

November 22, 2011

FERC REPORTS ON 2011 ENFORCEMENT ACTIVITIES AND LIMITS AFFILIATE BIDDING FOR GAS PIPELINE CAPACITY

On November 17, 2011, FERC issued its annual report on enforcement activities. The report is significant because it identifies FERC's Office of Enforcement's ("Enforcement") priorities and provides information regarding non-public enforcement activities, including self-reported violations and investigations closed without public enforcement action. As such, the report should be of interest to all market participants because it helps provide a better understanding of FERC's enforcement concerns and thus provide some guidance to compliance efforts.

In addition, FERC adopted a new rule prohibiting multiple affiliates of the same entity from bidding in an open season for natural gas pipeline capacity in which capacity is allocated on a *pro rata* basis, unless each affiliate has an independent business reason for submitting a bid. The new rule is aimed at preventing a strategy of bidding with multiple affiliates to defeat the *pro rata* allocation mechanism and obtain a greater share of the available capacity than a single bidder could have acquired by itself. The rule should be of interest to firms that participate in FERC's natural gas markets.

2011 REPORT ON ENFORCEMENT (DOCKET No. AD07-13-004)

Enforcement remains primarily concerned with cases involving the greatest harm to the public, where there is often significant gain to the violator and/or loss to the victims. Enforcement's priorities for FY2011 and FY2012 continue to be (i) fraud and market manipulation, (ii) serious violations of reliability standards, (iii) anticompetitive conduct, and (iv) conduct that threatens transparency in regulated markets. Anticompetitive conduct and conduct that threatens transparency include violations of rules designed to limit market power or to ensure the efficient operation of regulated markets. With respect to reliability, Enforcement primarily focuses on violations resulting in actual harm, but also is concerned with cases involving repeat violations, violations of standards that carry a high violation risk factor, and violations that present a substantial actual risk to the Bulk-Power System.

An overview of the activities of each of Enforcement's divisions during FY2011 follows:

Division of Investigations ("DOI")

- **Significant Matters:** During FY2011, there were twelve FERC orders related to investigations. Nine of the orders pertained to settlements that collectively resulted in the payment of over \$2.9 million in civil penalties and more than \$2.75 million in disgorgement. The nine settlements resolved investigations concerning market manipulation, the submission of misleading information, reliability standards, open access transmission tariff ("OATT") violations, natural gas open access policies, and market based rate regulations. Notably, settlements involving

capacity release violations have continued to decrease. The Report states that this trend is not surprising because capacity release regulations and compliance programs have matured.

During FY2011, civil penalties were also assessed against two individuals. Thirty million dollars in civil penalties were assessed against former Amaranth Advisors L.L.C. trader Brian Hunter for violating FERC's anti-manipulation rule and \$50,000 in civil penalties were assessed against Moussa I. Kourouma for violating FERC regulations by knowingly submitting misleading information and omitting material facts in communications with FERC and a FERC-approved RTO.

In a matter involving allegations of market manipulation against ISO-New England, Inc. and several other parties, FERC agreed with DOI that the complainants failed to demonstrate scienter, in part because market participants fully intended to deliver capacity-backed energy in the unlikely event ISO-NE called on it.

Finally, in addition to matters before the Commission, DOI appeared in federal district court to enforce a subpoena against a non-cooperative witness in a market manipulation investigation and sought an injunction to enforce the terms of a hydropower license.

- **Self-Reports:** Since the issuance of FERC's first Policy Statement on Enforcement in 2005, DOI has received 458 self-reports, 107 of which were received during FY2011. In FY2011, OATT violations continued to account for a significant portion of self-reports. Of the 107 reports received in FY2011, 54 were closed after an initial review without opening an investigation and review is still pending for 53 self-reports. Reasons cited for closing self-reports with no action include the absence of harm or wrongful intent, prompt self-reporting and remedial action, a lack of willful conduct, and inadvertent errors.
- **Investigations:** DOI opened twelve non-self-reported investigations and two inquiries in FY2011. Five investigations involved tariff violations, eight investigations involved market manipulation or false statements, two investigations related to hydropower licenses, one investigation involved standard of conduct issues, and one investigation related to FERC's authority under the Interstate Commerce Act (some of the investigations involved more than one type of violation or multiple subjects). Nineteen investigations were closed through settlement, an order to show cause, or without enforcement action. Reasons for closing investigations without further action included the fact that violations lent themselves more readily to resolution by a regional entity, a lack of economic gain/harm, and improvement with respect to compliance programs. DOI learned of the investigations through referrals from market monitors, the Division of Energy Market Oversight ("Market Oversight") and other FERC offices, and the Enforcement Hotline. In addition, FERC identified the need for an investigation into significant disturbances on the Bulk-Power System.
- **Notices of Penalty ("NOP") and Alleged Violations:** DOI processed 270 NOPs, in which Regional Entities proposed monetary penalties totaling approximately \$12 million for violations of reliability standards. In addition, eleven notices of alleged violations were issued in FY2011.
- **Enforcement Hotline:** During FY2011, Enforcement received 161 hotline calls and resolved 144 matters (including matters that remained open at the end of FY2010). A significant percentage of calls received related to subjects outside of FERC's jurisdiction or contested matters pending before the Commission.

Division of Audits ("DA")

- **Audits:** In FY2011, DA completed 72 audits and related activities. Fifty-six audits were traditional audits of public utilities, natural gas pipelines, and storage companies. These audits

were financial and nonfinancial. The audits addressed compliance with OATT provisions, market-based rates tariffs, electric quarterly reports, mergers and acquisitions, pipeline postings, affiliate transaction rules, fuel cost recovery mechanisms, and reporting requirements. These audits resulted in 300 recommendations for corrective action and included the write off of \$95.8 million in regulated assets for one company.

The remaining 16 audits were reliability oversight audits jointly conducted with the Office of Electric Reliability to observe and provide feedback to regional entities as they conducted their audits of registered entities.

- **Compliance:** To promote compliance through transparency and outreach, DA posted audit commencement letters and audit reports on FERC's website and focused on providing greater detail in audit reports. DA shared "best practices" including the use of compliance help lines, annual certifications, and external consultants and auditors. DA observed innovative approaches to compliance, including company-sponsored art competitions with ethics as a theme and an "Ethics Week." DA continued to see evidence of robust compliance programs in which companies proactively and quickly implemented corrective actions and enhancements. Several companies exceeded compliance requirements.
- **Other Activities:** DA continued to focus on significant accounting matters, including compliance with rules and regulations contained in the Uniform System of Accounts, requests for approval from the Chief Accountant, certificate proceedings, merger and acquisition proceedings, rate proceedings, efforts to incorporate International Financial Reporting Standards into the financial reporting system of publicly traded companies in the United States, and FERC's policy on the allowance for funds used during construction.

Market Oversight

- **Market Monitoring:** Market Oversight initiated projects designed to evaluate market trends, assess behavior and identify potential manipulation and fraud. During FY2011, projects included analyses of bidweek natural gas prices and assessments of renewable portfolio standards.

Market Oversight also presented an analysis of physical gas market transactions for 2009 using Form 552 submissions to help the public understand the market's level of reliance on published price indices. Market Oversight concluded that the data indicated that index publishers were deriving index prices from relatively small volumes of gas and noted that this practice may be of some concern because the indices may set the price of physical and financial gas contracts.

Finally, the United States Court of Appeals for the Fifth Circuit vacated Order No. 720, a final rule which required certain intrastate natural gas pipelines to post scheduled flow information.

- Other activities conducted by Market Oversight included technical analysis and investigation support, outreach and communication, forms administration and filing compliance, and rulemakings.

FERC's 2011 Report on Enforcement is available [here](#).

RESTRICTIONS ON AFFILIATE BIDDING FOR GAS PIPELINE CAPACITY

The affiliate bidding rule, issued in FERC Order No. 894, prohibits multiple affiliates of the same entity from bidding in an open season for natural gas pipeline capacity in which the capacity is

allocated on a *pro rata* basis, unless each affiliate has an independent business reason for submitting a bid.

FERC allows available interstate pipeline capacity to be allocated to shippers that value it the most, up to the pipeline's maximum tariff rate. Some pipelines hold open seasons where shippers bid for available capacity, and FERC allows pipelines to evaluate the bids based on their net present value to the pipeline. If there is not enough capacity to meet all bids at the maximum tariff rate with the same net present value, one tiebreaker mechanism used is a *pro rata* allocation of capacity whereby the capacity is allocated based on the ratio of each shipper's respective nomination to all qualifying nominations.

FERC's reason for the new rule is that some entities have used a strategy of bidding with multiple affiliates to defeat the *pro rata* allocation tiebreaker mechanism and obtain a greater share of the available capacity than a single bidder could have acquired by itself. Each affiliate could then release the capacity to a single affiliate or otherwise allow its affiliate to obtain use of the allocated capacity. FERC says such gaming of the *pro rata* allocation mechanism has a chilling effect on competition and denies a fair distribution to all maximum rate bidders.

While prohibiting bidding for pipeline capacity by multiple affiliates in general, FERC recognized that not all multiple affiliate bidding is used to defeat the *pro rata* allocation mechanism. Accordingly, the rule provides an exception for affiliates that have independent business reasons for submitting their bids. The intent of this exception is to allow each affiliate to acquire capacity "which will facilitate or enhance its ability to provide service of value to its own customers or otherwise help accomplish its own business goals."

FERC recognized that it is impossible to describe every situation that demonstrates an independent business reason for bidding, but it did provide a few examples, such as:

- A marketing arm of an energy company may bid to secure capacity for its wholesale customers and a retail operation of the same company may bid to secure capacity to serve its retail customers.
- A marketing company may have two or more affiliates operating in different geographic areas, thus serving distinct markets all of which may be served by transportation on the same pipeline.
- An affiliate may use natural gas to operate an industrial plant, refinery, or electric generation facility, and seek pipeline capacity to transport natural gas to that facility.
- A producer affiliate may be developing a new production field and seek pipeline capacity to transport natural gas produced from that field to market.
- A marketer affiliate participating in a retail access program may seek pipeline capacity to serve its retail customers.
- A marketer affiliate may seek pipeline capacity to transport natural gas to any other type of customer to whom it ordinarily sells natural gas.

FERC noted that in these examples the affiliate is seeking pipeline capacity to transport natural gas which it will consume in its own business operations or sell to others as part of its ordinary course of business. By contrast, indications that a company is not acting independently would be if the business unit "is used by its parent or affiliate in a way that differs from its usual business operations, is used to perform transactions that an affiliate or parent could not, or is acting as an 'alter ego' of an affiliate or parent."

The rule will be effective 30 days after publication in the Federal Register and no earlier than December 22.

Order No. 894 is available [here](#).

If you have any questions concerning the material discussed in this client alert, please contact the following members of our energy practice group:

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