public utility districts like those in the State of Washington and State of Nebraska, and rural electric cooperatives that have loans from the U.S. Department of Agriculture Rural Utilities Service. The Commission has limited jurisdiction over “transmitting utilities,” a term that includes otherwise nonjurisdictional transmission owners, for purpose of wheeling orders issued under § 211 of the Federal Power Act. See Federal Power Act § 211, 16 U.S.C. § 824j (2000). Altogether, these nonregulated electric utilities control twenty percent of generating capacity in the United States, *Existing & Future, Utility & Non-Utility Capacity* (Nov. 15, 2004), available at <http://www.platts.com/Databases%20%20Directories/POWERdat/>, and thirty-two percent of the transmission system, EDISON ELEC. INST., *STATISTICAL YEARBOOK OF THE ELECTRIC UTILITY INDUSTRY: 2001 DATA WITH PREVIEW OF 2002*, 116–17 (2003).

not have the discretion to ignore them. The Commission does have discretion on how it discharges these legal duties, however.<sup>10</sup> Historically, the Commission has discharged its legal duty to prevent unjust and unreasonable rates by directly setting rates for individual sellers, typically setting a cost-based rate that allows for cost recovery plus a regulated return on investment.<sup>11</sup> That approach, also known as “profit level regulation,” effectively regulates the profit margin of a utility rather than its costs.<sup>12</sup> As discussed below, that approach has been changing in recent decades.

### *B. Review Disposition of Jurisdictional Facilities*

Under section 203 of the Federal Power Act, the Commission is charged with reviewing all dispositions of “facilities subject to the jurisdiction of the Commission”<sup>13</sup> by public utilities.<sup>14</sup> Approval of such dispositions will be

10. See *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 314–15 (1989) (refusing to adopt constitutional standard for ratemaking because the standard would unnecessarily foreclose alternatives that could benefit both consumers and investors); *FERC v. Pennzoil Producing Co.*, 439 U.S. 508, 517–19 (1979) (reversing Fifth Circuit decision vacating Commission order because decision encroached on Agency’s broad ratemaking discretion); *FPC v. Texaco, Inc.*, 417 U.S. 380, 387–90 (1974) (recognizing wide discretion afforded the Commission in ratemaking); *Mobil Oil Corp. v. FPC*, 417 U.S. 283, 306–10 (1974) (noting that Court will reverse FPC orders only when orders’ results are arbitrary); *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 767 (1968) (stating that courts lack authority to set aside rates that lie within a “zone of reasonableness”); *Wisconsin v. FPC*, 373 U.S. 294, 309 (1963) (rejecting challenge to ratemaking methodologies used by Commission because “no single method need be followed by the Commission in considering the justness and reasonableness of rates . . .”); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944) (declaring the FPC is “not bound to the use of any single formula or combination of formulae” to calculate rates); *Jersey Cent. Power & Light Co.*, 810 F.2d at 1177 (noting the Commission may establish any ratemaking methodology that assures rates fall within the “zone of reasonableness”); *Farmers Union Cent. Exch., Inc.*, 734 F.2d at 1501–09 (recognizing broad discretion granted to the Commission but vacating order because it lacked reasoned basis).

11. See *Pub. Util. Dist. No. 1 v. Dynege Power Mktg. Inc.*, 384 F.3d 756, 758 (9th Cir. 2004) (reviewing establishment of cost-based rates by Commission). A basic principle of traditional rate regulation is that public utility rates are based on the utility’s cost of service.

[Public utility commissions] typically [review calculation of rate regulation] by undertaking a thorough examination and appraisal of total company costs in a recent, ‘test’ year. In this way, item by item, they build up an estimate of total permissible ‘revenue requirements.’ On the basis of this total, adjusted as much as possible for known or readily predictable changes between the test year and the period for which rates are to be ascertained, the company is ordered or permitted to propose the required adjustments in its rate schedules. Therefore, discussions of rate levels are really discussions of total revenues.

1 ALFRED E. KAHN, *THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS* 26 (John Wiley & Sons, Inc. 1970) [hereinafter KAHN I]; *Id.* at 26–57 (detailing nature of cost-of-service regulation); BREYER, *supra* note 8, at 15–59 (examining typical justifications for regulation and methods of cost-of-service ratemaking).

12. See KAHN I, *supra* note 11, at 31 (“The process has focused primarily on profits, also, because these are politically the most visible—excessive profits the most obvious danger and sign of consumer exploitation, in the absence of effective competition, regulated profits the most obvious and comforting evidence that regulation can be ‘effective.’”).

It is through the regulation of price that the limitation on profits is purportedly achieved; it is incident to the regulation of price that the levels and permissible kinds of cost are controlled, by allowing or disallowing payments for various inputs, by supervising methods of financing and controlling financial structures. Price regulation is the heart of public utility regulation.

*Id.* at 20.

13. Federal Power Act § 203(a), 16 U.S.C. § 824b (Supp. 2004).

14. Federal Power Act § 201(e), 16 U.S.C. § 824(e) (Supp. 2004) (providing definition of “public

granted only if the Commission finds it is “consistent with the public interest.”<sup>15</sup> In 1996, the Commission issued its Merger Policy Statement, which defined the public interest test it would apply in public utility mergers and dispositions of jurisdictional facilities.<sup>16</sup> The Commission later clarified the public interest test it would apply to dispositions in Order No. 642, which sets forth the Commission’s filing requirements for section 203 applications.<sup>17</sup>

Under the Merger Policy Statement and Order No. 642, the Commission generally takes account of three factors in its section 203 analysis: the effect on competition, the effect on rates, and the effect on regulation.<sup>18</sup> With respect to the effect on competition, the Commission recognized that effective competition in wholesale power markets can assure just and reasonable rates.<sup>19</sup> The Commission also expressed concern about the effect of accumulation of generation market power on competition in wholesale power markets.<sup>20</sup> If the Commission finds a proposed disposition has a negative effect on competition, it has broad authority to condition the transaction to mitigate any anticompetitive impact.<sup>21</sup>

### III. EVOLUTION OF FERC POLICY IN RESPONSE TO CHANGES IN WHOLESALE POWER MARKETS

#### A. Background

Wholesale power markets have changed dramatically since the Federal Power Act was enacted into law. In 1935, there was relatively little interstate commerce in electricity and limited wholesale sales. The transmission system in most cases did not cross state lines, and few utilities were interconnected. In effect, electricity markets were neatly confined within state boundaries. Virtually all generation was built in load centers, and all segments of the industry—generation, transmission, and local distribution—were presumed to be natural monopolies.<sup>22</sup>

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utility”).

15. Federal Power Act § 203(a), 16 U.S.C. § 824b (Supp. 2004).

16. See Order No. 592, *Inquiry Concerning the Commission’s Merger Policy Under the Federal Power Act: Policy Statement*, F.E.R.C. STATS. & REGS. ¶ 31,044, 61 Fed. Reg. 68,595 (1996), *reh’g granted*, Order No. 592-A, 62 Fed. Reg. 33,341 (1997) [hereinafter *Merger Policy Statement*].

17. See Order No. 642, *Revised Filing Requirements Under Part 33 of the Commission’s Regulations*, F.E.R.C. STATS. & REGS. ¶ 31,111, 65 Fed. Reg. 70,983 (2000), *reh’g granted*, Order No. 642-A, 66 Fed. Reg. 16,121 (2001) [hereinafter *Revised Filing Requirements*].

18. See *Merger Policy Statement*, *supra* note 16, at 30,111; *Revised Filing Requirements*, *supra* note 17, at 31,873. The discussion in this article of the Commission’s authority to review dispositions of jurisdictional facilities reviews only the effect on competition, not the effect on rates or the effect on regulation.

19. See *Merger Policy Statement*, *supra* note 16, at 30,117 (“[W]e believe that competition is now the best tool to discipline wholesale electric markets and thereby protect the public interest.”).

20. See *id.* (“[A] concentration of generation assets that allows a company to dominate a market will dampen or preclude the benefits of competition.”).

21. Federal Power Act § 203(b), 16 U.S.C. § 824b (2000).

22. See 2 ALFRED E. KAHN, *THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS* 119–23 (John Wiley & Sons, Inc. 1971) [hereinafter *KAHN II*] (reviewing natural monopoly theory of public utility regulation); ENERGY INFO. ADMIN., U.S. DEP’T OF ENERGY, *THE CHANGING STRUCTURE OF THE ELECTRIC*

The industry remained stable for decades.<sup>23</sup> Beginning in the late 1960s, however, electric utilities began to significantly expand their interconnections. They did so largely as a response to the 1965 blackout in the Northeast, which resulted in heightened concerns about system reliability. This strengthened interconnection of the transmission grid made possible the later acceleration of competition in wholesale power markets, since a robust transmission grid was a necessary foundation for effective competition.

The next major change was the increase in nonutility generation and the rise of competition in wholesale power markets. Much of the change in the electric power industry since 1978 has resulted from technological change, perhaps the most important of which has been improvements in gas turbine technology.<sup>24</sup> In 1978, utilities controlled ninety-seven percent of electric power generation capacity in the United States.<sup>25</sup> However, technology spurred development of nonutility generation, destroying the natural monopoly in electric generation, if it ever truly existed.<sup>26</sup> The rise of independent power production made more vigorous competition possible. While competition in wholesale power markets has doubtless increased since 1978, it was present beforehand. In fact, federal electricity law envisioned some level of competition in wholesale power markets from the very beginning.<sup>27</sup>

POWER INDUSTRY 2000: AN UPDATE 1 (Oct. 2000) [hereinafter CHANGING STRUCTURE OF THE ELECTRIC POWER INDUSTRY] (“The long-standing traditional structure of the industry was based, in part, on the economic theory that electric power production and delivery were natural monopolies . . .”); *id.* at 5 (“The early structure of the electric utility industry was predicated on the concept that a central source of power supplied by efficient, low-cost utility generation, transmission, and distribution was a natural monopoly.”).

23. See CHANGING STRUCTURE OF THE ELECTRIC POWER INDUSTRY *supra* note 22, at 8 (“Prior to passage of [the Public Utilities Policy Regulatory Act] in 1979 [sic], the electric power industry had been relatively stable for approximately 45 years.”).

24. See *id.* at ix (“Today, the changes that are occurring are . . . driven by . . . economic and technological factors.”); CHANGING STRUCTURE OF THE ELECTRIC POWER INDUSTRY, *supra* note 22, at 44 (“Restructuring has been sustained primarily by technological improvements in gas turbines. . . . These improvements also have recast economies of scale in electric power generation technologies.”).

25. See *id.* at 117.

26. See CHANGING STRUCTURE OF THE ELECTRIC POWER INDUSTRY, *supra* note 22, at 1 (“[T]echnological advances have altered the economics of power production.”); KAHN II, *supra* note 22, at 10 (“[T]echnology is perpetually developing: so the natural monopoly of yesterday may no longer be natural today.”).

27. See *Gulf States Utils. Co. v. FPC*, 411 U.S. 747, 759 (1973) (stating that “within the confines of a basic natural monopoly structure, limited competition of the sort protected by the antitrust laws seems to have been anticipated” by the Federal Power Act); *Otter Tail Power Co. v. United States*, 410 U.S. 366, 374 (1973) (finding “the history of Part II of the Federal Power Act indicates an overriding policy of maintaining competition to the maximum extent possible consistent with the public interest.”). Contemporaneously with the enactment of the Federal Power Act, Congress found that the national public interest “may be adversely affected . . . [by the] evils result[ing] . . . from restraint of free and independent competition” in interstate commerce in electricity. Public Utility Holding Company Act of 1935, § 1(b), 16 U.S.C. § 79a(b) (2000). In addition, the Tennessee Valley Authority Act of 1933, Bonneville Project Act of 1937, and the Rural Electrification Act of 1936 were intended, in part, to introduce greater competition into wholesale power markets.

It is, clear, therefore, that [the Tennessee Valley Authority’s] acts have resulted and will result in the establishment of municipal and cooperative distribution systems competing with those of some or all the appellants in territory which they now serve, or reasonably expect to serve by extension of their existing systems, and in direct competition with [existing utilities].

Competition in wholesale power markets was greatly expanded by enactment of the Public Utility Regulatory Policies Act of 1978 (PURPA).<sup>28</sup> The PURPA promoted competition in wholesale power markets by establishing a mandatory purchase obligation,<sup>29</sup> requiring utilities to purchase generation from qualifying facilities that met certain requirements.<sup>30</sup> Utilities were barred from owning qualifying facilities, so this new class of generation was reserved for nonutilities.<sup>31</sup> The result was a dramatic expansion of electricity generation by independent power producers.<sup>32</sup> Ironically, promoting competition was even not one of the purposes of the PURPA.<sup>33</sup> The success of the PURPA in this respect must be viewed as fortuitous.

The Energy Policy Act of 1992 advanced competition in wholesale power

Tenn. Elec. Power Co. v. Tenn. Valley Auth., 306 U.S. 118, 137 (1939).

See also Bonneville Project Act of 1937 § 2(b), 16 U.S.C. § 832a(b) (Supp. 2004) (authorizing construction of transmission lines in order to “encourage the widest possible use of all electric energy that can be generated and marketed and to provide reasonable outlets therefor [sic], and to prevent the monopolization thereof by limited groups . . .”). Legal challenges to the constitutionality of these laws were rebuffed by the courts, which concluded the statutes envisioned competition in wholesale power markets. See *Tenn. Power Co.*, 306 U.S. at 139 (“The franchise to exist as a corporation, and to function as a public utility, in the absence of a specific charter contract on the subject, creates no right to be free of competition . . .”); *Ky. Utils. Co. v. Tenn. Valley Auth.*, 375 F.2d 403, 415 (6th Cir. 1966) (“[Kentucky Utilities] does not have an exclusive franchise and, accordingly, has no contractual, statutory or constitutional right to be free from competition.”), *cert. granted*, 386 U.S. 980 (1967); *Ala. Power Co. v. Ala. Elec. Coop., Inc.*, 394 F.2d 672, 674 (5th Cir. 1968) (“As to the claim of standing under the [Rural Electrification Act], it has been repeatedly held that increased competition which may result to a private power company does not give it sufficient standing to enjoin the making of a loan by a federal agency.”); *Rural Electrification Admin. v. Cent. La. Elec. Co.*, 354 F.2d 859, 864 (5th Cir. 1966) (“Appellees do not have a Constitutionally guaranteed, unrestricted privilege to engage in business free of competition.”).

[I]t is indisputable that the essence of plaintiffs’ complaint is the competition which they will suffer if the Government’s contracts are carried out. They can claim no other interest or injury. . . . Their sole interest and objective is to eliminate the competition which they fear. Controlling decisions of the Supreme Court, dealing with other electric power contracts of the Federal Government, establish that an interest of this kind is not sufficient to enable them to sue to enjoin execution of the power contracts and program of the Government.

*Kan. City Power & Light Co. v. McKay*, 225 F.2d 924, 928 (D.C. Cir. 1955) (dismissing challenge to loans issued under the Rural Electrification Act).

See also *Ala. Power Co. v. Ickes*, 302 U.S. 464, 480 (1938) (rejecting challenge by investor-owned utility to federal loans to municipal utilities on basis that grounds that “[i]f its business be curtailed or destroyed by the operations of the municipalities, it will be by lawful competition from which no legal wrong results.”).

28. Public Utility Regulatory Policies Act of 1978 §§ 1–608, 16 U.S.C. §§ 2601–2645 (2000).

29. See *id.* § 210(a), 16 U.S.C. § 824a-3 (2000).

30. See Federal Power Act § 3(17)–(18), 16 U.S.C. § 796(17)–(18) (2000).

31. See *id.* §§ 3(17)(C)(ii), (18)(B)(ii), 16 U.S.C. §§ 796(17)(C)(ii), (18)(B)(ii) (2000) (limiting “qualifying small power production facility” and “qualifying cogeneration facility” to facilities that are “owned by a person not primarily engaged in the generation or sale of electric power” other than from qualifying facilities). Under the Commission’s regulations interpreting this provision, utilities may not own more than fifty percent of a qualifying facility. See 18 C.F.R. § 292.206 (2004).

32. See CHANGING STRUCTURE OF THE ELECTRIC POWER INDUSTRY, *supra* note 22, at 1 (“[T]he effects of the Public Utility Regulatory Policies Act of 1978, which encouraged the development of nonutility power producers . . . demonstrated that traditional vertically integrated electric utilities were not the only source of reliable power.”); *Id.* at 8 (“PURPA became a catalyst for competition in the electricity supply industry, because it allowed nonutility facilities . . . to enter the wholesale market.”).

33. See Public Utility Regulatory Policies Act of 1978 §§ 2, 101, 16 U.S.C. §§ 2601, 2611 (2000).



markets, by further promoting the development of independent power producers.<sup>34</sup> This new class of generators, known as “exempt wholesale generators,” is exempt from the Public Utility Holding Company Act of 1935.<sup>35</sup> Since enactment of the Energy Policy Act, most nonutility generation additions have been exempt wholesale generators.<sup>36</sup> These new entrants challenged the utilities by competing for wholesale power sales.<sup>37</sup>

### B. FERC Response to Changed Industry Conditions

In response to these developments in the electricity industry, the Commission instituted fundamental changes in policy, changes that continue to this day. Beginning in the 1980s, the Commission began to rely increasingly on market forces to lower wholesale power prices. To this end, the Commission began to authorize public utilities to charge market-based rates for wholesale power sales, rather than cost-based rates. This marked a fundamental change in Commission policy. The objective of this new policy was clearly to lower wholesale power prices.<sup>38</sup> The Commission’s authorization of market-based

34. See CHANGING STRUCTURE OF THE ELECTRIC POWER INDUSTRY, *supra* note 22, at 8 (“The growth of nonutilities was further advanced by the Energy Policy Act of 1992 (EPACT). EPACT expanded nonutility markets by creating a new category of power producers – exempt wholesale generators (EWGs) – that are exempt from [the Public Utility Holding Company Act’s] corporate and geographic restrictions.”).

35. See Energy Policy Act of 1992, Pub. L. No. 102-486, § 724, 106 Stat. 2776, 2920 (1992) (establishing category of exempt wholesale generators not subject to the Public Utility Holding Company Act of 1935 (PUHCA)). The PUHCA regulates interstate holding companies engaged, through subsidiaries, in the electric utility business or in the retail distribution of natural or manufactured gas. These holding companies are subject to regulation by the Securities and Exchange Commission (SEC) on matters such as structure of their utility systems, transactions among companies that are part of the holding company utility system, acquisitions, business combinations, the issue and sale of securities, and financing transactions. See *generally* Public Utility Holding Company Act of 1935, §§ 1–36, 15 U.S.C. §§ 79a–79 (2000).

36. Analysis by Office of Market Oversight and Investigations, Fed. Energy Regulatory Comm’n (Nov. 15, 2004).

37. Electric power generation in the United States is changing from a regulated industry to a competitive industry. Where power generation was once dominated by vertically integrated investor owned utilities (IOUs) that owned most of the generation capacity, transmission, and distribution facilities, the electric power industry now has many new companies that produce and market wholesale and retail electric power.

CHANGING STRUCTURE OF THE ELECTRIC POWER INDUSTRY, *supra* note 22, at 1.

38. See *Energy Servs., Inc.*, 58 F.E.R.C. ¶ 61,234, 61,753 (1992) (stating that competitive markets can provide greater efficiencies than traditional cost-based rate regulation in electric generation and supply); *Pub. Serv. Co. of Ind.*, 51 F.E.R.C. ¶ 61,367, 62,225 (1990) (noting that “improved supply options should allow the purchasing utilities to reduce their costs, which will benefit their ratepayers when these cost reductions are passed through in their bills.”), *modified sub nom. PSI Energy, Inc.*, 52 F.E.R.C. ¶ 61,260 (1990), *clarified*, 53 F.E.R.C. ¶ 61,131 (1990), *petition dismissed sub nom. N. Ind. Pub. Serv. Co. v. FERC*, 954 F.2d 736 (D.C. Cir. 1992); *Pac. Gas & Elec. Co.*, 38 F.E.R.C. ¶ 61,242, 61,790 (1987) (allowing experimental competitive rates because “competition . . . encourages utilities to make efficient decisions with a minimum of regulatory intervention. Ultimately, consumers should benefit from lower prices as competition improves efficiency.”), *modified*, 47 F.E.R.C. ¶ 61,121 (1989), *modified*, 50 F.E.R.C. ¶ 61,339 (1990), *modified sub nom. W. Sys. Power Pool*, 55 F.E.R.C. ¶ 61,099, 61,319 (1991) (rejecting flexible pricing for bulk power because applicant had failed to eliminate anticompetitive effects by mitigating market power in generation or transmission), *granting stay*, 55 F.E.R.C. ¶ 61,154 (1991), *reh’g granted in part*, 55 F.E.R.C. ¶ 61,495 (1991), *modified*, 59 F.E.R.C. ¶ 61,249 (1992); *Pub. Serv. Co. of N.M.*, 25 F.E.R.C. ¶ 61,469, 62,038 (1983) (declaring that “competition penalizes a seller that is inefficient or has an unreasonable pricing strategy [and that

rates was a departure from traditional cost-based ratemaking, which is focused on preventing the exercise of market power by controlling profits rather than fostering efficiency.<sup>39</sup> The Commission's policy was intended to create competitive pressures that would improve efficiency and lower wholesale power prices.<sup>40</sup>

It is important to note that this increased reliance on competitive forces does not mean the Commission made a break with regulation.<sup>41</sup> Alfred Kahn perhaps expressed it best thirty years ago:

The two principal institutions of social control in a private enterprise economy are competition and direct regulation. Rarely do we rely on either of these exclusively: no competitive markets are totally unregulated, and no public utilities are free of some elements of rivalry. The proper object of search, in each instance, is the best possible mixture of the two.<sup>42</sup>

That is what the Commission has been working towards: the best possible mixture between regulation and competition, relying more on competition than it did in the past, while retaining significant direct regulation. It has been a struggle to reach an appropriate balance.<sup>43</sup>

The policy decision to rely increasingly on competitive forces to control wholesale power prices is consistent with the Commission's legal duty to assure just and reasonable rates for the sale of wholesale power by jurisdictional public utilities. The Commission's theory was, and remains, that

[i]n a competitive market, where neither buyer nor seller has significant market power, it is rational to assume that the terms of their voluntary exchange are reasonable, and specifically to infer that price is close to marginal cost, such that the seller makes only a normal return on its investment.<sup>44</sup>

One may question this theory, but it has been upheld by the courts.<sup>45</sup> Regardless,

consumers . . . benefit because the improvements in efficiency [due to competition] lead to lower prices.").

39. See KAHN I, *supra* note 11, at 26–30 (describing need for regulation to restrain monopolies such as utility companies from charging higher rates than would be possible in a competitive market).

40. See 58 F.E.R.C. ¶ 61,234, at 61,753 (approving market-based rates for large wholesale power sales because rates set through competitive forces will result in cost savings to ratepayers); 51 F.E.R.C. ¶ 61,367, at 61,224–25 (stating that competitive pricing improves efficiency by creating incentives for full utilization of existing capacity and innovation).

41. The decision to regulate never represents a clean break with competition. No regulatory statute to the author's knowledge completely abandons reliance on competition as one guarantor of good performance. The determination of the proper mixture of competitive rivalry and government orders in the formula for social control is or ought to be the central, continuing responsibility of legislatures and regulatory commissions.

KAHN II, *supra* note 22, at 113–14 (footnote omitted).

42. *Id.* at xiii.

43. The marriage (perhaps the better term would be miscegenation) of [competition and regulation] is inevitably an uneasy one. But the almost universal conception is that the mixed marriage is better than none: that such competition as can be permitted, consistent with efficiency, can contribute to improved performance; yet unregulated competition is infeasible—provided, that is, that the industry is properly treated as a public utility in the first place!

KAHN II, *supra* note 22, at 115.

44. *Tejas Power Corp. v. FERC*, 908 F.2d 998, 1004 (D.C. Cir. 1990).

45. See *Associated Gas Distribs. v. FERC*, 824 F.2d 981, 1008–09 (D.C. Cir. 1987) ("Agencies do not need to conduct experiments in order to rely on the prediction that an unsupported stone will fall; nor need they

there is no doubt the Commission believed its increased reliance on competitive forces was fully consistent with its statutory duty to assure just and reasonable rates.<sup>46</sup>

One reason the Commission began to rely increasingly on market forces to assure just and reasonable rates was a recognition of the limitations of cost-of-service regulation.<sup>47</sup> Traditional rate regulation does not encourage the regulated utility to be efficient and provide service at a low cost.<sup>48</sup> Moreover, cost-of-service regulation has not proved terribly effective in eliminating excessive costs.<sup>49</sup> It was the perceived failure of cost-based regulation that led the

do so for predictions that competition will normally lead to lower prices.”).

46. See 58 F.E.R.C. ¶ 61,234, at 61,752–54 (noting the statutory duty of the Commission to ensure that wholesale power rates are just and reasonable and approving market-based rates that will fall within the zone of reasonableness); 51 F.E.R.C. ¶ 61,367, at 62,221 (“Under section 205 of the [Federal Power Act] the Commission must ensure that all rates for the transmission or sale of electric energy at wholesale in interstate commerce are ‘just and reasonable.’”); 38 F.E.R.C. ¶ 61,242, at 61,781 (“We believe that the experimental rates are just and reasonable and comply with the underlying goals of the Federal Power Act (FPA): to bring about the lowest cost to consumers in the long run and to ensure efficiency in the electric utility industry.”).

47. See 58 F.E.R.C. ¶ 61,234, at 61,753 (“Traditional cost-of-service rate regulation is not always adequate to meet [electricity supply] needs and, at times, competitive markets can provide more efficient, lower-cost capacity for the long term as well as lower-cost energy in the short term.”); 51 F.E.R.C. ¶ 61,367, at 62,224–25 (approving market-based rate sales because “[t]he industry has developed in ways that make traditional cost-of-service rate regulation inappropriate in some circumstances. . . . [and] efficiency improvements may not be feasible under traditional cost-of-service regulation.”); 38 F.E.R.C. ¶ 61,242, at 61,790 (“Traditional regulation is essentially reactive. Its success can be questionable during times of changing industry conditions.”) (quoting Notice of Inquiry, *Regulation of Electricity Sales-for-Resale and Transmission Service*, [Regs. Preambles 1982–85] F.E.R.C. STAT. & REGS. ¶ 35,518 (1985), 50 Fed. Reg. 23,445 (1985) (to be codified at 18 C.F.R. pt. 35)).

Regulated monopoly is a very imperfect instrument for doing the world’s work. It suffers from the evils of monopoly itself—the danger of exploitation, aggressively or by inertia, the absence of pervasive external restraints and stimuli to aggressive, efficient and innovative performance. Regulation itself tends inherently to be protective of monopoly, passive, negative, and unimaginative.

KAHN II, *supra* note 22, at 325.

48. See KAHN II, *supra* note 22, at 326 (“Regulation is ill-equipped to treat the more important aspects of performance—efficiency, service innovation, risk taking, and probing the elasticity of demand. Herein lies the great attraction of competition: it supplies the direct spur and the market test of performance.”).

In a competitive industry, firms are motivated to produce efficiently—to find ways to cut production costs—by the hope of increased profits and by the fear that failure to keep costs low will cause more efficient firms to capture their customers by lowering price. In a regulated industry, the stick is usually unavailable.

*Id.* at 59.

[I]nsofar as cost-of-service ratemaking is advocated as a ‘cure’ for market failure, one must believe that the unregulated market is functioning quite badly to warrant the introduction of classical regulation. That is to say, the regulatory process—even when it functions perfectly—cannot reproduce the price signals that a workably competitive marketplace would provide.

BREYER, *supra* note 8, at 47.

49. See KAHN I, *supra* note 11, at 27–30 (reviewing the inability of public utility regulation to eliminate excessive cost by concealment of profits through exaggeration of costs, by holding profits below certain levels through incurring greater costs than is in the best interest of the consumer, by extracting potential monopoly profits through paying excessive prices to unregulated affiliate companies, by absence of competitive pressures, and other causes); BREYER, *supra* note 8, at 49 (stating that utility cost-of-service regulation tends to only disallow extreme instances of unnecessary expenses).

Commission to turn to competition.<sup>50</sup>

It is important to note that the Commission's policy was never intended to deregulate wholesale power markets. Notwithstanding the great debates that have taken place in the United States over deregulation, our economic markets are not truly unregulated in the sense that they are completely free from rules. Virtually all markets are subject to some kind of market rules, either rules laid down by an economic regulatory agency or established under antitrust law.<sup>51</sup> The most notable exception is major league baseball, which is not subject to regulation and is exempt from antitrust law.<sup>52</sup>

As the Commission has relied on competitive forces to assure just and reasonable rates, its role has changed significantly from the one it has played historically. Instead of setting rates for each seller subject to its jurisdiction, the role has changed to one of regulating markets, by setting rules of general applicability. Those rules, in turn, are intended to ensure that wholesale markets are subject to effective competition. The Commission has struggled to develop market rules to govern competition in wholesale power markets in a manner consistent with its legal duties.

The panoply of market rules established by the Commission belies descriptions of the Agency's policy objective as deregulation. When the Commission establishes price caps, as it has in regional transmission organization and independent system operator markets and in the West, it does so in order to prevent wholesale power prices from rising to the level of monopoly rents.<sup>53</sup> When it authorizes capacity payments, the Commission does so to provide generators a reasonable opportunity to make a profit. Both sets of rules are designed to produce rates that are just and reasonable—that fall inside the zone of reasonableness. This effort is most obvious in the organized markets, where spot markets are governed by rules approved by the Commission.<sup>54</sup>

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50. See 58 F.E.R.C. ¶ 61,234, at 61,753 (justifying Agency policy change supporting market-based rate regulation by pointing out that traditional cost-of-service regulation is not always adequate to meet the needs of growing competitive wholesale power markets); 51 F.E.R.C. ¶ 61,367, at 62,225 (approving market-based rates for wholesale power sales in order to provide a less costly means of supplying new power demands); 38 F.E.R.C. ¶ 61,242, at 61,789 (stating that “[b]ecause not all utilities are equally good at building and operating generating plants, we believe that a rational regulatory policy requires that we encourage electric utilities to engage in bulk power trades that coordinate their resources and thus produce efficiency gains.”) (footnote omitted); 25 F.E.R.C. ¶ 61,469, at 62,059–60 (approving experiment to promote efficiency in bulk power markets through market-based pricing of wholesale sales among utilities with differing generation costs.).

51. See BREYER, *supra* note 8, at 156 (stating that antitrust law “typically accompanies the absence of regulation” and “unregulated markets are subject to the antitrust laws—a form of governmental intervention designed to maintain a workably competitive marketplace.”).

52. See Fed. Baseball Club of Balt., Inc. v. Nat'l League of Prof'l Baseball Clubs, 259 U.S. 200, 209 (1922) (exempting baseball from antitrust laws). Perhaps that exception can be explained by the belief in some quarters that major league baseball is more a religion than it is a business.

53. See generally *San Diego Gas & Elec. Co.*, 95 F.E.R.C. ¶ 61,418 (2001) (price mitigation adopted to prevent the exercise of market power), *reh'g granted in part*, 97 F.E.R.C. ¶ 61,275 (2001), *reh'g denied*, 99 F.E.R.C. ¶ 61,160 (2002).

54. See *infra* note 72.

### C. Court Review of the FERC Market-Based Rate Program

The courts have upheld the Commission's decision to rely on market-based rates, and found that doing so is consistent with the Agency's legal duty to assure just and reasonable rates. In *Louisiana Energy and Power Authority*, the U.S. Court of Appeals for the District of Columbia Circuit explicitly held that:

[t]he Federal Power Act requires that all rates demanded by public utilities for the transmission or sale of electric energy be 'just and reasonable.' Where there is a competitive market, the Federal Energy Regulatory Commission (FERC) may rely on market-based rates in lieu of cost-of-service regulation to ensure that rates satisfy this requirement.<sup>55</sup>

Relying on competitive forces to assure just and reasonable rates has also been upheld by the courts outside the context of federal electricity regulation. In *Elizabethtown Gas Co. v. FERC*, the U.S. Court of Appeals for the District of Columbia Circuit upheld the Commission's use of market-based rates for certain natural gas sales.<sup>56</sup> This has bearing on the use of market-based rates in federal electricity regulation, since the courts have recognized the similarities between the Natural Gas Act and the Federal Power Act and interpreted the laws accordingly.<sup>57</sup>

The Commission's authority to approve market-based rates and rely on competitive forces to assure just and reasonable rates was recently reaffirmed by the Ninth Circuit in *California v. FERC*.<sup>58</sup> In reviewing the origins of the Commission's market-based rate policy, the court noted that the Commission is obligated to ensure that wholesale power rates are just and reasonable<sup>59</sup> and recognized that the Commission's policy decision to rely on market-based rates instead of cost-based rates was intended to achieve that result.<sup>60</sup>

Significantly, the court, holding that market-based rates do not violate the Federal Power Act,<sup>61</sup> also concluded that the Commission cannot rely solely on market forces to assure just and reasonable rates.<sup>62</sup> The court distinguished the

55. *La. Energy & Power Auth. v. FERC*, 141 F.3d 364, 365 (D.C. Cir. 1998) (citations omitted). The Commission cannot authorize market-based rates where the market is not competitive.

56. *Elizabethtown Gas Co. v. FERC*, 10 F.3d 866, 870-71 (D.C. Cir. 1993) (rejecting the claim that the Commission was required to adhere to its historical policy of basing rates upon the cost of providing service plus a fair return on invested capital as "not a tenable position").

57. *FPC v. Sierra Pac. Power Co.*, 350 U.S. 348, 353 (1956) (stating that the relevant provisions of the Federal Power Act and the Natural Gas Act "are in all material respects substantially identical . . .").

58. *California v. FERC*, 383 F.3d 1006 (9th Cir. 2004), *petition for reh'g filed*, No. 02-73093 (9th Cir. Oct. 25, 2004).

59. *See id.* at 1011 ("FERC is obligated to ensure that wholesale power rates are 'just and reasonable' . . .")

60. [A]pproximately a decade ago, companies began to file market-based tariffs that did not specify the precise rate to be charged. As a result, FERC then departed from its historical policy of basing rates upon the cost of providing service plus a fair return on invested capital, and began approving market-based [rates].

*California*, 383 F.3d at 1012.

61. *See id.* at 1013 (determining that market-based tariffs do not, per se, violate the Federal Power Act).

62. *See California*, 383 F.3d at 1013 ("Rather, the crucial difference between *MCI/Maislin* and the present circumstances is the dual requirement of an ex ante finding of the absence of market power and sufficient post-approval reporting requirements. Given this, FERC argues that its market-based tariff does not

Commission's market-based rate program from market-based programs developed by the Federal Communications Commission program and Interstate Commerce Commission that had been previously struck down in *MCI Telecommunications Corp.*<sup>63</sup> and *Maislin Industries*.<sup>64</sup> Those other programs were overturned because the Agencies improperly relied on market forces alone in approving market-based tariffs.<sup>65</sup> By contrast, the court found that the Commission did not rely solely on a finding that the applicant for market-based rates lacks market power, but also relied on reporting requirements in order to assure that rates are just and reasonable and not subject to market manipulation.<sup>66</sup>

#### *D. Recent Improvements to FERC's Market-Based Rate Program*

Under *California*, the Commission must do more than rely solely on market forces. The market-based rate authorization program, as reviewed by the *California* court, relied on an ongoing reporting requirement to buttress its ex ante findings with respect to the absence of market power. The Commission relies on much more than that today.

First, the Commission strengthened the reporting requirement that was in effect during the period examined by the court. In April 2002, the Commission issued Order No. 2001, which revised the quarterly filing requirements for public utilities that make wholesale power sales, both cost-based and market-based.<sup>67</sup> The Commission also revised the generation market power test that it uses to make ex ante market power findings.<sup>68</sup> In addition, the Commission issued the Market Behavior Rules, which amend all electric market-based tariffs to proscribe market manipulation.<sup>69</sup> Further, the Commission issued a rule on

run afoul of *MCI* or *Maislin*, and we agree.”). See also *FPC v. Texaco*, 417 U.S. 380, 400 (1974) (concluding “the Commission lacks the authority to place exclusive reliance on market prices” to assure just and reasonable rates under the Natural Gas Act).

63. See *MCI Telecomms. Corp. v. AT&T*, 512 U.S. 218, 234 (1994).

64. See *Maislin Indus., U.S., Inc. v. Primary Steel, Inc.*, 497 U.S. 116, 132–33 (1990).

65. See *California v. FERC*, 383 F.3d 1006, 1013 (9th Cir. 2004) *petition for reh'g filed*, No. 02-73093 (9th Cir. Oct. 25, 2004) (“The agencies in *MCI* and *Maislin* relied on market forces alone in approving market-based tariffs.”).

66. In contrast, FERC's system consists of a finding that the applicant lacks market power (or has taken sufficient steps to mitigate market power), coupled with strict reporting requirements to ensure that the rate is “just and reasonable” and that markets are not subject to manipulation. Here, FERC required the wholesale seller to file a market analysis every four months [sic], and quarterly reports summarizing its transactions during the preceding three months.

*Id.* at 1013. However, the court found the Commission did not adequately enforce the reporting requirement. *California*, 383 F.3d 1014.

67. See Order No. 2001, *Revised Public Utility Filing Requirements*, [Regs. Preambles] F.E.R.C. STATS. & REGS. ¶ 31,127, 30,120, 67 Fed. Reg. 31,043, 31,046 (2002) (to be codified at 18 C.F.R. pts. 2, 35) (stating the revised filing requirements “will allow the Commission to perform its historic regulatory functions . . . while providing information on market-based power sales in a usable format. This will also better allow customers and the Commission to identify situations that indicate the possible exercise of market power that warrant specific investigation.”) [hereinafter *FERC Revised Public Utility Filing Requirements*].

68. See *AEP Power Mktg., Inc.*, 97 F.E.R.C. ¶ 61,219 (2001), *reh'g granted*, 107 F.E.R.C. ¶ 61,018, *reh'g denied*, 108 F.E.R.C. ¶ 61,026 (2004), *appeal docketed sub nom. Entergy Servs., Inc. v. FERC*, No. 04-1241 (D.C. Cir. July 19, 2004).

69. See *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 105

Standards of Conduct to govern the relationships between natural gas and public utility transmission providers and their affiliates, in order to prevent affiliate abuse.<sup>70</sup> In organized markets operated by regional transmission organizations and independent system operators,<sup>71</sup> the Commission established a wide range of market rules and provides for market monitoring.<sup>72</sup> More recently, the Commission issued a final rule to standardize its reporting requirement for changes in status that implicate the Commission's ex ante findings regarding the absence of market power.<sup>73</sup> The Commission recognizes the importance of this proposed rule to the Commission's duty to assure just and reasonable rates.<sup>74</sup>

#### IV. LIMITATIONS ON FERC AUTHORITY TO PREVENT MARKET MANIPULATION AND THE ACCUMULATION OF MARKET POWER

##### A. FERC Authority to Address Market Manipulation

###### 1. General Observations

As discussed above, the Commission's role has changed fundamentally as a result of dynamic changes in the electricity industry. While the Commission's legal duty to prevent unjust and unreasonable rates and prevent undue discrimination or preference has remained constant, the policy means by which the Commission discharges these duties has changed significantly. Instead of setting rates for individual sellers and individual transmitting utilities, the Commission increasingly establishes rules of general application that regulate markets by enforcing market rules.

In a broad sense, the Commission's role has shifted to become more like

F.E.R.C. ¶ 61,218 (2003) [hereinafter *Market Behavior Rules Order*], *reh'g denied*, 107 F.E.R.C. ¶ 61,175 (2004) [hereinafter *Market Behavior Rules Rehearing Order*], *appeal docketed*, No. 04-1168 (D.C. Cir. May 28, 2004). These rules are discussed at length in Part IV of this Article.

70. See Order No. 2004, *Standards of Conduct for Transmission Providers*, [Regs. Preambles] F.E.R.C. STATS & REGS. ¶ 31,155, 68 Fed. Reg. 69,134 (2003) (to be codified at 18 C.F.R. pts. 37, 161, 250, 284, 358), *reh'g granted*, Order No. 2004-A, 107 F.E.R.C. ¶ 61,032 (2004), *reh'g granted*, Order No. 2004-B, 108 F.E.R.C. ¶ 61,118 (2004), *appeal docketed sub nom. Cinergy Servs., Inc. v. FERC*, No. 04-1168 (D.C. Cir. May 28, 2004).

71. A regional transmission organization is a public utility certified by the Commission to operate the transmission grid that may also be authorized to operate certain energy markets in a particular region. An independent system operator serves the same role, but is limited to a single state.

72. See, e.g., *Midwest Indep. Transmission Sys. Operator, Inc.*, 108 F.E.R.C. ¶ 61,163 (2004), *reh'g granted*, 109 F.E.R.C. ¶ 61,157 (2004); *Atl. City Elec. Co.*, 86 F.E.R.C. ¶ 61,248 (1999); *Cent. Hudson Gas & Elec. Corp.*, 86 F.E.R.C. ¶ 61,062 (1999); *New Eng. Power Pool*, 85 F.E.R.C. ¶ 61,379 (1998); *Pa.-N.J.-Md. Interconnection*, 81 F.E.R.C. ¶ 61,257 (1997); *Pac. Gas & Elec. Co.*, 81 F.E.R.C. ¶ 61,122 (1997); *Pac. Gas & Elec. Co.*, 77 F.E.R.C. ¶ 61,204 (1996).

73. See Federal Energy Regulatory Commission, *Reporting Requirements for Changes in Status for Public Utilities with Market-Based Rate Authority*, <<http://www.ferc.gov/whats-new/comm-meet/020905/E-6.pdf>> (to be codified at 18 C.F.R. pt. 35) [hereinafter *Reporting Requirements for Changes in Status for Public Utilities with Market-Based Rate Authority*].

74. See *id.* at 32,080 ("To carry out its statutory duty under the FPA to ensure that market-based rates are just and reasonable, the Commission must rely on market-based rate sellers to provide accurate, up-to-date information regarding any relevant change in status, such as ownership or control of jurisdictional facilities and affiliate relationships.").

other federal economic regulatory agencies, such as the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC). Those agencies discharge their legal duties by setting rules of general application that regulate the commodity and securities markets, respectively.

This is not to say that the role of the Commission is now identical to those of the CFTC and the SEC. Unlike the Commission, the CFTC and SEC do not have a duty to assure that the price of a commodity or a security is “just and reasonable.”<sup>75</sup> Instead, their legal duty is to prevent behavior that would pervert the normal operations of commodity and securities markets and result in prices that are higher or lower than would otherwise occur through unmolested market forces. This is demonstrated by the fact that one of the principal charges of the CFTC and SEC in their regulation of commodity and securities markets is to prevent market manipulation.<sup>76</sup> Both the Commodity Exchange Act and the Securities Exchange Act of 1934 include express prohibitions of market manipulation that reflect a recognition by the Congress that commodities and securities markets cannot operate properly if subject to market manipulation.<sup>77</sup>

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75. See generally Commodity Exchange Act §§ 1–22, 7 U.S.C. §§ 1–25 (2000); Securities Exchange Act of 1934 §§ 1–36, 15 U.S.C. §§ 78a–78mm (2000).

76. One of the stated purposes of the Commodity Exchange Act is “to deter and prevent price manipulation or any other disruptions to market integrity . . . [and] to protect all market participants from fraudulent or other abusive sales practices . . .” Commodity Exchange Act § 3(b), 7 U.S.C. § 5(b) (2000). A premise of the Securities Exchange Act of 1934 was that “[f]requently the prices of securities on such exchanges and markets are susceptible to manipulation and control . . . resulting in sudden and unreasonable fluctuations in the prices of securities . . .” Securities Exchange Act of 1934 § 2, 15 U.S.C. § 78b(3) (2000).

77. The Commodity Exchange Act has a variety of provisions designed to prevent market manipulation. Section 9 of the Commodity Exchange Act includes an express prohibition of market manipulation, providing that “[i]t shall be a felony punishable by a fine of not more than \$1,000,000 (or \$500,000 in the case of a person who is an individual) or imprisonment for not more than five years, or both, . . . for . . . [a]ny person to manipulate or attempt to manipulate the price of any commodity in interstate commerce . . .” Commodity Exchange Act § 9(2), 7 U.S.C. § 13(a) (2000). The Commodity Exchange Act also provides for specific enforcement powers and penalties for market manipulation. Commodity Exchange Act § 6(c), 7 U.S.C. § 9 (2000); Commodity Exchange Act § 6(d), 7 U.S.C. § 13b (2000). The Securities Exchange Act includes a number of provisions intended to prevent market manipulation:

It shall be unlawful for any person, by the use of the mails or any means or instrumentality of interstate commerce or of any facility of any national securities exchange, to use or employ any act or practice in connection with the purchase or sale of any equity security in contravention of such rules or regulations as the [Securities and Exchange] Commission may adopt, consistent with the public interest, the protection of investors, and the maintenance of fair and orderly markets . . . to prescribe means reasonably designed to prevent manipulation of price levels of the equity securities market or a substantial segment thereof . . .

Securities Exchange Act of 1934 § 9(h), 15 U.S.C. § 78i(h) (2000). Section 10 of the Act includes an express prohibition of manipulative practices:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities Exchange Act of 1934 § 10, 15 U.S.C. § 78j (2000). The Securities Exchange Act of 1934 also proscribes particular practices that are, in effect, deemed to be inherently manipulative. Securities Exchange Act of 1934 § 9(a), 15 U.S.C. § 78i(a) (2000) (prohibiting wash trades, certain practices relating to swap agreements, and price fixing). The concern with respect to market manipulation extends to registration of securities exchanges, since the Act prohibits registration of securities exchanges unless the SEC determines that



## 2. The FERC's Market Behavior Rules

Markets subject to manipulation cannot operate properly. This premise has been recognized in the context of commodities and securities regulation, and Congress has properly granted the CFTC and SEC express authority to prevent market manipulation. Yet, commodities and securities markets are not the only markets susceptible to market manipulation. There have been instances of manipulation of wholesale power markets subject to the Commission's jurisdiction, and manipulation contributed to the western electricity crisis of 2000–01.<sup>78</sup> Indeed, the Commission recognizes the urgent need to proscribe manipulation of electricity markets.<sup>79</sup> Yet, there is no express prohibition of market manipulation in federal electricity law.<sup>80</sup> Of the scores of criminal violations arising out of prosecutions of market manipulation in the electricity industry, there is not one alleged violation of the Federal Power Act, which speaks volumes about the adequacy of current electricity law.<sup>81</sup>

The Commission has interpreted its existing legal authority in an effort to prevent market manipulation. In November 2003, the Commission issued a rule to proscribe certain forms of market behavior in wholesale power markets.<sup>82</sup> The purpose of the rule, known as the Market Behavior Rules Order, is to protect wholesale power customers from market abuses, by (a) providing for effective remedies in the event anticompetitive behavior or other market abuses occur, (b) providing clear rules of the road for wholesale power sellers authorized to sell at market-based rates, and (c) limiting regulatory uncertainty, by defining reasonable bounds within which market activity can be conducted.<sup>83</sup> The Market Behavior Rules Order conditions market-based rate authorization on compliance with the behavioral rules. Conduct that runs afoul of the market behavior rules constitutes an electric tariff violation.

"[t]he rules of the exchange are designed to prevent fraudulent and manipulative acts . . ." Securities Exchange Act of 1934 § 6(b)(5), 15 U.S.C. § 78f(b)(5) (2000).

78. FED. ENERGY REGULATORY COMM'N, FINAL REPORT ON PRICE MANIPULATION IN WESTERN MARKETS: FACT-FINDING INVESTIGATION OF POTENTIAL MANIPULATION OF ELECTRIC AND NATURAL GAS PRICES ES-1 (Mar. 26, 2003) (FERC Docket No. PA02-02) ("This Report is the culmination of a yearlong effort by [the] Commission Staff to determine whether and, if so, the extent to which California and Western energy markets were manipulated during 2000 and 2001. . . . Staff found significant market manipulation . . .") [hereinafter FINAL REPORT ON PRICE MANIPULATION IN WESTERN MARKETS].

79. See *Market Behavior Rules Order*, *supra* note 69, at 62,165 ("We must be able to protect market participants against abuses whose precise form and nature cannot be envisioned today."); see also *Market Behavior Rules Rehearing Order*, *supra* note 69, at 61,708 ("Our rule . . . has been designed to remain flexible in a way that will . . . serve to prohibit all forms of market manipulation, including market abuses whose precise form and nature cannot be envisioned today.").

80. See generally Federal Power Act §§ 201–214, 16 U.S.C. §§ 824–824m (2000).

81. See generally CORP. FRAUD TASK FORCE, SECOND YEAR REPORT TO THE PRESIDENT (2004), available at [http://www.usdoj.gov/dag/cftf/2nd\\_yr\\_fraud\\_report.pdf](http://www.usdoj.gov/dag/cftf/2nd_yr_fraud_report.pdf).

82. See *Market Behavior Rules Order*, *supra* note 69, at 62,142. The Commission issued a companion order modifying natural gas market blanket certificates to proscribe many of the same behaviors identified in the Market Behavior Rules Order. See Order No. 644, *Amendments to Blanket Sales Certificates*, [Regs. Preambles] F.E.R.C. STATS. & REGS. ¶ 31,153 (2003), 68 Fed. Reg. 66,323 (2003) (to be codified at 18 C.F.R. pt. 284) (stating the purpose of the order is to prohibit actions that are intended to manipulate natural gas market rules, prices, or conditions), *reh'g denied*, 107 F.E.R.C. ¶ 61,174 (2004).

83. See *Market Behavior Rules Order*, *supra* note 69, at 62,142.

The Commission acknowledged that preventing market manipulation is important to its duty to prevent unjust and unreasonable rates. In the Market Behavior Rules Order, the Commission found that existing electric market-based tariffs were unjust and unreasonable and that proscribing anticompetitive behavior was necessary to ensure that rates remain within a zone of reasonableness.<sup>84</sup> The Commission also held that its Market Behavior Rules are just and reasonable, and will help assure just and reasonable rates.<sup>85</sup> The Commission acknowledged that the Market Behavior Rules, by themselves, will not be adequate to guarantee that rates are just and reasonable.<sup>86</sup> As the Commission stated in the Market Behavior Rules Order, “[o]ur prohibition against market manipulation is not the only tool we intend to rely upon to ensure competitive markets. It is, however, a necessary tool . . . .”<sup>87</sup>

The Market Behavior Rules Order established six behavioral rules. Among them is Market Behavior Rule 2, which prohibits “[a]ctions 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 . . . .”<sup>88</sup> The Commission was very plain that the intent of the Market Behavior Rules Order was to prohibit all forms of market manipulation.<sup>89</sup> Although the Federal Power Act does not include an express prohibition of market manipulation, the Commission did just that in the Market Behavior Rules Order.

Market Behavior Rule 2 not only establishes a general prohibition of market manipulation, it also proscribes specific manipulative practices. Rule 2(a) prohibits pre-arranged offsetting trades of the same product among the same parties, which involve no economic risk and no net change in beneficial ownership, otherwise known as wash trades.<sup>90</sup> Wash trades have been deemed a manipulative practice in other economic regulatory schemes.<sup>91</sup> Rule 2(b) prohibits transactions predicated on submission of false information to transmission providers and other entities responsible for operation of the

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84. *See id.* (“Without such behavioral prohibitions, the Commission will not be able to ensure that rates are the product of competitive forces and thus will remain within a zone of reasonableness.”).

85. *See Market Behavior Rules Order, supra* note 69, at 62,142 (“We further find that our Market Behavior Rules . . . are just and reasonable and will help ensure that rates are the product of competitive forces and thus remain just and reasonable.”).

86. *See id.* at 62,160 (“We share the views of those commenters who assert that the Commission’s proposed Market Behavior Rules, taken alone, will not be adequate to ensure that the rates, terms and conditions offered by market-based rate sellers will be just and reasonable.”).

87. *Market Behavior Rules Order, supra* note 69, at 62,148.

88. *Id.* at 62,170.

89. *See Market Behavior Rules Order, supra* note 69, at 62,165 (“We must be able to protect market participants against abuses whose precise form and nature cannot be envisioned today.”); *see also Market Behavior Rules Rehearing Order, supra* note 69, at 61,708 (“Our rule . . . has been designed to remain flexible in a way that will . . . serve to prohibit all forms of market manipulation, including market abuses whose precise form and nature cannot be envisioned today.”).

90. *See Market Behavior Rules Order, supra* note 69, at 62,170 (“Prohibited actions and transactions include, but are not limited to: pre-arranged offsetting trades of the same product among the same parties, which involve no economic risk and no net change in beneficial ownership . . . .”).

91. *See* Commodity Exchange Act § 4(c), 7 U.S.C. § 6(c) (2000); Securities Exchange Act of 1934 § 9(a)(1), § 15 U.S.C. § 78i(a)(1) (2000).

transmission grid.<sup>92</sup> Other regulatory regimes similarly prohibit manipulative practices based on fraud and misrepresentation.<sup>93</sup> Rule 2(c) prohibits transactions in which an entity creates artificial congestion and then purports to relieve that congestion.<sup>94</sup> Rule 2(d) prohibits collusion with other parties for the purpose of manipulating market prices, market conditions, or market rules.<sup>95</sup> Significantly, the specific manipulative practices proscribed by the Market Behavior Rules included those used by Enron.<sup>96</sup>

A number of parties challenged Market Behavior Rule 2 on the grounds it is unconstitutionally vague and overbroad.<sup>97</sup> Parties argued the rule violated due process requirements, by not providing adequate notice of behaviors that were prohibited.<sup>98</sup> Constitutional due process requirements mandate that the Commission's rules and regulations be sufficiently specific to give regulated parties sufficient notice of the conduct it requires or prohibits.<sup>99</sup> The Commission noted that "[t]his standard is satisfied '[i]f, by reviewing [our rules] and other public statements issued by the agency, a regulated party acting in good faith would be able to identify, with ascertainable certainty, the standards with which the agency expects parties to conform.'"<sup>100</sup> The Commission concluded it met this due process requirement.<sup>101</sup> In particular, the Commission

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92. See *Market Behavior Rules Order*, *supra* note 69, at 62,170 ("Prohibited actions and transactions include, but are not limited to: . . . transactions predicated on submitting false information to transmission providers or other entities responsible for operation of the transmission grid . . . unless Seller exercised due diligence to prevent such occurrences . . .").

93. See Commodity Exchange Act § 4(b), 7 U.S.C. § 6(b) (2000); Securities Exchange Act of 1934 § 9(a)(4), § 15 U.S.C. § 78i(a)(4) (2000).

94. See *Market Behavior Rules Order*, *supra* note 69, 62,170 ("Prohibited actions and transactions include, but are not limited to: . . . 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) . . .").

95. See *id.* ("Prohibited actions and transactions include, but are not limited to: . . . collusion with another party for the purpose of manipulating market prices, market conditions, or market rules for electric energy or electricity products.").

96. See FINAL REPORT ON PRICE MANIPULATION IN WESTERN MARKETS, *supra* note 78, at VI-11-VI-24 (reviewing Enron market manipulation practices).

97. See *Market Behavior Rules Order*, *supra* note 69, at 62,163; *Market Behavior Rules Rehearing Order*, *supra* note 69, at 62,703-04.

98. See *Market Behavior Rules Order*, *supra* note 69, at 62,163; *Market Behavior Rules Rehearing Order*, *supra* note 69, at 62,703-04.

99. See *Freeman United Coal Mining Co. v. Fed. Mine Safety & Health Review Comm'n*, 108 F.3d 358, 362 (D.C. Cir. 1997) ("In order to satisfy constitutional due process requirements, regulations must be sufficiently specific to give regulated parties adequate notice of the conduct they require or prohibit."); *Gen. Elec. Co. v. EPA*, 53 F.3d 1324, 1330 (D.C. Cir. 1995) (holding that the Agency's interpretation of its rules was "so far from a reasonable person's understanding of the regulations that [the regulations] could not have fairly informed GE of the agency's perspective."); *Faultless Div., Bliss & Laughlin Indus., Inc. v. Sec'y of Labor*, 674 F.2d 1177, 1185 (7th Cir. 1982) ("[T]he regulations will pass constitutional muster even though they are not drafted with the utmost precision; all that due process requires is a fair and reasonable warning.").

100. *Market Behavior Rules Rehearing Order*, *supra* note 69, at 61,704 (quoting *Gen. Elec. Co. v. EPA*, 53 F.3d 1324, 1330 (D.C. Cir. 1995) (alteration in original). The *General Electric* court held that the Agency's interpretation of its rules was "so far from a reasonable person's understanding of the regulations that [the regulations] could not have fairly informed GE of the agency's perspective." *Gen. Elec. Co.*, 53 F.3d at 1330.

101. *Market Behavior Rules Rehearing Order*, *supra* note 69, at 61,704. The Commission found that the due process standard allows for flexibility in the wording of an agency's rules and for a reasonable breadth in

determined that the prohibition against market manipulation in Market Behavior Rule 2 passed constitutional muster.<sup>102</sup>

The Commission also sought to comply with due process requirements by incorporating an intent standard into the Market Behavior Rules, including Market Behavior Rule 2, which expressly prohibits market manipulation.<sup>103</sup> The Commission explicitly declined to adopt a specific intent standard, and intent can be inferred.<sup>104</sup>

The principal remedy for violation of the Market Behavior Rules is disgorgement of profits.<sup>105</sup> Commenters challenged the proposed remedy, arguing that it exceeds the limits of the refund provisions in section 206 of the Federal Power Act.<sup>106</sup> Section 206 provides that a refund effective date cannot be earlier than 60 days after the filing of a complaint or the initiation of a proceeding by the Commission.<sup>107</sup> The Commission distinguished the remedies provided under the Market Behavior Rules Order from refunds ordered under section 206.<sup>108</sup> The Market Behavior Rules Order amended all then-existing

their construction. *See id.* The Agency cited *Ray Evers Welding Co. v. OSHRC*, which held that “[b]y requiring regulations to be too specific [courts] would be opening up large loopholes allowing conduct which should be regulated to escape regulation.” *See id.* (quoting *Ray Evers Welding Co. v. OSHRC*, 625 F.2d 726, 730 (6th Cir. 1980)). The Commission also noted that the courts have allowed a less strict application of the vagueness test in cases involving economic regulation. *See Market Behavior Rules Rehearing Order*, *supra* note 69, at 61,704 (“the regulated enterprise may have the ability to clarify the meaning of the regulation by its own inquiry, or by resort to an administrative process.”) (quoting *Vill. of Hoffman Estates v. Flipside, Hoffman Estates, Inc.*, 455 U.S. 489, 498 (1981)).

Texas Eastern, as a major pipeline company, in which trenching and excavation are a part of its routine, had ample opportunity to know of the earlier interpretation, should have been able to see the sense of the regulations on their face, and if still in doubt Texas Eastern should have taken the safer position both for its employees and for itself.

*Id.* at n.18 (quoting *Tex. E. Prods. Pipeline Co. v. OSHRC*, 827 F.2d 46, 50 (7th Cir. 1987)).

102. *See Market Behavior Rules Order*, *supra* note 69, at 62,165 (“[W]e cannot agree that the prohibitions against market manipulation, as set forth in Market Behavior Rule 2, are unclear in their requirement.”).

103. In the Market Behavior Rules Order, we stated that in determining whether an activity has violated our rules, we would examine all relevant facts and circumstances surrounding the activity to establish its purpose and intended or foreseeable result. If that intended or foreseeable result is the manipulation of market prices, market conditions or market[] rules, then the seller will be found to have violated the rule against market manipulation.

*Id.* The Commission denied rehearing requests that sought to eliminate the intent and foreseeability elements of Market Behavior Rule 2. *See Market Behavior Rules Rehearing Order*, *supra* note 69, at 61,708 (“Several parties have argued that intent or foreseeability should not be a part of the definition for market manipulation or otherwise request that the definition be modified. We decline to do so.”) (footnotes omitted).

104. *See Market Behavior Rules Order*, *supra* note 69, at 62,148 (“[W]e also recognize that intent often must be inferred from the facts and circumstances presented. Therefore, a violation of Market Behavior Rule 2 must involve conduct which is intended to, or could foreseeably result in, distorted prices.”).

105. *See id.* at 62,161 (“In the June 26 Order, we indicated that in complaint proceedings brought before the Commission to enforce our proposed Market Behavior Rules, the principal remedy available . . . would be disgorgement of the seller’s unjust profits attributable to the specific violation at issue.”).

106. *See Market Behavior Rules Order*, *supra* note 69, at 62,163 (“A number of commenters continue to challenge the Commission’s authority to promulgate and/or enforce its proposed Market Behavior Rules, given the asserted limitations of Section 206 of the FPA.”).

107. *See Federal Power Act* § 206(b), 16 U.S.C. § 824e(b) (2000).

108. *See Market Behavior Rules Order*, *supra* note 69, at 62,164.

market-based rate tariffs, and is now applied to new market-based rate tariffs.<sup>109</sup> By that device, the Market Behavior Rules are incorporated into electric tariffs, and violations are made subject to disgorgement of profits. Strictly speaking, the “penalty” provided under the Market Behavior Rules is not a refund, but a remedy for violation of a tariff provision prohibiting specific conduct. For that reason, the Commission is not constrained by the time limits in section 206 in setting a tariff penalty charge.

This is consistent with the broad remedial authority recognized by the courts.<sup>110</sup> The Commission has authority under sections 205 and 206 of the Federal Power Act to set charges for jurisdictional service, such as wholesale power sales.<sup>111</sup> These charges in turn are incorporated into tariffs administered by the Commission, and the Commission has broad authority to redress violation of those tariffs.<sup>112</sup>

It is interesting to observe what the Commission did not do in the Market Behavior Rules Order. First, the Commission did not amend existing cost-based tariffs to include the Market Behavior Rules. As a result, compliance with the behavioral rules is limited to sales made under market-based tariffs, notwithstanding the recognition by the Commission that cost-based tariffs afford sellers substantial flexibility.<sup>113</sup> However, most wholesale sales take place under market-based tariffs.<sup>114</sup> Second, the Commission did not find that specific manipulative practices are themselves unjust and unreasonable. Arguably, the Commission could have concluded that market manipulation is inherently unjust and unreasonable, roughly equivalent to per se violations of antitrust law, practices that on their face would always or almost always tend to manipulate markets.<sup>115</sup> It did not do so. Instead, the Commission concluded that current market-based tariffs are unjust and unreasonable or may lead to unjust and unreasonable rates without inclusion of the Market Behavior Rules, and relied on its broad discretion to condition a discretionary act, namely authorizing the sale of wholesale power at market-based rates.<sup>116</sup>

Under the Market Behavior Rules Order, when market manipulation

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109. See *Market Behavior Rules Rehearing Order*, *supra* note 69, at 61,702.

110. See *Gulf Oil Corp. v. FPC*, 563 F.2d 588, 606–08 (3rd Cir. 1977) (upholding remedy of disgorgement of profits and recognizing the Commission has “wide discretion in selecting the tools with which to safeguard the public interest. . .”).

111. See Federal Power Act § 205(a), 16 U.S.C. § 824d(a) (2000); Federal Power Act § 206(a), 16 U.S.C. § 824e(a) (2000).

112. See *Gulf Oil Corp.*, 563 F.2d at 606 (reviewing the broad remedial authority of the Commission).

113. See *FERC Revised Public Utility Filing Requirements*, *supra* note 67, at 30,126 (noting that a number of cost-based rate tariffs on file at the Commission do not specify a rate, and grant wholesale power sellers flexibility in making sales).

114. Analysis by Office of Market Oversight and Investigations, Fed. Energy Regulatory Comm’n (Nov. 15, 2004) (indicating that during the third quarter of 2004, over 90 percent of wholesale sales were under market-based tariffs).

115. See BREYER, *supra* note 8, at 158 (reviewing per se violations of antitrust law, such as price fixing, market division, boycotts, and tying arrangements).

116. See *Market Behavior Rules Order*, *supra* note 69, at 62,142 (“Without such behavioral prohibitions, the Commission will not be able to ensure that rates are the product of competitive forces and thus will remain within a zone of reasonableness.”).

constitutes a tariff violation, the Commission can impose a tough remedy: disgorgement of profits.<sup>117</sup> However, that remedy is inadequate. There are three possible outcomes from a manipulative scheme. First, it may fail to affect price. That does not mean there is no reason to sanction the practice. Attempts to manipulate markets undermine the operation of markets, even when unsuccessful, reducing incentives to enter and dampening competition. It is for that reason that the Commodity Exchange Act and Securities Exchange Act of 1934 prohibit attempts to manipulate markets, regardless of their success.<sup>118</sup> Under the Market Behavior Rules, however, there is no remedy for unsuccessful attempts to manipulate markets, although such conduct would violate the behavioral rules, since an unsuccessful attempt would not generate profits.

Second, an attempt to manipulate markets may succeed, resulting in economic gain in the form of a foregone loss. A foregone loss is a true economic gain. For example, if a seller would have lost \$100, but reduced his or her loss to \$10 through market manipulation, he or she realized an economic gain of \$90. Under the Commodity Exchange Act and Securities Exchange Act of 1934, successful market manipulation that results in economic gain in the

117. See *supra* note 105.

118. If the Commission has reason to believe that any person . . . is manipulating or attempting to manipulate or has manipulated or attempted to manipulate the market price of any commodity, in interstate commerce, . . . or otherwise is violating or has violated any of the provisions of this chapter or of the rules, regulations, or orders of the Commission . . . thereunder, it may serve upon such person a complaint stating its charges in that respect, which complaint shall have attached or shall contain therein a notice of hearing, . . . requiring such person to show cause why an order should not be made prohibiting him from trading on or subject to the rules of any registered entity . . . . Upon evidence received, the Commission may . . . assess such person a civil penalty of not more than the higher of \$100,000 or triple the monetary gain to such person for each such violation. . . .”

Commodity Exchange Act § 6(c), 7 U.S.C. § 9 (2000).

If any person . . . is manipulating or *attempting to manipulate* or has manipulated or *attempted to manipulate* the market price of any commodity, in interstate commerce, . . . or otherwise is violating or has violated any of the provisions of this chapter or of the rules, regulations, or orders of the Commission . . . thereunder, the Commission may . . . make and enter an order directing that such person shall cease and desist therefrom and, if such person thereafter . . . shall fail or refuse to obey or comply with such order, such person shall be guilty of a misdemeanor and, upon conviction thereof, shall be fined not more than the higher of \$100,000 or triple the monetary gain to such person . . . .

Commodity Exchange Act § 6(d), 7 U.S.C. § 13b (2000). Section 9(h) of the Securities Exchange Act of 1934 prohibit practices that violate rules reasonably designed to prevent manipulation of price levels of the securities market, without regard to whether those practices had an effect on price. Securities Exchange Act of 1934 § 9(h), 15 U.S.C. § 78i(h) (2000). Section 10 also prohibited the use of manipulative and deceptive devices in connection with the purchase or sale of a security, also without regard to whether the device had an effect on price. Securities Exchange Act of 1934 § 10, 15 U.S.C. § 78j (2000). The amount of civil penalties that can be imposed under the Securities Exchange Act of 1934 depend on the nature of the wrongful conduct, whether the penalty is sought against a natural person or entity, and whether the conduct involved substantial loss or risk of substantial loss. Securities Exchange Act of 1934 § 21(d)(3)(B), 15 U.S.C. § 78u(d)(3)(B) (2000). Clearly, securities law prohibits attempts to manipulate securities markets, since the highest amount of civil penalties can be imposed where there was a “significant risk” of substantial losses, and there is no requirement that actual losses be incurred. Securities Exchange Act of 1934 § 21(d)(3)(B)(ii)–(iii), 15 U.S.C. § 78u(d)(3)(B)(ii)–(iii) (2000). Since civil penalties can be imposed in the absence of actual losses, securities law prohibits attempts to manipulate markets, in addition to successful manipulation.

form of a foregone loss can be sanctioned.<sup>119</sup> Again, the Market Behavior Rules fall short. The only monetary remedy that can be imposed under the rules is disgorgement of profits, which does not encompass economic gains such as foregone losses.

Third, an attempt to manipulate markets may succeed, resulting in an economic gain in the form of a profit. There is no question that the Commodity Exchange Act and Securities Exchange Act of 1934 provide for sanctioning market manipulation that results in a profit.<sup>120</sup> This is the only circumstance where the Commission can impose a remedy, namely where an attempt to manipulate markets is successful and produces a profit rather than a foregone loss.

As noted above, the principal remedy the Commission can impose for violation of the Market Behavior Rules is disgorgement of profits. The Commission can also suspend or revoke market-based rate authorization.<sup>121</sup> These remedies may discourage market manipulation to some extent. However, that penalty will prove inadequate in circumstances when the manipulative scheme is unsuccessful, and where it succeeds, but produces an economic gain in the form of a foregone loss rather than a profit. In the latter case, there still is an economic gain, but not one the Commission can sanction. In neither instance will the Commission be able to sanction the prohibited behavior, although it could constitute a violation of the Market Behavior Rules. The Commission has acknowledged that some violations of the Market Behavior Rules would not be subject to the principal penalty provided by the Rules, disgorgement of profits.<sup>122</sup>

It has been argued the Market Behavior Rules Order approaches the limits of the Commission's legal authority to prevent market manipulation. Others maintain the Commission has actually exceeded its legal authority,<sup>123</sup> and the order has been challenged in court.<sup>124</sup> It is incontrovertible however, that the Market Behavior Rule represents a very vigorous bid by the Commission to prevent market manipulation. A violation of the Market Behavior Rule is subject to the most severe penalty the Agency can impose: disgorgement of profits. Notwithstanding, in my view the Commission's authority to prevent market manipulation is insufficient.

### 3. The FERC's Authority to Address Federal Power Act Violations

Unlike other federal economic regulatory agencies, the Commission lacks

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119. Both the Commodity Exchange Act and the Securities Exchange Act of 1934 provide for civil penalties for market manipulation in the absence of a profit. See Commodity Exchange Act § 6(c), 7 U.S.C. § 9(c) (2000); Securities Exchange Act of 1934 § 21(d)(3)(B)(iii) (2000).

120. See *supra* note 118, and *infra* notes 129–130.

121. See *Market Behavior Rules Rehearing Order*, *supra* note 69, at 61,708.

122. See *Market Behavior Rules Order*, *supra* note 69, at 62,148 (“The rule, then, covers actions that are intended to manipulate prices regardless of whether these actions actually accomplish their purpose. We note, however, that in most such cases, there will be no unjust profits to disgorge.”).

123. See *id.* at 62,163–64 (reviewing arguments of commenters who argued the proposed behavioral rules violated the refund limitations of section 206 of the Federal Power Act and constitutional due process requirements).

124. See *supra* note 69.

civil penalty authority for most violations of the Federal Power Act.<sup>125</sup> Section 316A of the Act limits civil penalties to violations of provisions added or amended by the Energy Policy Act of 1992, namely sections 211, 212, 213, and 214.<sup>126</sup> The Commission has no legal authority to impose civil penalties for other violations of the Federal Power Act, most notably sections 205 and 206.

This lack of civil penalty authority is a severe handicap in the Commission's enforcement of market rules. Civil penalties are a principal means by which federal economic regulatory agencies enforce their rules.<sup>127</sup> The Commission's civil penalty authority is inadequate, not only with respect to scope, but also the level of penalties. Section 316A limits civil penalties for the specified provisions of the Federal Power Act to not more than \$10,000 per day per violation.<sup>128</sup> By contrast, the Commodity Exchange Act provides for civil penalties capped at the higher of \$100,000 or triple the monetary gain.<sup>129</sup> The Securities Exchange Act of 1934 provides for civil penalties of up to the greater of \$100,000 for an individual or \$500,000 for a company, or "the gross amount of pecuniary gain."<sup>130</sup>

The inadequacy of the Commission's civil penalty authority is clear outside the context of market manipulation. There are other instances where violations of the Federal Power Act go unsanctioned, because the Commission lacks legal authority to impose civil penalties for violations other than the new provisions added by the Energy Policy Act of 1992. For example, section 203 of the Federal Power Act requires that public utilities seek prior authorization from the Commission before entering into a merger.<sup>131</sup> However, if public utilities were to merge without Commission authorization, the Agency could not impose civil penalties, since section 203 falls outside the ambit of section 316A. Section 203 also requires prior authorization by the Commission before a public utility disposes of jurisdictional facilities.<sup>132</sup> Yet, the Commission could impose no

125. See U.S. GEN. ACCOUNTING OFFICE, ENERGY MARKETS: CONCERTED ACTIONS NEEDED BY FERC TO CONFRONT CHALLENGES THAT IMPEDE EFFECTIVE OVERSIGHT 48-49 (2002).

126. See Federal Power Act § 316A, 16 U.S.C. 825o-1 (2000) (providing for civil penalties for violations of sections 211, 212, 213, and 214 of the Federal Power Act, or any rule or order issued thereunder). Section 211 authorizes the Commission to issue wheeling orders. Federal Power Act § 211, 16 U.S.C. § 824j (2000). Section 212 governs issuance of wheeling orders under section 211. Federal Power Act § 212, 16 U.S.C. § 824k (2000). Section 213 provides for information requirements relating to wholesale transmission service. Federal Power Act § 213, 16 U.S.C. § 824l (2000). Section 214 governs sales by exempt wholesale generators under the Public Utility Holding Company Act of 1935. Federal Power Act § 214, 16 U.S.C. § 824m (2000).

127. See *Friends of the Earth, Inc. v. Laidlaw Env'tl. Servs. (TOC), Inc.*, 528 U.S. 167, 184 (2000) ("We have recognized on numerous occasions that 'all civil penalties have some deterrent effect.'") (quoting *Hudson v. United States*, 522 U.S. 93, 102 (1997)).

128. See Federal Power Act § 316A(b), 16 U.S.C. § 825o-1(b) (2000).

129. See Commodity Exchange Act § 6(c), 7 U.S.C. § 9c (2000).

130. See Securities Exchange Act of 1934 § 21(d)(3)(B)(iii), 15 U.S.C. § 78u(d)(3)(B)(iii) (2000). In the case of insider trading violations, the Act provides for up to the "greater of \$1,000,000, or three times the amount of the profit gained or loss avoided as a result of . . . [the] violation." Securities Exchange Act of 1934 § 21A(a)(3), 15 U.S.C. § 78u-1(a)(3) (2000).

131. See Federal Power Act § 203(a), 16 U.S.C. § 824b(a) (2000) ("No public utility shall . . . directly or indirectly, merge or consolidate [jurisdictional] facilities . . . without first having secured an order of the Commission authorizing it to do so.").

132. See Federal Power Act § 203(a), 16 U.S.C. § 824b(a) (2000) ("No public utility shall sell, lease, or



civil penalty if a public utility engaged in an unauthorized disposition. The same is true of section 204 (concerning issuance of securities), section 205 (imposing certain filing requirements), section 301 (providing for rules governing accounts and records), section 304 (directing public utilities to file reports), and section 305 (requiring prior authorization for interlocking directorate positions). For example, the Commission has no authority to impose a civil penalty on parties that make material false statements to the Agency. This stands in contrast with other regulatory statutes.<sup>133</sup>

The Commission's criminal penalty authority is also inadequate. Under the Federal Power Act, a knowing and willful violation is subject to a maximum penalty of \$5000, and imprisonment for up to two years, and an additional \$500 per day for a continuing violation.<sup>134</sup> This is the amount set by Congress in 1935. By contrast, the Commodity Exchange Act provides for criminal penalties of not more than \$1 million and imprisonment for up to five years,<sup>135</sup> and the Securities Exchange Act of 1934 provides for criminal penalties of not more than \$25 million and imprisonment for up to ten years.<sup>136</sup> The Commodity Exchange Act and the Securities Exchange Act of 1934 have been amended since their enactment to raise the level of criminal penalties.<sup>137</sup> The criminal penalties in the Federal Power Act have not changed since 1935.

The inadequacy of the Commission's authority to prevent market manipulation is made plain by a comparison on how various manipulative schemes would be redressed under the Market Behavior Rules Order, the Commodity Exchange Act, and the Securities Exchange Act of 1934. As discussed above, there are three possible outcomes from a manipulative scheme: it may fail to affect price, it may succeed; resulting in economic gain in the form of a foregone loss; or it may succeed, resulting in an economic gain in the form of a profit.

In the event of an unsuccessful attempt at market manipulation, the CFTC could impose a civil penalty of up to \$100,000,<sup>138</sup> the SEC could impose a civil penalty of up to \$500,000,<sup>139</sup> and the Commission could impose no penalty whatsoever. In the event of a successful attempt at market manipulation that results in an economic gain in the form of a foregone loss, the CFTC could

otherwise dispose of the whole of its facilities subject to the jurisdiction of the Commission . . . without first having secured an order of the Commission authorizing it to do so.”)

133. See, e.g., Atomic Energy Act of 1954 § 234(a), 42 U.S.C. § 2282(a) (Supp. 2004) (providing for civil penalties of up to \$100,000 per violation for “any violation for which a license may be revoked under section 2236,” which includes material false statements).

134. Federal Power Act § 316, 16 U.S.C. § 825o (2000).

135. See Commodity Exchange Act § 9, 7 U.S.C. § 13 (2000).

136. See Securities Exchange Act of 1934 § 32(a), 15 U.S.C. § 78ff (Supp. 2004).

137. The criminal penalties of the Commodity Exchange Act were raised in 1992 by enactment of Futures Trading Practices Act of 1992. Futures Trading Practices Act of 1992, Pub. L. No. 102-546, § 212(a)(1)(A), (C), 106 Stat. 3590, 3608 (1992). The criminal penalties in the Securities Exchange Act of 1934 were raised in 2002, through passage of the Corporate Fraud Accountability Act of 2002. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 1101, 116 Stat. 745 (2002).

138. See Commodity Exchange Act § 6(c), 7 U.S.C. § 9 (2000).

139. See Securities Exchange Act of 1934 § 21(d)(3)(B)(iii), 15 U.S.C. § 78u(d)(3)(B)(iii) (2000).

impose a civil penalty of up to \$100,000 or triple the monetary gain,<sup>140</sup> the SEC could impose a civil penalty of up to the greater of \$100,000 for an individual or \$500,000 for a company, or the “gross amount of pecuniary gain,”<sup>141</sup> and, again, the Commission could impose no penalty.

Only in the third instance, a successful attempt at market manipulation that results in an economic gain in the form of a profit, could the Commission impose a penalty, namely disgorgement of profits. It can only do so by virtue of having added the Market Behavior Rules to the tariffs of all jurisdictional power sellers. With the addition of those rules, the Commission can collect a penalty charge, even though it lacks statutory authority to impose civil penalties. By comparison, the CFTC could impose a civil penalty of up to triple the monetary gain,<sup>142</sup> and the SEC could impose a civil penalty equal to the gross amount of pecuniary gain.<sup>143</sup>

The Commission has recognized the need for strong penalties to encourage compliance with the Market Behavior Rules, stating “[w]here these rules are violated, it is appropriate that the Commission provide a remedy for such conduct. It is important that such conduct be deterred to the extent possible.”<sup>144</sup> Unfortunately, the penalties provided for in the Market Behavior Rules Order may prove insufficient to prevent market manipulation.

There is a need for legislation to strengthen the Commission’s civil penalty authority, both to expand the scope of section 316A to include all violations of Part II of the Federal Power Act, not merely the newer provisions added or amended by the Energy Policy Act of 1992, and to raise the level of civil penalties to levels comparable under other federal economic regulatory regimes. The Commission has acknowledged it would use this additional authority to enforce the prohibition against market manipulation.<sup>145</sup> The Commission needs certain tools to prevent market manipulation. There is no valid policy reason why the Commission should not have the same tools that other federal regulatory agencies possess to prevent market manipulation in other industries, no more, no less. If Congress does not grant the Commission strengthened civil penalty authority, it may be difficult to prevent market manipulation in the electricity industry.

#### *B. FERC Authority to Prevent Accumulation of Generation Market Power*

In addition to the Commission’s authority under sections 205 and 206, discussed above, the Commission has a legal duty under section 203 of the Federal Power Act to review dispositions of jurisdictional facilities. Review under section 203 is subject to two limitations. First, the Commission can

140. See Commodity Exchange Act § 6(c), 7 U.S.C. § 9 (2000).

141. See Securities Exchange Act of 1934 § 21(d)(3)(B)(iii), 15 U.S.C. § 78u(d)(3)(B)(iii) (2000).

142. See Commodity Exchange Act § 6(c), 7 U.S.C. § 9 (2000).

143. See Securities Exchange Act of 1934 § 21(d)(3)(B)(iii), 15 U.S.C. § 78u(d)(3)(B)(iii) (2000).

144. *Market Behavior Rules Order*, *supra* note 69, at 62,160.

145. *Market Behavior Rules Order*, *supra* note 69, at 62,162 (“Moreover, if Congress grants the Commission additional remedial power, including the authority to levy civil penalties, the Commission will, in addition to the remedies set forth herein, implement such authority and utilize it when appropriate for violations of these Market Behavior Rules.”).

review only dispositions by public utilities.<sup>146</sup> Second, the Commission can review only dispositions of “facilities subject to the jurisdiction of the Commission”<sup>147</sup> Facilities that either fall outside the Commission’s jurisdiction or dispositions that do not involve public utilities are exempt from this review.

Section 201(b)(1) of the Federal Power Act limits the scope of the Commission’s jurisdiction to review dispositions of facilities, providing that the Commission “shall not have jurisdiction, except as specifically provided in this subchapter and subchapter III of this chapter, over facilities used for the generation of electric energy . . . .”<sup>148</sup> Section 203 does not in turn “specifically provide” for Commission jurisdiction over generation facilities within the meaning of section 201(b)(1).<sup>149</sup> Guided by the plain meaning of section 203, the Commission has consistently disclaimed jurisdiction over generation-only dispositions,<sup>150</sup> and the courts have affirmed this limitation on the Commission’s authority to review dispositions.<sup>151</sup> In a recent case, the U.S. Court of Appeals for the District of Columbia Circuit affirmed a Commission order disclaiming jurisdiction over the potential disposition of generation-only facilities, citing “the Commission’s longstanding, reasonable interpretation” of section 203.<sup>152</sup>

Significantly, the acquisition of a generation-only facility that is not subject to review by the Commission escapes federal review altogether. The antitrust agencies do not review acquisitions of generation-only facilities, and would review such a transaction only if it constituted an “attempt to monopolize” under the Sherman Act.<sup>153</sup> By that time, antitrust review may be too late: the public utility would have already accumulated generation market power to the point where it dominated the generation market.

It is true that states would retain authority over these acquisitions, but state review is inadequate. Power markets in the United States are regional in nature and are no longer neatly defined by state boundaries. Review by an individual state of the acquisition of a generation facility by a regulated electric utility in that state could hardly suffice to consider the effects of the transaction on the

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146. See Federal Power Act § 203(a), 16 U.S.C. § 824b (2000) (“No public utility shall sell, lease, or otherwise dispose of the whole of its facilities subject to the jurisdiction of the Commission . . . without first having secured an order of the Commission authorizing it to do so.”). See *supra* note 9 (discussing definition of “public utility” in Federal Power Act and the exemptions from the definition). Public utilities own eighty percent of U.S. electric generation capacity and about two-thirds of the transmission system. See *supra* note 9.

147. Federal Power Act § 203(a), 16 U.S.C. § 824b (2000).

148. Federal Power Act § 201(b)(1), 16 U.S.C. § 824(b)(1) (2000).

149. Section 203 makes no reference to generation facilities. See generally Federal Power Act § 203, 16 U.S.C. § 824b (2000). See also *Duke Power Co. v. FPC*, 401 F.2d 930, 950 (D.C. Cir. 1968) (holding that Congress did not “specifically provide[]” in section 203 for Commission jurisdiction over the acquisition of otherwise nonjurisdictional facilities).

150. See *Perryville Energy Partners, LLC*, 109 F.E.R.C. ¶ 61,019, at 61,094 (2004) (disclaiming jurisdiction over disposition of generation-only facility); *Am. Pub. Power Ass’n*, 94 F.E.R.C. ¶ 61,104, at 61,423 (2001) (stating that “[f]or Section 203 purposes, the term, jurisdictional facilities, has never been read to include generation facilities.”), *aff’d*, *Citizen Power, Inc. v. FERC*, No. 01-1240, 2002 WL 1359619, at \*\*1 (D.C. Cir. Apr. 25, 2002) (per curiam), *cert. denied*, 537 U.S. 1046 (2002) (noting that “the Commission has for decades consistently disclaimed jurisdiction over dispositions of generating facilities under § 203.”).

151. See *Citizen Power*, 2002 WL 1359619, at \*\*1; *Duke Power Co.*, 401 F.2d at 942.

152. See *Citizen Power*, 2002 WL 1359619, at \*\*1.

153. See Sherman Act § 2, 15 U.S.C. § 2 (Supp. 2004).

region. Indeed, state law would likely bar consideration of regional impacts and instead require consideration only of the effect on the individual state. Moreover, state review may focus merely on whether the purchase price was prudent and would likely ignore the effects on competition in wholesale power markets, an area reserved to the exclusive jurisdiction of the Commission.

Section 203 reflects the time when it was written. In 1935, public utility regulation was characterized by cost-of-service rate regulation. That was the means by which the Commission, as well as other federal economic regulatory agencies, prevented unjust and unreasonable rates. As changes in the electricity industry have led the Commission to rely increasingly on competition to assure just and reasonable rates, it may fairly be asked whether there is a need to amend section 203. The limitation on the Commission's authority to review generation-only dispositions reflects an indifference towards the accumulation of generation market power. That indifference may have been appropriate in 1935, when generation market power was restrained by the setting of wholesale power rates for each seller. However, it is no longer sufficient in an era when the Commission relies on competition to assure just and reasonable rates.

In a cost-based regulatory regime, the accumulation of generation market power is arguably not particularly important. The exercise of generation market power can be controlled by setting cost-based rates for wholesale power sales, allowing recovery of costs plus a regulated profit margin. However, the accumulation of generation market power poses more of a threat in a regulatory regime where sellers can charge market-based rates. In that context, a seller may be able to exercise generation market power and charge rates that exceed market levels.

The Commission has taken steps consistent with its existing authority under section 203 to guard against that eventuality. As discussed earlier, the Commission has strengthened its reporting requirements.<sup>154</sup> In addition, it has issued a final rule to require jurisdictional public utilities authorized to charge market-based rates to report changes in status, including increases in ownership or control of generation capacity.<sup>155</sup> Under the final rule, the reporting requirement is not limited to jurisdictional dispositions, so a public utility would be required to report the purchase of a generation facility that was not reviewed by the Commission under section 203.<sup>156</sup> If a public utility were to acquire a generation facility in a transaction not subject to Commission review, the Commission would have authority to revoke that utility's market-based rate authorization if it determined the acquisition resulted in the accumulation of too much generation market power.

In the event a jurisdictional public utility were to accumulate generation market power through one or more generation-only acquisitions, the Commission may have no choice but to revoke its authorization to charge

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154. See *FERC Revised Public Utility Filing Requirements*, *supra* note 67.

155. See *Reporting Requirements for Changes in Status for Public Utilities with Market-Based Rate Authority*, *supra* note 73.

156. See *id.* at 32,079–80 (requiring public utilities to report any change of status with respect to ownership or control of generation facilities).

market-based rates. Otherwise, the public utility would be able to exercise unmitigated generation market power and charge above-market rates. The Commission's duty to prevent unjust and unreasonable rates requires that it not allow that.

There is a perception that the Commission is unalterably opposed to utility acquisitions of generation facilities. That perception is simply incorrect. The Commission recognizes that Congress, in enacting section 203, did not intend the Commission to be hostile to mergers and other dispositions.<sup>157</sup> In fact, the Commission has approved all recent utility proposals to acquire generation facilities reviewed under section 203.<sup>158</sup> If the Commission were unalterably opposed to these transactions it presumably would have uniformly rejected utility applications to acquire independent generation. It has not done so.

There is potential for accumulation of significant generation market power through transactions that are outside Commission review. Some dispositions have involved large amounts of generation.<sup>159</sup> For example, Duke Energy recently sold 5325 megawatts of generating capacity to a new entrant, a disposition that was reviewed and approved by the Commission, largely because the sale was to a new entrant and involved no accumulation of generation market power.<sup>160</sup> It is possible, however, the transaction could have been structured to avoid Commission review. If that amount of generation had been transferred to an incumbent public utility, it would have represented a significant accumulation of market power.

Ironically, the limitation on the Commission's authority to review generation-only dispositions may result in more severe restrictions on public utilities that acquire generation facilities through transactions that escape review under section 203. The Commission can condition approval of dispositions under section 203 and has broad discretion to fashion conditions to mitigate accumulation of generation market power resulting from dispositions of jurisdictional facilities.<sup>161</sup> In a recent case, the Commission approved the

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157. See *Merger Policy Statement*, *supra* note 16, at 30,114 ("Congress did not intend the Commission to be hostile to mergers.") (citing *Pac. Power & Light Co. v. FPC*, 111 F.2d 1014, 1016 (9th Cir. 1940); *Northeast Utils. Serv. Co. v. FERC*, 993 F.2d 937 (1st Cir. 1993)).

158. See *Ameren Corp.*, 108 F.E.R.C. ¶ 61,094 (2004); *Oklahoma Gas & Elec. Co.*, 108 F.E.R.C. ¶ 61,004 (2004); *Puget Sound Energy, Inc.*, 107 F.E.R.C. ¶ 61,082 (2004); *Cinergy Servs., Inc.*, 102 F.E.R.C. ¶ 61,128 (2003), *reh'g denied*, 108 F.E.R.C. ¶ 61,250 (2004).

159. See *Duke Energy N. Am., LLC*, 108 F.E.R.C. ¶ 62,112 (2004) (approving transfer of 5325 megawatts of electric generation); *Exelon New Eng. Holdings, LLC*, 107 F.E.R.C. ¶ 61,148 (2004) (authorizing sale of 3000 megawatts of generating capacity); *TPS GP, Inc.*, 103 F.E.R.C. ¶ 62,170 (2003) (allowing disposition of 4570 megawatts of electric generation); *Sithe Energies, Inc.*, 100 F.E.R.C. ¶ 62,197 (2002) (approving transfer of 3870 megawatts of generating capacity); *Potomac Elec. Power Co.*, 96 F.E.R.C. ¶ 61,323 (2001) (authorizing sale of 5889 megawatts of electric generating capacity); *NRG Energy, Inc.*, 94 F.E.R.C. ¶ 62,042 (2001) (allowing disposition of 4804 megawatts of generating capacity); *Sithe Md. Holdings LLC*, 91 F.E.R.C. ¶ 62,020 (2000) (approving transfer of 4117 megawatts of electric generation).

160. See *Duke Energy N. Am., LLC*, 108 F.E.R.C. ¶ 62,112, at 64,186 (2004) (finding the disposition of jurisdictional facilities is consistent with the public interest).

161. Federal Power Act § 203(b), 16 U.S.C. § 824b(b) (2000) (granting the Commission authority to condition an order issued under section 203 "upon such terms and conditions as it finds necessary or appropriate to secure the maintenance of adequate service and the coordination in the public interest of facilities subject to the jurisdiction of the Commission."). Section 203(b) explicitly gives Commission

acquisition of a generating facility by an incumbent public utility with relatively modest conditions providing for transmission capacity expansion.<sup>162</sup> However, the Commission cannot condition transactions that are not subject to its review. In the event an acquisition that is not subject to the Commission's review under section 203 results in the accumulation of significant generation market power, the Commission may be presented with two choices: allow the seller to exercise unmitigated generation market power or revoke or condition its market-based rate authorization. That is no choice at all. The Commission has a legal duty to prevent the exercise of market power, and does not have the discretion to allow a jurisdictional seller with unmitigated generation market power to charge monopoly rents.

#### V. NEED FOR LEGISLATIVE ACTION AND OUTLINES OF LEGISLATIVE PROPOSAL

The Federal Power Act is a well-crafted law that has withstood the passage of time. However, any law reflects the circumstances of the period in which it was enacted. Congress does not write a law on a mountaintop; it looks around at the world that surrounds it. In a perfect world, it considers that the world may change, and provides flexibility in that law. While electricity markets and the industry have changed, the Federal Power Act remains largely the same. In my view, the time has come to make fundamental reforms to the statute.

The Federal Power Act reflects certain unspoken assumptions by Congress. One of those assumptions was that there is a natural monopoly in electricity generation. Another was that electricity markets would remain neatly confined within state boundaries. We now know that these assumptions are no longer valid as the natural monopoly theory was disproved over twenty-five years ago and electricity markets in the United States are now regional in nature. In fact, much generation is located remotely from load centers, not even necessarily in the same state.

The Act reflects other assumptions, namely that the transmission grid would also remain largely confined within state lines. If Congress had not relied on this assumption in creating the Act, it might well have provided for federal siting of transmission facilities, in the same manner it provided for federal siting of interstate natural gas pipelines.<sup>163</sup>

The electricity market has also changed dramatically since 1935. Today,

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authority to condition grants "under this section," i.e., under Section 203(a). *Id. See Northeast Utils. Serv. Co.*, 56 F.E.R.C. ¶ 61,269, at 62,011-13 (1991) (defining the Commission's broad authority to condition mergers in the public interest under sections 203(a) and (b)), *reh'g granted*, 57 F.E.R.C. ¶ 61,340 (1991), *modified*, 58 F.E.R.C. ¶ 61,070, *reh'g dismissed as moot*, 59 F.E.R.C. ¶ 61,089 (1992); *Utah Power & Light Co.*, 45 F.E.R.C. ¶ 61,095, at 61,280 (1988) (stating that power to condition mergers is not impermissible extension of Commission's authority to deny merger requests), *clarified*, 45 F.E.R.C. ¶ 61,132 (1988), *reh'g granted*, 45 F.E.R.C. ¶ 61,500 (1988), *reh'g granted in part*, 47 F.E.R.C. ¶ 61,209 (1989), *enforced*, 51 F.E.R.C. ¶ 61,295 (1990), *remanded on other grounds sub nom. Envtl. Action, Inc. v. FERC*, 939 F.2d 1057 (D.C. Cir. 1991). Conditioning approval under section 203(a) achieves the same end as requiring the applicant to submit a new application that resolves the concerns that caused rejection of the initial application.

162. *See Okla. Gas & Elec. Co.*, 108 F.E.R.C. ¶ 61,004, at 61,036 (2004) (finding the proposed transmission upgrade will mitigate effect of disposition on competition).

163. *See Natural Gas Act* § 7, 15 U.S.C. § 717f (Supp. 2004).

interstate commerce in electricity has exploded; the transmission grid is not only interstate, but international. These dramatic changes that have swept across the industry further highlight the need for reform of federal electricity laws, in the same manner that changes in the telecommunications industry, financial services industry, and commodities industry led Congress to make reforms to the federal laws that govern those industries.<sup>164</sup>

In my view, the Commission lacks the necessary tools to address these dramatic industry changes, including the threat of market manipulation. A comparison of the Federal Power Act with other federal economic regulatory laws makes that plain. Securities and commodities laws include express prohibitions of market manipulation.<sup>165</sup> This is lacking in the Federal Power Act.<sup>166</sup> Securities and commodities laws also provide for tough and effective penalties for both attempts to manipulate markets and manipulation itself.<sup>167</sup> There is no valid public policy reason why the Commission should not have the same enforcement tools as other federal economic regulatory agencies. A comparison of the Federal Power Act with other federal economic regulatory laws also demonstrates that there is a need for tough civil and criminal penalties. If violations of market rules can go unpunished, they will become more frequent. Again, the Federal Power Act comes up short.

There is recognition in Congress of the need to increase the Commission's enforcement authority. The first step towards expanding the scope and raising the level of the Commission's civil penalty authority took place in 1999, when a Congressional panel approved electricity legislation that expanded the scope of section 316A to Part II of the Federal Power Act.<sup>168</sup> The Bush Administration later proposed expanding the scope of the Commission's civil penalty authority, raising the level of monetary penalties, and extending the term for criminal violations.<sup>169</sup> The electricity legislation Congress considered during the 107<sup>th</sup> and 108<sup>th</sup> Congresses adopted the Administration's proposal with respect to both civil and criminal penalties.<sup>170</sup> It should be enacted.

The energy legislation is also intended to strengthen the Commission's ability to prevent market manipulation. The bill specifically prohibits certain manipulative practices, such as transactions based on false information and

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164. See Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (codified as amended in scattered sections of 47 U.S.C. (2000)); Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (codified as amended in scattered sections of 12 and 15 U.S.C. (2000)); Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (codified as amended in scattered sections of 7 U.S.C. (2000)).

165. See *supra* note 75.

166. The Commission issued the Market Behavior Rule to prohibit market manipulation by rulemaking, but, as discussed above, the penalties for violations are not sufficient. See *supra* note 69.

167. See *supra* notes 75, 118, 129-30.

168. See H.R. 2944, 106th Cong. § 106(a) (1999).

169. See Letter from The Honorable Dan R. Brouillette, Assistant Secretary for Congressional and Intergovernmental Affairs, U.S. Department of Energy, to the Honorable Jeff Bingaman, Chairman, Committee on Energy and Natural Resources, U.S. Senate 3 (Oct. 9, 2001) (on file with author) [hereinafter Bush Administration electricity proposal] (proposing increased criminal penalties and expanding the scope of civil penalties to include any violation of the Federal Power Act).

170. See H.R. 6, 108th Cong. § 1283(d)-(e) (2003).

“round trip trading.”<sup>171</sup> However, it does not include an express prohibition of market manipulation. There are other legislative proposals to establish an express prohibition of market manipulation, and there is support for these proposals.<sup>172</sup>

It is unlikely that legislatively prohibiting specific manipulative practices will prove an effective way to prevent market manipulation. The legislative process can be slow and arduous. As a case in point, nearly five years after the electricity crisis in California and the West, not one of the manipulative practices Enron used has been prohibited by law. As Congress struggled to enact legislation, the Commission issued the Market Behavior Rules, establishing a general prohibition of market manipulation and banning a number of specific manipulative practices used by Enron.

Those who engage in market manipulation can have very creative minds. It is unlikely, given the speed of Congressional action, that an approach rooted in enactment of legislation to prohibit specific manipulative practices will be able to keep pace with the creativity of the rogues and scoundrels who stand to earn unjust profits from market manipulation. A better approach would be to establish a general prohibition of market manipulation and authorize the Commission to prohibit specific manipulative practices. As discussed above, that is the approach taken to prohibit market manipulation in securities and commodities laws.

Another necessary change to the Federal Power Act is to amend section 203 and grant the Commission jurisdiction over the disposition of generation facilities. That will enable the Commission to prevent the accumulation of unmitigated generation market power. The Commission could still approve the acquisition of generation facilities, even by jurisdictional public utilities with significant existing generation market power. However, it would have the ability to condition these dispositions to mitigate any market power impact. The Bush Administration proposed providing the Commission authority over generation acquisitions.<sup>173</sup>

There are other enforcement powers possessed by federal economic regulatory agencies that should be extended to the Commission. For example, the CFTC can issue cease and desist orders, preventing a person from manipulating or attempting to manipulate the market price of a commodity.<sup>174</sup> Failure to comply with a cease and desist order is a misdemeanor, subject to

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171. See *id.* § 1282.

172. See S. 2015, 108th Cong. § 2(a) (2004). An amendment identical to S. 2015 was approved by the Senate in H.R. 2673, the Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act, on November 5, 2003, by a vote of fifty-seven to forty (Amendment No. 2087). 149 CONG. REC. S13,998, S14,001 (daily ed. Nov. 5, 2003) (statement of Sen. Cantwell, recorded vote on Amendment No. 2087).

173. See Bush Administration electricity proposal, *supra* note 169, at 3.

174. If any person . . . is manipulating or attempting to manipulate or has manipulated or attempted to manipulate the market price of any commodity, in interstate commerce, . . . or otherwise is violating or has violated any of the provisions of this Chapter or of the rules, regulations, or orders of the Commission . . . thereunder, the Commission may . . . enter an order directing that such person shall cease and desist therefrom . . .

Commodity Exchange Act § 6(d), 7 U.S.C. § 13b (Supp. 2004).



monetary penalties and not less than six months nor more than one year in prison.<sup>175</sup> The SEC also can issue cease and desist orders not only in the event of past or ongoing violations of the Securities Exchange Act of 1934 or SEC rules or regulations, but also future violations.<sup>176</sup>

There is also a need to strengthen the Commission's ability to collect market information on a routine basis from all market participants, not just public utilities.<sup>177</sup> Without the ability to obtain information from all sellers or other entities that have market price information, it is difficult to adequately monitor and understand market developments. Under current law, the Commission can obtain information only from market participants other than public utilities in the course of a specific enforcement investigation,<sup>178</sup> or in the preparation of a report to Congress.<sup>179</sup> Market participants other than public utilities are also not subject to the Commission's quarterly filing requirements.

## VI. CONCLUSION

As stated earlier, the Commission has a legal duty to prevent unjust and unreasonable prices for wholesale power sales by jurisdictional public utilities. This duty is absolute, and not discretionary, although the Commission has discretion in how it discharges this responsibility. The Commission has chosen to rely increasingly on market forces to assure just and reasonable rates, largely in reaction to the dramatic changes that have taken place in the industry. The courts have upheld that approach.

The Agency has been careful not to rely solely on market forces, and has taken aggressive steps to strengthen its regulatory regime governing the market-based sales program. An important component of that regulatory regime is the rules the Commission issued to prevent market manipulation: the Market Behavior Rules. However, those rules may be as far as the Agency can go under its existing legal authority. They do not go far enough. The Market Behavior

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175. *See id.*

176. If the Commission finds, after notice and opportunity for hearing, that any person is violating, has violated, or is about to violate any provision of this chapter, or any rule or regulation thereunder, the Commission may publish its findings and enter an order requiring such person, and any other person that is, was, or would be a cause of the violation . . . to cease and desist from committing or causing such violation and any future violation of the same provision, rule, or regulation. Such order may, in addition to requiring a person to cease and desist from committing or causing a violation, require such person to comply, or to take steps to effect compliance, with such provision, rule, or regulation, upon such terms and conditions and within such time as the Commission may specify in such order.

*See* Securities Exchange Act of 1934 § 21C(a), 15 U.S.C. § 78u-3(a) (2000).

177. FERC needs to access market information on wholesale transactions; however, no federal agency, including FERC, has access to complete and timely information on [the operations of] electricity markets and market participants, exposing gaps in key information. Such information gaps exist primarily because FERC is limited in its authority to collect information for full and effective market oversight and it lacks specific authority to collect current information which may lead to market participants challenging these collection activities.

U.S. GEN. ACCOUNTING OFFICE, *ELECTRICITY RESTRUCTURING: ACTION NEEDED TO ADDRESS EMERGING GAPS IN FEDERAL INFORMATION COLLECTION* 3 (2003).

178. *See* Federal Power Act § 307, 16 U.S.C. § 825f (2000).

179. *See* Federal Power Act § 311, 16 U.S.C. § 825j (2000).

Rules have also been challenged in court.<sup>180</sup> If the Commission is reversed, and the behavioral rules are overturned, it may prove difficult for the Commission to prevent manipulation of wholesale power markets. The best way to secure the ability of the Commission to prevent market manipulation is to grant the Agency express statutory authority to do so.

If Congress shares the Commission's concern about preventing market manipulation and preventing the exercise of unmitigated market power, it should enact legislation to establish an express prohibition of market manipulation, authorize the Commission to proscribe specific manipulative practices by rule or order, strengthen the Commission's penalty and enforcement authority, and grant the Commission authority to review all dispositions of generation facilities by jurisdictional public utilities. If Congress does act, and grants the Commission the authority it needs to prevent market manipulation and prevent the exercise of unmitigated generation market power, the Commission will judiciously use this authority to discharge its legal duty to assure just and reasonable rates. If Congress fails to act, it may prove difficult for the Commission to prevent market manipulation and the accumulation of generation market power, a result that can only disserve the public interest.

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180. See *supra* note 69.