ORAL ARGUMENT IS SCHEDULED FOR MARCH 6, 2006

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 04-1168
(Consolidated with Nos. 04-1170, 04-1188, 04-1235, 04-1237, 04-1238)

CINERGY MARKETING & TRADING, LP, *et al.*,
PETITIONERS,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
RESPONDENT.

ON PETITIONS FOR REVIEW OF ORDERS OF THE
FEDERAL ENERGY REGULATORY COMMISSION

BRIEF FOR RESPONDENT FEDERAL ENERGY REGULATORY COMMISSION

JOHN S. MOOT
GENERAL COUNSEL

ROBERT H. SOLOMON
SOLICITOR

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, DC 20426

FINAL BRIEF: JANUARY 24, 2006

CIRCUIT RULE 28(a)(1) CERTIFICATE

A. Parties and Amici

All parties appearing before the Commission and this Court are identified in Petitioners' Rule 28(a)(1) certificates.

B. Rulings Under Review

The rulings under review appear in the following orders issued by the Federal Energy Regulatory Commission:

1. *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations,* "Order Amending Market-Based Rate Tariffs and Authorizations," 105 FERC ¶ 61,218 (2003), JA 91;

2. *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, "Order on Rehearing," 107 FERC ¶ 61,175 (2004), JA 244;

3. *Amendments to Blanket Sales Certificates, Final Rule,* "Order No. 644, 105 FERC ¶ 61,217 (2003), JA 65;

4. *In the Matter of Amendments to Blanket Sales Certificates,* "Order Denying Rehearing of Blanket Sales Certificates Order," 107 FERC ¶ 61,174 (2004), JA 229.

C. Related Cases

This case has not previously been before this Court or any other court. Counsel is not aware of any other related cases pending before this or any other court.

_____

Robert H. Solomon
Solicitor

January 24, 2006

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 04-1168
(Consolidated with Nos. 04-1170, 04-1188, 04-1235, 04-1237, 04-1238)

CINERGY MARKETING & TRADING, LP, *et al.*,
PETITIONERS,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
RESPONDENT.

ON PETITIONS FOR REVIEW OF ORDERS OF THE
FEDERAL ENERGY REGULATORY COMMISSION

BRIEF FOR RESPONDENT FEDERAL ENERGY REGULATORY COMMISSION

STATEMENT OF THE ISSUES

1. Whether the Federal Energy Regulatory Commission ("Commission" or "FERC") properly found that, to be just and reasonable, market-based rate tariffs of public utilities and natural gas companies subject to FERC jurisdiction under the Federal Power Act ("FPA"), 16 U.S.C. § 824 *et seq.*, and the Natural Gas Act ("NGA"), 15 U.S.C. § 717 *et seq*., respectively, must include, among other things, a provision that prohibits any type of market manipulation.

2. Whether the Commission properly determined that certain natural gas sales do not meet the definition of "first sales" within the meaning of the Natural Gas Policy Act of 1978 ("NGPA"), Pub. L. 95-621 (Nov. 8, 1978), 92 Stat. 3350, *codified at* 15 U.S.C. § 3301 *et seq.*, and thus fall within the scope of FERC's NGA jurisdiction.

3. Whether the Commission adopted appropriate remedies and procedures to resolve alleged violations of the market behavior rules.

4. Whether FERC's market-based rate regime satisfies the Commission's statutory consumer protection responsibilities.

PERTINENT STATUTORY AND REGULATORY PROVISIONS

Pertinent sections of the NGA, the NGPA, and the FPA, and the regulations thereunder, are set out in an addendum to this Brief. In addition, Appendix A includes the Market Behavior Rules and the Remedies and Complaint Procedures at issue.

STATEMENT OF THE CASE

I. Nature of the Case, Course of Proceedings, and Disposition Below

This case resulted from Commission concern that existing tariffs and blanket certificates allowing for market-based rates did not sufficiently assure the consumer protection that is at the heart of FERC's responsibilities under the FPA and the NGA. In response to that concern, the Commission in late 2001 "proposed to condition all new and existing market-based rate tariffs and authorizations to include a provision

prohibiting the seller from engaging in anticompetitive behavior or the exercise of market power." *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 103 FERC ¶ 61,349 at P 1 (2003)("Proposed Rules Order").

The instant proceeding, commenced under FPA § 206, *id*. at P 10, JA 40, proposed tariff provisions designed to protect against problems encountered as part of the implementation of organized energy markets around the country, particularly those encountered in the California energy markets during 2000-01. *Id*. at P 4, JA 39. Paper hearing procedures were established with comments and reply comments; in addition, FERC Staff held a technical conference in March 2001 to address the proposed tariff provisions that was followed by more comments. *Id*. at P 12, JA 40.

The Proposed Rules Order put forward a set of market behavior rules for inclusion with all market-based rate tariffs and authorizations, *see generally id*. at pp. 62,375-78 and 62,380-81, JA 42-45, 47-48, and invited comments and reply comments. *Id*. p. 62,380 at P (D). On November 17, 2003, the Commission established market behavior rules: on the electric side, the rules were set out in *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 105 FERC ¶ 61,218 (2003)("Electric Rules Order"), JA 91; and, on the natural gas side, comparable regulations were set in *Amendments to Blanket Sales Certificates*, FERC Stats. & Regs. ¶ 31,153 (2003)("Order No. 644"), JA 65. Both

orders set out, *inter alia*, a general prohibition against market manipulation. *See* Order No. 644 at P 27, JA 71 (setting out proposed 18 C.F.R. §284.288(a)) *and* Electric Rules Order at P 35, JA 97 (setting out Rule 2).

Parties sought rehearing of both orders, which were generally denied, albeit with modifications to Rule 2's language. *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 107 FERC ¶ 61,175 (2004) ("Electric Rehearing Order"), JA 244, and *In the Matter of Amendments to Blanket Sales Certificates*, 107 FERC ¶ 61,174 (2004)("Gas Rehearing Order"), JA 229.

The petitions for review followed.

II. STATEMENT OF FACTS

A. Statutory and Regulatory Background

FERC has been delegated authority to set just and reasonable rates for the wholesale sale of: (1) electric energy by FPA §§ 205 and 206, 16 U.S.C. §§ 824d and 824e, and (2) natural gas by NGA §§ 4, 5, and 7, 15 U.S.C. §§ 717c, 717d, and 717f. The underlying proceeding arose from FERC's concern that the then-existing language of the tariffs and blanket certificates authorizing sellers to employ market-based rate pricing was inadequate to assure the level of customer protection required by the FPA and the NGA. Proposed Rules Order at P 1, JA 39. To remedy those concerns, the Commission instituted proceedings under FPA § 206 and NGA § 5 to

promulgate market behavior rules applicable to all sellers with market-based rate authority.

The primary goal of customer protection had to be balanced against the need for notice and a fact-specific resolution process in the promulgation of the rules:

> first, the need to provide for effective remedies on behalf of customers in the event anticompetitive behavior or other market abuses occur; second, the need to provide clearly-delineated 'rules of the road' to market-based rate sellers while, at the same time, not impairing the Commission's ability to provide remedies for market abuses whose precise form and nature cannot be envisioned today; and third, the need to provide reasonable bounds within which conditions on market conduct will be implemented so as not to create unlimited regulatory uncertainty for individual market participants or harm to the marketplace in general.

Electric Rules Order at P 4, JA 92.

B. Events Leading To And the Orders On Review

A paper hearing was conducted as part of the rules' promulgation, with parties having an opportunity to file comments, reply comments, and to participate in a technical conference that led to another round of comments. *See* Electric Rules Order, Appendix C, JA 121, and Order No. 644, Appendix, JA 88 (both listing parties that filed comments). The comments "generally concurred that establishing a clear set of market behavior standards governing sellers' conduct in the wholesale markets is necessary." Electric Rules Order at P 8, JA 93. Nonetheless, parties took issue with different aspects of the proposed rules.

1. Market Behavior Rule 2

Rule 2 prohibits manipulative conduct, and was envisioned "to capture manipulative conduct in all its forms . . . [and] to prohibit market-based rate sellers from taking actions which interfere with the prices that would otherwise be set by competitive forces, or from manipulating market conditions or market rules." *Id*. at P 36, JA 97 (footnote omitted). Comments questioned inclusion of "legitimate business purpose" as a part of Rule 2, but its inclusion would allow "sellers acting in a pro-competitive manner [to] have the opportunity to show that their actions were not designed to distort prices or otherwise manipulate the market." *Id*. at P 37, JA 97; *see id.* at P 44, JA 98 (same); *see also* Order No. 644 at P 35, JA 73 (stating term is "intended to give sellers some latitude in determining their business actions, while safeguarding market participants against market manipulation for which there can be no legitimate business purpose").

Responding to comments questioning the need for Rule 2 given other tools available to protect energy markets, the Commission found it "reflects the reality that [FERC] oversee[s:] a dynamic and evolving market where addressing yesterday's concerns may not address tomorrow's." *Id.* at P 39, JA 98. Rule 2 along with the other Rules[1] serve a dual purpose: a step "to assure just and reasonable rates for a

---

1 Notwithstanding that, as presented (*see* Appendix A hereto), Rule 2 encompasses

specific transaction" as well as a means of "providing guidance to sellers in general." *Id*. Reconciling those purposes for violations would occur during the remedy analysis where FERC "will take into account factors such as how self evident the violation is and whether such violation is part of a pattern of manipulative conduct." *Id.*

When a violation of Rule 2 is alleged, the threshold question would be whether "the facts presented appear to warrant further inquiry into whether the transaction appears to be of a questionable purpose," such as "whether the action was designed to lead to (or could foreseeably lead to) a distorted price not reflective of a competitive market." *Id.* at P 42, JA 98. Such "case-by-case" analysis would seek to determine "when, and if, a strategy employed by a seller lacks a legitimate business purpose." *Id.* at P 44, JA 99. When a Rules violation is alleged as grounds to abrogate a contract, another element of the required showing is "to demonstrate that such a violation had a direct nexus to contract formation and tainted contract formation itself." *Id*. at P 45, JA 99.

Petitioners and others sought rehearing on grounds that Rule 2 was vague and overbroad, was too narrow, and should not require a direct nexus showing for contract abrogation. Electric Rehearing Order at P 30-36, JA 249-50. The Commission denied the rehearing requests.

---

several subsections, each subsection is treated as a separate Rule. *See, e.g.*, Electric

Inclusion of "legitimate business purpose" answered criticism that Rule 2 was vague and overbroad by placing sellers on notice that their "actions and transactions" must have "intended or desired result that is consistent with the seller's authorized business activities." *Id*. at P 37, JA 250. Because, in the "vast majority of cases," a seller's conduct "will track or be related to established industry practices, as previously authorized or permitted by the Commission," a seller will know, prior to taking action, whether the action or transaction will be for a legitimate business purpose. *Id*. at P 38, JA 250. The Rule is "further narrowed in its reach to exclude acts explicitly contemplated by Commission-approved rules and regulations in the applicable power market or acts taken at the direction of an ISO or RTO." *Id*. at P 39, JA 250. Finally, the provision offers sellers a mean "to defend its conduct" in any such hearing. *Id*. at P 38, JA 250; *see id*. at P 43, JA 251 (indicating "careful consideration of the facts and circumstances").

2. Remedy and Complaint Procedures

On the other side, the Commission declined to provide "greater specificity" to the meaning of legitimate business purpose because responding to "various hypothetical applications" of the standard could "invite the creation of loopholes which could be used by sellers for the purpose of avoiding [Rule 2]." *Id*. at P 40-41,

---

Rules Order at PP 46-58, JA 99-100 (discussing Market Rule 2(a) – wash trades).

JA 250. The Commission also declined to eliminate a showing that the "intended or foreseeable result is manipulation of market prices, market conditions or market rules" as a necessary element to prove a Rules violation. *Id.* at P 42, JA 250. "[R]ecognizing that intent must often be inferred," a seller's conduct would be closely examined in the specific circumstances. *Id.* at P 43, JA 251.

Rehearing was also directed against the complaint procedures. *See* Electric Rehearing Order at PP 136-45, JA 263-64 (summarizing rehearing requests). Questions were raised about the 90-day limitations period for filing a complaint, Electric Rules Order, Appendix B, JA 121, both as to its length and to its exceptions procedures. The Commission found that the limitations period balanced the "need for rate certainty" with "the fact that many market abuses are not immediately apparent." *Id*. at 147, JA 264. While, in general, a 90-day period applies, an action may be brought after the period expires upon "an adequate showing to convince the Commission that [the complainant] could not know of the alleged violation" during the limitations period. Electric Rehearing Order at P 148, JA 264. That allows a "reasonable person exercising due diligence . . . sufficient time to discover wrongful conduct and submit a claim." *Id.*

The limitations period for the Commission itself is "within 90 days from the date it knew of an alleged violation . . . or knew of the potentially manipulative

character of an action or transaction." *Id*. at P 149. To make it easier to report violations, no "specific procedural forum [was] established for enforcement of these rules." *Id*. at P 150. Complaints received via FERC's enforcement Hotline could initiate an investigation. *Id.* The complainant will bear the burden of proof "regarding the facts and law asserted," *id*., but would not face any special summary judgment or burden of proof determinations when filing a complaint. *Id.* at P 152, JA 264-65. Rather, FERC's "existing rules of practice and procedure" will apply. *Id*.

The proposed disgorgement remedy, Electric Rules Order, Appendix B at P (4), JA 121, was also challenged on rehearing as exceeding FERC's statutory authority "by setting forth overly-broad and unduly vague tariff conditions that, when and if applied in a future case, against a particular seller, will impose on that seller the functional equivalent of a retroactive refund liability." Electric Rehearing Order at P 154, JA 265. The Commission disagreed, finding that the Rules "will operate as a set of conditions, on a going-forward basis, to sellers' grant of market-based rate authority." *Id*. at P 158, JA 265. Inclusion of the Rules as part of market-based rate tariffs was justified by the FPA § 206 finding that "sellers' currently effective tariffs are unjust and unreasonable, or may lead to unjust and unreasonable rates without the inclusion of [the] proposed Market Behavior Rules." *Id*. at P 159, JA 266; *see id.* at P

161, JA 266 (when Rules violation alleged, "the issue would be whether the seller at issue has violated its tariff").

Other parties argued that the orders "failed to adequately explain the basis for [the] determination that a disgorgement remedy in lieu of any other monetary remedies should be regarded as appropriate," and that a disgorgement remedy "unlawfully conflicts with the FPA . . . [and] the Commission's general policy of providing refunds." *Id*. at P 126, JA 261. But disgorgement is not the sole remedy; its use does "not foreclose [FERC's] reliance on existing procedures or other remedial tools, as may be necessary, including generic rule changes or the approval of new market rules applicable to specific markets." *Id.* at P 129, JA 262; *see id*. at P 131 (noting another remedy is "possible revocation of Sellers' market-based rate authority"); *see also* P 129 n. 46 (noting FERC's strong endorsement of legislation "that would provide the Commission with additional civil penalty authority").

Parties requested rehearing of the due diligence defense applied to Market Rule 2(b), *see* Electric Rules Order, Appendix A, JA 120 (setting out rule), on grounds that it should not override a seller's liability for its employees' conduct. Electric Rehearing Order at P 57, JA 253. Due diligence evidence "may be directly relevant to the issue of intent;" specifically, where procedures are in place to assure "the sufficiency and accuracy of the information submitted by the seller," as required by Rule 2(b), such

evidence may show "in a given case that the false submission at issue was in the nature of an inadvertent or honest error." *Id*. at P 68, JA 254. Nonetheless, "the state of mind of the seller's employees may be permitted to be considered in adjudicating the seller's liability." *Id*. at P 69, JA 254.

3. Market Behavior Rules 1 and 2(c)

Rehearing of Market Rule 1, related to generating unit operation, was sought on the basis that the absence of "an affirmative real-time must-offer obligation," Electric Rehearing Order at P 18, JA 247, could allow "physical withholding and other market power abuses [to] go unchecked." *Id.* at P 19. The Commission declined to use Market Rule 1 to "impose a new stand-alone requirement" in the form of "a substantive must-offer requirement," *id*. at P 27, JA 248, because that would "conflict with or defeat the objectives of existing Commission-approved rules or regulations in a specific market," where "standardized rules and procedures" have been adjusted to "recognize[] the validity of regional variations with respect to certain rules and procedures." *Id.* at P 24, JA 248. Market Rule 1 was designed to enhance, not to replace, those rules. *Id*. Thus, while Market Rule 1 does not create a stand-alone must-offer obligation, a seller in a region with a must-offer obligation must satisfy that obligation. *Id*. at P 27, JA 248.

Rehearing requests regarding Market Rule 2(c), which prohibits the introduction of artificial congestion, Electric Rules Order, Appendix A, JA 120, sought to expand the Rule's scope to include any type of congestion. The Commission stated, however, that the rule "is designed to prohibit a specific form of market manipulation" based on Enron trading strategies that had a "significant and harmful" effect on the Western markets. Electric Rehearing Order at P 78, JA 255. The Rule's "relatively limited" scope adequately supplements in-place market structures designed to reduce congestion and its possible adverse effects by "serv[ing] as an important illustrative example of the type of market abuse" that is prohibited. *Id*. at P 79, JA 255.

Rule 2(c)'s limited scope was clarified to encompass "any form of congestion that may result from scheduling power flows in an uneconomic manner for the purpose of creating real or perceived congestion," as scheduling in an uneconomic manner could not have a legitimate business purpose *Id*. at P 81, JA 255. But the Commission declined to expand the rule to cover any and all congestion on the basis that other market rules were better situated to deal with congestion tactics that lack a legitimate business purpose. *Id*. at P 80, JA 255.

The petitions for review followed.

SUMMARY OF ARGUMENT

FERC orders are reviewed under the arbitrary and capricious standard that looks to whether the Commission's decision was based on the relevant facts and represents reasoned decisionmaking.

Here, FERC promulgated a series of market behavior rules for inclusion in market-based rate tariffs and authorizations to protect customers against behavior that could or does prevent or impede markets from working in a competitive manner. MP Parties argue Rule 2, which generally proscribes manipulative conduct, is impermissibly vague because it does not identify specific prohibited conduct. A valid proscription is marked, however, by flexibility and reasonable scope, not by rigid specificity. Here, the definition given to "legitimate business purpose," as any intended result consistent with a seller's authorized business activities, meets that standard, particularly given that sellers' business activities are largely subject to FERC-approved tariffs. Sellers thus have sufficient notice of what activities are authorized. Legitimate business purpose may also serve as a potential defense based on the particular factual circumstances and the evidence proffered. Petitioners' assertion that Rule 2 does not fully account for regional tariff differences can be evaluated on a case-by-case basis.

MP Parties similarly challenge the inclusion of manipulation in Rule 2 as vague and uninformative absent current identification of specific prohibited conduct. But the Supreme Court has not found such specificity necessary to decide whether conduct is manipulative, relying, instead, on the dictionary definition of "manipulation" as a guide, which provides sufficient notice of proscribed conduct.

MP Parties' contention that Rule 2 circumvents the statutory structure by allowing remedies for acts not previously identified as proscribed assumes that until specifically identified, a manipulation or act lacking a legitimate business purpose is legally authorized. That assumption is invalid. Market-based rate authority is founded on markets working competitively. As (1) manipulation is designed to control or artificially affect price, and (2) acts without a legitimate business purpose unnecessarily restrict competition, they are impediments to markets working competitively that may be remedied by disgorgement, consistent with Congress' intent that FERC step in to protect customers where energy markets are operating in an anti-competitive manner.

Rule 2 does not violate the filed rate doctrine. By requiring sellers to act consistently with authorized business activities in a highly regulated industry, the Rule places sellers on notice that their rates might change if they are based on actions that circumvent, or are intended to circumvent, authorized activities.

MP Parties are wrong that the procedures for bringing a Rules violation complaint improperly shifts the statutory burden. A complainant has the burden of going forward to demonstrate that the facts alleged support all elements of a *prima facie* case. If a complainant meets that burden, then the burden properly shifts to the seller to demonstrate a legitimate business purpose for its action.

MP Parties' reliance on an FTC policy statement as support for limiting disgorgement to prospective application for clear violations based on existing precedent is overstated. The FTC policy statement uses a sliding scale approach to judge whether disgorgement of past profits is appropriate. The factors cited by the FTC as favoring disgorgement of past profits supports FERC's proposed remedy.

FERC's interpretation of the "first sale" under NGPA § 2(21) was challenged as exceeding the Commission's statutory authority. This Court lacks jurisdiction to consider much of the argument under NGA § 19(b). In any event, Petitioners fail to show that FERC's interpretation is irrational.

Turning to the CA Petitioners' claims, the disgorgement remedy does not violate the statutory plan because it fully protects customers. Refunds under the FPA will not necessarily yield greater amounts to customers than would disgorgement. Refunds allow a seller to retain normal return on investment (profit), but disgorgement

requires a seller to return all its profits. FPA § 206 offers only prospective relief from the refund effective date, but disgorgement allows recovery of past profits.

CA Petitioners assert the 90-day limitations period for filing a complaint does not comply with the FPA. The cases on which they rely address, however, attempts to limit the extent of refunds. Policy considerations support the limitations period here. In addition, exceptions may be allowed where a complainant can show that it did not and reasonably could not know of the complaint within the limitations period. Such matters can and should be addressed in a specific factual context, not here.

CA Petitioners decry what they see as unnecessary roadblocks – seller intent, motive, due diligence, and direct nexus – to showing a Rules violation. They state those factors are not required to show rates are unjust and unreasonable under the FPA or NGA. Accepting that as true does not invalidate the use of those factors in evaluating whether a Rules violation occurred. The Commission did not limit what remedies could be employed to resolve a Rules violation; thus it may, in appropriate circumstances, require other remedies besides disgorgement. The direct nexus requirement applies only to FERC's threshold evaluation in contract abrogation, and does not preclude other avenues for seeking to abrogate a contract.

Rule 1 need not contain a universal must offer obligation to override RTO/ISO tariffs that do not include such an obligation. The Rule is intended to supplement, not

to replace, the rules and regulations of the markets in which a seller does business. Rule 2(c) proscribes artificially-created congestion; it need not be expanded to prohibit the exercise of market power any time congestion occurs, as any exercise of market power is prohibited. Rule 2(c) is designed to go a step further by preventing sellers from seeking to create congestion artificially, as a means to exercise market power.

Some of the CA Petitioners challenge FERC's authority to adopt a market-based rate (MBR) regime. That issue has been addressed previously, and FERC's authority was upheld in *Lockyer*. Indeed, much of the argument seems to challenge the Ninth Circuit's, not FERC's, reasoning. Here, the Commission was attempting to assure that all market-based rates remain just and reasonable by proscribing anticompetitive behavior. It was not reexamining its long-standing, court approved MBR regime.

Petitioners assert FERC cannot rely on indirect regulation for its MBR regime, but nothing in the NGA or FPA prevents reliance on indirect regulation to set just and reasonable rates. The instant orders are just one of many means implemented to assure that markets are competitive by proscribing conduct that could lead to anticompetitive conditions. Petitioners claim that the MBR regime has no theory by which FERC can prevent unduly discriminatory rates. The MBR regime protects against such

discrimination in many ways, primarily through the use of industry-wide, *pro forma* (open access) transmission tariffs, and FERC-established real-time energy markets operated by RTOs/ISOs.

The MBR regime is not the equivalent of the detariffing present in *Maislin* and *MCI*, both of which involved a complete lack of any filing requirement. FERC's MBR regime includes pre- and post-authorization filing requirements that help assure markets are competitive, and thus the resulting rates are just and reasonable.

ARGUMENT

I. STANDARD OF REVIEW

The Court reviews FERC orders under the arbitrary and capricious standard set out in 5 U.S.C. § 706(2)(A). *Public Utils. Comm. v. FERC*, 254 F.3d 250, 253-54 (D.C. Cir. 2001). Under this standard, a "court must consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment. . . . The court is not empowered to substitute its judgment for that of the agency." *ExxonMobil Gas Marketing Co. v. FERC*, 297 F.3d 1071, 1083 (D.C. Cir. 2002), *cert. denied* 124 S. Ct. 48 (2003)(citations and internal quotation marks omitted). The Commission considered and reasonably responded to all concerns and objections raised by diverging parties in promulgating the Rules at issue.

RESPONSE TO MARKET PARTICIPANT PETITONERS' AND SUPPORTING INTERVENORS' BRIEFS

II. RULE 2 DOES NOT EXCEED FERC'S STATUTORY AUTHORITY

The Market Participant Petitioners and intervenors supporting Cinergy (jointly, "MP Parties") challenge Market Behavior Rule 2 ("Rule 2"), *see*, *e.g.*, Electric Rules Order at P 35, JA 97 (text of Rule), but do not seek review of any other Rule. *See* MPP Br. 15 and CI Br. at 1 (noting narrow issues raised for review). The MP Parties claim that Rule 2 is unlawfully vague, does not give adequate notice of what is proscribed, and cannot provide the basis for a disgorgement remedy related to future violations. *See generally* MPP Br. 18-29. Those claims are all invalid.

A. Rule 2 Is Not Impermissibly Vague

Rule 2 proscribes any actions or transactions that "are without a legitimate business purpose and that are intended to or foreseeably could manipulate market prices, market conditions, or market rules for electric energy or electricity products." Electric Rules Order, Appendix A, JA 120.[2] The MP Parties contend such a "catch-all provision," CI Br. 1, does not give "regulated entities fair notice, 'with ascertainable certainty, [of] the standards with which the agency expects parties to conform.'" MPP Br. 19 (citation omitted). That contention looks to FERC's statement that Rule 2

---

2 The comparable prohibition for jurisdictional natural gas sales is found at 18 C.F.R. § 284.288(a)(2005). *See* Order No. 644 at 30,795, JA 71. As Petitioners focus attention on Rule 2, the Commission's brief likewise focuses on it.

"provide[s] remedies for market abuses *whose precise form and nature cannot be envisioned today*," MPP Br. 20, citing Electric Rehearing Order at P 8, JA 245 (emphasis added by Petitioners), as highlighting the lack of requisite specificity. *See also* CI Br. 2 (same). In the MP Parties' view, only those abuses whose precise form and nature can be identified today could be the subject of future FERC remedial action. *See* MPP Br. 20 ("required or proscribed action must be stated with particularity").

Prescience is not required to set the scope of proscribed conduct. A valid proscription is "marked by 'flexibility and reasonable breadth, rather than meticulous specificity.'" *Grayned v. City of Rockford*, 408 U.S. 104, 110 (1972)(citation omitted); *see* Electric Rehearing Order at P 14 & n. 16, JA 246 (citing *Grayned*). In examining for vagueness, courts must "extrapolate the allowable meaning" from the words of the proscription itself, interpretations given to analogous proscriptions, and interpretations given by those enforcing the proscription, all with an ultimate goal of determining whether "it is clear what the [provision] as a whole prohibits." 408 U.S. at 110. Using those criteria, what Rule 2 as a whole prohibits can be readily determined.

The proscriptive language of Rule 2 states: "Actions or transactions that are without a legitimate business purpose and that are intended to or foreseeably could manipulate market prices, market conditions, or market rules for electric energy or

electricity products are prohibited." Electric Rules Order at P 35, JA 97. The MP Parties charge that the use of "overly general verbiage in the generic rule, such as 'legitimate business purpose,' 'manipulation,' and 'market conditions' are given no meaningful definition by the Commission as they may apply to unique, complex and still-evolving wholesale electric and gas markets." MPP Br. 26; CI Br. 3. But the meaning given those terms as applied to other unique, complex, and evolving markets can be also applied to electric and gas markets.

B. Legitimate Business Purpose Separates Valid from Invalid Conduct

The Commission defines "legitimate business purpose" as having "an intended or desired result that is consistent with the seller's authorized business activities," Electric Rehearing Order at P 37, JA 250. That signals an intent to use the term, as courts have, as a dividing line between allowed and disallowed conduct. As such, and contrary to MP Parties' views, the term is meant to be applied flexibly in varying contexts, not rigidly restricted to pre-selected acts. Flexible application of legitimate business purpose was employed in *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585 (1985), where the Court addressed the validity of jury instructions that stated in part: "'if there were legitimate business reasons for the refusal, then the defendant, even if he is found to possess monopoly power in a relevant market, has not violated the law.'" *Id*. at 597.

The Court "assume[d] that the jury concluded that there were no valid business reasons for the refusal. The question then is whether that conclusion finds support in the record." 472 U.S. at 605. To answer that question, the Court examined, *id*. at 605-08, the particular aspects of the ski industry at Aspen. In addition, the evidence (or lack thereof) addressing possible justifications for the defendant's conduct was considered. *See id*. at 608-09 (finding "failure to offer any efficiency justification whatever for its pattern of conduct" as strong support for jury conclusion that conduct was not "justified by any normal business practice"); *see id*. at 609-10 (rejecting other claims as inconsistent with normal business purpose).

FERC will follow the same approach: it will examine the challenged conduct for consistency "with the seller's authorized business activities" in the context of the particular circumstances. Electric Rehearing Order at P 37, JA 250. Further, just as was done in *Aspen*, FERC allows a seller to present a legitimate business purpose defense. *Id*. at P 38, JA 250. Such ad hoc evidentiary determinations are an appropriate means to identify whether particular conduct lacks a legitimate business purpose, contrary to MP Parties' claim (Br. 26) that only pre-identified practices can violate the Rule. Further, because "the seller's conduct, in most cases, will track or be related to established industry practices, as previously authorized or permitted by the Commission, sellers know in advance what type of conduct (outside established or

approved practices) will likely result in a violation." Electric Rehearing Order at P 38, JA 250. Thus, using ad hoc evidentiary hearings to decide whether future conduct lacks a legitimate business purpose is an appropriate means to enforce the Rule, and provides sufficient notice.

C. FERC Properly Applied The Normal Meaning of "Manipulation"

Similarly, the Rule's inclusion of "manipulation" as the proscribed conduct without specifying individual acts that are proscribed adequately informs sellers of what conduct to avoid. Manipulation "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976). While that definition was given in the context of securities markets, it could easily be applied to the electric and gas markets by substituting "buyers" for "investors" and "natural gas or electricity" for "securities." Applying the Court's definition from a securities case to energy markets is supported by the Court's reliance on *Webster's International Dictionary* (2d ed. 1934), as explaining the meaning of manipulation. 425 U.S. at 199 n. 21("'to manage or treat artfully or fraudulently . . . to force (prices) up or down . . . to rig"); *accord Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 7 (1985)("the meaning the Court has given the term 'manipulative' is consistent with the use of the term at common law, and with its traditional dictionary definition," citing *Webster*

Third New International Dictionary 1378 (1971)). Contrary to MP Parties' assertion (MPP Br. 26) manipulation need not be given a special energy definition for it to have force in energy markets. The Court applied "the normal meaning of the term" *Schreiber*, 472 U.S. at 6, to decide whether specific conduct was proscribed.

MP Parties' preferred approach of limiting manipulation to acts that can now be specified runs the risk "of excluding from [the Rule's] prohibition conduct which should be prohibited." Electric Rehearing Order at P 41, JA 250. Nothing requires that "manipulation" be confined to previously- and specifically-identified acts to avoid vagueness. Rather, "cases interpreting the term [manipulative] reflect its use as a general term comprising a range of misleading practices." *Schreiber*, 472 U.S. at 6.

Lastly, the MP Parties claim that the use of "market conditions" in Rule 2 is vague. MPP Br. 26.[3] The Commission provided "an example of sellers' ability to manipulate market conditions" in the section related to wash trades (Rule 2(a)). Electric Rules Order at P36 n. 23, JA 97. Market conditions identified there include "market liquidity as well as other indicators of market performance," *Id*. at P 53, JA 100. Wash trades, by distorting market liquidity and other performance indicators, lead to distorted market prices. *See* Electric Rehearing Order at P 49, JA 251-52 ("a

3 Interestingly, the MP Parties do not challenge inclusion of "market conditions" (or, for that matter, "manipulation") as making Rule 2(d) vague, and offer no explanation for this apparent inconsistency.

seller engaging in a wash trade may have the ability to manipulate market prices by creating the illusion of trading activity . . . and/or the illusion of price movement. The seller may then attempt to 'cash in' in the form of a third party transaction when the price is right."). From this, it can be reasonably inferred that market conditions encompass any aspect of a market whose distortion can result in distorted market prices. *See* Electric Rules Order at P 42 n. 28, JA 98 (indicating that in "deciding how best to allocate our enforcement resources," the Commission will focus on "actions or transactions that have, in fact, caused distorted market prices").

D. The Rules Give Adequate Notice of Proscribed Conduct

The MP Parties argue market participants cannot know what is prohibited because electric markets are developing "on a region-specific basis, with varying market designs, so that what may be 'manipulative' and 'without a legitimate business purpose' in one market may not be in another." MPP Br. 24. But alleged violations of Rule 2 will be judged on a case-by–case basis where regional differences may properly be raised. *See* Electric Rules Order at P 37, JA 97 ("sellers acting in a pro-competitive manner will have the opportunity to show that their actions were not designed to distort price or otherwise manipulate the market"); *see also* Electric Rehearing Order at P 38, JA 250 (a seller is "free to defend its conduct before the Commission in any proceeding in which this conduct may be in issue").

Further, regional differences in tariffs will require FERC approval prior to implementation, as the MP Parties recognize. MPP Br. at 24 n. 50. Sellers would thus know, or should know, what FERC has approved in each region, and can tailor their conduct accordingly. Such compliance could operate as a defense to claimed violations. *See* Electric Rehearing Order at P 38, JA 250 ("the seller's conduct, in most cases, will track or be related to established industry practices, as previously authorized or permitted by the Commission").

The MP Parties express concern that the meanings of manipulative or without a legitimate business purpose "will depend on the subjective content that the Commission gives" those terms. MPP Br. 26; *see id*. at 28 (claiming that "fact-specific determination" of the term cannot provide sufficient notice). But deciding whether specific facts satisfy an established standard falls within FERC's discretion, and is not, as the MP Parties contend, an impermissible "we-know-it-when-we-see-it" approach. MPP Br. 29 & n. 64, citing *City of Vernon v. FERC,* 845 F.2d 1042, 1048 (D.C. Cir. 1988). *Vernon* did not address the exercise of FERC's discretion in deciding whether a party had satisfied an established standard, but whether the Commission had shuffled the elements of a *prima facie* case. *See id*. ("FERC has ample latitude, within the constraints of due process to establish 'procedures for presenting and rebutting a

prima facie case,' but if it requires the establishment of a *prima facie* case, it must explain the threshold it has set.")(citation and footnote omitted).

Here, the terms of Rule 2 set out the elements of a *prima facie* case: "our rule addresses only [1] actions or transactions that can have [2] no legitimate business purpose and which are [3] intended to or foreseeably could [4] manipulate market prices, market conditions, or market rules." Electric Rehearing Order at P 39, JA 250; *see id*. at P 44, JA 251; *see also* Electric Rules Order at P 40, JA 98 (same). Thus, the Commission has specified the *prima facie* elements, and will not, as the Court found happened in *Vernon*, shift those elements from case to case. *See* 845 F.2d at 1048 ("But FERC did not indicate that evidence on load flows and capacity charges is a necessary component of a *prima facie* case, much less explain the relevance of those things"). Hearings will then address the sufficiency of the evidence supporting those elements.

The MP Parties contend that far from giving meaning to Rule 2, "the Commission's explanations are merely circular, defining and cross-referencing one vague and ambiguous term by reference to another equally so." MPP Br. at 28. That contention ignores that those terms can only be judged in context. *See* Order No. 644 at P 35, JA 73 (noting legitimate business purpose "can only have meaning with specific reference to seller's own business practices and motives").

Here, the Commission identified the context for evaluating whether transactions or actions have a legitimate business purpose: "if the behavior was undertaken to provide service to a buyer with rates, terms, and conditions disciplined by the competitive forces of the market." Electric Rehearing Order at P 43, JA 251. This, coupled with the earlier indication that legitimate transactions track FERC-approved practices, *id*. at P 38, JA 250, provides adequate guidance of what types of transactions or actions – ones with noncompetitive prices or terms and that fall outside FERC-approved practices – will likely draw attention as potentially proscribed.

Notwithstanding Petitioners' efforts to make Rule 2 appear obtuse, its strictures are clear and simple, as Order No. 644 at P 44, JA 75, explained:

> Stripped to their essentials, these guidelines amount to the following: (i) act consistently within the Commission's established rules; (ii) do not manipulate or attempt to manipulate natural gas [or electricity] markets; (iii) be honest and forthright with the Commission[,] the institutions it established to implement open access transportation[,] and entities publishing indices for the purpose of price transparency; and (iv) retain associated records.

E. Adopting Rule 2 Is Consistent With The Statutory Balance

The MP Parties assert that Rule 2 "is a direct circumvention of the governing statutes." MPP Br. 33; CI Br. 7 (same). The asserted circumvention rests on MP Parties' view that existing market-based rate tariffs give sellers the right to engage in

any form of manipulative conduct, or any actions without a legitimate business purpose, that has not been previously-identified as proscribed:

> Cinergy does not here dispute that a violation of a sufficiently specific condition *could* constitute an unauthorized provision of a sale or service, and FERC *could* remedy such violation by, among other things, requiring refunds of amounts collected. However, the conceptual basis for this refund authority is that the rate charged or service provided was *never legally authorized in the first place*, not that the Commission may somehow grant itself retroactive refund authority under Section 205 and Section 7 by imposing vague, yet-to-be-defined "catch-all" provisions.

MPP Br. 36-37 (emphasis in original; footnote omitted). The negative inference of that statement is that only conditions that have been sufficiently identified by FERC are not legally authorized, while any unspecified manipulation or action without a legitimate business purpose is legally authorized. That reasoning cannot hold.

Use of market-based rate authority is justified only when "there is a competitive market [so] the FERC may rely upon market-based prices in lieu of cost-of-service regulation to assure a 'just and reasonable' result." *Elizabethtown Gas Co. v. FERC*, 10 F.3d 866, 870 (D.C. Cir. 1993)(citation omitted). That justification collapses whenever a market is not working in a competitive fashion, in which case Congress has, by passage of the FPA and the NGA, indicated a clear intent to impose regulation that will protect customers from anticompetitive rates or conditions. *See, e.g.*, *Texaco*, 417 U.S. at 397-99 (noting regulation imposed "because of anti-competitive

conditions in the industry," which precluded reliance solely on market prices as the arbiter of just and reasonable rates).

"Legitimate business purpose" has long been used to indicate whether a party is or is not acting in a manner that "impair[s] competition in an unnecessarily restrictive way." *Aspen Skiing*, 472 U.S. at 605 (footnote omitted). Likewise, the general term "manipulation" connotes "conduct designed to deceive or defraud" in a way that "control[s] or artificially affect[s]" prices. *Ernst & Ernst*, 425 U.S. at 199. Thus, in any form, manipulation or conduct without a legitimate business purpose will undermine the foundation – prices set by a competitive market – on which market-based tariffs rest.[4] It follows, contrary to MP Parties' logic (Br. 36-37), that any form of manipulation or action without a legitimate business purpose is never legally authorized by market-based rate tariffs. Rule 2 simply embodies that principle.

As any action or transaction that runs afoul of Rule 2 was never authorized by market-based rate tariffs, the Commission may "remedy such violation by, among

---

4 The MP Parties state that "the reality is that very little market manipulation has been proven, and many allegations have been disproved." MPP Br. 30 (footnote omitted). Even accepting that statement (despite settlements worth several billion dollars in the California cases) does not mean that any form of manipulation is legally authorized by market-based rate tariffs. Rather, it shows that certain conduct in the conditions presented was not manipulative. Whether the same result would apply in different circumstances is an open question.

other things, requiring refund of amounts collected," to borrow MP Parties' phrase. MPP Br. 36. Such an approach is fully consistent with congressional intent to impose regulation as a means to prevent anticompetitive behavior from causing customers to pay unjust and unreasonable rates. In short, Rule 2 does not circumvent the statutory design, it supports it.

F. Application of Rule 2 Will Not Violate The Filed Rate Doctrine

As a variation on their theme that Rule 2 is vague and ambiguous, the MP Parties assert that future application of the Rule will violate the filed rate doctrine because "the vague and ambiguous standards of the generic rule provide insufficient notice to sellers, acting in a dynamic and fast-paced market environment, of how behavior undertaken in the present is likely to be judged later." MPP Br. 40. As the MP Parties state, predictability is an underlying purpose of the Rule, as is the protection of buyers and sellers. *Id*. at 39-40.

For the reasons discussed above, Rule 2 is neither vague nor ambiguous because it employs a flexible and reasonable scope of proscribed activities. Accordingly, its future application in the absence of a list of specific prohibited acts no more violates the filed rate doctrine than does the absence of specific numerical rates in market-based rate tariffs. The required predictability is satisfied in both instances by parties' being on notice that rates might change in the future depending

on circumstances, allowing them to plan accordingly. *See* Electric Rehearing Order at P 158, JA 265 (noting filed rate "will be the behavioral standards voluntarily incorporated into the seller's tariff as an agreed condition" for market-based rate authority).

Sellers under Rule 2 know that if an action or transaction lacks a legitimate business purpose or is intended to or could manipulate, they may have to disgorge, and can plan accordingly. The filed rate doctrine does not come into play because sellers know that rates *might* change in certain circumstances, whether or not rates actually do change. "The filed rate doctrine simply does not extend to cases in which buyers are on adequate notice that resolution of some specific issue may cause a later adjustment to the rate being collected at the time of service." *Natural Gas Clearinghouse v. FERC*, 965 F.2d 1066, 1074 (D.C. Cir. 1992).

From a practical standpoint, promulgation of Rule 2 provides sellers with sufficient notice that future "market" rates, based on actions/transactions lacking a legitimate business purpose or that are intended to, or foreseeably could, manipulate those rates, are subject to adjustment. Such notice "changes what would be purely retroactive ratemaking into a functionally prospective process by placing the relevant audience on notice at the outset that the rates being promulgated are provisional only

and subject to later revision." *Columbia Gas Transmission Corp. v. FERC*, 895 F.2d 791, 797 (D.C. Cir. 1990).[5]

G. The Burden of Proof Has Not Been Misallocated

The MP Parties contend that because Rule 2 is allegedly vague, it cannot serve to shift "onto sellers the burden of having to prove, upon challenge, that their past rates and services have been just and reasonable." MPP Br. 41; *see* CI Br. 7-8 (same). As the MP Parties recognize, *id*., the Commission granted Petitioners' rehearing, and ruled that when a complaint is filed, "the complainant carries the burden of proof regarding the facts and law asserted, consistent with the Commission's existing complaint procedures." Electric Rehearing Order at P 150, JA 264; *see* 18 C.F.R. § 385.206 (2005)(complaint procedures). By presenting a valid *prima facie* case of a Rule 2 violation, the complainant would satisfy its burden and prevail unless the seller can show why its actions are not proscribed by the Rule.

But, assuming a complainant meets the burden of proof in presenting a *prima facie* case of a Rule 2 violation, the burden then switches to the seller to rebut the allegations. *See* 18 C.F.R. § 2.17(e)(noting that in price squeeze cases, "burden of

5 This Court distinguished *Public Utilities Comm. of California v. FERC*, 894 F.2d 1372, 1383 (D.C. Cir. 1990), on which the MP Parties rely (Br. 39 & n. 90), as "not present[ing] any suggestion that the rates at issue had been subject to change or that petitioners were on notice of a potential change." *Public Utilities Comm. of California v. FERC*, 988 F.2d 154, 166 (D.C. Cir. 1993).

proof (i.e., the risk of nonpersuasion) to rebut the allegations of price squeeze and to justify the proposed rates are on the utility proposing the rates" under FPA § 205(e)). Of course, should the complainant fail to support a *prima facie* case, then the complaint is subject to dismissal. Thus, a valid *prima facie* case shifts the burden to the seller.

Placing the initial burden on the complainant does not "implicitly recognize[]" that the "conceptual basis for refund authority *should* be Section 206 or Section 5," MPP Br. 42 n. 97 (emphasis in original). Rather, it is designed for the orderly processing of complaints under the existing FERC rules. *See* Electric Rehearing Order at P 150, JA 264 ("the Commission will act on any properly filed complaint under its existing complaint procedures"); *see also* 18 C.F.R. § 385.206(b)(providing list of required contents for complaint). Depending on the substance of the complaint, the Commission may: send the matter for alternative dispute resolution; dismiss it on the pleadings; or set it for hearing. *Id*. § 385.206(g). In effect, the FERC process resembles the process for dealing with motions for judgment on the pleadings, Fed. R. Civ. P. 12(b)(6), or for summary judgment at the pleadings stage. Fed. R. Civ. P. 56, which examines the sufficiency of the allegations as grounds for moving forward. *See* Electric Rules Order at P 42, JA 98 ("As a threshold matter, the Commission will

evaluate if the facts presented appear to warrant further inquiry into whether the transaction appears to be of a questionable purpose.").

The issue at the initial stage of the FERC complaint process is whether the complaint justifies moving forward, and not, contrary to the MP Parties claim (Br. 42), what will be the conceptual or actual basis for any remedy that may be allowed if the case moves forward. The instant Orders separated the conceptual basis for proposed remedies from the discussion of the complaint process. *See generally* Electric Rules Order at PP 153-61, JA 113-114 *and* Electric Rehearing Order at PP 128-34, JA 262. In those sections, addressing remedies, the Commission rejected the view that remedies could only be prospective under FPA § 206 or NGA § 5. The necessary finding for FPA § 206 or NGA § 5 relief to prevent proscribed conduct was made in the instant matter by adding the Rules to existing tariffs. "[W]e find that sellers' existing tariffs and authorizations, without clearly-delineated rules of the road to govern market participant conduct, are unjust and unreasonable. . . . 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." Electric Rules Order at P 3, JA 92; *see id*. at P 159, JA 114 (a finding that existing tariffs are unjust and unreasonable, without Rules, "would require that these tariffs be revised, but only a prospective basis, as Section 206 [and NGA § 5] requires").

H. The Choice of Remedies Properly Balanced Competing Interests

Remedies to cure violations of the revised tariffs and authorizations may include disgorgement of profits resulting from violations of the Rules because the revised rate tariffs and authorizations now include Rule 2 and the other Rules. *Id*. at P 161, JA 114 ("the Commission has the authority to impose the appropriate remedy where it finds violations of its Market Behavior Rules have occurred"), *citing Coastal Oil & Gas Corp. v. FERC*, 782 F.2d 1249 (5th Cir. 1986). In that case, the Fifth Circuit found acceptable: remedies that "restore the status quo ante and prevent unjust enrichment of the wrongdoer," strip the wrongdoer of "its profits in excess of what it would made under the [lawful] contract," and "address [the customer's] injury []or restore the status quo ante of either party." 782 F.2d at 1253. *See also* Electric Rehearing Order at P 129, JA 262 (noting "disgorgement of the seller's unjust profits would be an appropriate remedy," but keeping open other remedial options).

The MP Parties argue that appropriate remedy policy "would levy monetary remedies under [Rule 2] only after appropriate standards have been developed through case law." MPP Br. 22 (footnote omitted). As support for their preferred policy choice, the MP Parties rely on the Federal Trade Commission's "Policy Statement on Monetary Equitable Remedies in Competition Cases," *available at* http://www.ftc.gov/os/2003/07/disgorgementfrn.htm.

The MP Parties would read the FTC policy statement as allowing disgorgement only where the specific act has been previously identified as proscribed, MPP Br. 23 (stating FTC would seek disgorgement "prospectively after a *clear* violation based on *existing* precedent")(emphasis in original). But the FTC uses a sliding scale on which the value of disgorgement as a deterrent "is reduced when the violator has no reasonable way of knowing in advance that its conduct *is placing it in jeopardy* of having to pay back all the potential gains." *Id*. text at n. 9 (emphasis added). Here, Rule 2 does currently place sellers on notice of what conduct will put them in jeopardy of a disgorgement remedy. Further, on the sliding scale, where "significant consumer harm will not (for one reason or another) be redressed through a private action" – the situation under the FPA and NGA, both of which vest exclusive jurisdiction over rates in FERC and do not allow private actions – the FTC would "consider seeking restitution even if the conduct at issue does not otherwise meet our definition of a 'clear' violation." *Id*. at n. 9.

In addition, the FTC noted that equitable factors could also play a role in whether to seek disgorgement, including: whether "other remedies are likely to fail to accomplish fully the purposes of the" governing law, "when private actions likely will not remove the total unjust enrichment from a violation," and where the advantages of a violation "greatly outweigh the specific penalties prescribed in applicable laws" and

will not "offset a civil penalty assessment against disgorgement or restitution." *Id.* & n. 13. In the context of the FPA and the NGA with their anemic civil penalty provisions when the Rules were promulgated, *e.g.*, FPA § 316, 16 U.S.C. § 825o (but subsequently strengthened by § 1284 of the Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594 (2005)), the FTC policy statement would, on the whole, support FERC's choice of disgorgement as the appropriate remedy.

III. FERC'S INTERPRETATION OF "FIRST SALE" DOES NOT CLASH WITH ITS STATUTORY AUTHORITY

The second portion of the MPP Brief challenges the interpretation to the definition of "first sale" under NGPA § 2(21). *See* Order No. 644 at PP 14-15, JA 69. Western Gas Resources, Inc. (Western") and supporting intervenors contend that FERC "exceeded its statutory jurisdiction and acted contrary to statutory limits imposed by the NGPA on FERC's residual NGA jurisdiction." MPP Br. 44; *see* "Brief of Industrial Intervenors" 3 ("II Br.")(same).[6] Notwithstanding the MP Parties' views

---

6 The Industrial Intervenors consist of the Process Gas Consumers Group and the American Forest & Paper Association. II Br. Circuit Rule 26.1 Disclosure Statement. Neither entity was a party to the FERC proceeding below. *See* MPP Br. Certificate As To Parties, Rulings, and Related Cases (although both entities listed as intervenors before this Court, neither listed as party at FERC). Neither entity filed a request for rehearing at FERC in which the objections they now present to the Court were raised. *See* Certified Index To The Record (filed Sept. 16, 2004) at pp. 35-39 (neither party sought rehearing). Accordingly, under 15 U.S.C. § 717r(b), this Court lacks jurisdiction to consider Industrial Intervenors' Brief.

as to the efficacy of FERC's reading (MPP Br. 45-51; II Br. 3-4), the question for review is whether the Commission reasonably interpreted the statutory language. As is demonstrated below, the reading is reasonable, and thus is entitled to deference.

The statutory language being interpreted is NGPA § 2(21)(A), which states:

> (A) General Rule.- The term "first sale" means any sale of any volume of natural gas-
> (i) to any interstate pipeline or intrastate pipeline;
> (ii) to any local distribution company;
> (iii) to any person for use by such person;
> (iv) which precedes any sale described in clauses (i), (ii), or (iii); and [sic, or]
> (v) which precedes or follows any sale described in clauses (i), (ii), (iii), or (iv) and is defined by the Commission as a first sale in order to prevent circumvention of any maximum lawful price established under this Act.

Specifically, the MP Parties contend FERC's reading of clause (iv) is "made of whole cloth and lacks support in the language, structure or purpose of the statute." MPP Br. 48. To the contrary, FERC reasonably interpreted the statutory language and purpose.

The Commission interpreted § 2(21)(A)(i)-(iv) to mean that "all sales in the chain from the producer to the ultimate consumer are first sales until the gas is purchased by an interstate pipeline, intrastate pipeline, or LDC. The Commission reasoned that once such a sale is executed and the gas is in the possession of a pipeline, LDC, or retail customer, the chain is broken and no subsequent sale, whether the sale is by the pipeline, or LDC, or by a subsequent purchaser of gas that has passed

through the hands of a pipeline or LDC, can qualify under the general rule as a first sale o[f] natural gas." Gas Rehearing Order at P 25, JA 233; *see* Order No. 644 at P 14, JA 69.

Western asserts that FERC's interpretation "misread[s] 'any' in clause (iv) to mean 'every' or 'all,'" MPP Br. 53, and improperly "interpret[s] the phrase 'precede any' to mean 'precede every' sale described in clauses (i), (ii), and (iii)." *Id.* 52; *see* II Br. 8 (same). While Western emphasizes that the word "any" appears "*six* times in the first four clauses of Section 2(21)(A)," MPP Br. 53 (emphasis in original); II Br. 7 (same), and argues that FERC's reading takes the sixth appearance of "any," in clause (iv), "out of context ignoring other uses of 'any' that modify clause (iv)," MPP Br. 54, Western itself uses different variants of "any" in its preferred interpretation. *See id*. (interpreting "'*any* sale of *any* volume . . . which precedes *any* sale [to a pipeline, LDC or end user]' includes <u>all</u> sales that precede <u>a</u> sale to a pipeline, LDC or end user")(italics and alteration in original; underlined added).

None of the above arguments (MPP Br. 52-57) were presented in Petitioner Western Gas Resources Inc.'s request for rehearing at FERC. *See* JA 223 (Western's rehearing request; for example, the phrase "every sale" never appears in the request). As none of those objections were urged before the Commission, this Court lacks jurisdiction to consider them on review. NGA § 19(b), 15 U.S.C. §717r(b). As

indicated earlier (at n. 6), Industrial Intervenors were neither parties nor submitted rehearing request(s) at FERC, and thus there is no jurisdiction to consider their brief.

In any event, as its own phrasing shows, Western's preferred reading does not give "any" the same meaning in all six places, and changes the singular "any sale" in clause (iv) to the plural "all sales." In contrast, FERC's interpretation treats "any" consistently throughout the four clauses, and maintains the singular "any sale" in clause (iv). *See* Order No. 644 at P 14, JA 69 ("first sales of natural gas are defined as any sale to an interstate or intrastate pipeline or LDC or retail customer, or any sale in the chain of transactions *prior* to a sale to an interstate or intrastate pipeline or LDC or retail customer")(italics in original; underlined added). Thus, whenever a sale is made to any enumerated purchaser, "the chain is broken, and no subsequent sale . . . can qualify under the general rule as a first sale o[f] natural gas." *Id*.; *see* Gas Rehearing Order at P 24, JA 233 (same).

Western next finds it "peculiar that FERC would attempt to defend a massive extension of NGA regulation based on a highly artificial hypothesis about "impractical results' that might have occurred under a price-regulation regime that terminated more than a decade ago." MPP Br. 58, referring to Gas Rehearing Order at P 28, JA 233. But the Commission, in response to Western's assertion of what Congress intended when it passed the NGPA (Western Rehearing Request at 2, JA

224), was attempting to replicate the situation with NGPA regulation in effect, not what would happen today with the NGPA no longer in effect. "The NGPA *originally* set ceiling prices for first sales of natural gas linked to various categories of natural gas for sales of such gas. Once the chain of first sales was broken, the gas sales become subject to the jurisdiction of the NGA." Gas Rehearing Order at P 28, JA 233 (emphasis added). In determining congressional intent, it is not peculiar to consider how the NGPA worked while it was operative.

Further, Western misses the point of FERC's example of how Petitioners' reading leads to a "perverse effect," to wit, "of requiring a buyer to accept an NGPA ceiling price for its gas sale which is less than the price it paid for the gas under NGA." Gas Rehearing Order at P 28, JA 233. Both agree that result, required because NGPA prices were mandatory for covered gas, would be economically irrational. MPP Br. 58. Both also agree that once the § 2(21)(A) chain was broken, the next sale was subject to NGA jurisdiction. They disagree on how sales subsequent to that next sale were priced: Western asserts the first sale chain was reestablished, making all subsequent sales subject to NGPA prices, while FERC found the chain remained broken and subsequent sales were subject to NGA pricing.

Western seeks to avoid the logical consequence of its position (that reestablishing the NGPA chain results in economically irrational decisions) by

hypothesizing that, in that case, a hypothetical purchaser would not buy, ask for a lower price, or seek relief from FERC. MPP Br. 58.[7] While those hypotheses avoid the problem, they offer absolutely no insight as to how the statutory plan worked, and thus into congressional intent. Further, the negative implication of their answer is that Congress intended such perverse effects, and left it to purchasers to avoid them as best they could. FERC's reading, on the other hand, assumes Congress did not intend such perverse effects, reflected in the language of clause (iv) that NGPA pricing ended (and NGA jurisdiction applied) "[o]nce the chain of first sales was broken." Gas Rehearing Order at P 28, JA 233. FERC's reading rationally interprets the statute in a way that avoids the perverse effects resulting from pricing that switches from NGPA to NGA and then back to NGPA jurisdiction.

Western argues that reliance on § 2(21)(A)(v), *id*., to support FERC's reading of clause (iv) is misplaced because clause (v) "merely allows FERC to *expand* the potential range of 'first sales' to include 'sales by' entities that would otherwise be excluded from 'first sale' status by Subparagraph (B)." MPP Br. 60. Even if that claim reflected the structure of § 2(21), *but see Public Service Comm. v. Mid-Louisiana Gas Co.*, 463 U.S. 319, 325 (1983) (§ 2(21) "takes the form of a general rule, qualified by

---

7 This argument was not raised on rehearing, *see* Western Rehearing Request, JA 223, and thus the Court lacks jurisdiction to consider it under NGA § 19(b).

an exclusion"), it ignores the first phrase in clause (v) --"which precedes or follows." Western's reading of clause (iv) would make it immaterial whether a sale occurs before or after an enumerated sale, thus rendering the first phrase in clause (v) superfluous, particularly the words "or follows."

FERC's reading interprets the words "or follows" in clause (v) as allowing "the reestablishment of the first sale chain in only one specific circumstance," *i.e.*, "to prevent the circumvention of a [NGPA] maximum lawful price." Gas Rehearing Order at P 28, JA 233. That reading rationally incorporates all the words of clause (v). Based on the starting point that clause (v) allows the first sale chain to be reestablished in only one specific circumstance, the Commission "reasonably interpreted the definition as not allowing the chain to be reestablished in other circumstances." *Id*.

RESPONSE TO CALIFORNIA STATE PARTIES' AND CONSUMER ADVOCATES' BRIEFS

IV. THE RULES APPROPRIATELY BALANCE COMPETING INTERESTS IN SETTING REMEDIES AND ENFORCEMENT PROCEDURES

The California State Parties and Consumer Advocates (jointly "CA Petitioners") contend that the Commission unlawfully restricted the remedies available and the enforcement procedures related to possible violations of the Rules. *See generally* CA Petitioners' Brief ("CA Pet. Br.") 27-39; *see* Joint Intervenors' Brief In Support of CA Petitioners ("CA Int. Br.") 4-8 (same).

A. Disgorgement Is Consistent With the FPA

On the remedy issue, the CA Petitioners claim that "FERC cannot demonstrate that its profit disgorgement remedy is consistent with the FPA's mandates." CA Pet. Br. 28. They view disgorgement as "unlawfully giv[ing] preference to seller interests and fail[ing] to ensure a just and reasonable rate." *Id*. at 31; *see id.* at 28 (regulatory certainty and transaction finality "cannot trump consumer protection and the requirement of just and reasonable rates"). The CA Petitioners assert that reliance on regulatory certainty and transaction finality are "euphemisms for FERC's view that lax rules and a remedy that allows sellers to keep all or some of their ill-gotten gains are perfectly acceptable." *Id*. at 29. The CA Petitioners contend that "in the context of market-based sales," the Commission has set a "make-the-market-whole remedy" for alleged cases where unlawful rates are charged. *Id*. at 30 (citing cases).

Contrary to CA Petitioners' implication, the disgorgement remedy is not the sole remedy that may be employed where violations of the Rules occur. While it is a principal remedy, the Commission did "not foreclose [] reliance on existing procedures or other remedial tools as may be necessary," including generic or market-specific rule changes and application of "additional remedial power, including the authority to levy civil penalties," to the extent granted by Congress. Electric Rules Order at P 149 and n. 87, JA 112. As the Commission will consider violations on a

"case-by-case basis, with full opportunity for input for all interested parties," *id*. at P 150, it can consider whether additional or different remedies are appropriate in the circumstances.

While the cases cited by CA Petitioners (Br. 30) allowed market-wide remedies, that was due to the nature of the markets involved, and do not require that all Rules violations would or should require the violator make the market whole. For example, the two cited *San Diego* cases both involve, as CA Petitioners acknowledge, "market clearing prices in a single price auction," *id*., in which all sellers received the same price for sales at a given time, and thus resetting the single clearing price at a just and reasonable level leads to refunds from all sellers. A similar remedy would not be appropriate in a bilateral transaction market because a Rules violation related to one bilateral transaction does not necessarily taint other bilateral transactions. Thus, given FERC's case-by-case approach, different remedies have been and can be fashioned to fit differing situations.

The CA Petitioners' allegations regarding the inapplicability of a profit disgorgement remedy implicitly assume that disgorgement yields a lower recovery for customers than would refunds to the just and reasonable level. *E.g.*, CA Pets. Br. 29 (suggesting limited disgorgement remedy does not constitute full refund protection). But that assumption is not valid: a just and reasonable market-based rate transaction

allows a seller to make a "normal return on its investment," viz., a profit. *Id*. at 28. Accordingly, refunds of excessive rates down to the just and reasonable level would allow a seller to retain a normal return on investment. That contrasts with disgorgement of profits under which a seller retains no profit.

The contrast undermines the CA Petitioners' claim that disgorgement would not act as an effective deterrent. CA Pets. Br. 31. Contrary to their assertion that disgorgement means a violator "can never be worse off by cheating," *id*., a violator loses its profit by disgorgement, while under just and reasonable refunds a cheater retains normal return on investment. Thus, a seller who violates the Rules will be worse off than one who, in some non-violative manner, charges unjust and unreasonable rates, even if both sellers charged the same price for the same service.

B. The Limitations Period Is Appropriate

The CA Petitioners assert the limitations period applicable to complaint filings is "unsupportable as a matter of general law, and specifically under the FPA." CA Pets. Br. 32. The Commission allowed "90 days from the end of the quarter from which a violation occurred for a party to bring a complaint based on these rules." Electric Rules Order at P 147, JA 112. CA Petitioners' general law assertion relies on cases involving civil actions at federal district court. *See, e.g., SEC v. Rind,* 991 F.2d 1486, 1488 (9th Cir. 1993)(referring to SEC "civil enforcement actions"). Law

governing federal civil actions does not necessarily govern what procedures agencies may employ. Here, the Commission found the 90-day period "provides a reasonable balance between encouraging due diligence in protecting one's rights, discouraging stale claims, and encouraging finality in transactions." Electric Rules Order at P 147, JA 112.

The CA Petitioners also charge that a limitations period "conflicts with the express mandates of the FPA," and, in particular, FPA§ 206. CA Pets. Br. 32. The CA Petitioners are correct that nothing in FPA § 206 "empowers FERC to restrict [filing] rights by imposing limitations periods." CA Pets. Br. 32. But, unlike the limited relief of disgorgement of past profits for past violations of these Rules, FPA § 206 addresses prospectively rate relief. *See* FPA § 206(a) (prospective relief from the date of the FERC order setting new rates). Consistent with the prospective nature of FPA § 206, the Commission did not rely on it as justifying remedies for a Rules violation:

> In a proceeding brought pursuant to these rules, the issue would be whether the entity has violated its tariff. Therefore, in a remedial proceeding brought pursuant to these rules, unlike an FPA Section 206 investigation initiated by the Commission, the regulated entity has notice of the conditions required for service at the time of the implementation of the service conditions and the Commission may, at its discretion, fashion an appropriate remedy.

Electric Rules Order at P 162, JA 114. Because of the different possibilities, a party may have to decide whether filing for rate relief under FPA § 206 or for disgorgement under these Rules would better remedy the alleged problem.[8]

Despite the CA Petitioners' claim that the limitations period "defies a common sense application of the governing principles and regulatory structure of the FPA," CA Pets. Br. 32, their examples (Br. 33-35) present matters that can be considered in the context of whether to grant an exception to the filing deadline, not as grounds to void the general rule. The examples – complexity and difficulty in detecting manipulation, backlog of pending cases, or time for discovery and analysis (*id*. at 33) – may present valid grounds for an exception. *See* Electric Rules Order at P 147, JA 112 (noting exception "incorporates a reasonableness standard"). Likewise, state commission difficulties in obtaining needed evidence to present a complaint might be sufficient to justify an exception. *Cf*. Fed. R. Civ. P. 56(f). If requests for an exception are denied, the aggrieved party would be free to argue that application of the rule erroneously led to denial of an exception, but that would not invalidate the limitations period itself.

The CA Petitioners assert "there is no rational basis for FERC's decision to impose a 90-day period," rather than some other period. *Id.* at 33. But the Commission

8 In addition, as made clear, seeking disgorgement does not exclude an FPA § 206 remedy, where appropriate. *E.g.*, Electric Rehearing Order at P 129, JA 262 (not foreclosing other remedies for Rules violation).

"modif[ied] the original proposal [for 60 days] to allow 90 days." Electric Rules Order at P 147, JA 112. Setting this period was rationally based on FERC's view of the appropriate balance "between encouraging due diligence in protecting one's rights, discouraging stale claims, and encouraging finality in transactions," coupled with a reasonableness standard for evaluating requests for exceptions. *Id*.

A 90-day period is sufficient because most cases will be brought by "market participants who may be buyers or otherwise directly affected by the transaction," *id*. at P 148. FERC, on the other hand, because it "may not be aware of actions or transactions that potentially may violate [the] rules," gave itself 90 days from when it knew of the alleged violation, or "knew of the potentially manipulative character of an action or transaction," to act. *Id*.[9] That distinction suggests the Commission may be sympathetic to the problems faced by state commissions (CA Pet. Br. 35) and other non-market participants in identifying potential violations, and will factor such considerations into any request for an exception to the period by those types of parties.

The claim that "market-based rates are formula rates" is not supported by the cases cited (CA Int. Br. 5). The formula rate in *NRG Power Marketing, Inc. v. New*

---

9 CA Petitioners argue that reliance on calls to FERC's Hotline as one means to start the limitations period running for FERC is a "nebulous standard [that] fails to ensure meaningful enforcement of the Rules." CA Pet. Br. 34 n. 17. That argument is better left to an actual factual situation than to a general rule challenge.

York ISO, 91 FERC ¶ 61,346, 62,166 (2000), involved "a prescribed formula using the actual market data," not unadorned market prices. *See id*. at 62,165 (describing methodology for "calculating market clearing energy prices"). Similarly, reliance on the statement that the Commission "'*could not conceive of a reasonable basis*' for limiting the period during which violations of the formula rate can be corrected," CA Int. Br. 5 (emphasis in original), is misplaced. The concern addressed by that statement was not the period for bringing a complaint, but attempts to limit the scope of refunds. "Carolina requests that the Commission limit the scope of the proceeding to outages occurring only in the 12 months immediately preceding the filing of" the complaint. *North Carolina Elec. Membership Corp., et al. v. Carolina Power & Light Co.*, 57 FERC ¶ 61,332 at p. 62,065 (1991). *See Cities and Villages of Albany and Hanover, Ill., et al*, 61 FERC ¶ 61,037 at p. 61,184 (1992) (utility argued it "should not be exposed to a refund obligation over the length of the contracts at issue").

The Commission could not "conceive of a reasonable basis" for the proposed refund limitations as they would preclude "relief for excessive fuel adjustment clause billings despite what may turn out to be a long history of imprudence." 57 FERC at p. 62,065. Here, the policy involves the time for filing a complaint, not the period over which refunds may be allowed. In *Carolina* and *Cities*, after ruling against the attempt to limit refund liability, the Commission expressed many of the same concerns that

support use of a 90-day period in the instant circumstances. "Prompt action is necessary to ensure that information will be available to evaluate the complaint and that corrective action can be taken to ensure that only prudent costs are billed the FAC." 61 FERC at p. 61,187.

Contrary to the assertions (CA Int. Br. 5), there was no reason for FERC "either to acknowledge its existing policy or articulate a reasoned explanation for its decision to effect[uate] a change in that policy." *Id*. The issue in the instant matter differs completely from the issue in the cited cases, as discussed above, and, therefore, the policy in the cited cases is inapposite to the instant situation. It follows there was no need to acknowledge, much less to explain away, the earlier policy on a completely different issue.

C. FERC Properly Conditioned What Conduct Is Actionable

The CA Petitioners assert the Rules place "additional roadblocks [seller intent, motive, due diligence, and direct nexus] to recovery of overcharges." CA Pet. Br. 35. CA Petitioners conflate two regulatory remedial approaches in claiming those factors as roadblocks: refunds for unjust and unreasonable rates with disgorgement of profits for a Rules violation. *See*, *e.g.*, CA Pet. Br. 36 ("seller intent and motive do not determine whether an unlawful rate was charged"). Accepting that statement as true does not preclude intent and motive as determinative of whether a Rules violation

occurred, which is what the instant matter addresses. Nor does a refund remedy for unlawful rates preclude a disgorgement remedy, or vice versa, in the same fact scenario involving the same seller. *See, e.g.*, Electric Rules Order at P 45, JA 99 ("rules will not supersede or replace parties' rights under Section 206 of the FPA"). Finally, a Rules remedy may be warranted in the absence of unlawful rates, and rates may be found unlawful in cases where no Rules violation occurs. In short, the two remedies are neither mutually exclusive nor redundant. *See* Electric Rehearing Order at P 129, JA 262 ("[FERC] would not foreclose our reliance on existing procedures or other remedial tools, as may be necessary").

Virtually all of CA Petitioners' argument (Br. 36-39) assumes that the refund remedy should be applied for a Rules violation. *E.g.*, Br. 36 ("premising the justness and reasonableness of market-based rates on a showing of wrongful intent or motive has no basis in the FPA"). Nothing in the instant orders suggest that motive or intent is applicable to whether rates are reasonable within the meaning of FPA §§ 205 and 206 because the reasonableness of rates will be addressed under FPA standards, not those for Rules violations. Electric Rules Order at P 45, JA 99. The same answer applies to CA Petitioners' argument that "due diligence does not ensure a lawful rate," CA Pet.

Br. 37, in that the Commission will judge whether rates are lawful under the FPA standards, not those set out for these Rules.[10]

The CA Petitioners assert the "direct nexus" requirement where a party is seeking to abrogate an existing contract on the basis of a Rules violation is "unlawful for the same reasons that it is impermissible for FERC to restrict enforcement to intentional misconduct or to restrict remedies for tariff violations." CA Pet. Br. 38. Just as FERC's action regarding the other points is permissible, so, too, is its action regarding the direct nexus requirement. Again, CA Petitioners' claim rests on a faulty premise: that Rules violation claims are the sole means to remedy allegedly unlawful contract terms. *See id*. (arguing violator should not be allowed "to keep the benefits of that contract simply because it cannot be shown that the seller's misconduct directly affected a contract negotiation").

The Commission indicated that the direct nexus requirement did not negate other avenues of relief for Rules violations and/or contract abrogation. *See* Electric Rehearing Order at P 45 n. 28, JA 251 ("we note that these rules will not supersede or replace parties' rights under section 206 of the FPA to file a complaint contending that

---

10 It is also true that a finding that rates are lawful under the FPA does not preclude a finding that these Rules have been violated. *See* Electric Rules Order at P 40 n. 27, JA 98 ("The rule, then, covers actions that are intended to manipulate prices regardless of whether these actions actually accomplish their purpose.").

a contract should be revised by the Commission, pursuant to either the 'just and reasonable' or 'public interest' tests as required by the contract"); *see also* Electric Rules Order at P 45, JA 99 (same). The direct nexus requirement is limited to cases where a "party [is] seeking contract reformation or abrogation based on a violation of one or more of the" Rules. *Id*. In those cases, the complainant must show the Rules violation "had a direct nexus to contract formation and tainted contract formation itself." *Id*.

In CA Petitioners' example (CA Pet. Br. 38, relying on Commissioner Kelly's dissent to the Electric Rehearing Order), the buyer could still obtain relief even if it could not abrogate the contract.[11] If a wash trade were proven in the example, then the Commission could order disgorgement, with those funds turned over to the buyer. An FPA § 206 complaint could be filed to seek reduction of the hypothesized manipulative electric price index and to set the future contract rate. Electric Rehearing Order at P 45 n. 28, JA 251. Thus, even if the direct nexus requirement precluded

11 The example appears to be more restrictive than the Orders in that it suggests the Commission would not allow evidence to be presented of a Rules violation during any contract abrogation hearing. The orders indicate an intent not "to entertain contract abrogation complaints predicated on our" Rules without a direct nexus. Electric Rules Order at P45, JA 99. They do not address what will happen where evidence of a post-contract formation Rules violation is presented during trial in a contract abrogation case predicated on other grounds.

contract abrogation in the example, a buyer would have other avenues to seek relief from possible adverse effects of a Rules violation affecting a contract.

D. The Orders Properly Do Not Specify What Acts Constitute Manipulation

The CA Petitioners assert that "FERC should be required to adopt a uniform rule unequivocally prohibiting [certain] known manipulative practices," to wit, the withholding and "the exercise of market power whenever transmission congestion exists." CA Pet Br. 39 and 43-44. In both cases, the Commission presented valid reasons for not specifying prohibited behavior.

The CA Petitioners seek to replace Rule 1 (Electric Rules Order, App. A, JA 120) with one that "prohibit[s] withholding outright," encompasses all, not just ISO or RTO, energy markets, and incorporates a "must offer" obligation. Br. at 40-41. That approach would contravene, however, the intent of the Rule as well as of existing FERC policies. The "core requirement embodied" in Rule 1 is that "sellers conduct their business in a manner that complies with the Commission-approved rules and regulations of the applicable power market." Electric Rehearing Order at P 22, JA 248. The Rule is intended as "reinforcing a seller's compliance obligation" with existing rules, not to overlay a new rule on those already in place. *Id*. As existing FERC policies recognize "the validity of regional variations with respect to certain rules and regulations," *id*. at P 24, JA 248, Rule 1 was designed to tie sellers' conduct "to the

rules and regulations of the power markets in which they do business." Electric Rules Order at P 19, JA 95. While CA Petitioners insinuate that FERC's approach means sellers need only comply "with unspecified rules of the applicable regional power market," CA Pets. Br. 41, all the regional power market rules are subject to comment and to FERC approval.

While CA Petitioners assert that a universal rule is needed "in the event that a regional market does not have sufficiently comprehensive rules," *id*., they present no evidence that any regional market lacks a "sufficiently comprehensive plan." Further, the better approach, if they think a regional market's plan is lacking, would be to amend that plan, not to impose a universal rule. *See* Electric Rehearing Order at P 24, JA 248 ("While the Commission's policy objectives in recent years have included the approval of standardized rules and procedures in these [regional] markets, where appropriate, implementation of these rules and procedures has appropriately occurred, in large part, on a case-by-case basis."). Contrary to CA Petitioners' claim (Br. 41), Rule 1 does apply to bilateral transactions "where the actions undertaken by a contracting party are subject to the Commission-approved tariff, rules and regulations that apply to the applicable power market." Electric Rehearing Order at P 26, JA 248.

Similarly, CA Petitioners' proposal to include a universal must offer obligation in Rule 1 runs against the policy under which RTOs and ISOs can determine whether

a must offer obligation should be included in their plans. Electric Rules Order at P 21, JA 95. FERC also rejected "the implicit rationale underlying this request, *i.e.*, that capacity withholding for an anti-competitive purpose can only be remedied by way of a generic must-offer obligation." Electric Rehearing Order at P 27, JA 248. As there is no legitimate business purpose for intentionally withholding capacity, *id*., a seller could not avoid a Rules violation remedy "by submitting evidence that certain known withholding strategies have a 'legitimate business purpose,'" as asserted. CA Pet. Br. 42-43.

The CA Petitioners attack Rule 2(c) as impermissibly limited to sellers who artificially create market congestion; they propose to expand the Rule to "prohibit the exercise of market power whenever transmission congestion exists." CA Pet. Br. 43-44. Of course, FERC prohibits the exercise of market power in any situation, so it is unclear what CA Petitioners' approach could add. *See* Electric Rehearing Order at P 80, JA 255 (noting that the issue is already being addressed in other rules). As the exercise of market power is generally prohibited, Rule 2(c) properly focuses on sellers who attempt to create congestion as the type of "purposeful conduct [by sellers] that cannot have a legitimate business purpose." *Id*. In other words, while other rules prohibit exercise of market power in any conditions, Rule 2(c) seeks to reduce efforts to create market power opportunities.

V. FERC'S MBR REGIME IS FULLY CONSISTENT WITH THE FPA

Certain of the CA Petitioners[12] ("Consumer Advocates") used the occasion of the Rules' implementation to mount a full-scale attack on FERC's authority to adopt a market-based rate ("MBR") regime, and continue that attack before this Court. CA Pet. Br. 14-27. Although Consumer Advocates assert (*id*. at 26-27) it was arbitrary and capricious for the Commission to dispose summarily (*see* Electric Rehearing Order at PP 114 & 118, JA 260, citing Electric Rules Order at PP 137-38, JA 110) of their challenges to the MBR regime, the validity of FERC's use of a MBR regime was not the subject of the instant proceeding, and has been litigated many times previously. *E.g., California ex rel. Lockyer v. FERC*, 383 F.3d 1006 (9th Cir. 2004)("*Lockyer*").

Indeed, it appears that, to no small degree, the MBR argument challenges the *Lockyer* decision itself, not a FERC order. *See, e.g.*, CA Pet. Br. 19 ("the Ninth Circuit in *Lockyer*, 383 F.3d at 1013, erroneously distinguished the FPA from other rate filing statutes. The court mistakenly relied on decisions of this Circuit . . . . *Lockyer* analyzed the issue exactly in reverse order of the Supreme Court's analysis . . . ."). Further, although their brief argues that it is arbitrary and capricious for the challenged orders not to discuss their contentions at length, Consumer Advocates disclaim any

---

12 *See* CA Pet. Br. 14 n. 12 ("The California State Parties do not assert or join the arguments in this section.").

interest in a remand for further explanation because "FERC's views are known from the Ninth Circuit *Lockyer* proceeding and its initial orders herein." *Id*. at 27. In view of how the issue has been presented, we address it on the merits. *See also* September 12, 2005 Order (denying FERC request for voluntary remand). As shown below, the challenges to FERC's MBR regime are invalid.

A. The MBR Regime Is Consistent with FPA §§ 205 and 206

Consumer Advocates assert that the Rules are part of a hodge-podge of market power determinations "that assume competitive markets exist." CA Pet. Br. 14-15; *see also id*. at 14 ("FERC is attempting to regulate electric markets through conditions on market participants"). In their view, such an approach does not amount to a "ratemaking method" that "FERC must apply" to assure just and reasonable rates. *Id.* While conceding FERC's approach "eventually" will show whether a market is competitive, Consumer Advocates contend that is not enough: "FERC is still relying solely on the assumption that all rates set in competitive markets will be just and reasonable, contrary to [*FPC v. Texaco Inc.*, 417 U.S. 380 (1974)]." *Id*. at 15. They posit the problem with FERC's approach as being "no objective standard to determine if the market produces just and reasonable rates, or rates within a zone of reasonableness," and thus it is an "indirect method" of regulation that, they claim, was rejected in *Texaco. Id*.

Consumer Advocates' claims parallel ones that have been made and rejected by the courts previously. Just the opposite of their assertion, the Court in *Texaco* stated, "We do, however, make clear that under the present Act the Commission is free to engage in indirect regulation . . . providing that it insures that the rates . . . ultimately borne by the consumer, are just and reasonable." 417 U.S. at 401; *see id*. at 387 (Court "see[s] nothing in the Act . . . which proscribes the kind of indirect regulation undertaken here"). While Consumer Advocates are wrong that FERC's MBR regime relies on indirect methods to assure the lawfulness of market-based rates, even if they were correct, indirect regulation is allowed.

Similarly, Consumer Advocates' position, that *Texaco* does not allow FERC to rely on competitive markets to produce just and reasonable rates due to the lack of an objective standard (Br. 15), was found "not [to be] a tenable position" by this Court:

> First, nothing in [*Texaco*] precludes the FERC from relying upon market based pricing. The Supreme Court's point in that case was only that where the Congress has "subject[ed] producers to regulation because of anticompetitive conditions in the industry," *id*. 417 U.S. at 399 [], the market cannot be the "final" arbiter of the reasonableness of a price. 417 U.S. at 397 []. In *Texaco*, the Commission had failed even to mention the "just and reasonable" standard; it appeared to apply only the "standard of the marketplace" in reviewing the "reasonableness of a rate." 417 U.S. at 396-97[]. Here, in contrast, the FERC has made it clear that it will exercise its § 5 authority upon its own motion or upon that of a complainant to assure that the market (*i.e.*, negotiated) rate is just and reasonable.

Elizabethtown Gas, 10 F.3d at 870.

The instant matter makes good on FERC's promise. The Rules had their genesis in FERC's investigation of the 2000-01 western markets, and provides one (of many) responses resulting from that investigation as well as FERC's ongoing review of energy markets. "[FERC] issued this proposal, in the form of proposed *pro forma* tariff provisions, to address on an industry-wide basis the types of market abuses that had occurred in the western market during 2000-01, which were only then being uncovered in our then-pending investigation of th[o]se markets." Electric Rehearing Order at P 2, JA 244; *see* Electric Rules Order at P 1, JA 92 (same).

Further, the Rules were designed as one means to assure that customers pay just and reasonable rates under a MBR regime: "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. [FERC] further finds that [its] Market Behavior Rules, as modified . . . are just and reasonable and will help ensure that rates are the product of competitive forces and thus remain just and reasonable." *Id*. at P 3, JA 92. Contrary to Consumer Advocates' assertions (Br. 15), FERC's ratemaking method of assuring markets are competitive, by itself, sufficiently meets the FPA's requirement that the rates in such markets are just and reasonable based on objective measures. "In 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 the price is close to marginal cost, such that the seller makes only a normal return on investment." *Tejas Power Corp. v. FERC*, 908 F.2d 988, 1004 (D.C. Cir. 1990); *accord Elizabethtown*, 10 F.3d at 870.

Consumer Advocates make related assertions that even if FERC can rely on a competitive market, "FERC has not offered a theory whereby the market can prevent rates that are unduly preferential or discriminatory," and "has no standard" to make such judgments. CA Pet. Br. 15. Both assertions are unfounded. The standard for judging undue discrimination or preference remains what it has always been: disparate rates for similarly situated customers that are receiving the same service. FERC's MBR regime includes many regulatory policies designed to prevent such unlawful behavior. One prominent MBR ratemaking "theory" is the adoption of *pro forma* tariff conditions that apply industry-wide, *e.g.*, the *pro forma* open access tariff under Order 888, which assures that potential customers are treated similarly. *See* Electric Rules Order at P 24, JA 95 (noting one tool used is "non-discriminatory transmission access").

Regional transmission organizations ("RTOs" and "ISOs") run real time energy markets under FERC-approved tariffs. These single price auction markets with stacked bidding from buyers and sellers set clearing prices on economic dispatch principles (that is, prices are set based on the lowest incremental priced energy needed

to serve load), to which various safeguards have been added to protect against anomalous bidding. *See generally, e.g., PSEG Energy Res. & Trade, LLC v. FERC*, 360 F.3d 200 (D.C. Cir. 2004)(describing New York ISO's real time market bidding and safeguards). All those FERC-approved ratemaking mechanisms are means to prevent discriminatory or preferential rates. For bilateral markets, quarterly reporting requirements, which are "transaction summaries [that] include long and short-term contracts," *Lockyer*, 383 F.3d at 1013, provide a means for monitoring the rates charged for reasonableness, including whether transactions are unduly discriminatory or preferential.

In short, a panoply of FERC-approved mechanisms integral to the MBR regime are designed to prevent, to discover, and to remedy unduly discriminatory rates.

B. The MBR Regime Does Not Violate FPA Filing Requirements

Consumer Advocates argue at length (Br. 16-25) that FERC's MBR regime violates the plain language of FPA § 205(c), and exceeds the authority granted by FPA § 205(d). To a large degree, those arguments repeat the arguments raised against the MBR regime in *Lockyer*, and decided against Consumer Advocates' position there. Despite Consumer Advocates' disdain for the *Lockyer* analysis and ruling, nothing

they raise undercuts the validity of the Ninth Circuit's reasoning that the FPA does not proscribe adoption of an MBR regime to set just and reasonable rates.

Most of Consumer Advocates' argument attempts vainly to show that FERC's MBR regime is equivalent to the "detariffing" undertaken in *MCI Telecomms. Corp. v. Am. Tel. & Tel. Co.*, 512 U.S. 218 (1994), and *Maislin Indus. U.S. v. Primary Steel Inc.*, 497 U.S. 116 (1990). CA Pet. Br. 16-21. The Ninth Circuit correctly ruled that the FERC MBR regime "is different from those under consideration in *MCI* and *Maislin*," finding that in both those cases, the agency "relied on market forces alone in approving market-based tariffs." 383 F.3d at 1013. Consumer Advocates contend that ruling was mistaken and improperly analyzed. CA Pet. Br. 19.

But the contrast in the regulatory regimes involved is striking. In *MCI*, the FCC first adopted "a mandatory detariffing policy, which prohibited nondominant carriers from filing tariffs," which was struck down as *ultra vires* on appeal, 512 U.S. at 221, followed by "a permissive detariffing policy," that effectively led to the same result. *Id*. at 223. Similarly, in *Maislin*, the Court was faced with an ICC policy under which "many of the carrier's rates are privately negotiated and *never* disclosed to the ICC." 497 U.S. at 132-33 (emphasis added). In contrast, FERC's MBR regime requires every seller to make two types of filings: "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." *Lockyer*, 383 F.3d at 1013.

Contrary to Consumer Advocates, the Ninth Circuit neither "mistakenly relied on decisions in this Circuit" nor "analyzed the issue exactly in reverse order of the Supreme Court's analysis." CA Pet. Br. 19. First, the Ninth Circuit relied on this Circuit's opinions for a different point (what prerequisites are needed to establish a valid MBR regime, 383 F.3d at 1012-13), not as guides to whether FERC's regime differed from those in *MCI* or *Maislin.*[13] Second, the Ninth Circuit did not have to analyze the statutory schemes in *MCI* or *Maislin* to decide factually that differing regulatory regimes were at issue. 383 at 1013.

C. The MBR Regime Does Not Violate FPA §§ 205(d) and 205(e)

Consumer Advocates assert that the filing requirements under FERC's MBR regime "cannot possibly satisfy [FPA § 205(d)'s] 'definite and specific' statutory

---

13 Consumer Advocates state that *Elizabethtown* and *Louisiana Energy and Power Auth. v. FERC*, 141 F.3d 364 (D.C. Cir. 1998) ("*LEPA*"), "never addressed the statutory procedural requirements" that Advocates are raising here. Br. 20. But, contrary to their implication (*id*. at 20-21), the Ninth Circuit did not rely on those decisions to reach its rulings that the initial filing and quarterly report filings under FERC's MBR regime satisfy FPA § 205(c). *See Lockyer*, 383 F.3d at 1013 (relying on statutory language in concluding FERC "has broad discretion to establish effective reporting requirements for administration of the tariff").

notice-by-filing requirement." CA Pet. Br. 22.[14] In their view, "FERC's sweeping reclassification of 'changes' in rates and charges as subject to mere 'reporting requirements' has been done without explanation of how this satisfies the plain language" or intent of FPA § 205(d). *Id.* Recognizing that their position was raised and rejected in *Lockyer*, Consumer Advocates state the Ninth Circuit "didn't go far enough," but should have voided the entire MBR regime as eliminating "all of the other consumer protections in sections 205(c), (d), and (e)." CA Pet. Br. 23-24. Those assertions misapprehend nearly every relevant aspect of the MBR regime as well as the ruling in *Lockyer*.

---

14 Although claiming to interpret the FPA, Consumer Advocates rely on *Southwestern Bell Corp. v. FCC*, 43 F.3d 1515, 1521 (D.C. Cir. 1995), as support. Br. 22. *Southwestern* involved different statutory language from that found in FPA § 205(d) and a different regulatory approach from FERC's MBR regime. On the latter point, the FCC "adopt[ed] a policy of permitting non-dominant common carriers to file a range of rates as opposed to fixed rates showing a schedule of charges." 43 F.3d at 1517 (citation omitted). This Court ruled the Federal Communications Act language "connotes a specific list of discern[i]ble rates, it does not admit a range of rates." *Id*. at 1521. Consumer Advocates' apparent reliance on that ruling is misplaced because the FERC quarterly reports require each seller to list the terms of each transaction individually. *See Lockyer*, 383 F.3d at 1014 (noting the "transaction-specific nature of the required filings and quoting FERC that the filings by many sellers of "aggregate data did not comply with the reporting requirements"). The transaction-specific data required in FERC's quarterly reports do not constitute a range of rates similar to what was rejected in *Southwestern.*

As summarized in *Lockyer*, 383 F.3d at 1012-13, following this Court's instruction in *Tejas*, *LEPA*, and *Elizabethtown*, "FERC's system consists of a finding that the applicant lacks market power (or has taken sufficient steps to mitigate market power), coupled with a strict reporting requirement to ensure that the rate is 'just and reasonable' and that markets are not subject to manipulation." *Id*. at 1013. Under the MBR regime, the rate change occurs when an applicant makes an FPA § 205 filing to shift from cost-of-service pricing to market-based filing. At that time, there is an "opportunity for rate suspension and hearing with the burden of proof on the [applicant], and the immediate imposition of a refund obligation," CA Pet. Br. 24, consistent with FPA § 205, as the applicant must show it lacks, or has adequately mitigated, market power before being authorized to charge market-based rates; *see generally* 18 C.F.R. Part 35 (2005)(filing requirements and procedures).

If an applicant is granted MBR rate authority, then if must file quarterly reports showing transaction-specific data for all transactions. *See* 18 C.F.R. § 35.10b. Consumer Advocates apparently believe those reports should be replaced by "procedures for notice and review" as the only means to comply with the FPA refund protection. CA Pet. Br. 24-25. The Ninth Circuit reached the opposite conclusion, ruling that FERC has "the authority to impose retroactive refunds for § 205 violations" in cases where sellers "overcharge and manipulate markets in violation of

the FPA." *Lockyer*, 393 F.3d at 1017. In contrast to Consumer Advocates' view that the reports are *per se* invalid, the Ninth Circuit found "the reporting requirements as integral to the [MBR] tariff, with implied enforcement mechanisms sufficient to provide substitute remedies for the obtaining of refunds for the imposition of unjust, unreasonable and discriminatory rates." 383 at 1016; *see id*. at 1017 ("it is clearly incorrect to conclude that the reporting requirements are anything less than essential to a valid administration of the market-based system at issue in this case").

That ruling refutes Consumer Advocates' assertion that, by relying on quarterly reports as an integral part of the MBR regime's monitoring and protection, "FERC has relegated ratepayers entirely to section 206 process for protection against unjust and unreasonable rates." CA Pet. Br. 25 (citation omitted).[15]

CONCLUSION

---

15 Consumer Advocates contend that FERC erred by "*not* stat[ing] that rates privately adopted by sellers who obey these new market [behavior] rules will be 'just and reasonable.'" CA Pet. Br. 26. The premise of that contention is not valid, as the Commission recognized, because rates may be unjust and unreasonable for reasons other than a failure to follow the market behavior rules. *See*, *e.g.*, Electric Rehearing Order at P 45 n. 28, JA 251 ("these rules will not supersede or replace parties' rights under section 206 of the FPA to file a complaint contending that a contract should be revised by the Commission, pursuant to either the 'just and reasonable' or 'public interest' tests as required by the contracts").

*/ The principal author of this brief, Dennis Lane, was FERC Solicitor at the time of initial submission of this brief.

For the reasons stated, the Commission submits that the challenged Orders should be upheld in all respects, and the petitions for review denied.

Respectfully submitted,

John S. Moot
General Counsel

Robert H. Solomon
Solicitor

Federal Energy Regulatory Commission
Washington, DC 20426
TEL: (202) 502-6600
FAX: (202) 273-0901

October 17, 2005
Final Brief: January 24, 2006 */

TABLE OF CONTENTS

PAGE

TABLE OF CONTENTS

PAGE

TABLE OF CONTENTS

PAGE

TABLE OF AUTHORITIES

COURT CASES: **PAGE**

*** Cases chiefly relied upon are marked with an asterisk**

TABLE OF AUTHORITIES

COURT CASES: **PAGE**

TABLE OF AUTHORITIES

COURT CASES: **PAGE**

ADMINISTRATIVE CASES:

TABLE OF AUTHORITIES

STATUTES: **PAGE**

REGULATIONS:

TABLE OF AUTHORITIES

REGULATIONS: **PAGE**

GLOSSARY

CA Petitioners	Petitioners California State Parties and Consumer Advocates
CI	Intervenors in support of Petitioner Cinergy
Electric Rehearing Order	*Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 107 FERC ¶ 61,175 (2004), JA 244
Electric Rules Order	*Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 105 FERC ¶ 61,218 (2003), JA 91
FPA	Federal Power Act, 16 U.S.C. § 824 *et seq*.
Gas Rehearing Order	*In the Matter of Amendments to Blanket Sales Certificates*, 107 FERC ¶ 61,174 (2004), JA 229
I I	Industrial Intervenors
MBR regime	Market-based rate regime
MP Parties	Market Participant Petitioners
NGA	Natural Gas Act, 15 U.S.C. § 717, *et seq.*
NGPA	Natural Gas Policy Act, Pub. L. 95-621 (Nov. 8, 1978), 92 Stat. 3350, *codified at* 15 U.S.C.§ 3301 *et seq.*
Order No. 644	*Amendments to Blanket Sales Certificates*, FERC Stats. & Regs. ¶ 31,153 (2003), JA 65
Proposed Rules Order	*Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 103 FERC ¶ 61,349 (2003), JA 39
Western	Petitioner Western Resources, Inc.