

Testimony of Lee Ann Watson
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Federal Energy Regulatory Commission
Before the Committee on Commerce, Science and Transportation
United States Senate
June 3, 2008

Madam Chair and members of the Committee: Thank you for inviting me to testify today. My testimony addresses the Federal Energy Regulatory Commission's (FERC) implementation of the aspects of the Energy Policy Act of 2005 (EPAAct 2005) provisions prohibiting manipulation of wholesale electric energy and natural gas markets. I appear before you today as a staff witness and do not represent the views of the Commission or any individual Commissioner.

At the outset, I should note for the Committee's information that I am not prepared to discuss whether there is or has been manipulation of oil or petroleum markets nor am I able to discuss crude oil or gasoline prices. With respect to oil and petroleum, FERC's jurisdiction is very limited. FERC has jurisdiction only over ratemaking of oil pipeline transportation in interstate commerce under the authority of the Interstate Commerce Act and the Department of Energy Organization Act of 1977, 42 U.S.C. § 7101 *et seq.* FERC has no jurisdiction over, and therefore no authority to investigate, the prices charged for oil, gasoline, diesel, or heating oil, or the markets where those and other oil and petroleum products are traded.

FERC's primary mission is to ensure "just and reasonable" rates for certain wholesale sales of electric energy and natural gas in interstate commerce and electric transmission and natural gas transportation in interstate commerce. FERC's efforts to prohibit manipulation of the wholesale sales of electric energy and natural gas markets began in earnest in November 2003, prior to EPAAct 2005. At that time, the FERC adopted the Market Behavior Rules, including Market Behavior Rule 2.¹ In contrast to the FERC's current broad EPAAct 2005 anti-manipulation regulations, which I will discuss momentarily, Market Behavior Rule 2 was limited in scope and application; it applied to certain sales and sellers of electricity and natural gas. Notwithstanding its limitations, Market Behavior Rule 2 and its companion rules were an important first step in an evolving enforcement program at FERC that balanced the need for clearly delineated "rules of the road" for market participants without unduly impairing FERC's ability to address new and unforeseen abuses.

On August 8, 2005, EPAAct 2005 became law and significantly supplemented the Commission's enforcement authorities. Three enforcement tools in particular provided FERC with the ability to more adequately police jurisdictional electric and natural gas

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), *reh'g denied*, 107 FERC ¶ 61,175 (2004); *Amendments to Blanket Sales Certificates*, 105 FERC ¶ 61,218 (2003), *reh'g denied*, 107 FERC ¶ 61,174 (2004).

markets and sanction manipulative behavior in those markets. First, EAct 2005 amended the FPA and NGA to grant broad statutory authority to prohibit fraud and market manipulation. Second, it granted robust civil penalty authority to deter and punish violations of FERC orders, rules and regulations. Third, it provides authority to seek a court order to bar individuals found to have violated FERC's new anti-manipulation authority from acting as an officer or director of a jurisdictional entity, or engaging in FERC-jurisdictional transactions. I discuss these new authorities in further detail below.

In sections 315 and 1283 of EAct 2005, Congress added section 4A to the Natural Gas Act (NGA) and section 222 to the Federal Power Act (FPA), respectively.² These sections prohibit “any entity,” not only those traditional energy companies regulated by FERC, from the use or employment of “any manipulative or deceptive device or contrivance,” as those terms are used in section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), in connection with the purchase or sale of natural gas, electric energy, or transportation or transmission services subject to FERC's jurisdiction.³ Although sections 315 and 1283 of EAct were not self-implementing, by modeling them on section 10(b) of the Exchange Act, and explicitly directing that certain terms be used as in section 10(b), Congress provided FERC a clear model to follow – SEC Rule 10b-5 – in prohibiting market manipulation.⁴

On October 20, 2005, only two months after the passage of EAct 2005, FERC took the first public step toward implementing the anti-manipulation fraud authority when it issued a Notice of Proposed Rulemaking (NOPR).⁵ FERC was able to act quickly in part because FERC staff had been studying SEC Rule 10b-5 in anticipation of the passage of EAct 2005. Upon the passage of EAct 2005, FERC staff met with senior enforcement staff from the SEC and held several subsequent conference calls with them to aid in FERC's understanding of the model upon which it would propose its anti-manipulation rule. Thirty parties filed comments and nine parties filed reply comments to the NOPR, representing a diverse group of industry stakeholders. Overwhelmingly, commenters were supportive of our efforts to implement well-developed, clear and fair rules modeled on SEC Rule 10b-5 because the approach provided FERC, and industry, the opportunity, where appropriate, to make use of the significant body of case law that has developed under Exchange Act section 10(b) and SEC Rule 10b-5. In the NOPR, FERC noted the overlap between its previously adopted Market Behavior Rule 2 and the proposed EAct 2005 anti-manipulation regulations. FERC said that it would retain Market Behavior Rule 2 pending the promulgation of a final EAct 2005 regulation so as to ensure there would be no gap in FERC's prohibition of market manipulation. FERC also said, however, that it would seek comment on whether it should revise or rescind Market Behavior Rule 2.

² Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594 (2005) *et seq.*; 15 U.S.C. §§ 717 *et al.* (2000); 16 U.S.C. §§ 791 *et al.* (2000).

³ Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2000).

⁴ 17 C.F.R. § 240.10b-5 (2007).

⁵ *Prohibition of Energy Market Manipulation*, 113 FERC ¶ 61,067 (2005) (NOPR).

In November 2005, FERC proposed to rescind Market Behavior Rule 2 and the analogous gas regulation once it issued new anti-manipulation provisions of EAct 2005.⁶ FERC noted that rescission of Market Behavior Rule 2 would simplify FERC's rules by avoiding duplicative regulation, and in so doing, reduce regulatory uncertainty by assuring that all market participants are held to the same standard. FERC explained that rescinding the Market Behavior Rules was consistent with Congressional intent in EAct 2005, which provided FERC explicit anti-manipulation authority and a clear model to follow in implementing that authority. FERC was concerned that having two general anti-manipulation rules, differing in scope and application, would result in significant regulatory uncertainty without offering any additional protection for customers. After careful review of the 21 comments and four reply comments in response to the November 2005 order, which were mostly supportive of FERC's objective to bring greater clarity to its rules and regulations, FERC exercised its discretion and rescinded Market Behavior Rule 2 in February 2006, approximately a month after the effective date of the new EAct 2005 anti-manipulation regulations.⁷

As mentioned earlier, in EAct 2005, Congress added section 4A to the NGA and section 222 to the FPA. These sections prohibit "any entity" from the use or employment of "any manipulative or deceptive device or contrivance," as those terms are used in section 10(b) of the Exchange Act, in connection with the purchase or sale of natural gas, electric energy, or transportation or transmission services subject to FERC's jurisdiction.

On January 19, 2006, just five months after the passage of EAct 2005, FERC implemented section 4A to the NGA and section 222 to the FPA and promulgated its final EAct 2005 anti-manipulation regulations, which are codified in Part 1c of Title 18 of the Code of Federal Regulations.⁸ Consistent with Congressional intent, the scope of application of Part 1c is not limited to FERC jurisdictional entities. Instead, Part 1c is a "catch-all" provision, applying to any entity that perpetrates a fraud, with the requisite scienter, in connection with the purchase or sale of natural gas or electric energy or transportation or transmission services subject to FERC's jurisdiction. The issues raised by commenters to the NOPR did not require substantive changes to the proposed rule because the preamble to the final rule, Order No. 670, deals with the issues raised and provides clarity and guidance as to how the rule will operate.⁹ For example, in Order No. 670, FERC recognizes the differences in mission between the FERC and the SEC – that is, the SEC does not have a duty to assure that the price of a security is just and reasonable just as FERC's duty is not to protect purchasers through a regime of disclosure. Despite these differences in mission, however, FERC recognized that natural gas and power markets, like securities markets, are susceptible to fraud and market manipulation.

⁶ *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 113 FERC ¶ 61,190 (2005).

⁷ *Order Revising Market-Based Rate Tariffs and Authorizations*, 114 FERC ¶ 61,165 (2006).

⁸ 18 C.F.R. § 1c (2007).

⁹ *Prohibition of Energy Market Manipulation*, III FERC Stats. & Regs., Regulation Preambles P31,202 (2006) (Order No. 670).

Part 1c gives FERC an important tool to ensure that the markets subject to its jurisdiction are well-functioning, and represents an important step toward assuring that customers are properly safeguarded from acts of market manipulation while providing regulatory certainty to market participants. Part 1c became effective upon its publication in the Federal Register on January 26, 2006. Two enforcement actions, one under Part 1c and one under its predecessor Market Behavior Rule 2, where FERC made preliminary findings of market manipulation involving traders' unlawful actions in natural gas markets and proposed civil penalties totaling \$458 million, demonstrate that FERC is dedicated to ensuring the markets subject to its jurisdiction are well-functioning and free from fraud.¹⁰ FERC's investigative activities are not limited to these two matters, but FERC's regulations prohibit staff from discussing any other potential investigative matters.

In EAct 2005, Congress also granted FERC enhanced authority to assess civil penalties for violations of the Federal Power Act, Natural Gas Act and the Natural Gas Policy Act in three important ways. First, Congress expanded FERC's FPA civil penalty authority to cover violations of any provision of Part II of the FPA, as well as of any rule or order issued there under.¹¹ Second, Congress extended FERC's civil penalty authority to cover violations of the NGA or any rule, regulation, restriction, condition, or order made or imposed by FERC under NGA authority.¹² Third, Congress established the maximum civil penalty FERC may assess under the NGA, NGPA, or Part II of the FPA as \$1,000,000 per violation for each day that it continues.¹³ Since January 1, 2006, FERC has employed its new civil penalty authority, which was not made retroactive by EAct 2005, in 15 cases resulting in a total of over \$52 million in civil penalties and tailored compliance plans.

The third tool EAct 2005 provided FERC is the ability to seek an order of a federal district court to prohibit, conditionally or unconditionally, and permanently or for such period of time as the court determines, any individual who is engaged or has engaged in practices constituting a violation of FERC's EAct 2005 anti-manipulation regulations from: (1) acting as an officer or director of a natural gas company; or (2) engaging in the business of the purchasing or selling of natural gas or electric energy, or the purchasing or selling of transmission services subject to FERC's jurisdiction. This is a particularly useful tool where, for example, FERC determines that it is necessary to seek the removal of a rogue trader that was found to have violated Part 1c as an individual. A similar provision is contained in the FPA.

Prior to the promulgation of FERC's new anti-manipulation rule, but on the same day in October 2005 when FERC issued its proposed anti-manipulation rule NOPR, FERC issued its Policy Statement on Enforcement to provide the public with guidance and regulatory certainty regarding FERC's enforcement of the statutes, orders, rules and

¹⁰ See *Energy Transfer Partners, L.P.*, 120 FERC P 61,086 (2007) (Market Behavior Rule 2); *Amaranth Advisors L.L.C.*, 120 FERC P 61,085 (2007) (Anti-Manipulation Rule).

¹¹ 16 U.S.C. § 825o-1 (2000) (as amended by EAct 2005, § 1284(e)); 16 U.S.C. § 823b (2000).

¹² 15 U.S.C. § 717t-1 (2000) (added by EAct 2005, § 314(a)(1)).

¹³ *Supra* notes 11 and 12; 15 U.S.C. § 3414(b)(6) (2000) (as amended by EAct 2005, § 314).

regulations it administers.¹⁴ Among other things, the Policy Statement on Enforcement details the FERC's penalty assessment process. Shortly after the issuance of the Policy Statement on Enforcement, FERC's instituted a No-Action Letter Process whereby regulated entities can seek informal staff advice regarding whether a transaction would be viewed by staff as constituting a violation of certain orders or regulations.¹⁵ In both Orders, FERC drew on the best practices of other economic regulators including the Department of Justice, SEC and CFTC. As of May 15, 2008, following a public conference where stakeholders were invited to comment on aspects of FERC's enforcement program, FERC issued a Revised Policy Statement on Enforcement which builds on the October 2005 statement.¹⁶ Additionally, in December 2006, FERC issued a policy statement regarding the process for assessing civil penalties, which provides a comprehensive review of the statutory requirements associated with the imposition of civil penalties under Parts I and II of the FPA, the NGA, and the NGPA.¹⁷

In conclusion, I want again to thank the Committee for this opportunity to testify today on an important aspect of the FERC's enforcement program. I would be happy to answer any questions members of the Committee may have.

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In sum, below are the milestones in the implementation timeline for the EAct 2005 anti-manipulation regulations:

1. Pre-Passage of EAct 2005: FERC staff conducts due diligence on SEC and CFTC anti-manipulation rules and precedent.
2. August 8, 2005: EAct 2005 becomes law and FERC staff forms an anti-manipulation rule drafting team.
3. September 14, 2005: FERC staff meets with SEC staff to discuss SEC's experience with Rule 10b-5.
4. October 20, 2005: FERC issues its NOPR to prohibit energy market manipulation and FERC issues its first Policy Statement on Enforcement to provide guidance and regulatory certainty regarding FERC's enforcement program.
5. November 18 – December 30, 2005: FERC receives and reviews thirty comments and nine reply comments on the NOPR.
6. January 19, 2006: FERC promulgates its anti-manipulation rules by amending its regulations to implement the anti-manipulation authority granted in EAct 2005.
7. January 26, 2006: FERC's anti-manipulation regulations became effective.

¹⁴ *Enforcement of Statutes, Orders, Rules, and Regulations*, 113 FERC ¶ 61,068 (2005).

¹⁵ *Informal Staff Advice on Regulatory Requirements*, 113 FERC ¶ 61,174 (2005).

¹⁶ *Enforcement of Statutes, Orders, Rules, and Regulations*, 123 FERC ¶ 61,156 (2008) (Revised Policy Statement on Enforcement) (superseding *Enforcement of Statutes, Orders, Rules, and Regulations*, 113 FERC ¶ 61,068 (2005)).

¹⁷ *Process for Assessing Civil Penalties*, 117 FERC ¶ 61,317 (2006).