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August 24, 2012

Via Email

Steven C. Tabackman
Federal Energy Regulatory Commission
Office of Enforcement, Division of Investigations
888 First Street, N.E.
Room 51-69
Washington, D.C. 20426

Re: *In Re PJM Up-to Congestion Transactions*, Docket No. IN10-5-000

Dear Steve:

I haven't heard from you in awhile and thought I would check in. When we met at FERC back in February to discuss the issues raised in Powhatan's and Dr. Chen's position statements, you and your colleagues estimated that you would be in a position to make a decision about this investigation by June. I hope the fact that we are now in late August means that you have decided to focus your attention on other endeavors and that the investigation of Powhatan and Dr. Chen can be closed.

As you know, we at Powhatan believe that FERC can never win this case. If you go forward, it will only result in an adverse federal court decision that will terminate this case and haunt you in others. Considering the relatively small dollar amounts involved here, it makes no sense for FERC to voluntarily – and needlessly – run into a wall in this case.

The position statements, as well as Dr. Chen's supplemental submission in March, go into detail as to why there is no fraud here. The Powhatan position statement also developed the due process argument, explaining that neither Powhatan nor Dr. Chen was on reasonable notice of a potential violation. As I mentioned to you after Dr. Tabors' deposition in May, the due process argument could be the ultimate winner: faced with this case, there really would be no need for a court to delve into the details of the trading (or the details of the arguments regarding fraud and scienter) when there is such an obvious constitutional prohibition against liability. Thus, the due process issue deserves a closer look.

As we noted in our position statement, Powhatan was never put on notice prior to or during the relevant period at issue that executing up-to-congestion transactions which were motivated in part by the collection of transmission loss credits ("TLCs") was prohibited. As we explained, no express PJM tariff provision, no pronouncement and no

Commission order ever alerted Powhatan that such trading could be unlawful – and the tariff language related to the TLCs expressly provided for the credits to be paid to anyone who incurred the transmission costs and other fixed costs of the PJM system, without any other limitation. We provided you with the *Upton* case, as an example of the SEC violating due process in circumstances in which the individual at issue there had much *more* notice than Powhatan had here. *See Upton v. SEC*, 75 F.3d 92, 98 (2d Cir. 1996).

We also reminded you that when it first addressed the allocation of transmission loss credits in the *Black Oak Energy* proceedings, the Commission itself recognized the incentives that the credits would provide to virtual traders:

> Paying excess loss charges to arbitrageurs also is inconsistent with the concept of arbitrage itself. The benefits of arbitrage are supposed to result from trading acumen in being able to spot divergences between markets. As stated above, arbitrageurs create their own load by the volume of their trades. ***If arbitrageurs can profit from the volume of their trades, they are not reacting only to perceived price differentials in LMP or congestion, and may make trades that would not be profitable based solely on price differentials alone.***

Black Oak Energy, Order Denying Complaint, 122 F.E.R.C. ¶ 61,208 at P 51 (Mar. 6, 2008) (emphasis added). We noted that despite such concerns, the Commission ultimately approved the inclusion of virtual traders in the allocation of TLCs with no limitation other than that the traders pay into the fixed costs of the system, which as the Commission expressly recognized, would include up-to-congestion transactions. *See Black Oak Energy*, Order Accepting Compliance Filing, 128 F.E.R.C. ¶ 61,262 at P 26 (Sept. 17, 2009) ("As PJM acknowledges, some arbitrageurs or virtual traders pay transmission access charges related to Up-to-Congestion transactions, which contribute to the fixed costs of the transmission system, and which should be included in the allocation process . . .").

At our meeting on February 28, 2012, Lauren Rosenblatt responded to the foregoing due process argument by suggesting that we had read the above excerpt from the *Black Oak Energy* proceedings "out of context." Ms. Rosenblatt is wrong. We have not read anything out of context. Indeed, the Commission again addressed the very same issue about including virtual traders in the allocation of transmission loss credits when it considered Black Oak Energy's request for rehearing of the Commission's Order denying the complaint:

> Complainants further claim that they are entitled to a large portion of the marginal line loss surplus because the Commission has recognized the value of arbitrage in energy markets. We do not dispute the value of arbitrage in energy markets. However, such arbitrage is valuable because the arbitrageur faces the marginal cost of energy and can therefore make transactions that reduce price divergence between the Day-Ahead and Real-Time markets. For arbitrage to be effective, arbitrageurs therefore should pay and receive the market price for energy, which in this case includes marginal line losses. As long as arbitrageurs receive and pay the marginal energy price, arbitrage is not jeopardized, and we see no entitlement to additional payment of surplus unrelated to the transmission charges. ***Indeed, payment of the surplus to arbitrageurs that is unrelated to the transmission costs could distort arbitrage decisions and reduce the value of arbitrage by creating an incentive for arbitrageurs to engage in purchase decisions, not because of price divergence, but simply to increase marginal line loss payments.***

Black Oak Energy, Order Denying Reh'g in Part & Granting Reh'g in Part, 125 F.E.R.C. 61,042 at P 43 (Oct. 16, 2008) (citing Complaint Order, 122 F.E.R.C. ¶ 61,208 at P 51) (emphasis added).

Thus, having at least *twice* addressed the issue of including virtual traders in the allocation of TLCs, the Commission nevertheless requested that PJM revise its tariff to include up-to-congestion virtual traders. And despite having had the opportunity to circumscribe the very conduct at issue in this matter, the Commission did not ask PJM to limit or qualify the virtual traders' receipt of TLCs for up-to-congestion transactions, nor did the Commission issue any pronouncement or order advising virtual traders that it would consider trading for the TLCs to be wrongful conduct. In other words, the Commission evaluated and assessed how adding TLC payments would affect trading behavior, and it consciously chose to change the incentives of the trade. Not only did the Commission predict that traders would alter their behavior, but the Commission arguably encouraged traders to do the very thing that Dr. Chen did. On this basis alone, any case against Powhatan or Dr. Chen is dead on arrival.

With that background in mind, it is worth reviewing a recent FERC case in which due process concerns took center stage – and ultimately led the Office of Enforcement to drop its market manipulation claim. In 2009, the Office of Enforcement recommended that the Commission issue an order to show cause and notice of proposed penalties

against National Fuel Marketing Company, LLC ("NFM") for alleged violations of the Commission's market manipulation rule and the Commission's shipper-must-have-title requirement. *See National Fuel Marketing Company, LLC, et al.*, Order to Show Cause and Notice of Proposed Penalties, 126 F.E.R.C. ¶ 61,042 (Jan. 15, 2009) ("NFM Order to Show Cause"). The claims against NFM arose out of the Office of Enforcement's investigation into bidding for interstate natural gas transportation capacity on Cheyenne Plains Gas Pipeline Company ("Cheyenne") in March 2007. At that time, Cheyenne had posted an open season notice inviting bids for its unsubscribed capacity. In response, NFM and three of its subsidiaries each placed bids and subsequently were among the 48 "winning" bidders awarded a pro rata allocation of the available capacity.

Following the close of the bidding, however, the Office of Enforcement received complaints from other market participants who claimed that some bidders had submitted multiple bids through affiliated companies in order to "game" Cheyenne's pro rata allocation. The Office of Enforcement opened investigations into several bidders, including NFM, who had engaged in multiple affiliate bidding and ultimately alleged that their conduct violated the Commission's market manipulation rule. Four of those bidders chose to settle with the Commission and agreed to pay civil penalties and disgorge profits related to the Cheyenne bidding. NFM decided to contest the Office of Enforcement's allegations.

In January 2009, the Office of Enforcement convinced the Commission to issue a show cause order against NFM. The order was issued over the strong dissents of two of the five Commissioners, Philip D. Moeller and Marc Spitzer. Significantly, the dissents of both Commissioner Moeller and Commissioner Spitzer were based on due process.

In his dissent, Commissioner Moeller concluded that NFM did not have advance notice that multiple affiliate bidding could be a violation of the Commission's market manipulation rule. Commissioner Moeller chastised the Commission for issuing an order against NFM that "violat[ed] th[e] principle of fundamental fairness." NFM Order to Show Cause, Moeller, Commissioner dissenting at 1 ("Commissioner Moeller Dissent"). Specifically, he noted that he had "stated twice in the last year [that] '[t]hose who are subject to Commission penalties need to know, in advance, what they must do to avoid a penalty.'" *Id.* (citing *Enforcement Statutes, Regulations, and Orders* 123 F.E.R.C. ¶ 61,156 (2008) (Moeller, Commissioner concurring) and *Compliance with Statutes, Regulations, and Orders* 125 F.E.R.C. ¶ 61,058 (2008) (Moeller, Commissioner concurring)).

Yet the Commission had ignored that basic principle by issuing an order to show cause against NFM, which violated due process because (1) the Office of Enforcement's interpretation of what constituted 'legitimate' multiple affiliate bidding was not disclosed to the bidders, including NFM, on the Cheyenne open season until *after* the Office of

Enforcement launched their market manipulation investigation; (2) the Commission had previously declined to address the issue of legitimate multiple affiliate bidding when faced with the very same issue following the Trailblazer open season several years before; and (3) the Commission likewise did not take the opportunity to change its policy with respect to interstate pipelines such as Cheyenne when it had previously addressed the issue of multiple affiliate bidding in the context of the Alaska pipelines. Commissioner Moeller Dissent at 3-7. Although Commissioner Moeller noted that as part of the Trailblazer investigation, the Office of Enforcement had asked Trailblazer to notify the industry that bidders could not "game" the system by using affiliate bids, he concluded that "notification by a pipeline is not equivalent to a Commission order" and he further noted that even the Office of Enforcement Staff recognized this in their report: "'[I]t is a well-settled principle that the Commission speaks through its orders, not the absence thereof.'" *Id.* at 6 (quoting NFM Report at 27). Finally, in addition to his due process concerns, Commissioner Moeller also found "fundamental flaws" in the Office of Enforcement's claims of market manipulation against NFM because he noted that "fraud almost universally involves an allegation of concealment or misrepresentation," and such allegations were absent from the Staff's report on NFM's conduct. *Id.* at 7.

Similarly, Commissioner Spitzer dissented from the show cause order because he found that over the years the Commission had been "less than clear" and had sent a "mixed message" to the industry about the propriety of multiple affiliate bidding. *Statement of Commissioner Marc Spitzer on Enforcement Actions* at 1 (Jan. 15, 2009) ("Commissioner Spitzer Dissent"). As such, he found that "[a] reasonable mind could have concluded multiple-affiliate bidding was not unlawful." *Id.* at 3. Thus, he concluded that "the Commission should have used the[] proceedings to first provide guidance regarding multiple-affiliate bidding practices rather than impose civil penalties." *Id.*

In February 2009, NFM responded to the show cause order and requested rehearing. *See National Fuel Marketing Company, LLC, et al.,* Dkt. No. IN09-10-000, Answer of National Fuel Marketing Company, LLC, et al. in Opposition to Order to Show Cause and Notice of Proposed Penalties and Alternative Motion for a Formal Evidentiary Trial-Type Hearing Before an Administrative Law Judge and Request for Rehearing of National Fuel Marketing Company, LLC, et al., (February 17, 2009). NFM continued to fight the allegations of market manipulation for an additional two years.

In April 2011, NFM and the Office of Enforcement reached a settlement. The Office of Enforcement dropped the market manipulation claim against NFM in its entirety, including the bulk of its originally recommended $4.5 million civil penalty, and NFM agreed to pay a minimal fine to settle the lesser claim of violating the Commission's shipper-must-have-title requirement. *See National Fuel Marketing*

Company, LLC et al., Order Approving Stipulation and Consent Agreement, 135 F.E.R.C. ¶ 61,011 (Apr. 7, 2011).

The similarities between the NFM matter and the instant matter are palpable. Here, as in NFM, no Commission order or express regulation or rule ever alerted Powhatan that trades motivated in part by the collection of TLCs were possibly unlawful. It was only *after* the Office of Enforcement began its investigation into the up-to-congestion transactions on the PJM system that Powhatan learned that the Commission may view such transactions as prohibited. Moreover, here, Powhatan had even *less* notice than NFM because there were no prior investigations into the conduct at issue nor any industry pronouncement that even could have theoretically alerted Powhatan to the potential danger.

Also, similar to NFM, the Commission had the opportunity to prevent the very conduct at issue but failed to act. What is more, in this case, the Commission actually took the affirmative step of including virtual up-to-congestion traders in the allocation of transmission loss credits when they were not included previously, despite the Commission's express recognition that TLCs create incentives for virtual traders to engage in "volume"-based trades targeting the credits. This goes well beyond the "mixed messages" Commissioner Spitzer found at issue in NFM. As we noted in our position statement, having predicted that allocating transmission loss credits to up-to-congestion virtual traders would result in volume-based transactions aimed at profiting from the collection of those credits, the Commission cannot claim now that Powhatan's up-to-congestion transactions were fraudulent.

Finally, just like in NFM, there is no evidence that Powhatan or Dr. Chen concealed or misrepresented anything related to the up-to-congestion transactions. As we pointed out in our initial submission, the up-to-congestion transactions were conducted in good faith in an open and transparent manner. Dr. Chen accurately entered the information necessary to effect the transactions, which were carried out openly and he did not attempt to hide, conceal, or misrepresent anything to anyone.

Given the result in NFM, it might be difficult for the Office of Enforcement to convince the Commission that it would not be making the same mistake twice by proceeding against Powhatan here. Even if the Commission were to issue an order to show cause, Powhatan would vigorously contest any charges of market manipulation. The case would be played out in federal court, where the due process issue would receive the attention that it deserves. Thus, in addition to the *Upton* case, a recent decision out of the Southern District of New York is particularly relevant.

In *SEC v. Pentagon Capital Management*, 844 F. Supp. 2d 377 (S.D.N.Y. 2012), the SEC brought an enforcement action against Pentagon Capital Management PLC

("Pentagon") and Lewis Chester ("Chester"), Pentagon's former Chief Executive Officer, alleging that between 1999 and 2003, Pentagon and Chester had orchestrated a scheme to defraud mutual funds through late trading and deceptive market timing in violation of, among other things, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Following a bench trial, the court granted in part and denied in part the relief requested by the SEC. Although the court found violations of securities law related to defendants' late trading, the court concluded that the defendants had not engaged in market manipulation in violation of Section 10(b) and Rule 10b-5 by pursuing a strategy of market timing.

With regard to the SEC's market timing claim, the court noted that prior to 2003, there were no clear rules regarding market timing. *Id.* at 414. The court observed that prior to 2003, "the SEC had never commenced an enforcement proceeding against any mutual fund, market timer, or securities firm for market timing." *Id.* at 393. Specifically, the court stated:

> Defendants' actions thus took place in an atmosphere of uncertainty. There were no definitions or prohibitions from the responsible agency with respect to market timing, and the funds' enforcement of their provisions relating to timing was discretionary, inconsistent, and occasionally conflicted with capacity agreements. The SEC issued no guidelines as to which fund provisions it might seek to enforce and, of course, prior to the Canary enforcement action by the NYAG in September 2003, the SEC had not initiated any proceedings to obtain the relief sought here.

Id. at 415. Indeed, it was only after the time period at issue, in April 2004, that the SEC adopted a market timing rule requiring mutual funds to disclose their policies toward market timing. *Id.* at 392.

Accordingly, the court concluded that "the lack of regulation or clear rules or practices regarding market timing during the period in question cannot be remedied by a finding of liability." *Id.* at 418. "Litigation in the absence of clear standards may further raise due process concerns, upsetting the basic notion that individuals have fair notice of the standards under which they may be held liable. Prospective regulation by the SEC and clear rules by the funds are preferable to *post hoc* litigation." *Id.* (citation omitted). Those words are of particular force here.

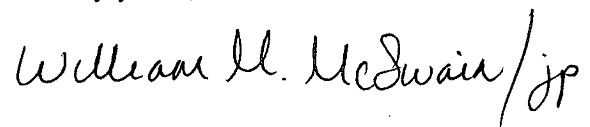
In the instant matter, just as in *Pentagon*, there were no guidelines or prohibitions from the Commission or any pronouncements from PJM with respect to the collection of TLCs. Powhatan had no way of knowing that responding to the incentives created by the

TLCs could be considered prohibited conduct. Given that the Commission had specifically acknowledged such incentives and done nothing to prohibit or discourage trading influenced by such incentives, Powhatan had every reason to believe that the trading was lawful. The paramount concern of due process is "that individuals have fair notice of the standards under which they may be held liable." *Pentagon*, 844 F. Supp. 2d at 418. That concern is clearly implicated here, and would bar any liability for supposed market manipulation.

Pentagon also explains that in the context of a market manipulation case, due process concerns reinforce a lack of scienter. Specifically, the *Pentagon* court observed that although it was clear that Pentagon and Chester "generally sought to outwit the funds and knew that the funds at least in some instances did not permit market timing," the SEC did not show that defendants knew or should have known any particular fund's limits, given the lack of clarity in the rules. *Id.* at 416. Accordingly, the court found that "[w]ithout the clarity of what the funds' rules were, despite Defendants' general intent to deceive, the SEC [ ] failed to establish the requisite scienter required by Section 10(b) [and] Rule 10b-5." *Id.* Here, of course, it cannot be said that Powhatan had even a "general intent" to deceive. The bottom line is that any market manipulation claim against Powhatan would violate due process and also would fail because the Commission could never demonstrate the requisite scienter.

For the foregoing reasons, as well as many others that we have already discussed with you, it is time for the investigation of Powhatan and Dr. Chen to end, once and for all. I look forward to hearing from you.

Sincerely yours,



William M. McSwain

WMM/jp

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