UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
RICHMOND DIVISION

FEDERAL ENERGY REGULATORY COMMISSION, Petitioner, v. POWHATAN ENERGY FUND, LLC, HOULIAN "ALAN" CHEN, HEEP FUND, INC., and CU FUND, INC. Respondents.	)	Civil Action No. 3:15-cv-00452 (MHL)

MEMORANDUM OF LAW IN SUPPORT OF FERC'S OPPOSITION TO MOTION TO DISMISS OF RESPONDENT POWHATAN ENERGY FUND, LLC.

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INTRODUCTION

In its Motion to Dismiss and Memorandum in support thereof ("Mem.) (ECF No. 21), Respondent Powhatan Energy Fund, LLC ("Powhatan") advances a single argument for dismissing the Petition: that it lacked fair notice that its trading conduct was manipulative. This argument – which was fully adjudicated in the administrative proceeding below – is without merit and the motion should be denied in full.[1]

In fact, as the Commission found in the Order Assessing Penalties ("Penalty Assessment"), Powhatan's trading was just like the manipulative practices – specifically, the "Death Star" scheme and wash trading (neither of which Powhatan even mentions in its brief) – committed by Enron and others in the Western Energy Crisis that led Congress to give the Commission the very anti-manipulation authority underlying this case. There are many other reasons why Powhatan's fair notice argument lacks merit, but in light of the fact that the Commission determined that Powhatan's conduct constituted wash trading and could not be meaningfully distinguished from Death Star, the fair notice argument falls apart.

This case is about enormous volumes of round-trip (A-to-B/B-to-A) trades by Respondents in the PJM regional electricity market not for the legitimate purpose of that type of trade – arbitrage – but to collect based solely on trading volume. All told, Respondents together extracted over $10 million in payments that would otherwise have gone to other market participants, including millions of dollars that would have gone to utilities serving retail electric customers. Pet. Ex. 1 at PP 68, 98.

[1] On October 28, 2015, Powhatan filed notice that it "joins in the Motion to Dismiss (ECF No. 22 and Memorandum of Support thereof (ECF No. 23) of defendants Houlian Chen, HEEP Fund, Inc., and CU Fund, Inc." Joinder of Powhatan Energy Fund (ECF No. 25). To the extent Powhatan joins in Chen's arguments, Petitioner addresses them in the Opposition to Chen's Motion to Dismiss, also filed today.

Respondents make a single argument in support of their motion to dismiss: that they were supposedly not given "fair notice" that it might be improper to do self-cancelling financial trades in wholesale energy markets to collect payments based on sheer trading volume. Respondents are wrong.

As to the trading scheme at issue here, not only were Respondents fully on notice that they could not count on the absence of a specific prohibition as a defense,[2] but any reasonable market participant knew that wash trading (which the Commission had long prohibited) was improper. Likewise, any reasonable market participant knew that engaging in trading similar to Enron's infamous Death Star scheme was improper. As the Commission determined in its exhaustive Penalty Assessment, Respondents' self-cancelling A-to-B / B-to-A transactions *were* wash trades and *were* similar to Death Star—another strategy designed to "make money by moving electricity around in a circle." Ex. 1 at P 46 (citation omitted).

ARGUMENT

A motion to dismiss under Rule 12(b)(6) for failure to state a claim '"tests the sufficiency of a complaint; importantly, it does not resolve contests surrounding the facts, the merits of a claim, or the applicability of defenses."' *Jones v. Equifax, Inc.*, No. 3:14CV678, 2015 WL 5092514, at *1 (E.D. Va. Aug. 27, 2015) (citation omitted) (denying motion to dismiss). Although merely conclusory statements are not presumed to be true, "a plaintiff's well-pleaded allegations are taken as true and the complaint is viewed in the light most favorable to the plaintiff." *Id.* (citing *Ashcroft v. Iqbal,* 556 U.S. 662, 679 (2009)). All that is required is that the plaintiff (here, petitioner) assert facts showing a claim that is "plausible on its face." *Id.* (quoting

[2] *Prohibition of Energy Market Manipulation*, Order No. 670, FERC Stats. & Regs. ¶ 31,202 at P 50 (2006) (Order No. 670) ("[f]raud is a question of fact that is to be determined by all the circumstances of a case.").

Iqbal, 556 U.S. at 678–79 (citing *Twombly,* 550 U.S. at 570)). And that simply means '"plead[ing] factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged."' *Id.* (citing *Twombly,* 550 U.S. at 556). In short, the gist of Powhatan's Motion is not really that the Petition fails to plead a claim for market manipulation, but rather that Powhatan disagrees with the Commission on the merits— an issue that should be addressed later, in the context of the Court's review of the Commission's Penalty Assessment.

I. Fair Notice Precedent Supports the Commission

A. The Commission Applied an Appropriate Standard for Evaluating Notice

In addressing Respondents' fair notice claims in the Penalty Assessment, the Commission applied the standard set forth in *Freeman United Coal Mining Co. v. Fed. Mine Safety & Health Review Comm'n*, 108 F.3d 358 (D.C. Cir. 1997) (*Freeman*). Pet. Ex. 1 at P 117. *Freeman* held that the question of fair notice amounts to whether a "reasonably prudent person, familiar with the conditions that the regulations are meant to address and the objective the regulations are meant to achieve, [has] fair warning of what the regulations require." *Freeman*, 108 F.3d at 362. As the Commission noted, this formulation has been adopted by other circuits. Pet. Ex. 1 at P 117 & n.284 (citing *Rock of Ages Corp. v. Sec'y of Labor*, 170 F.3d 148, 156 (2d Cir. 1999)); *see also*, *Walker Stone Co. v. Sec'y Labor*, 156 F.3d 1076 (10th Cir. 1998); *Stillwater Mining Co. v. Fed. Mine Safety & Health Review Comm'n*, 142 F.3d 1179, 1182 (9th Cir. 1998).

In addressing the issue of fair notice, the Fourth Circuit has formulated a standard similar to *Freeman*'s.[3] The Fourth Circuit has held that fair notice requires '"clear notice"' of the obligations imposed. *United States v. Hoechst Celanese Corp.*, 128 F.3d 216, 224 (4th Cir.

[3] Indeed, at least one judge in this division has cited it with approval. *See Tafas v. Dudas*, 511 F. Supp. 2d 652, 667 (E.D.Va. 2007), *citing Freeman*, 108 F.3d at 362.

1997) (citing *First Am. Bank v. Dole*, 763 F.2d 644, 651 n.6 (4th Cir. 1985)). Under *Hoechst Celanese*, the standard for ascertaining whether notice is adequate is an objective one. *Hoechst Celanese*, 128 F.3d at 219-224; *see United States v. Tracy*, 456 F. App'x 267, 271 (4th Cir. 2011) (same) (rejecting claim of lack of fair notice in criminal case).

The objective standard of fair notice takes into consideration the "the relevant facts of each case," *Hoechst*, 128 F.3d at 224, along with the context of the regulation and the nature of the parties subject to it. *See Varandani v. Bowen*, 824 F.2d 307, 312 (4th Cir. 1987) (rejecting a vagueness challenge to the regulations implementing the Social Security Act and finding that "[t]he definition of adequate medical care cannot be boiled down to a precise mathematical formula; it must be grounded in what, from time to time, other health professionals consider to be acceptable standards of health care."); *see also, e.g., Ohio Cast Prods., Inc. v. OSHRC*, 246 F.3d 791, 799 (6th Cir. 2001) (determination of fair notice '"is made with reference to what an employer familiar with the industry could reasonably be expected to know."'); *Precious Metals Assocs., Inc. v. CFTC*, 620 F.2d 900, 907 (1st Cir. 1980) (citation omitted) ("The appropriate measure for testing a statute directed at a class of persons possessed of specialized learning is whether the language sufficiently conveys a definite warning as to the proscribed conduct, when measured by common understanding and commercial practice.') (citation omitted) (internal quotation marks omitted).

B. The Precedent Relied Upon by Powhatan Are Readily Distinguishable

Under both *Freeman* and *Hoechst Celanese*, Respondents had more than adequate notice that the Commission regarded the conduct they were engaged in as manipulative. None of the cases cited by Powhatan supports a different conclusion.

With respect to *Hoechst Celanese*, Powhatan claims that, "[e]ven though the government's interpretation in *Hoechst Celanese* had several things going for it, the Court *still*

found a lack of fair notice because there was nothing in the regulations that 'mandated' the government's interpretation, and HCC had an objective 'reason to believe' that its contrary interpretation was accurate." Powh. Mem. at 17 (citation omitted, italics in original).

Powhatan's characterization of *Hoechst Celanese* omits critical facts. Of particular significance, Powhatan fails to note that, unlike in this case, HCC sought and received guidance on the interpretation of the EPA regulation at issue only months after EPA promulgated it. Specifically, HCC asked the Texas Air Control Board (TACB), a state agency with authority to implement and enforce the relevant regulatory standards with respect to an HCC facility in Texas that was similar to the facility sanctioned by EPA. *Hoechst Celanese* at 225. Like the Celriver facility at issue in *Hoechst Celanese*, HCC's Texas facility recycled large volumes of benzene. *Id*. The TACB advised HCC that the determinant factor was the total benzene inventory at the facility. *Id*. "Thus, the TACB concluded that the [Texas] plant qualified for an exemption because it did not maintain an *inventory* of more than 1,000 megagrams of benzene" and therefore was exempt from the regulations. *Id*. (emphasis in original). The TACB provided a copy of that letter to the EPA, which declined to correct it. HCC also made a second inquiry of the TACB that reinforced its view that the Celriver plant was exempt from the regulation. *Id*. at 225-26. The Court found that

> [t]hese undisputed facts demonstrate that, although HCC made no direct inquiry as to the application of the exemption to the Celriver plant, it did not fail to make *any* inquiry as to the meaning of the NESHAP. *Cf. Texas Eastern Products [Pipeline Co. v. OSHRC*, 827 F.2d 46 at 50 (7th Cir. 1987)]. Rather, it asked TACB for an exemption and waiver of the regulation for two HCC plants located in Texas, which recycled benzene just as the Celriver plant did. In response, TACB issued the requested exemption and waiver, with copies to EPA's Region 6. . . . *On the basis of the TACB's actions and the inaction of EPA Region 6, the company had reason to believe that its interpretation of the exemption – equating "use" to "consumption" – was accurate*.

Hoechst Celanese at 226 (emphasis added). The official guidance that HCC received (and relied on) regarding the application of the regulation to a facility similar to the one at issue, was central to the Fourth Circuit's ruling that HCC had not received fair notice of EPA's differing interpretation of "use." *Id*.

In this case, not only did Powhatan never receive an interpretation of the Commission's position regarding its trading, *it never even sought any such interpretation*. In fact, as discussed in the Enforcement Staff Report and Recommendation ("Staff Report") appended to the Order to Show Cause (Exhibit 2 to the Petition), Respondents explicitly discussed making inquiries about their trading— but apparently decided not to do so. *See* Pet. Ex. 2 at 20-21.

As the Supreme Court has explained of regulations, "no more than a reasonable degree of certainty can be demanded. Nor is it unfair to require that one who deliberately goes perilously close to an area of proscribed conduct shall take the risk that he may cross the line." *Boyce Motor Lines, Inc. v. United States*, 342 U.S. 337, 331 (1952). *Hoechst Celanese* thus does not support Powhatan – in fact, Respondents' conduct is the very opposite of HCC's in *Hoechst Celanese*. HCC sought and obtained guidance from the regulator, while Respondents consciously decided not to seek guidance about whether it was permissible to "make money by moving electricity in a circle." That has nothing to do with lack of fair notice, but is rather an example of calculated, self-serving willful blindness.

Nor are respondents helped by *First American Bank of Va. v. Dole*, 763 F.2d 644 (4th Cir. 1985) (Powh. Mem. at 17-20). In that case, the Civil Aeronautics Board ("CAB"), concerned about unscrupulous tour operators taking advantage of their customers, required the operators to enter into depository agreements with banks and required the bank "to maintain a separate accounting for all funds deposited by each charter group." 763 F.2d at 645-46.

One of the tour operators that banked at First American failed to handle customer funds properly. *Id*. at 646-48. When First American was initially alerted to the tour operator's possibly improper deposits, it questioned the operator, with whom the bank had a "long and trouble-free" relationship, and accepted its reasonable explanation. *Id* at 651. When the bank later realized what the operator had done, it promptly took corrective action. *Id*. at 647-48, 654. Among other things, the bank ensured that no one was harmed. *Id*. at 647. First American did not "reap[] any benefit" from the wrongful actions of the tour operator. *Id.* at 651.

In reversing the CAB's civil penalty, the Court noted that under the CAB's charter regulations, depository banks' only duty under the regulations is to "maintain a separate accounting [of charter passengers' funds] for each charter group." *Id*. at 650 (citation omitted). Furthermore, the court pointed out that "the CAB proposed amending its charter regulations to impose more substantial, affirmative duties upon depository banks," but had dropped that proposal. *Id.* at 646. Finally, the court took note of the substantial efforts that First American had taken to protect the tour operator's customers, even though state banking law (which set out the bank's standard of conduct in the absence of federal regulations) did not impose such requirements on the bank. *Id*. at 651. Accordingly, the Court concluded, in effect, that the CAB had "imposed civil penalties on First American for the violation of a duty that its own regulations neither contemplated nor established," and had actually considered and rejected. *Id*. at 651-52.

The circumstances here could not be more different. The Commission did not propose, and then abandon, rules prohibiting sham trading such as Respondents' self-cancelling trades. The Commission's precedents at all times made clear that wash trading and Death Star-like transactions (like Respondents' trades) were improper. Far from acting prudently and reasonably to protect the public from losses (while making no money themselves), Respondents

aggressively pursued a scheme to divert to themselves millions of dollars that would otherwise have gone to other market participants. *See* Pet. Ex. 1 at P 98.

In sum, Powhatan's fair notice cases (Mem. at 15-26) are readily distinguishable. These cases typically involve either: 1) an agency that contemplated imposing a specific requirement on the regulated community, declined to do so, but subsequently sought to enforce the substance of that requirement anyway,[4] 2) an agency that declined to clarify its regulations despite being aware of widespread misunderstanding or noncompliance,[5] 3) regulated entities diligently attempting to ascertain the import of the regulations and comply with them,[6] 4) "sensitive areas of basic First Amendment freedoms,"[7] 5) retroactive application of a new regulation,[8] or 6) novel and expansive applications of limited authority.[9]

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[4] *FCC v Fox Television Stations, Inc*., 132 S. Ct. 2307 (2012), *First American Bank of Va. v. Dole*, 763 F.2d 644 (4th Cir. 1985); *Diamond Roofing Co. v. OSHRC*, 528 F.2d 645 (5th Cir. 1976).

[5] *Upton v. SEC*, 75 F.3d 92 (2d Cir. 1996).

[6] *Hoechst Celanese Corp*., 128 F.3d 216 (4th Cir. 1997)*; First Am. Bank of Va. v. Dole*, 763 F.2d 644 (4th Cir. 1985); *Trinity Broad. of Fla., Inc. v. FCC*, 211 F.3d 618 (D.C. Cir. 2000) (company relied on advice of counsel and prior agency statements in interpreting ambiguous regulation); *Gen. Elec. Co. v. EPA*, 53 F.3d 1324 (D.C. Cir. 1995) (company's interpretation of the regulation was reasonable and produced environmental benefits); *In re Metro-E. Mfg. Co*., 655 F.2d 805 (7th Cir. 1981) (company relied on advice of counsel).

[7] *FCC v. Fox Television Stations, Inc*., 132 S. Ct. 2307, 2318 (2012) (quoting *Baggett v. Bullitt*, 377 U.S. 360, 372, 84 S. Ct. 1316, 12 L.Ed.2d 377 (1964) (other citations omitted); *Smith v. Goguen*, 415 U.S. 566 (1974); *Grayned v. City of Rockford*, 408 U.S. 104, 108 (1972).

[8] *United States v. AMC Entm't, Inc*., 549 F.3d 760 (9th Cir. 2008); *Peterson v. ConAgra Foods, Inc.*, No. 13-cv-3158-L (NLS) 2014 WL 3741853 (S.D. Cal. Jul. 29, 2014).

[9] *Fabi Constr. Co., Inc. v. Sec'y of Labor*, 508 F.3d 1077 (D.C. Cir. 2007); *Radio Athens, Inc. (WATH) v. FCC*, 401 F.2d 398 (D.C. Cir. 1968). In *KPMG, LLP v. SEC*, the Court found that the interpretation adopted by SEC – unsupported even by its own witness – was "novel and involved a strained reading of the rule," and that the rule itself was not "intended . . . to fill in gaps." 289 F.3d 109, 116 (D.C. Cir. 2002). Similarly, in *SEC v. Pentagon Capital Mgmt.,* the SEC sought to enforce civil penalties against traders who had engaged in "market timing" – a strategy known to SEC that was "neither illegal nor necessarily fraudulent," and at that at that

None of those circumstances is present here. The Commission's prohibition of wash trading and similar schemes was well-established for years before the conduct at issue occurred.[10] The Commission took immediate action upon discovering the conduct at issue. Pet. at ¶¶ 4, 47-48 (citing Pet. Ex. 1 at P 26). The commercial conduct at issue implicates no sensitive First Amendment issues. Powhatan does not claim that it made any attempt to ascertain the legality of its trading, nor is there any evidence it took such steps. *See* Pet. Ex. 2 at 70-71 & n.363. This case does not involve retroactive application of a new regulation. Perhaps most fundamentally, this is not an instance where the Commission has attempted a novel and expansive application of limited authority; the Commission's actions are, instead, deeply rooted in its fundamental power to protect the public from fraud and manipulation in the energy markets. *See* Pet. at ¶¶ 30-32, Pet. Ex. 1 at PP 49-51, Pet. Ex. 2 at 47-57.

II. Powhatan Mischaracterizes the Commission's Actions and Precedents

To make this case appear to resemble the cases on which it relies, Powhatan elides or distorts critical facts and ignores ample Commission precedent. To understand just how comprehensively misconceived Powhatan's Motion is, a brief review of the context and history of the Commission's authority is useful.

A. The Commission's Enforcement Action in this Case is Fully Consistent with Over a Decade of Commission Policy Since the Western Energy Crisis

Organized wholesale energy markets as they presently exist are a relatively new phenomenon, but throughout their history, the regulated industry has been aware of the fact that

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point had not been prohibited. 844 F. Supp. 2d 377, 412 (S.D.N.Y. 2012). In fact, only certain methods of implementing a "market timing" strategy were prohibited, and those methods were prohibited by specific market fund rules. *Id*. at 414. It was unclear whether any of the defendants' actions rose to the level of a violation of any of the specific market fund rules, thus it is unclear to what extent *Pentagon Capital* is properly conceived of as a "fair notice" case rather than a simple failure to prove the elements of the claim. *Id*. at 414-415.

[10] This point is discussed further in section II.A, *infra*.

tariffs (the Commission-approved market rules that govern organized markets) cannot possibly anticipate every possible future scenario. In the 1990s, when the "deregulated" wholesale energy markets were in their infancy, the newly-established California market (the "California Independent System Operator Corp.," or "CAISO") adopted a tariff provision that prohibited "gaming."[11] "Gaming" was broadly defined to include, among other things, "taking unfair advantage of the rules and procedures set forth in the . . . [t]ariffs . . . to the detriment of the efficiency of, and of consumers in, the ISO markets." *See* Final Staff Report at VI-8 (quoting MMIP 2.1.3). That prohibition proved to be prescient, as during (and to some extent precipitating) the Western Energy Crisis of 2000 – 2001, gaming was rife: Any number of market participants exploited gaps or "loopholes" in specific tariff provisions in an array of ways, and did so to the profound detriment of the market and ultimately of consumers.

Through a Commission investigation, certain Enron memoranda came to light that delineated many of these gaming practices.[12] The Commission issued orders to show cause, in which it analyzed these practices, found that many of them constituted impermissible "gaming," and directed certain market participants to show cause why they should not be found to have violated their obligations under the tariff by engaging in such gaming practices. *Am. Elec. Power Serv. Corp. et al.*, 103 FERC ¶ 61,345 (2003) (the "Gaming Order"); *see also Enron*

[11] This provision was one of a set of "Market Monitoring Information Protocols" ("MMIPs"). This and other MMIPs are discussed in the Final Staff Report on Price Manipulation in Western Markets, *Fact-Finding Investigation of Potential Manipulation of Electric and Natural Gas Prices*, Docket No. PA02-2-000, at VI-6–VI-10 (Mar. 2003) ("Final Staff Report"). The Final Staff Report (divided into three parts) is available at http://www.ferc.gov/industries/electric/indus-act/wec.asp (visited Oct. 26, 2015).

[12] *See* Memorandum from Christian Yoder and Stephen Hall to Richard Sanders, *Traders' Strategies in the California Wholesale Power Markets/ISO Sanctions* (Dec. 2000), http://www.ferc.gov/industries/electric/indus-act/wec/enron/12-06-00.pdf (visited Oct. 27, 2015) (Enron Gaming Memo).

Power Mktg., Inc., et al., 103 FERC ¶ 61,343 (2003) ("Enron Revocation Order") (revoking market based rate authority for Enron's having engaged in the gaming activities discussed in the Gaming Order). One of these gaming practices merits particular attention here, because of its remarkable similarity to Respondents' manipulative trading.

1. Circular Schedules Such as "Death Star" Are Prohibited

"Circular Scheduling," better known as "Death Star," was a congestion-related practice "designed to generate payments for relieving transmission congestion by 'fooling' the Cal ISO's computerized congestion management program." Final Staff Report at VI-26, *and see* Gaming Order, 103 FERC ¶ 61,345 at P 41. In Death Star trades, traders scheduled a counterflow (i.e., a trade in the opposite direction of congestion)[13] within CAISO to receive a congestion relief payment, but also scheduled offsetting transactions outside of CAISO. In other words, an A-to-B schedule within CAISO was offset with a B-to-A schedule outside of CAISO, which was not actively concealed from CAISO but also not readily apparent to it. The net result was that "power did not actually flow and congestion was not relieved. Circular Scheduling was profitable as long as the congestion relief payments were greater than the cost of scheduled transmission." Gaming Order at P 43.

In taking action against Death Star and other gaming practices, the Commission rejected claims that market participants were not on notice of the conduct that was proscribed because the anti-gaming prohibition was impermissibly vague. The Commission noted that it would be "unrealistic" to require the agency to "have the prescience to include in a rate schedule *all*

[13] Simplifying somewhat, because transmission lines have finite capacity, they can become "congested" when the demand to move power from A to B approaches or exceeds the line's capacity to deliver it. When counterflows are scheduled from B to A, however, they offset some of the demand from A to B, and thus allow additional electricity to be scheduled from A to B. This is known as "relieving congestion."

specific misconduct in which a particular market participant could conceivably engage" and that such a standard "would render regulatory agencies impotent to address newly conceived misconduct and allow them only to pursue, to phrase it simply, last year's misconduct—essentially, to continually fight the *last* war and deny the capability to fight the present or next one." *Am. Elec. Power Serv. Corp., et al.*, 106 FERC ¶ 61,020, at PP 45, 48 (2004). As to notice, the Commission concluded:

> [T]he MMIP provided adequate notice to market participants of what conduct was prohibited. The mere fact that the MMIP does not expressly prohibit in so many words specific trading strategies . . . simply means that the Commission did not (as, indeed, it could not) foresee all the myriad means that certain market participants could employ to the detriment of competition; it does not mean that market participants determined to have engaged in Gaming Practices and Partnership Gaming may escape disgorgement of the unjust profits that they gained by their conduct. . . . . It is . . . clear that Enron, the author of these trading strategies, recognized that its trading strategies could have been prohibited by the MMIP and that Enron could be severely sanctioned for the trading strategies, if it were caught. Given this, Enron's (and others') current position that the language of the MMIP does not allow market participants to know what conduct is prohibited is not credible.

Id. at P 48; accord, *Enron Power Mktg., Inc., et al.*, 106 FERC ¶ 61,024 (2004) (rejecting Enron's fair notice defense concerning gaming practices).

2. Wash Trading Is Prohibited

A second manipulative strategy that the Commission discovered during its investigation into the causes of the Western Energy Crisis was wash trading. *See, e.g.*, Final Staff Report at VII-1 – VII-16, *Enron Revocation Order*, 103 FERC ¶ 61,343 at P 61. Unlike many of the more complex gaming strategies described in the Enron memoranda (which depended on exploiting certain specific market features), wash trading was conceptually much simpler, so the staff recommended that the Commission "establish specific rules banning any form of prearranged wash trading activities." Final Staff Report at VII-15. The Commission accepted staff's recommendation, and set about establishing a ban on wash trading, along with other

manipulative practices in 2003, through the adoption of Market Behavior Rules. Adopting Market Behavior Rules that would apply to all sellers at wholesale also addressed the fact that only a small fraction of transactions in the wholesale energy markets were subject to provisions such as CAISO's MMIPs. With specific reference to the Enron gaming strategies, the Commission determined that there was a need for all market-based rate transactions to be subject to tariff provisions prohibiting manipulative conduct, so in June 2003, the Commission issued an order seeking comment on a set of provisions, now known as "Market Behavior Rules," to be included in all market based rate tariffs.[14] The Commission adopted the Market Behavior Rules in November 2003.[15]

Market Behavior Rule 2 prohibited "[a]ctions or transactions that are without a legitimate business purpose and that are intended to or foreseeably could manipulate market prices, market conditions, or market rules for electric energy or electricity products." *Investigation of Terms and Conditions of Pub. Util. Mkt.-Based Rate Authorization*, 105 FERC ¶ 61,218 at P 35 and Appx. A. Along with the rule, the Commission provided a non-exhaustive list of certain practices that were prohibited by Market Behavior Rule 2. This list included wash trading – a species of sham trading that the Commission described as "pre-arranged offsetting trades of the same product among the same parties, which involve no economic risk and no net change of beneficial ownership." *Id*. at P 52 and Appx. A. The Commission was clear that this description of wash trading was not rigid or formalistic but was intended to capture the "key elements" of a

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[14] *Investigation of Terms and Conditions of Pub. Util. Mkt.-Based Rate Authorization*, 103 FERC ¶ 61,349 (2003).

[15] *Investigation of Terms and Conditions of Pub. Util. Mkt.-Based Rate Authorization*, 105 ERC ¶ 61,218 (2003).

wash trade, rather than to define the practice narrowly. *Id.* at P 53. As the Commission observed in the Penalty Assessment (at P 104), the "economic risk" element "need not be zero." Rather, as long-standing precedent makes clear, "[w]ash trading produces a *virtual* financial nullity because the resulting net financial position is *near or equal to* zero." *Wilson v. CFTC*, 322 F.3d 555, 559 (8th Cir. 2003) (emphasis added).

The Commission expressly rejected arguments that the rule should be construed narrowly to proscribe only specifically identified forms of conduct:

> We will reject commenters' argument that Market Behavior Rule 2 should identify and prohibit only expressly-defined acts of manipulation. For all the reasons discussed above, it is essential and appropriate that we have a prohibition designed to prohibit all forms of manipulative conduct.

Investigation of Terms and Conditions of Pub. Util. Mkt. -Based Rate Authorization, 105 FERC ¶ 61,218, at P 41.

The Commission clarified that, with respect to "transactions with economic substance," where "value is exchanged for value," sellers would have the opportunity to demonstrate "that their actions were not designed to distort prices or otherwise manipulate the market." *Id.* at P 37. Such transactions must be "disciplined by the competitive forces of the market." *Id.* at P 42. Finally, although the rule was intentionally broad in scope, the Commission stated, "sellers can recognize the difference between actions and strategies that are in furtherance of legitimate profit opportunities," and those that are not. *Id.* at P 44.

3. The Commission's Authority Post-EPAct 2005 Encompasses Pre-Existing Prohibitions.

In parallel with the Commission's efforts to enhance its ability to police the wholesale energy markets, Congress was at work developing legislation to ensure that the Commission would have the tools and the authority to prevent, deter, and punish misconduct in those markets— and thus to avoid any repeat of the problems that plagued California and other states

in the Western Energy Crisis. These efforts culminated in the Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594 (2005) ("EPAct 2005"). In relevant part, this statute included provisions (FPA §§ 222 and 316A, 16 U.S.C. §§ 824v and 825*o*-1) that conferred on the Commission specific, broad, and powerful anti-manipulation authority.

The Commission implemented that authority by issuing Order No. 670, which promulgated the Commission's Anti-Manipulation Rule, 18 C.F.R. § 1c. In Order No. 670, the Commission clarified that the conduct prohibited by Market Behavior Rule 2 would also be equally prohibited under the Anti-Manipulation Rule. Order No. 670 at P 59. When the Commission rescinded Market Behavior Rule 2, it reiterated that the Anti-Manipulation Rule proscribed, among other things, all of the conduct prohibited under Market Behavior Rule 2. *Investigation of Terms and Conditions of Pub. Util. Mkt.-Based Rate Authorizations*, 114 FERC ¶ 61,165, at P 24 (2006) (citing Order No. 670, 114 FERC ¶ 61,047 at P 59). As noted, this included the prohibition on wash trading in energy markets.

In that same order, it again emphasized that its anti-manipulation authority was broad in scope and could not be defined narrowly because doing so would only reward clever manipulators who invented novel and unforeseen schemes to defeat otherwise well-functioning markets: "fraud is a very fact-specific violation, the permutations of which are limited only by the imagination of the perpetrator. Therefore, no list of prohibited activities could be all-inclusive. The absence of a list of specific prohibited activities does not lessen the reach of the new anti-manipulation rule." *Id.* Courts have similarly found that the purpose of the 1934 Exchange Act's anti-manipulation provisions to be to give effect "to the realization that an honest securities market depended on more than the exclusion of the cruder forms of lying, such

as wash sales, matched orders, and the like." *Rosenberg v. Hano*, 121 F.2d 818, 820 (3d Cir. 1941).

Powhatan's own Memorandum tacitly acknowledges the illegality of wash trading and other forms of gaming in the Commission's markets. This is readily illustrated in *Cal. Indep. Sys. Operator Corp.*, 134 FERC ¶ 61,211 (2011) ("*CAISO Capacity Order*"), cited by Powhatan. Powh. Mem. at 13 n.6. In the *CAISO Capacity Order*, CAISO proposed revisions to its tariff to implement a Capacity Procurement Mechanism. Certain parties objected that CAISO's proposal "presents an opportunity for gaming," and therefore "could distort seller behavior and potentially harm ratepayers." *CAISO Capacity Order* at P 106 (footnote omitted). The Commission rejected these arguments, finding that "CAISO's proposal contains multi-layered safeguards and stringent requirements that will adequately protect against . . . . any potential for gaming." *Id.* at P 131. These "multi-layered safeguards" include the fact that CAISO's tariff requires its Department of Market Monitoring ("DMM") to refer "such a suspected violation . . . to the Commission for appropriate sanction." *Id.* at PP 131, 132 (footnote omitted); *see also*, *e.g.*, *Cali. Indep. Sys. Operator Corp*., 132 FERC ¶ 61,045 (2010) (in the absence of a violation of terms expressly set forth in the tariff, CAISO's DMM "shall make a non-public referral to the Commission in all instances where [it] has reason to believe that a Market Violation has occurred." *Id*. at P 73 (quoting CAISO Tariff Appx. P § 11.1).

4. Powhatan's Trading Fits Squarely Within Prior Prohibitions

a. Death Star

A brief review of the facts demonstrates just how central Powhatan's conduct is to the proscriptions of the Commission's anti-manipulation authority. Powhatan's trading scheme was gaming: it took unfair advantage of the rules and procedures set forth in the tariff to the detriment of the efficiency of and consumers in the market. The Commission found that, like

Death Star, Powhatan's scheme involved offsetting A-to-B/B-to-A trades to capture credits that any reasonable person would know were not intended to go to such trades. *See* Pet. Ex. 1 at P 46 ("Mr. Gates described the round-trip UTC trades as the ability to 'make money by moving electricity around in a circle.'") (footnote omitted) and P 96. In the Penalty Assessment, the Commission explained:

> We . . . reject Respondents' argument that their trades were nothing like Enron's Death Star trading. Like Death Star's circular strategy, Respondents engaged in round-trip UTC trading that resulted in no net position and, thus, no possibility for profit or loss from market prices. Moreover, Death Star's strategy was profitable so long as the credits received exceeded the cost of scheduling the transactions; similarly, Respondents' strategy was profitable so long as the MLSA payments exceeded their transaction costs. In addition, Respondents' round-trip UTC trades falsely appeared to PJM as legitimate, arbitrage-related trades when in fact they were nullities placed to garner MLSA payments. Thus, similar to Death Star, Respondents' UTC trades involved offsetting pairs to capture revenues without providing the corresponding benefit to the market.

Id. at P 96. These similarities are fatal to Respondents' claim that they were denied "fair notice" that their conduct was unlawful.

b. Wash Trading

Powhatan's scheme constituted manipulative wash trading. The trades were not "transactions with economic substance" that were "disciplined by the competitive forces of the market," where "value [was] exchanged for value." *See Investigation of Terms and Conditions of Pub. Util. Mkt.-Based Rate Authorization*, 105 FERC ¶ 61,218 at PP 37, 42. There were two '"key elements"' in the Commission's definition of '"wash trading"' under Market Behavior Rule 2 –that the transactions: are (1) '"prearranged to cancel each other out"'; and (2) '"involve no economic risk."' Pet. Ex. 2 at 53 (citing *Investigation of Terms and Conditions of Pub. Util. Mkt.-Based Rate Authorization*, 105 FERC ¶ 61,218 at P 53). The Commission explained that

> [W]e find Respondents' round-trip UTC trades satisfy both these elements and were, by design, wash trades. That is, Respondents' trades were designed to cancel each other out and to eliminate price spread risk caused by differences in congestion prices between the selected nodes. We find that in Commission-

> regulated energy markets, the market risk associated with a wash trade need not be zero; it only need be small enough so that the risk has no practical or expected impact on the transaction, as was the case here. While Respondents note the theoretical potential for one leg of the transaction to break, the evidence shows that Respondents' round-trip UTC trades always cleared during the Manipulation Period (as Respondents expected) and that because both legs cleared together, Respondents' round-trip UTC trades had no practical market risk.
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> Pet. Ex. 1 at P 104 (footnotes omitted).

There can be no argument that Respondents lacked fair notice that wash trading in the wholesale energy markets was forbidden.

B. Powhatan Mischaracterizes the *Black Oak* Proceeding

1. Background of the *Black Oak* Proceeding & Acceptance of the MLSA Distribution Methodology

When electricity travels through the grid, a certain amount of energy is lost to heating of the transmission lines. This is called "line loss." The farther energy must travel on power lines, the greater the line loss. To ensure that the market price at each pricing node reflects the actual costs of providing energy to that particular location, charges for line losses are one of the three components of the individualized prices at different locations—called "Locational Marginal Prices" (LMP)—in PJM and other organized markets.

Also to promote market efficiency, the Commission has directed PJM to set the price for line losses at marginal, rather than average, cost. *Atl. City Elec. Co. v. PJM Interconnection, L.L.C.*, 115 FERC ¶ 61, 132, at P 4 (2006) (footnote omitted) ("the actual cost of meeting [demand for electricity] would be reduced by using the marginal loss method."); *id* at P 22 ("Billing on the basis of marginal costs ensures that each customer pays the proper marginal cost price for the power it is purchasing."). Because marginal costs of line losses are higher than average costs, PJM collects more in line loss payments than the total amount of actual line losses. In other words, line losses are (necessarily) over-collected, resulting in a "marginal loss surplus." *Id*. at P 24.

As the Commission in 2006 recognized in directing PJM to set prices for line losses at marginal cost, "a method needs to be determined for disbursing the over collected amounts." *Id.* at P 24. The procedure for distributing the extra line loss payments is called "Marginal Loss Surplus Allocation," or MLSA.

The Commission ruled out only one method for distributing MLSA: reimbursing customers for the amount they actually paid for line losses would undo the economic benefit of pricing line losses at marginal cost. *Id.* at P 24. The Commission therefore needed to find a different way to distribute the marginal loss surplus.[16]

In November 2006, the Commission approved a method for handling excess loss payments: distributing the money to "load," that is, to wholesale purchasers of physical energy in PJM. *Atl. City Elec. Co. v. PJM Interconnection, L.L.C.*, 117 FERC ¶ 61,169 (2006). In response, a group of virtual traders calling themselves the "Financial Marketers," led by Black Oak Energy, LLC, filed a complaint in December 2007, asking the Commission to direct PJM to

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[16] Examination of the *Black Oak* proceeding demonstrates that the MLSA credits are not, in any sense "rebates." A rebate is "a return of part of a payment, *serving as a discount or reduction*." Bryan A. Garner, *Black's Law Dictionary,* 10th ed. (West Group, 2014), *available at* http://thelawdictionary.org/ (visited Oct. 29, 2015) (emphasis added). Market participants pay line loss charges as part of the LMP. The Commission specifically and repeatedly *excluded* the possibility of returning the line loss payments to the market participants who paid them, since that would distort the LMP price signal; "the only fundamental principle to be applied is that the distribution should in no circumstance . . . distort the appropriate price signals which the use of marginal line loss pricing is designed to facilitate." *Black Oak*, 125 FERC ¶ 61,042 at P 37. Instead, of rebating excess line loss payments and distorting price signals, the Commission directed PJM to find other ways to distribute MLSA to market participants. The distribution ultimately approved was based on the volume of transactions with paid transmission, where the payment was *not* part of the energy price (LMP) but was tied to a separate transaction cost in connection with reservation of transmission on PJM's transmission scheduling system.

allow financial traders to share in the marginal loss surplus, and proposed a particular method for doing so.[17]

The Financial Marketers contended it was unduly discriminatory to allocate MLSA to load (*i.e*., physical transactions serving consumers) but not to financially-settled "virtual" transactions (i.e., transactions that do not involve flowing physical energy). *Black Oak Energy, LLC, et al. v. PJM Interconnection, L.L.C*., 122 FERC ¶ 61,208, at PP 5, 9 (2008). The Financial Marketers sought payment of MLSA to *all* financial transactions. The Commission rejected that proposal, noting that, because virtual trades are financially-settled, virtual traders (or "arbitrageurs") could artificially inflate the volume of their trading simply to capture credits. After distinguishing between arbitrageurs and physical traders, *id*. at P 49, the Commission concluded that

> 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.

Id. at P 51.[18]

In October 2008, the Commission, faced with a renewed request from the Financial Markets to pay MLSA to all virtual trades, again rejected that broad proposal, reiterating that (i) the purpose of virtual trading is arbitrage and (2) the Commission did not want to create

[17] All of the filings and Orders discussed in this section can be found on the Commission's E-Library site, http://www.ferc.gov/docs-filing/elibrary.asp.

[18] This concern about possible perverse incentives had been raised by a handful of parties in their comments. *See, e.g.,* Duke Energy Ohio, Inc.'s Motion to Intervene and Comments in Opposition to Complaint, Docket No. EL08-14-000, at 8 (Dec. 26, 2007) ("Financial Marketers can increase their gross volumes nearly limitlessly," and by doing large volumes of transactions with minimal expectation of spread gains, "Financial Marketers' expected overcharge refunds would continue to grow").

incentives for market participants to artificially inflate their trading volumes to capture credits. *Black Oak Energy, LLC, et al. v. PJM Interconnection, L.L.C.*, 125 FERC ¶ 61,042 (2008) ("We . . . are concerned that since arbitrageurs, unlike [purchasers of physical energy], control their [trading volume] by virtue of the number of transactions into which they enter, [the broad MLSA distribution proposal] would provide an incentive for the arbitrageurs to conduct trades simply to receive a larger credit.") But while rejecting the Financial Marketers' broad proposal for that reason, the Commission directed PJM to consider whether a small subset of virtual trades—those Up To Congestion trades in which the traders paid for transmission—should, like physical trades with paid transmission, be eligible for MLSA. *Id*. at P 49 (noting that most virtual trades do not pay for transmission).

In this October 2008 Order, the Commission both reiterated the proper role of arbitrage in its markets and explained why it was viewed the small subset of virtual trades with paid transmission differently from the "large number" (*id*. at P 38) of virtual trades that do not:

> 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 payment of 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.
>
> *Id*. at P 43 (emphasis added) (footnote omitted).

That is, the Commission made clear that it believed that the *broad* distribution proposal (MLSA paid to all virtual trades) was objectionable because it could lead to abusive trading

simply to collect MLSA, and for that reason directed PJM to consider a *narrow* approach (MLSA paid only to trades with paid transmission) that would address that problem.

In March 2009, PJM followed the narrower approach, proposing to pay MLSA to all trades with paid transmission (physical or virtual). In response to that filing, no party suggested that UTC trading would be susceptible to the kind of perverse incentives that the Commission understood could apply to most virtual trades. On the contrary, Financial Marketers once again reiterated that, "[t]here is no merit to the claim that updating the allocation percentage will give Market Participants perverse incentives to engage in virtual transactions in order to capture a larger share of the surplus. As always, Market Participants will conduct virtual transactions when they think they can profit from the difference between the day-ahead LMP and the real-time LMP that they expect." Protest of Black Oak Energy, LLC et al., *Black Oak Energy, LLC v. PJM Interconnection, L.L.C.*, Docket No. EL08-14-001, at 6 n.5 (Dec. 2, 2008). No party filed any comments rebutting this contention as to the narrow distribution method, and the Commission accepted it in September 2009. *Black Oak Energy, LLC, et al. v. PJM Interconnection, L.L.C.*, 128 FERC ¶ 61,262 (2009).

To summarize, the Commission *rejected* a proposed method of distributing MLSA because it could create incentives to do sham trading to collect the credits, instead accepting a narrower approach. It also repeatedly made clear that the purpose of virtual trading is arbitrage (i.e., seeking to profit from changes in price spreads). It would be impossible for a reasonable person acting in good faith to read these orders and conclude that the Commission was indifferent to whether traders engaged in circular trades solely to collect MLSA, regardless of whether those trades paid for transmission or not. That is particularly so since nothing in these

Orders suggested in any way that the Commission had backed away from its long-standing condemnation of wash trading and of Death Star-like schemes.

2. Powhatan's Reading of the *Black Oak* Proceeding Is Untenable.

Powhatan's central argument—that the Commission supposedly signaled in *Black Oak* that it had no objection to circular, non-arbitrage trades aimed at collecting MLSA—is incorrect. So is its contention that "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 rebates for UTC transactions, nor did the Commission issue any pronouncement or order advising virtual traders that it would consider trading for the rebates wrongful conduct." Powh. Mem. at 10.

The Commission did not reverse itself. In March 2008, the Commission rejected a proposal to distribute MLSA to *all* virtual transactions because that broad distribution rule might give financial traders an incentive to place trades not for bona fide arbitrage purpose but simply to collect credits based on trading volume. *Black Oak*, 122 FERC ¶ 61,208 at P 51. In October 2008, it did the same thing. *Black Oak*, 125 FERC ¶ 61,042 at P 43. But this time, it asked PJM to consider a much narrower approach, namely distribution of MLSA only to the small subset of virtual transactions that do pay for transmission*, i.e.*, some (but far from all) UTCs. *Id.*

The Commission was clear about why it made that distinction: "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." *Id.* (emphasis added). That is, the Commission believed that the broad distribution method would create perverse incentives, which would not arise under the narrower distribution method.

Powhatan has failed to cite any Commission pronouncement that would have given a reasonable market participant, acting in good faith, sound reason to believe that the Commission had suddenly changed its mind about perverse incentives to do sham trades—because there is none.[19]

For Powhatan's interpretation of the Commission's orders to be correct, this Court would have to believe that the Commission wanted to *prevent* the distortion of arbitrage decisions for financial trades involving no transmission costs, but was (inexplicably) *indifferent* to the distortion of arbitrage decisions for trades that did involve transmission costs. That would be like supposing that someone who bolted his door to prevent being robbed but unwittingly left his window unlocked has no objection to being robbed so long as the thief enters through the window. The Court would further need to believe that the Commission adopted this incoherent position without uttering a single word of explanation about why it had done so.

C. None of Powhatan's other contentions has any merit.

1. The "Safe Harbor" Provision of Order No. 670 Does Not Apply

Powhatan contends that the "safe harbor" provision of Order No. 670, which promulgated and explained the Commission's Anti-Manipulation Rule, immunizes Respondents' trading. Powh. Mem. at 11, 14-15, citing Order No. 670 at P 67. This issue too was litigated before, and adjudicated by, the Commission. *See* Pet. Ex. 1 at PP 108-123. The Commission explained:

[19] Powhatan's long list of citations to support the uncontroversial proposition that a specific agency regulation "trumps" a more general one (Powh. Mem. at 27-30) has no bearing on this dispute— not least because Powhatan never identifies the more "specific regulatory pronouncement" that would supersede the Anti-Manipulation Rule— and therefore need not be distinguished. Under Powhatan's view, the fact that the Commission has, from time to time, explicitly condemned some specific behaviors but not others means that only those specific behaviors are barred by Rule 1c. That reading is so incompatible with the history, the text, and the purpose of the Rule that it merits no further discussion.

> For the safe harbor to be invoked, the action must have been "explicitly contemplated in Commission-approved rules or regulations . . . ." We find that Respondents' actions were not explicitly contemplated by PJM's rules and that the Commission did not approve round-trip trades in the *Black Oak* proceedings, and therefore Respondents misinterpret and attempt to misapply the "safe harbor" provision. The *Black Oak* decisions' holdings focused only on the merits of an MLSA distribution mechanism, and not on how market participants trade UTCs or the ways in which a market participant might manipulate that mechanism. The Commission's passing mention of the issue in response to third-party comments was not an affirmation of the conduct. Because the Commission's *Black Oak* orders did not explicitly contemplate trading UTCs for the purpose of capturing MLSA revenues, Respondents cannot now claim to have reasonably concluded that their trades would not be subject to Commission scrutiny.

Pet. Ex. 1 at P 122 (footnotes omitted). Even if it did apply, all the "Safe Harbor" would do is provide a presumption of legality.[20] The presumption of legality that attaches to certain conduct under the "safe harbor" rule has no bearing here, and, in any case, cannot immunize conduct that is shown, in all the facts and circumstances, to have been manipulative.

2. Powhatan's Conduct Caused Harm

Powhatan contends that it caused no harm because "nobody was entitled to any particular 'share'" of MLSA. Powh. Mem. at 10 n.5. Powhatan is wrong: as the Commission explained in the Assessment Order, while no one had any right to a particular allocation *before a distribution method was set*, once the method was established, market participants had a right to their share under that method:

> We reject Powhatan's argument that Respondents' actions caused no harm because other market participants were not entitled to MLSA payments. While we have stated in the abstract that no market participant is entitled to a particular amount of MLSA payments and that PJM need not adopt a particular refund mechanism, Powhatan ignores that PJM nevertheless filed a MLSA provision that later became effective as part of PJM's Commission-approved tariff. Under the PJM Tariff's MLSA provision effective during the Manipulation Period,

[20] As discussed in the Staff Report, Pet. Ex. 2at 52-53, the "Safe Harbor" applies to two circumstances, neither of which applies to these facts: (1) where a specific action has been undertaken at the behest of the RTO or ISO, and (2) where the tariff explicitly authorizes certain activities. Neither circumstance is present here.

market participants who paid for transmission service for their transactions were entitled to receive the sum of MLSA payments established by the provision's Commission-approved hourly calculation.   (Assessment Order at P 98)

Nor does Powhatan address the Commission's finding that Respondents' conduct caused harm in a different way, by affecting the availability of transmission for other market participants. See Pet. Ex. 1 at P 99.

CONCLUSION

For the foregoing reasons, Powhatan's motion to dismiss should be denied.

Dated: October 30, 2015

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CERTIFICATE OF SERVICE

I hereby certify that on the 30th day of October, 2015, I will electronically file the foregoing with the Clerk of Court using the CM/ECF system, which will then send a notification of such filing (NEF) to the following:

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