UNITED STATES OF AMERICA

BEFORE THE

FEDERAL ENERGY REGULATORY COMMISSION

Houlian Chen	)	
Powhatan Energy Fund, LLC	)	Docket No. IN15-3-000
HEEP Fund, LLC	)	
CU Fund, Inc.	)	

POWHATAN ENERGY FUND LLC'S RESPONSE IN OPPOSITION TO ORDER TO SHOW CAUSE AND NOTICE OF PROPOSED PENALTY

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TABLE OF CONTENTS

Page

TABLE OF CONTENTS
(continued)

Page

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I. INTRODUCTION

This is no ordinary investigation. It has already received an enormous amount of attention – from the Office of Enforcement ("OE"), the media, the public, even Congress and the Inspector General of the Department of Energy. Everybody in the industry knows about this investigation and is watching it. They all want to know what the Commission will do.

The Commission has an opportunity here to demonstrate true leadership. An opportunity to make a decision based on the right reasons – like fidelity to the law and fundamental fairness to market participants – instead of the wrong ones, like deference to OE Staff just because the Staff has consumed over four years on its Up-to-Congestion (UTC) investigation and wants the Commission to validate the Staff's wasting of valuable agency resources and ratepayer funding on this investigation.

The OE Staff Report and Recommendation ("Report") is a pile of nonsense. The Staff has done a disservice to the Commission by throwing this nonsense in the Commission's lap and basically saying – here, you deal with it. The arguments in the Report are so off-base, so easily rebutted, that they show that the Staff simply cannot be reasoned with here. Communicating with the Staff in this matter – even communicating with the former Director of Enforcement himself, now-Commissioner Norman Bay – has been akin to beating one's head against the wall.

The Staff has refused to give any ground on even the simplest, most irrefutable points, if they think giving any ground might signal weakness or otherwise harm the Staff's case. The Staff has never given any meaningful consideration to the numerous arguments advanced by counsel or by the *twelve* independent experts[1] who think that Powhatan and Dr. Alan Chen have done nothing wrong.

Why has the Staff behaved in this manner? Presumably, because they think they can do so with impunity. They know that most defendants in most investigations will just roll over and settle prior to an order to show cause, so that the Staff does not have to prove anything (which is what happened with Oceanside Power in this UTC investigation). And for those that don't initially roll over, the Staff figures that the Commission will have the Staff's back and issue a whopping penalty assessment, at which point the pressure will be too great for defendants to bear. Here, the Staff wants to hold Powhatan responsible for civil penalties of nearly $19 million, which is wildly disproportionate to Powhatan's alleged fraudulent profits of less than $3.5 million and bears no relation to any supposed harm.

Powhatan, however, believes in the integrity of the Commission and the critical gate-keeping role that it plays. Powhatan and its principals have never, ever believed that they have

[1] **Susan J. Court**, Principal, SJC Energy Consultants, LLC, and former Director of Enforcement at FERC; **Jeffrey H. Harris**, Ph.D., Gary Cohn Goldman Sachs Endowed Chair in Finance at the Kogod School of Business, American University, and former Chief Economist at the CFTC; **Larry Harris**, Ph.D., Fred V. Keenan Chair in Finance, University of Southern California Marshall School of Business, and former Chief Economist at the SEC; **Terrence Hendershott**, Ph.D., Cheryl and Christian Valentine Chair, Haas School of Business, University of California at Berkeley; **William W. Hogan**, Ph.D., Raymond J. Plank Professor of Global Energy Policy, John F. Kennedy School of Government, Harvard University; **David Hunger**, Ph.D., Vice President, Charles River Associates International, Inc., and former Senior Economist at FERC; **Stewart Mayhew**, Ph.D., Principal, Cornerstone Research, and former Deputy Chief Economist at the SEC; **Craig Pirrong**, Ph.D., Professor of Finance and Director of the Global Energy Management Institute at the Bauer College of Business of the University of Houston; **Roy Shanker**, Ph.D., independent energy consultant with over 40 years of experience in PJM markets; **Chester S. Spatt**, Ph.D., Pamela R. and Kenneth B. Dunn Professor of Finance, Tepper School of Business, Carnegie Mellon University, and former Chief Economist at the SEC; **Richard D. Tabors**, Ph.D., former Vice President, Charles River Associates International, Inc. and current Principal, Across the Charles; and **Richard G. Wallace**, former Vice President and Chief Counsel for FINRA's Market Regulation Department and former partner at Foley & Lardner LLP.

done anything wrong – let alone anything illegal or fraudulent – and now all they want is a fair shake, an unbiased evaluation of their arguments.[2] After enduring over four years of frustration, they trust that time has finally come.

II. ARGUMENT

At the heart of this case is the relevant PJM tariff language that provided for transmission loss credits (referred to interchangeably as "TLCs," "credits," "MLSA," or "rebates") to be paid to anyone who incurred transmission costs. *See* PJM Open Access Transmission Tariff § 5.5 (Third Revised Sheet No. 399C). And because those credits were distributed *automatically* to all purchasers of transmission in PJM, the transmission loss credits were part of the overall pricing incentive for Dr. Chen (and other traders) to consider when entering into UTC trades.

Responding rationally to that pricing incentive, Dr. Chen (with Powhatan's support) made trades in the summer of 2010 that took the rebates fully into account. He put on trades that he otherwise would not have made, absent the rebates. And he made money on most (but certainly not all) of those trades, once the rebates were included. The Staff characterizes such trading as inherently fraudulent because it was supposedly different from what PJM expected the traders to do – in other words, Dr. Chen was exploiting a "loophole." Report at 21, 27, 31-32, 77.

[2] In addition to the arguments specifically advanced in this Response, Powhatan also hereby incorporates by reference the arguments and materials in its previous submissions, as well as the arguments and materials in Dr. Chen's previous submissions and in his Response to the order to show cause. *See* Written Submission to Comm'n Investigation Staff on Behalf of Powhatan Energy Fund LLC, dated Oct. 21, 2011; Letter from William M. McSwain to Steven C. Tabackman, dated Aug. 24, 2012; Letter from William M. McSwain to Steven C. Tabackman, dated Sept. 24, 2014; Written Submission to Comm'n Investigation Staff on Behalf of Dr. Houlian Chen, dated Dec. 13, 2010; Supp. Submission on Behalf of Dr. Alan Chen, dated Mar. 16, 2012; Letter from John N. Estes III to Steven C. Tabackman, dated Oct. 9, 2013; Letter from John N. Estes III to Steven C. Tabackman and Samuel G. Backfield, dated Sept. 24, 2014.

Maybe he was and maybe he wasn't. Dr. Chen might say that he wasn't exploiting a loophole because such trading was so obviously foreseeable from the tariff itself. Loopholes tend to be things that are not immediately obvious. But for the sake of argument, let's go with the Staff's view in the Report and assume that the trading exploited a loophole. That begs the question: so what? One can never be guilty of market manipulation simply by taking advantage of a flawed market design, or a "loophole." And even if we lived in some strange world in which exploiting a loophole could, by itself, be considered market manipulation, such an allegation could never survive due process scrutiny where, as here, the existing market rules affirmatively anticipated that traders would pursue the rebates. These arguments are explored more fully below.

A. There Is Nothing Inherently Fraudulent About Taking Advantage Of A Market Inefficiency Or "Loophole."

Much of the Report reads like a supposed "gotcha" narrative in which the Staff pats itself on the back for cobbling together various snippets from emails and testimony, usually involving Dr. Alan Chen and Kevin Gates of Powhatan. The problem with this narrative, however, is that every single thing that Dr. Chen and Mr. Gates (or anybody else at Powhatan) has ever said or done before or during the investigation is perfectly consistent with their belief that they did absolutely nothing wrong. The Staff seems to have little understanding of what traders do, how markets work or the relevant law. The only thing the "gotcha" narrative demonstrates is the Staff's own confusion. For example, the Report repeatedly treats "loophole" like the ultimate "gotcha" word: if Kevin Gates ever discussed taking advantage of a "loophole," then he must be admitting to fraud. That is downright ridiculous.

First, as a matter of common sense, there is no illegal connotation to the word "loophole." To the contrary, there is an assumption of *legality*. Indeed, "[t]aking advantage of loopholes in

laws is a time-honored American tradition. It is not a deceitful or unfair means to an end." *Buffalo S. R.R. Inc. v. Vill. of Croton-on Hudson*, 434 F. Supp. 2d 241, 254 (S.D.N.Y. 2006). Congress therefore talks of closing loopholes, not prosecuting them. The working assumption is that where a loophole exists, certain people are taking advantage of it and making money and perhaps the law should be changed to stop those people from profiting. Nobody (except, evidently, the Staff) ever pretends that there's fraud just because somebody is taking advantage of a loophole. *E.g., Macon Cnty. Ill. v. Merscorp*, 742 F.3d 711, 714 (7th Cir. 2014) ("If Macon County is right, a taxpayer who takes lawful advantage of a loophole in the Internal Revenue Code has been unjustly enriched and must disgorge his tax savings. No one believes that.").

Second, finding and exploiting market inefficiencies (or loopholes) is what traders do. They look to maximize profits within the existing rules, even if those rules are flawed. When Dr. Chen saw an opportunity to make money in the summer of 2010, he naturally wanted to make as much as he could, within the bounds of the existing PJM tariff and Commission orders. Arguably, he even had a fiduciary duty to Powhatan to try to maximize the profits he could make from the rebates. *See, e.g.*, Sworn Statement of Larry Harris, at 6 ("Chen had no responsibility to arrange his trades to maximize MLSA payments made to others or to minimize MLSA payments made to him and his clients. In fact, he had a fiduciary duty to his clients to fully consider the MLSA payments when placing his trades."); Sworn Statement of Chester S. Spatt, at 8-9 ("Arguably, Dr. Chen, the agent who was acting as an advisor, would not be fulfilling his fiduciary duty to his clients if he were to leave money 'on the table' and not undertake lawful strategies that he had identified within the context of investments permitted in the fund.").

Similarly, Kevin Gates wanted to maximize profits: there is nothing wrong with wanting to "scale up and try[ing] to become rich." Report at 16. This is America. And there is nothing

wrong with this even if the person exploiting the loophole may think that the market would probably be better off as a whole without the existence of the loophole. *See* Report at 21, 28, 75, 77.

Traders do not make the rules; they merely follow them. They obviously have no obligation to forego profit opportunities just because the rule makers promulgated some rules that arguably should be changed. *E.g.*, *Buffalo S. R.R. Inc.*, 434 F. Supp. 2d at 254 ("Taking advantage of loopholes in laws is a time-honored American tradition. It is not a deceitful or unfair means to an end. And (once again), the Village's remedy lies in a venue other than this Court: it can call Senators Schumer and Clinton and Representative Kelley, and urge them to support an amendment to the ICCTA to correct any manifest injustice that is being worked by the law's loose language."); *see also* Sworn Statement of Susan J. Court, at 6 ("[W]hose fault is it that there was a situation to take advantage of? Dr. Chen? His clients? His clients' investors? As there is no claim that any of them urged or was responsible for crafting the relevant tariff provision, the answer seemed clear, the fault lay with those who had structured the tariff.").

If anything, traders who aggressively exploit loopholes do both the market and the rule makers a service by highlighting the inefficiency of the rules, thereby leading the rule makers to fix whatever problem may exist. *See, e.g.*, Sworn Statement of David Hunger, at 5 ("Trading activities by virtual bidders such as Dr. Chen often expose flawed market rules that can in turn be changed through a tariff filing by the RTO under section 205 of the Federal Power Act (FPA) or by a complaint issued by the Commission or a market participant under section 206 of the FPA. In this sense, the virtual bidders or financial traders serve as the canary in the coal mine, testing the RTO market rules that have been approved by FERC."). That is evidently what happened here, when PJM changed the tariff in September 2010. *See* Report at 31-32.

Third, congressional testimony by the Acting Director of the Office of Enforcement in 2009, Anna Cochrane, confirms that there is nothing inherently fraudulent about exploiting a loophole. In response to questions from Senator James E. Risch of Idaho about market manipulation, Ms. Cochrane explained that "if the trader is tak[ing] advantage of a market rule or a market loophole then we don't have authority to go after them." *Energy Market Transparency and Regulation: Hearing Before the Subcomm. on Energy of the Comm. on Energy and Nat'l Res.*, 111th Cong. 25 (2009) (statement of Anna Cochrane, Acting Dir., Office of Enforcement, Fed. Energy Regulatory Comm'n), attached as Exhibit A. Acting Director Cochrane made her statement a year before the trades at issue here. There is no authority *anywhere* that contradicts her statement (and the Staff obviously points to none in its Report). As long as the trader follows the existing rules, he or she can exploit the loophole in the most aggressive – indeed, the most spectacular – fashion imaginable and not run afoul of the law. In short, the idea that Powhatan broke the law (or has anything to apologize for at all) just because it may have aggressively exploited a loophole is absurd.

It is true that following the rules includes conducting trades in an honest manner. All of Dr. Chen's trades met this standard: he accurately entered the information necessary to conduct the trades, which were carried out openly. He did not attempt to hide, conceal or misrepresent anything to PJM or to the market participants. He did not make false or misleading representations. Even the Staff recognizes this – although, predictably, it makes no difference to them. *See* Report at 50 (admitting that the trades "did not involve any false statements, active concealment, or other explicit tariff violations").

The bottom line is that the Staff, as well as PJM, simply does not like the trading at issue because it was too bold, too opportunistic, too profitable and, most importantly, too embarrassing

because it exposed the loophole in the system. According to the Report, PJM supposedly "worked assiduously if unsuccessfully to craft an MLSA distribution mechanism" that would have prevented trades like Dr. Chen's. Report at 70. That the trades embarrassed PJM and laid bare its "unsuccessful" efforts does not make the trading illegal. Smart traders exist to expose loopholes and to be bold, opportunistic and profitable. Now, in order to save face, PJM and the Staff want to manufacture a way to punish Dr. Chen and Powhatan and have settled upon the idea that they engaged in market manipulation. There was no market manipulation here. But what is even more obvious is that any allegation of market manipulation could never survive due process scrutiny. That is the most compelling reason why the Commission should prevent this case from proceeding any further.

B. Proceeding With This Case Would Be Unconstitutional Because Powhatan Never Received Prior Notice That The Trades At Issue Were Unlawful.

The Due Process Clause of the Fourteenth Amendment requires that "laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited." *Grayned v. City of Rockford*, 408 U.S. 104, 108 (1972). Due process "incorporates notions of fair notice or warning" and "requires legislatures to set reasonably clear guidelines for law enforcement officials and triers of fact in order to prevent 'arbitrary and discriminatory enforcement.'" *Smith v. Goguen*, 415 U.S. 566, 572-73 (1974) (citations omitted). As discussed below, Powhatan was never put on notice prior to or during the relevant period at issue that Dr. Chen's trades were prohibited.

1. *The Relevant Commission Orders Predicted That Traders Would Pursue Trades That Were Profitable Only After Including The Rebates And Never Stated That There Were Legal Problems With Such Trading.*

No PJM tariff provision and no Commission order ever alerted Powhatan that the trading at issue could be unlawful. Moreover, the tariff language relating to the rebates expressly

provided for them to be paid to anyone who incurred the transmission costs and other fixed costs of the PJM system, without any other limitation.

When it first addressed the allocation of TLCs in the *Black Oak Energy* proceedings, the Commission 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, LLC v. PJM Interconnection, LLC, Order Denying Complaint, 122 F.E.R.C. ¶ 61,208 at P 51 (Mar. 6, 2008) (emphasis added). The Commission 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). In the same order, the Commission also observed in a footnote that paying transmission loss credits to financial traders "would provide an incentive for the arbitrageurs to conduct trades simply to receive a larger credit." *Id.* at 125 F.E.R.C. ¶ 61,042 at P 38 n.46.

Ultimately, the Commission 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 UTC 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 . . ."). 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 UTC 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 rebates for UTC transactions, nor did the Commission issue any pronouncement or order advising virtual traders that it would consider trading for the rebates to be wrongful conduct. In other words, (1) the Commission evaluated and assessed how adding TLC payments would affect trading behavior, (2) changed the incentives of the trade, and (3) never cautioned that there would be anything

unlawful about virtual traders following those incentives. In sum, the Commission anticipated that traders would alter their behavior – and that is exactly what happened.[3]

Moreover, in Order No. 670, which implemented the Anti-Manipulation Rule, the Commission established a "safe harbor" whereby "[i]f a market participant undertakes an action or transaction that is explicitly contemplated in Commission-approved rules and regulations, we will presume that the market participant is not in violation of the Final Rule." *See Prohibition of Energy Mkt. Manipulation*, 114 F.E.R.C. ¶ 61,047 at P 67 (Jan. 19, 2006) ("Order No. 670") (setting forth the elements of the Commission's anti-manipulation rule, codified at 18 C.F.R. §1c2(a) (2006)). That is the situation here: as explained above, the relevant Commission orders explicitly contemplated – indeed, they explicitly *said* – that including virtual traders in the allocation of transmission loss credits would encourage them, for example, to "make trades that would not be profitable based solely on price differentials alone" and to "engage in purchase decisions, not because of price divergence, but simply to increase marginal line loss payments." If the safe harbor does not apply here, that portion of Order No. 670 is utterly meaningless.

There is nothing complicated or ambiguous about this. You don't have to be a constitutional law professor or claim to be an expert on energy markets to understand the import

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[3] The Report tries to make it seem like Dr. Chen was some sort of rouge outlier, as if he were the only trader crazy enough to contemplate trades that he otherwise would not have made, absent the rebate. *See* Report at 59-61, 67. The facts are just the opposite. The Report states that nine market participants were investigated and that Dr. Chen traded for three of them. *See id.* at 68. According to Appendix C of the January 6, 2011 Report from the IMM of PJM, entitled "PJM Marginal Loss Surplus Allocation and Market Participant Transaction Activity: May 15, 2010 through September 17, 2010," there were 56 trading participants that received TLCs (including the three that Dr. Chen traded for, Powhatan, HEEP Fund and CU Fund). This means that approximately 13% (7/54) of the individual traders in the UTC market were aggressively pursuing the rebates – and the actual percentage is likely higher than that because the chart in Appendix C redacts the names of the trading participants (other than Powhatan, HEEP and CU), so it is not possible to tell if there are "duplicates" in the chart such that a single trader was making trades for multiple companies, which would decrease the denominator in the 7/54 fraction. Prior to the summer of 2010, the UTC market had existed for approximately a decade without anybody being accused of market manipulation. But within a year of the rule change, FERC was actively investigating at least 13% of the traders. That is powerful evidence that the new rules incentivized the behavior at issue, which is what the Commission predicted would happen.

of the relevant orders here. All you have to do is know how to read. Given the above, how can Powhatan possibly have received fair notice that the trading at issue was illegal? What does the Report say about this? The Report makes two arguments, neither of which can be taken seriously. First, it says that certain parties (the "Financial Marketers' coalition") in the *Black Oak* proceedings "promised" that they wouldn't make trades for the purpose of receiving rebates, and second, it says that the relevant orders should be read to have "condemned" the very trading that they allow. Report at 59-71. (Tellingly, the Report says nothing about the safe harbor in Order No. 670.)

As to the first argument – who cares? It does not matter what any of the parties in the *Black Oak* proceedings did or did not promise. It is axiomatic that the Commission speaks through its orders – not through what certain parties may or may not have said to the Commission.

The same goes for the second argument: it does not matter what the Staff thinks the Commission *meant to say* in its orders. Because the Commission speaks through its orders, all that matters is what the orders *actually say*. The orders note the consequences that the Commission anticipated if it approved the new revenue stream provided by the rebates (specifically, that traders would make trades that were uneconomical absent the rebates) and then the orders approve this new revenue stream – never stating that there were any legal problems with those envisioned consequences. Under the Staff's tortured reading, however, the orders also say "and furthermore we condemn these consequences, think that they are illegal and that nobody should trade this way." But they *do not* say that, or anything like it. *See, e.g.*, Sworn Statement of William W. Hogan, at 4 ("There was a market defect in the poorly crafted rules for loss surplus allocation. The rule was adopted in the full light of day, with explicit discussion of

the incentive effects and the likely implications for trading strategies of market participants. This was not a hidden flaw. The market feature was already known and accepted by the Commission."). It would be completely bizarre for the Commission to issue orders requiring PJM to pay rebates to UTC traders, and in the same orders state that it would be market manipulation for traders to seek to collect those payments – but that is exactly how the Staff thinks the orders should be read.

The Staff's reading of the relevant orders is so preposterous that even Joseph Bowring, the Independent Market Monitor (IMM) for PJM, knows that the Staff is wrong. Dr. Bowring clearly did not like the trading at issue and wanted to stop it, but he understood that the existing market rules incentivized traders to, as the orders put it, "make trades that would not be profitable based solely on price differentials alone" and to "engage in purchase decisions, not because of price divergence, but simply to increase marginal line loss payments." Dr. Bowring called Dr. Chen on August 2, 2010 and asked him to stop the trading at issue, which he did. *See* Report at 30. (Dr. Bowring also told Dr. Chen that he wouldn't report him to FERC if he stopped the trading, but then Dr. Bowring went back on his word and reported Dr. Chen, anyway.) In any event, in a recorded conversation with another UTC trader who is a target of the Staff's UTC investigation, Dr. Bowring discussed the relevant trading, where traders pursue trades that they otherwise would not, absent the rebates. Dr. Bowring had this to say about the existing market rules:

> And ultimately, and ultimately, to try to get the, the rule, the rule changed because, I mean, ***it's incenting this behavior***, which is designed to make money from the fact that we have this weird discontinuity in the rules ***and I understand why, why your traders would be doing it***. . . . And again, I want to be clear, I want to be clear . . . you're not violating the rules.

Staff's Answer in Opp'n. to Expedited Mot. for Two-Week Extension of Time at Exhibit B-1, (Jan. 29, 2015) (emphasis added).

Thus, even Dr. Bowring admits that UTC traders were "incentivized" to make the trades at issue here. He "understands" why the traders would be doing it. And he wants the rules to be "changed." This could not be more different from the Staff's view of things. According to the Report, nobody was "incentivized" to trade this way – after all, the Commission had supposedly already "explicitly condemned" the trading at issue and had a "long history" of calling this type of trading manipulative. Report at 67, 74. Logically, then, there would be no need to "change" the rules; the only people who would trade this way would be rouge traders like Dr. Chen (and Powhatan) who knew that they were breaking the law and knew that they were executing a "scheme," but did it anyway because they wanted to make a lot of money. *See id.* at 75-77.

Yet, incredibly, the Staff insists that the Bowring tape is not *Brady* material or in any way exculpatory (thereby supposedly justifying their decision not to disclose the recording to Powhatan and Dr. Chen until January 29, 2015, after we learned of it from other sources and filed a motion, demanding disclosure). In fact, the Staff thinks that Dr. Bowring's statements are either irrelevant or inculpatory. *See* Staff's Answer in Opp'n. to Expedited Mot. for Two-Week Extension of Time, at 3-6. With that upside-down view, little wonder that the Staff has compiled such an abysmal record to date regarding its *Brady* obligations. As Commissioner Bay's recent written testimony to the Senate confirmed, OE in the last five years has identified and produced exculpatory materials under its *Brady* policy only *twice* in public investigations. Frankly, that is pathetic – but entirely consistent with what we have seen thus far in this investigation.[4]

[4] The Staff's arrogant, dismissive attitude towards its *Brady* obligations is also consistent with its overall approach in this matter. As we have pointed out previously, the lead investigator, Mr. Tabackman, fell asleep for a sustained period of time during the first deposition of Kevin Gates. *See* Letter from William M. McSwain *(cont'd)*

2. *The Due Process Concerns Evident In FERC's National Fuel Marketing Company Investigation Are Instructive Here.*

With the above 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, OE 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 Nat'l Fuel Mktg. Co., 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 OE'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, OE 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. OE opened investigations into several bidders, including NFM, who had engaged in multiple affiliate bidding and ultimately

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to Steven C. Tabackman, dated Jan. 13, 2012. Mr. Tabackman has never denied this – because he can't. There were too many witnesses. Mr. Tabackman also pulled Mr. Gates' counsel aside after Mr. Gates' second deposition and said to him: "Kevin's a businessman, isn't he? He knows that it's cheaper to settle than to fight this investigation." Mr. Tabackman's dismissive attitude is also evidenced by the fact that when Powhatan submitted its original position statement after the close of business on Friday, October 21, 2011 – which consisted of 35 pages of legal argument, over 40 pages of expert affidavits and a massive binder of attachments – Mr. Tabackman and his colleague, Tom Olson, called Powhatan's counsel on the very next business day, Monday, October 24, 2011, to say that they had rejected everything that Powhatan had presented.

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 allegations.

In January 2009, OE 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 L. 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) OE's interpretation of what constituted 'legitimate' multiple affiliate bidding was not disclosed to the bidders, including NFM, on the Cheyenne open season until *after* OE 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. *See* Commissioner Moeller Dissent at 3-7.

Although Commissioner Moeller noted that as part of the Trailblazer investigation, OE 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 OE 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) (emphasis added). Finally, in addition to his due process concerns, Commissioner Moeller also found "fundamental flaws" in OE'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 Nat'l Fuel Mktg. Co., LLC, et al.*, Dkt. No. IN09-10-000, Answer of Nat'l Fuel Mktg. Co., LLC, et al. in Opp'n. to Order to Show Cause & Notice of Proposed Penalties & Alt. Mot. for a Formal Evidentiary Trial-Type Hr'g Before an Admin. Law Judge and Request for Reh'g of Nat'l Fuel Mktg. Co., LLC, et al., (Feb. 17, 2009). NFM continued to fight the allegations of market manipulation for an additional two years.

In April 2011, NFM and OE reached a settlement. OE 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 Nat'l Fuel Mktg. Co., 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 by the collection of TLCs were unlawful. It was only *after* OE began its investigation into the UTC 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 declined to act. What is more, in this case, the Commission actually took the affirmative step of including virtual UTC 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" that concerned Commissioner Spitzer in NFM. Having predicted that allocating transmission loss credits to UTC virtual traders would result in volume-based transactions aimed at profiting from the collection of those credits, FERC cannot claim now that Powhatan's UTC transactions were fraudulent.

Finally, just like in NFM, there is no evidence that Powhatan or Dr. Chen concealed or misrepresented anything related to the UTC transactions. As noted above, the transactions were conducted in a 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.

3. *The Relevant Due Process Case Law Is Overwhelmingly In Powhatan's Favor.*

Just in case there is any remaining doubt about the due process violation here, let's review the most relevant and analogous federal court precedents.

For example, in *Upton v. SEC*, 75 F.3d 92 (2d Cir. 1996), the U.S. Court of Appeals for the Second Circuit found a due process violation in circumstances in which the individual there had much more notice than Powhatan had here. In *Upton*, the SEC brought an action against Mr. Upton, the chief financial officer of the brokerage firm FiCS, for failing to supervise an employee who allegedly aided and abetted a violation of SEC Rule 15c3-3(e), which was designed to prevent broker-dealers from using funds or securities on behalf of customers to finance non-customer transactions. Specifically, that rule required brokers to use a "special reserve bank account" and specified that computations to determine the minimum amount to be kept in the account were to be made "weekly, as of the close of the last business day of the week" and the deposit should be made "no later than 1 hour after the opening of banking business on the second following business day." *Id*. at 93.

At issue, FiCS engaged in a "pay-down" practice where the firm's money management department "paid down loans collateralized by customer securities just before the weekly Rule 15c3-3(e) computation and replaced them with unsecured loans" at a higher interest rate. *Id*. On the next business day, FiCS paid down the unsecured loans and "reinstated the customer-secured loans." *Id*. By doing this, FiCS was able to reduce its weekly reserve requirement by "$20 million on average and by as much as $40 million in some weeks." *Id*. at 94.

FiCS engaged in this "pay-down" practice from April 1988 until May 26, 1989. In November 1988, an NYSE examiner contacted an assistant in the money management department and advised that the "pay-down" practice was "questionable and should be stopped." *Id*. at 95. However, the head of the department ignored the warning. In May 1989, Mr. Upton received a telephone call from SEC staff advising him that the "pay-down" practice "violated the spirit of [the] Rule." *Id*. Mr. Upton then instructed the firm's money management department to stop the practice.

On August 23, 1989, the SEC circulated an interpretation memo, in which "for the first time it advised its members and member organizations that the paydown practice might violate Rule 15c3-3(e)." *Id*. Two years later, the SEC instituted public proceedings against Mr. Upton and the head of his money management department, alleging that his firm's "pay-down" practice from April 1988 until May 1989 violated Rule 15c3-3(e) by resulting in reserve bank account deficiencies averaging $20 million per week, placing broker-dealers and customers at "substantial risk." *Id*.

An evidentiary hearing was held before an ALJ, who issued an initial decision censoring Mr. Upton. The ALJ held that the FiCS's "pay-down" practice was "simply a device designed to evade the requirements of [Rule 15c3-3(e)]." *Id*. at 96. The ALJ further found that "[b]ecause

FiCS was able to use customer funds to finance proprietary activities, the very practice the Rule was designed to prevent, FiCS did not require specific notice that this circumvention of the Rule amounted to a violation." *Id.* The SEC affirmed the ALJ's decision. The Second Circuit reversed.

Mr. Upton claimed that he should not have been held liable for violating the rule because "the Commission knew about the paydown practice well before the underlying events in th[e] action took place and yet did not publicly condemn it until Interpretation Memo 89-10 was released on August 23, 1989." *Id.* at 98. Upon review of the facts, the court noted that it was "undisputed that FiCS complied with the literal terms of the Rule at all times." *Id.* at 94. The court also noted that the SEC had begun investigating the paydown practice at several firms "as early as 1986" and had "referred several such 'violations' of Rule 15c3-3(e) to the New York Stock Exchange and [had] instructed individual broker-dealers to discontinue the practice." *Id.* at 97. However, the Exchange had informed the SEC that it would not cite the firms for any violations because there had been no written interpretation with respect to the practice. In December 1987, the SEC brought an administrative proceeding against another brokerage firm for engaging in a "pay-down" practice. That case had settled and the SEC had issued a consent order. *Id.*

In vacating the SEC's order, the Second Circuit noted that the SEC "was aware that brokerage firms were evading the substance of Rule 15c3-3(e) by temporarily substituting customer loans on the Rule's computation date as early as 1986, two years before the events in this case took place. Apart from issuing one consent order carrying 'little, if any, precedential weight,' **the *Commission took no steps*** to advise the public that it believed the practice was questionable until August 23, 1989, after Upton had already stopped the practice." *Id.* at 98

(emphasis added). Accordingly, the court found that the SEC's order censoring Mr. Upton violated due process because Mr. Upton "was not on reasonable notice that FiCS's conduct might violate the Rule." *Id*; *see also KPMG, LLP v. SEC*, 289 F.3d 109, 115-16 (D.C. Cir. 2002) (following *Upton* and concluding that the SEC erred in finding that KPMG was in violation of a rule prohibiting the receipt of contingent fees because KPMG did not have fair notice that its success fee arrangement ran afoul of the rule from "any interpretation . . . the Commission ha[d] ever attached to [the] Rule").

The due process violation here would be much more apparent than the violation in *Upton*. First, Mr. Upton and his firm's money management department had received a warning from an NYSE market monitor about their "pay-down" practice six months after they began engaging in that practice. Despite the warning, they continued to engage in the "pay-down" practice for *another six months* before the SEC told them to shut it down. Here, as soon as Dr. Chen received a warning from Dr. Bowring on August 2, 2010, he stopped conducting the trades in question. And second, although the SEC had issued a previous consent order following the settlement of claims related to a "pay-down" practice at another brokerage firm, that *still* was not enough to put Mr. Upton on reasonable notice that a "pay-down" practice was unlawful. Here, there were no prior PJM pronouncements or Commission orders related to the transmission loss credits even suggesting that Dr. Chen's trading was illegal. Just the opposite: the Commission had anticipated the type of trading at issue here and nonetheless approved PJM's inclusion of virtual UTC traders in the allocation of the transmission loss credits.

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), *vacated in part on other grounds*, 725 F.3d 279 (2d Cir. 2013), 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 392. 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 (emphasis added). 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 (emphasis added). "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 declined 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 obviously front and center here.

While *Upton* and *Pentagon* are particularly relevant, there is an overwhelming amount of additional due process authority that would bar any liability here for supposed market manipulation.[5] The bottom line is that FERC would be laughed out of federal court if it argued

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[5] *E.g., FCC v. Fox Television Stations, Inc.*, 132 S. Ct. 2307, 2320 (2012) (setting aside notices of liability because broadcasters did not have sufficient notice of what was proscribed); *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 510 (2009) (noting that FCC did not seek a penalty where a change in policy had occurred, preventing the subject from having "requisite notice to justify a penalty") (citation omitted); *United States v. AMC Entm't*, 549 F.3d 760, 768 (9th Cir. 2008) (stating that "those regulated by an administrative agency are entitled to know the rules by which the game will be played" and holding that fair notice precluded the lower court from requiring AMC to retrofit its theatres built before the government announced its interpretation of the statute at issue) (internal citations omitted); *Fabi Constr. Co., Inc. v. Sec'y of Labor*, 508 F.3d 1077, 1085-86 (D.C. Cir. 2007) (holding that petitioners were deprived of fair notice because secretary announced its interpretation of regulation for the first time in an adjudicatory proceeding); *Trinity Broad. of Fla., Inc. v. FCC*, 211 F.3d 618, 619, 628-32 (D.C. Cir. 2000) (discussing fair notice doctrine and finding "neither the regulation nor the Commission's related statements gave fair notice" of a requirement sufficient "to justify punishing someone for violating it"); *Beaver Plant Operations, Inc. v. Herman*, 223 F.3d 25, 32 (1st Cir. 2000) (holding that fair notice doctrine prohibited OSHA from sanctioning employer for violating an agency guideline that was unknown to the employer until after the date of the alleged

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that Dr. Chen and Powhatan had adequate notice that the trading at issue was illegal. That is not in anybody's best interests – it is not good for the Commission's reputation or for the agency as a whole, and Powhatan and Dr. Chen would of course prefer that this matter end now, as it should.

C. The Report Contains So Many Obviously Wrong Accusations That Some Additional Comments On the Most Blatant Inaccuracies Are Warranted.

As discussed above, this case should be terminated on due process grounds. It is not necessary to dig any further into the Report in order to arrive at that conclusion. But the Report is so thoroughly littered with erroneous and illogical accusations that Powhatan feels obligated to make a few additional comments – or at least respond to the biggest whoppers. There are so many that it's hard to know where to start. But maybe we should just start with some simple math.

1. *Dr. Chen's "Home Run" Trading Strategy Is Not A "Post Hoc Invention" Because, Among Other Things, 35 Is Less Than 50.*

Dr. Chen's trading was not as simplistic as the Staff would have the Commission believe. He did not make trades *just* to collect rebates. Rather, he employed a "spread trading" strategy in which he hoped to hit it big (or hit a "home run") if one of the legs of his trades did not clear. Consistent with this strategy, he frequently entered into trades at less than the maximum

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violation); *Gen. Elec. Co. v. EPA*, 53 F.3d 1324, 1329 (D.C. Cir. 1995) (explaining that "when sanctions are drastic . . . 'elementary fairness compels clarity' in the statements and regulations setting forth the actions with which the agency expects the public to comply.") (quoting *Radio Athens, Inc. v. FCC*, 401 F.2d 398, 404 (D.C. Cir. 1968)); *Satellite Broad. Co., Inc. v. FCC*, 824 F.2d 1, 3-4 (D.C. Cir. 1987) (stating that "[t]raditional concepts of due process incorporated into administrative law preclude an agency from penalizing a private party for violating a rule without first providing adequate notice of the substance of the rule" and vacating FCC's orders dismissing applications where FCC failed to give full notice of its interpretation); *Diamond Roofing Co., Inc. v. OSHA*, 528 F.2d 645, 649 (5th Cir. 1976) (explaining that a regulated entity – in this case, an employer –"is entitled to fair notice in dealing with [its] government," and that "statutes and regulations which allow monetary penalties against those who violate them . . . must give . . . fair warning of the conduct" that is "prohibit[ed] or require[d]"); *Peterson v. ConAgra Foods, Inc.*, No. 13-cv-3158-L (NLS), 2014 WL 3741853 (S.D. Cal. July 29, 2014) ("To hold that ConAgra should have been complying with a regulation that was not explicitly clarified until November 19, 2012 would violate due process because ConAgra was not on fair notice.").

congestion limit of $50/MWh (often choosing $35/MWh instead), thereby intentionally increasing the possibility that one of the legs would be rejected. This exposed Dr. Chen and Powhatan to a greater possibility of profit (as well as a corresponding greater risk of loss).

The only conceivable purpose to Dr. Chen sometimes using a cap lower than $50/MWh, such as $35/MWh, was to increase exposure to a leg not clearing. If, as the Staff alleges, Dr. Chen always wanted both legs to clear and was only concerned with minimizing the risk of his trades, *then he would have always bid at the maximum congestion limit*. This is not a point that can be disputed – it is mathematical fact. Dr. Chen and Powhatan have repeatedly explained the details of this spread trading strategy to the Staff over the past four years.[6]

Nevertheless, the Report alleges that it's all made up. It calls the strategy a "post hoc invention" that was developed "by Respondents' experts." Report at 42, 57. What does the Report have to say, then, about Dr. Chen's frequent bids below the maximum congestion cap? The same thing that the Staff has been saying about it for the past four years – that is, absolutely nothing. This point goes completely unaddressed. Maybe the Staff thinks that nobody will notice. Or perhaps that it will be able to convince the Commission that 35 is not less than 50.[7]

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[6] The discussion on pp. 9-14 in Mr. Estes' September 24, 2014 letter to the Staff is particularly instructive.

[7] The Report points to the lack of email traffic between Dr. Chen and Kevin Gates during the summer of 2010 regarding the "home run" strategy. *See* Report at 44, 46. This is of no consequence, as Dr. Chen had no obligation (contractual or otherwise) to share all the details of his trading strategy with Mr. Gates – although he did, of course, discuss the rebates with him because that was such an obvious component of the trading. Contractually, Dr. Chen had the power to choose the trades and the trading volumes and did not need any approval from Powhatan beforehand to enter into trades. Indeed, Mr. Gates, who was not an energy trader, understood that Dr. Chen guarded some of the details of his trading and was not obligated to share those details. *See, e.g., id.* at 26 ("Gates believed that Chen 'had some sort of model that I wasn't privy to where he was able to model the expected transmission loss credits.'").

2. *The Staff's Analysis Of The "Indicia of Manipulation" Misses The Mark Entirely.*

The Report claims that Dr. Chen's trading bears "all the hallmarks of manipulation as clarified by recent Commission precedent." Report at 38. These indicia include: "(1) trading behavior inconsistent with supply and demand; (2) a marked difference in the trader's non-manipulative trading behavior versus the trading patterns of the manipulative scheme; (3) speaking documents that indicate the trader's intent; (4) whether the trades are uneconomic; and (5) failure to give plausible or credible explanations for the uneconomic nature of the trades." The Staff's analysis of these indicia leaves much to be desired.

First, the Report argues that the trading was inconsistent with supply and demand because "[t]he round trip UTC trades had no purpose at all other than to create a claim for MLSA." *Id.* Even if that were true, there would be nothing wrong with the trading at all. But as explained above, collecting rebates was not the *only* purpose of the trading: Dr. Chen used a spread trading strategy in which he hoped to hit a "home run" if one of the legs did not clear. There is no way around the fact that 35 is less than 50.

Second, the Report announces that there was a "sharp contrast" between Dr. Chen's previous trading and the trading during the summer of 2010, and that "Gates was aware and understood that they were doing something fundamentally different." *Id.* at 40. The response to that is – no kidding. The rules and the economics had changed. Saying that this is somehow indicative of manipulation makes about as much sense as saying that 35 is not less than 50. But the Staff apparently has no problem saying it.

Third, the Report declares that "Respondents' intent is not reasonably in dispute." *Id.* at 41. It is right about that – the intent was to make money, lots of it. And there is nothing wrong with that. Indeed, as noted above, Dr. Chen even had a fiduciary duty to Powhatan to try to

maximize the profits he could make from the rebates. The Report also chastises Dr. Chen and Mr. Gates for not consulting with an attorney about the legality of the trades, suggesting that their failure to do so is indicative of scienter.[8] *See id.* at 20-22, 75-77. But the concerns that they expressed to one another had absolutely nothing to do with being concerned about committing manipulation or fraud. Instead, they were simply concerned that PJM might have calculated the rebates incorrectly or might be crazy enough to try to change the rules retroactively and claw back rebates that had already been paid. Ultimately, they decided that was a risk worth taking and certainly had no obligation to consult with an attorney about it. Eventually, PJM did try to claw back some rebates, but the United States Court of Appeals for the District of Columbia Circuit has, at least for now, disallowed it. *Black Oak Energy, LLC v. Fed. Energy Regulatory Comm'n*, 725 F.3d 230, 243 (D.C. Cir. 2013) (concluding that the Commission "acted arbitrarily and capriciously when it effectively ordered PJM to recoup the refunds" and remanding to the Commission).

Fourth, the Report claims that the trades were "uneconomic" because they would have lost money, absent the rebate. But that is just putting the rabbit in the hat by assuming that some price signals count and others do not. For Dr. Chen and Powhatan – and for any rational trader, for that matter – all price signals count. The rebates count. And they were a part of *each individual trade* because they were paid automatically to all purchasers of transmission in PJM. All the trades were undertaken with a profit motive. And those trades that made money after

[8] The Staff asserts that had Dr. Chen and Mr. Gates sought legal advice about the trades, "counsel . . . would have informed them conclusively that their scheme was improper and illegal." Report at 81. This is a curious statement, as it refers to "counsel" in general – presumably the Staff thinks that any qualified lawyer would have given such advice. This just shows how close-minded the Staff is when it comes to this matter. Drinker Biddle certainly would not have given such advice. Skadden would not have, either. Nor would have the former Director of Enforcement, Susan J. Court. The list of counsel who would have quickly recognized that the trading here was perfectly legal is a long one.

accounting for the rebates (which was most, but not all, of the trades) were, by definition, economic. *See, e.g.*, Sworn Statement of Terrence Hendershott, at 2 ("The FERC staff's preliminary findings seem to attach significance to the breakdown of the profitability of trading between the trading revenues based on transaction prices and trading fees/rebates. There is absolutely no economic basis for making such a distinction. All economic agents rationally view the total costs and benefits of their actions and choose their behavior accordingly.").

Finally, the Staff concludes that the spread trading or "home run" strategy is an "implausible explanation" for what Dr. Chen was really doing in the summer of 2010. Report at 42-47. But once again . . . 35 is less than 50 and always will be.

3. *Dr. Chen's Trades Were Not "Wash-like" Or "Wash-type" – Whatever The Heck That Means.*

Manipulative wash trades are bad: they are trades that are designed to mislead other investors, make no money, take on no risk, cancel each other out and have no legitimate purpose. Is that what Dr. Chen was doing? Of course not. Even the Report does not come right out and call the trades "wash trades." Instead, it calls them "wash-like" or "wash-type," whatever that means. That's like saying somebody is in a "pregnant-like" or "pregnant-type" condition – and simply highlights that FERC could never demonstrate that the trades here were manipulative wash trades.

The Commission's anti-manipulation rule expressly requires the Commission to establish that the individual or entity it is seeking enforcement against acted with the requisite scienter. *See* Order No. 670 at P 49. This requirement is well-established in Rule 10b-5 precedent. In *Ernst & Ernst v. Hochfelder*, 425 U.S. 195 (1976), the United States Supreme Court defined scienter in the context of a Rule 10b-5 claim to mean "a mental state embracing intent to deceive, manipulate or defraud." *Id*. at 193 n.12. One year later, in discussing the term "manipulation,"

the Supreme Court reinforced the scienter requirement in Rule 10b-5 market manipulation actions by noting that the "term [manipulation] refers generally to practices, such as wash sales, matched orders, or rigged prices, *that are intended to mislead investors* by artificially affecting market activity." *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977) (emphasis added).[9] The Court also soon after clarified that the scienter requirement is equally applicable regardless of whether the plaintiff is a private party or an enforcement agency. *Aaron v. SEC*, 446 U.S. 680, 691 (1980) ("[T]he rationale of *Hochfelder* ineluctably leads to the conclusion that scienter is an element of a violation of § 10(b) and Rule 10b-5, regardless of the identity of the plaintiff or the nature of the relief sought.").

In order to plead and ultimately prove scienter, the Supreme Court has held that facts giving rise to a "strong inference" of scienter must be demonstrated. In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007), the Court explained:

> The strength of an inference cannot be decided in a vacuum. The inquiry is inherently comparative: How likely is it that one conclusion, as compared to others, follows from the underlying facts? To determine whether the plaintiff has alleged facts that give rise to the requisite . . . scienter, a court must consider plausible, nonculpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff . . . [T]he inference of scienter must be more than merely 'reasonable' or 'permissible' – ***it must be cogent and compelling, thus strong in light of other explanations***.

Id. at 323-24 (emphasis added).[10]

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[9] Based on such precedent, even in cases where the conduct, without a doubt, constituted wash trades or matched orders, courts have concluded that scienter is a separate element that still must be established. *E.g.*, *Rockies Fund, Inc. v. SEC*, 428 F.3d 1088, 1093 (D.C. Cir. 2005) (noting that defendants engaged in wash sales and matched orders but finding that "neither of these devices alone constitutes a securities violation. Section 10(b) (and, accordingly, Rule 10b-5) also requires a showing of intent and materiality.").

[10] *Tellabs* involved a private plaintiff, but as set forth in *Aaron v. SEC*, the requirement of proving scienter in Rule 10b-5 cases is the same for private litigants and the government. 446 U.S. at 691. Accordingly, the Supreme Court's articulation of the test for scienter is equally applicable in government enforcement actions. *E.g.*, *SEC v. Boling*, No. 06-1329 (RMC), 2007 WL 2059744, at *4 n.1 (D.D.C. July 13, 2007) (applying the Supreme Court's instruction in *Tellabs* to "take into account plausible opposing inferences" and to determine whether the *(cont'd)*

Here, Powhatan had a legitimate economic purpose for the Up-to Congestion Transactions: profiting from *each* of the trades, which included the collection of transmission loss credits. *See, e.g., United States v. Mulheren*, 938 F.2d 364, 368 (2d Cir. 1991) ("When the transaction is effected for an investment purpose, the theory continues, there is no manipulation, even if an increase or diminution in price was a foreseeable consequence of the investment."); *SEC v. Masri*, 523 F. Supp. 2d 361, 373 (S.D.N.Y. 2007) ("[I]f a transaction would have been conducted for investment purposes or other economic reasons, and regardless of the manipulative purpose, then it can no longer be said that it is 'artificially' affecting the price of the security, or injecting inaccurate information into the market, which is the principal concern about manipulative conduct.").

As should be obvious by now, Dr. Chen was rationally responding to price signals when taking the TLCs into account in his trades. Significantly, the Commission itself has found that the existence of a pricing incentive is evidence of a *lack* of fraudulent intent:

> [T]he existence of a pricing incentive is suggestive of the *lack* of a fraudulent device, scheme or artifice, and is indicative instead of market participants responding to existing prices, rather than artificially affecting them.
>
> * * *
>
> Since NYISO itself has identified a clear economic pricing incentive for the transactions, since the market participants agree that they placed the schedules in response to prices, and since the market participants did in fact make a profit on their Path 1 and Path 5 trades, there seems no reason to doubt that their motive was simply one of responding to the price signals in the market.

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inference of scienter was "cogent and at least as compelling as any opposing inference one could draw from the facts alleged" in deciding whether the SEC had adequately pled scienter).

Federal Energy Regulatory Commission, *Non-Public Investigation into Allegations of Mkt. Manipulation in Connection with Lake Erie Loop Flows: Enforcement Staff Report*, at 22, 24 (June 10, 2009) (emphasis in original), adopted by the Commission on July 16, 2009. *See N.Y. Indep. Sys. Operator, Inc.*, Order Authorizing Pub. Disclosure of Enforcement Staff Report & Directing the Filing of an Additional Report, 128 F.E.R.C. ¶ 61,049 at P 1 (July 16, 2009).

Furthermore, profit-driven actions in response to similar pricing incentives in other contexts are common and not considered fraud. For example, in *Idaho Wind Partners 1, LLC*, Order Dismissing Without Prejudice Petition for Declaratory Order, 134 F.E.R.C. ¶ 61,217 (Mar. 17, 2011), the Commission found that offsetting energy transactions entered into for the sole purpose of accruing benefits associated with Renewable Energy Credits ("RECs"), which like TLCs are a credit revenue stream, did not constitute market manipulation. There, the sale and repurchase of energy cancelled each other out completely. The transactions thus served *no* purpose other than obtaining the value of the RECs. *Id*. at PP 6, 24. Likewise, another energy market credit, the Wind Energy Production Tax Credit ("PTC") for wind-generated electricity, creates the incentive for wind generators to *lose* money on the sale of electricity by offering zero or even negative bids into their respective markets in order to capture the PTC. The Commission has acknowledged that certain resources are incentivized to make negative bids in order to gain revenue via PTCs and has never suggested that there is anything fraudulent about this practice. *See Midwest Indep. Transmission Sys. Operator, Inc*., Order Conditionally Accepting in Part and Rejecting in Part Tariff Filing & Requiring Compliance Filings, 134 F.E.R.C. ¶ 61,141 at P 83 (Feb. 28, 2011).

The trades at issue here also were not wash trades because they entailed risk. This is another mathematical fact that cannot be disputed. For instance, Dr. Chen did not (and could

not) know ahead of time that the rebates would exceed the other costs associated with the trades. He speculated that they would, hoped that they would, took the *risk* they that would – but sometimes he was wrong and the trades lost money. As the Staff has previously acknowledged, this happened about 20% of the time. *See* Preliminary Findings of Enforcement Staff's Investigation, dated Aug. 9, 2013, at 23 ("[T]hroughout the period in which he employed his identical matched-pair strategy, over 80% of the hours in which Chen scheduled the matching UTC transaction and associated reserved transmission yielded a MLSA high enough to completely absorb transmission-related charges, market charges, and ancillary service charges related to those transactions."). And as the Report states, "[a] week and a half *after* he began implementing the round trip UTC trading strategy, Chen explained to Gates that, 'we increased volumes but decreased risk. If we rate the risk on 5/30 at 1.0, we now have probably 0.5.'" Report at 45 (emphasis in original). The Staff points to this quote as supposed evidence that the trades involved no risk – that the Respondents and their experts are just making it all up that the trades involved risk. But Dr. Chen had lost over $176,000 on May 30, 2010. *See id.* at 23. If he then shifted his strategy to cut the risk in half, the trades obviously still involved meaningful risk. How else can that statement possibly be interpreted? The fact that the Staff would think that this quote helps to show that there were no risks to the trading is a complete head-scratcher. But at least it does tend to fit the narrative: in the Staff's view, up is down, black is white, and losing money does not mean that there is any risk.

Finally, the trades did not cancel each other out (as wash trades would) because, among other reasons, many of the trades involved unmatched daily volumes, meaning the congestion elements did not cancel out in the aggregate. Thus, there was a directional bet on congestion for these unmatched-volume trades. *See* Letter from John N. Estes III to Steven C. Tabackman and

Samuel G. Backfield, dated Sept. 24, 2014, at 2, 8-14 (providing additional detail on the unmatched-volume trades and the spread trading strategy). This, too, is a mathematical fact that the Staff ignores.[11] Indeed, it is ironic that the Staff alleges that "Respondents' defenses generally do not address Chen's actual trading or trading strategy," Report at 58, when it is the Staff that ignores the trading data itself and the mathematical facts that many of the trades had unmatched volumes, some of the trades lost money and, of course, that 35 is less than 50. The Staff must be hoping that the Commission will just take the Staff's word for it, no matter how preposterous, and simply will not dig into any of the relevant details.

4. *The Staff's Stubborn Reliance On The Unpublished, Non-Precedential* Amanat *Case Is Just Lame.*

In order to establish that Powhatan engaged in market manipulation, the Commission must show that Powhatan: (1) used a fraudulent device, scheme or artifice, made a material misrepresentation or omission, or engaged in a deceitful or fraudulent act, (2) with the requisite scienter, (3) in connection with a Commission-jurisdictional transaction. *See* Order No. 670 (setting forth the elements of the Commission's anti-manipulation rule, codified at 18 C.F.R. §1c2(a) (2006)). The Commission has stated that its anti-manipulation rule is modeled after the Securities and Exchange Commission's ("SEC") Rule 10b-5[12] and that the Commission must

[11] Underscoring the Staff's confusion on the wash trade issue is that, on the one hand, it likes to pretend that the trades were "self-cancelling" or "substantive nullities," Report at 50, 54, while on the other hand, it claims in the jurisdiction section that the trades "have the potential to affect the price of physical electricity," and were "integral . . . to the pricing and dispatch of physical energy," *id.* at 77, 79. This just shows that the Staff will change its tune when it thinks it suits its purposes, evidently without even realizing the contradiction.

[12] *See* 17 C.F.R. § 240.10b-5 (2005) ("It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.")

look to Rule 10b-5 precedent. *Id*. at P 7 ("[T]he Commission has modeled the Final Rule on Rule 10b-5. This approach will benefit entities subject to the new rule because there is a substantial body of precedent applying the comparable language of Rule 10b-5."); *id.* at P 30 ("We intend to adapt analogous securities precedents as appropriate to specific facts, circumstances and situations that arise in the energy industry . . . [This] will provide a level of substantial certainty with respect to how the regulations will operate that the Commission is not typically able to provide where a preexisting body of law and precedent is not readily available. The Commission likewise finds that modeling the Final Rule on SEC Rule 10b-5 provides clarity to affected parties similar to the clarity provided by Congress.").

In accordance with this directive, Powhatan and Dr. Chen have repeatedly brought relevant SEC authority to the Staff's attention. *See, e.g.*, Written Submission to Comm'n Investigation Staff on Behalf of Powhatan Energy Fund LLC, dated Oct. 21, 2011, at 4-22; Written Submission to Comm'n Investigation Staff on Behalf of Dr. Houlian Chen, dated Dec. 13, 2010, at 21-24; Supp. Submission on Behalf of Dr. Alan Chen, dated Mar. 16, 2012; Letter from John N. Estes III to Steven C. Tabackman and Samuel G. Backfield, dated Sept. 24, 2014, at 14-17. But they don't care – because the avalanche of SEC precedent in support of Dr. Chen and Powhatan does not fit the Staff's chosen narrative. So, despite the Commission's guidance, they try to bat all the SEC precedent away by saying that it really does not count. *See* Report at 71-72. Or, if it does count, the only thing that counts is one unpublished, non-precedential case in the Third Circuit, *Amanat v. SEC*, 269 F. App'x 217 (3d Cir. 2008). *See* Report at 73-74. *Amanat* is not going to save the day for the Staff.

As an initial matter, the *Amanat* court showed little enthusiasm for the SEC's findings, and only affirmed them because of the deferential standard of review. *Amanat*, 269 F. App'x at

220 ("Were we permitted to conduct a *de novo* review of the record, we might well reach a different conclusion with respect to certain of the Commission's findings."). Moreover, an unpublished opinion like *Amanat* has zero precedential weight.[13] So even if FERC, Powhatan and Dr. Chen end up litigating in the Eastern District of Pennsylvania (within the Third Circuit), no EDPA judge (or any other judge, for that matter) is going to care about *Amanat*.

In any event, the relevant facts in *Amanat* are unlike the facts here. In *Amanat*, the Third Circuit affirmed the SEC's finding that Irfan Amanat, the chief technology officer at MarketXT, an electronic communication network ("ECN")[14] broker-dealer, engaged in a fraudulent scheme to obtain market data rebates from Nasdaq by executing thousands of wash trades and matched orders through an automated trading program that he had designed. The similarities between *Amanat* and the trades here begin and end with the fact that *Amanat* involved a rebate.

In late 2001, Amanat learned that Nasdaq had instituted a rebate program to share with NASD members part of the revenue it received for selling transaction data, provided that the members met a minimum threshold of qualifying trades during the financial quarter. *In the Matter of Irfan Mohammed Amanat*, No. 3-11813, 2007 SEC LEXIS 2558, at *7 (Nov. 3, 2007) ("SEC Opinion"). MarketXT was eligible to participate in the program as an NASD member. Amanat "was aware that MarketXT had 'cash flow' problems" so he decided to try to qualify MarketXT for the rebate program for the March 2002 quarter. *Id*. at *8. However, by mid-March, MarketXT was not on pace to meet the minimum threshold requirement of qualifying

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[13] An unpublished decision holds no weight in the Third Circuit. *See* 3d Cir. I.O.P. 5.7 ("The court by tradition does not cite to its not precedential opinions as authority. Such opinions are not regarded as precedents that bind the court because they do not circulate to the full court before filing."). The panel echoed those limitations in their introduction to the opinion. *Amanat*, 269 F. App'x at 218 ("Because we write *only for the parties*, familiarity with the facts is presumed . . .") (emphasis added).

[14] An ECN is "an electronic trading system that automatically matches buy and sell orders at specified prices." *In the Matter of Irfan Mohammed Amanat*, No. 3-11813, 2007 SEC LEXIS 2558, at *3 n.2 (Nov. 3, 2007).

trades. *Id*. at *8-9 ("On March 11, 2002, Amanat heard from Nasdaq that, with three weeks left in the quarter, the firm was averaging only forty-nine qualifying trades per day, far less than the required daily average of five hundred trades.").

Recognizing that MarketXT would have to generate an enormous number of trades to qualify, Amanat enhanced an existing computer program ("RLevi2") to automatically send buy and sell market orders for the same number of shares of the same security within "milliseconds" at "regular, timed intervals." *Id*. at *11-12. Amanat executed the trades through two accounts at Momentum, a broker-dealer affiliated with MarketXT. *Id.* at *14. Amanat programmed RLevi2 to "cover[] every purchase order with a sell order to ensure that his position remained flat." *Id*. at *12. Amanat testified that he could also "shorten the time interval between buy and sell pairs of orders, thereby increasing the number of trades executed." *Id*. Between March 25 and March 27, 2002, Amanat ran RLevi2 in an attempt to meet the rebate program threshold. In doing so, he generated thousands of wash trades. *Id*. at *24-25 ("The trading data reveal[ed] that a total of 20,483 trades in Tape B securities were effected on MarketXT between March 25 and 27, 2002. Of those trades, seventy percent or over 14,000 of them were Amanat's wash and matched trades . . . ."). Because of those wash trades, executed through the two accounts at Momentum, Amanat was able to meet the rebate program minimum volume threshold and qualify MarketXT for the rebates. *Id*. at *25. Later that June, MarketXT received "nearly $50,000" in rebates from Nasdaq. *Id*.

Most importantly, unlike Powhatan or Dr. Chen, Amanat acted with scienter because his individual transactions had no legitimate economic purpose. *None* of Amanat's individual trades made money (or were intended to make money) or had any value at all. And Amanat never intended to profit from his trades: rather, he made his trades hoping to make money *later* on

account of the artificial volume that he had created. In contrast, the TLCs were part of the price signal for every single one of Dr. Chen's disputed trades.

Besides the absence of a legitimate economic purpose, many of the other traditional hallmarks of manipulation are present in the *Amanat* case. None of these are present in the instant matter.

First, Amanat's transactions undeniably constituted wash trades. Amanat even admitted this. *SEC Opinion*, 2007 SEC LEXIS 2558, at *16 ("Amanat admitted that the 1,696 trades in DIAs were 'wash trades.'"); *id*. at *39 ("Amanat [did] not dispute[] that his wash and matched trades involved no change in beneficial ownership."). Moreover, Amanat's own expert testified that "the element of risk involved in [Amanat's] trades was 'close to de minimis.'" *Id.* at *16. Consistent with the concept of wash trading, Amanat conducted his trades in accounts at one broker-dealer (Momentum) for the purpose of providing a subsequent benefit to *another* broker-dealer (MarketXT) from the artificial volume generated by his trades. In other words, Amanat's trades at Momentum were part of an artifice to make money later in some other fashion – namely, via rebate revenue to MarketXT.

Second, there was evidence that Amanat knew that what he was doing was wrong. He intentionally conducted wash trades for the purpose of benefiting later from their artificial volume. *Id*. at *13 (acknowledging that he "was familiar with the term 'wash trade'" and "knew that [it] was illegal, . . . [but] [n]onetheless . . . admitted that he did not program RLevi2 to prevent wash trading, although he could have done so."); *id*. at *20 ("After two days of running RLevi2 . . . Amanat was still thousands of trades short of the 18,000 trades needed to qualify for rebates. He decided to decrease again the number of seconds between his paired market orders.

He also adjusted the program so that each buy order preceded a sell order by seven hundred milliseconds.").

Third, at the end of the quarter, during his communications with Nasdaq about obtaining the rebates, Amanat intentionally concealed the fact that he had conducted wash trades. *Id*. at *23-24 ("On March 28, 2002, the day after he was told by Tradescape compliance and supervisory personnel that his trading was wrong, Amanat sent an e-mail to Nasdaq inquiring about rebates for his trades. He asked, '[C]ould you send me the list of trades we've done on [T]ape A and B, and tell me if we [MarketXT] qualified (crossing my fingers here!) Thanks!' Amanat did not reveal to Nasdaq that he had been on both sides of his trades, or that the firm had told him that his trading must stop."). This was a material misrepresentation or omission because Amanat "caused Nasdaq to believe that MarketXT had reached the trading threshold required to qualify for rebates . . . [which] triggered Nasdaq's payment to MarketXT of rebates for all of its reported trades, both legitimate and illegitimate." *Id*. at *29.

Finally, Amanat received the rebates for nothing. The trades that qualified him for the rebates were fictitious. And because they were fictitious, he was not entitled to the rebates, and thus, in a very real sense, he took rebates away from other market participants. *Id*. ("Amanat's trades through MarketXT caused Nasdaq to receive more than its proper share of market data revenue, thereby defrauding other CTA participants."). Powhatan, on the other hand, did not take transmission loss credits away from any other PJM member because Powhatan was entitled to the transmission loss credits based on its payment of the transmission costs and other fixed costs of the system – and the Commission itself had previously found that no entity was entitled to receive any particular amount of credits. *Black Oak Energy*, 125 F.E.R.C. ¶ 61,042 at P 12 ("[T]he Commission reiterated that no party is entitled to receive any particular amounts through

disbursement [of the credit that inevitably results from using the marginal line loss methodology], since the price each is paying (based on marginal line losses) is the correct marginal cost for the energy each is purchasing.") (citing *Black Oak Energy*, Order Denying Complaint, 122 F.E.R.C. ¶ 61,208 at P 46 (Mar. 6, 2008)).

In sum, even if *Amanat* had any precedential weight (which it does not), it still would not be relevant here. *See, e.g.*, Sworn Statement of Stewart Mayhew, at 4 ("The case brought by the FERC against Powhatan is not analogous to the SEC administrative proceeding brought against Mr. Amanat. Mr. Amanat's strategy involved wash trading, and Dr. Chen's strategy did not. The Division offered up a theory explaining why it believed Mr. Amanat's strategy was deceptive, and who was deceived; the FERC has not done so in its case against Powhatan. Mr. Amanat's trading platform would not have qualified for market data rebates had he not engaged in the wash trading strategy the Division alleged to be deceptive, whereas Dr. Chen's trades automatically qualified for the Marginal Loss Surplus Allocation payments. Mr. Amanat's strategy involved little or no risk, and Dr. Chen's strategy did involve risk.").

While the Report places far too much emphasis on *Amanat*, noticeably absent is any discussion of the *Kellogg* case – which was based on SEC precedent and is the case that most closely resembles the Staff's theory here. In 2004, a unanimous three-member panel of the National Association of Securities Dealers ("NASD," now the Financial Industry Regulatory Authority, or "FINRA") ruled in favor of Peter Kellogg and against the Department of Market Regulation on claims that Mr. Kellogg directed fraudulent wash and matched trades.[15] As a factual matter, there was no question that Mr. Kellogg indeed had engaged in matched trades

[15] The NASD panel in *Kellogg* was statutorily required to interpret and follow SEC law in issuing its decision. *E.g., Nat'l Ass'n of Sec. Dealers, Inc. v. SEC*, 431 F.3d 803, 806-07 (D.C. Cir. 2005) (explaining SEC oversight of the NASD).

with no change in beneficial ownership. But it did not matter because he had an economic motive for his trades – and that motive was simply to pay less taxes. If shielding money from the federal government is a "legitimate" enough economic motive to save an obvious matched trade scheme from securities liability, then surely the trades at issue here were legal.

The facts in *Kellogg* are worth a closer look. In early 2001, Mr. Kellogg invested hundreds of millions of dollars in IAT, an insurance company which he had founded. *Dep't of Mkt. Regulation v. Kellogg*, No. CMS030257, Disciplinary Proceeding, *available at* 2004 NASD Discip. LEXIS 64, *4-8 (Aug. 6, 2004) ("Hearing Panel Decision"). At that time, IAT was tax-exempt. *Id*. at *3. However, Mr. Kellogg expected that IAT would lose its tax-exempt status that coming November. IAT owned 100% of MMK, a Bermuda insurance company. At some point, IAT also had bought a controlling interest in MCM, a Delaware insurance company with $100 million in operating loss carry-forwards. MCM owned 100% of EH, a Delaware investment holding company. *Id*. at *4.

Mr. Kellogg was a significant investor in Thoratec Corporation ("THOR"). As of August 1, 2001, IAT held 2,033,500 shares of THOR and EH held 700,000 shares of THOR. *Id*. at *5. EH's shares of THOR had been purchased in February 2001 at just under $8.70. By August 2001, the price of THOR had risen to around $17, giving EH an unrealized gain on its shares. *Id*. at *5-6. Accordingly, as a wholly-owned subsidiary of MCM, EH could "offset any realized taxable capital gains on THOR by using MCM's loss carry-forwards before they expired." *Id*. at *7. As a long-term investor in THOR, Mr. Kellogg did not want to lose control of EH's shares. Thus, on August 1, Mr. Kellogg put in a sell order on behalf of EH for 700,000 shares of THOR; at the same time, he placed "an identical buy order on behalf of IAT, expecting the two orders would be crossed." *Id*. Trading records revealed that the trades were executed at

$18 per share and represented a hefty 54% of the trading volume in THOR that day. Six days later, on August 7, Mr. Kellogg placed a sell order on behalf of IAT for 1,000,000 shares of THOR. "[T]hat same day, he placed an identical buy order on behalf of EH." *Id*. The trades were executed at $17.50 and constituted around 70% of the trading volume in THOR. As a result of this trade, "IAT was able to realize gains on its investments in THOR before its tax exemption expired in November 2001." *Id*. at *7-8.

On August 9, Mr. Kellogg placed another sell order on behalf of IAT for 1,000,000 shares of THOR. "At the same time, he placed two buy orders for THOR, each for 500,000 shares[,]" one in a personal account and the other on behalf of MMK. *Id*. at *10. The trades were executed at $17.12 and represented a whopping 84% of the volume in THOR. "The purpose, again, was to take advantage of IAT's tax exemption before it expired in November." *Id*. On August 13, Mr. Kellogg reversed those trades. The trades were executed at $17.20 and constituted approximately 70% of the trading volume in THOR. Mr. Kellogg conducted the final trades to allow IAT to hold the same number of shares it held prior to August 9 because Mr. Kellogg wanted to remain a long-term investor in THOR. He also avoided margin interest on the 500,000 THOR shares in his own account and in MMK. *Id*. at *11.

Thus, Mr. Kellogg engaged in an obvious series of "matched orders." He placed identical, simultaneous buy and sell orders between his own accounts, thereby precluding any change in the beneficial ownership of those securities. He did this simply because he wanted to pay less taxes to the government. Based on those facts – which are far worse than any conceivable view of the facts here – the Hearing Panel unanimously concluded that Mr. Kellogg did not engage in market manipulation because he did not possess the requisite scienter.

In making its determination, the Hearing Panel rejected the regulators' argument – the same or at least substantially similar to the argument that the Staff is making here – that "wash trades" and "matched orders" are *per se* illegal and do not require an independent showing of scienter. *Hearing Panel Decision*, at *17-18. The Panel found that such a position flatly contradicted the Supreme Court's ruling in *Hochfelder*, as well as subsequent decisions addressing the interplay of Rule 10b-5 and the scienter requirement. *Id*. at *17-19. The Panel concluded that the regulators could not show scienter because "[t]here [was] no evidence that [Mr. Kellogg] had any motive for the trades, other than tax reasons and a desire not to reduce the size of [his company's] holdings of THOR. He had no motive artificially to affect the price of THOR or to induce others to trade the stock." *Id*. at *6. The Panel further concluded that Mr. Kellogg's trades were "effected in good faith" and there was "no evidence of any attempt or reason to manipulate the price of th[e] shares, to induce anyone to trade in th[e] shares, or to create the false or misleading appearance of market activity." *Id*. at *18-19. Finally, the Panel also noted that it found Mr. Kellogg's testimony credible that he "engaged in trades that he believed were bona fide, knew that they would be reported to the public, and made no attempt to conceal any aspects of his actions." *Id*. at *24.

The similarities between *Kellogg* and the instant matter are palpable. Like the NASD, the Staff here cannot show scienter because there is no evidence that Dr. Chen or Powhatan had any motive for the trades at issue, other than to make money via collection of TLCs and the possibility of gains if one of the legs did not clear. The trades were done in good faith; there is no evidence of any attempt to manipulate prices or to induce anyone else to make trades; and Dr. Chen and Powhatan engaged in trades that they believed were bona fide, knew that the trades would be reported to the public, and made no attempt to conceal any aspects of their actions.

Kellogg was decided against the regulators for good reason. The regulators' novel theory of market manipulation simply could not be squared with 35 years of Rule 10b-5 case law. Since the *Kellogg* decision was issued in 2004, no regulator has come into court and tried to make the same type of arguments that NASD/FINRA did in *Kellogg*. The Commission should not be the first.

5. *Uttering the Phrase "Enron" Or "Death Star" Does Not Magically Transform The Staff's Investigation.*

The Staff tries to compare Dr. Chen's trading to other trading practices at Enron during the Western Energy Crisis, including what it calls the "Death Star" trading strategy. Report at 47-50.[16] The Report goes out of its way to utter the phrase "Death Star" as much as possible – referring to it 11 times in the space of about three pages – as if repeating that scary-sounding phrase (as well as uttering the word "Enron" as much as possible), will smear Dr. Chen and Powhatan and convince the Commission that they did something wrong.[17]

It is noteworthy that two of the twelve experts in this matter who think Dr. Chen's trading was perfectly legal were involved with FERC's investigation of the Western Energy Markets, David Hunger and Chester Spatt. *See* Sworn Statement of David Hunger, at 1 ("Of particular relevance here, I was the lead economist in FERC's Investigation of Price Manipulation of Western Markets and Enron's impact on energy markets."); Sworn Statement of Chester S. Spatt, at 5 ("I served as an expert for the FERC in its 2002-03 investigation of the manipulation of the Western energy markets in the United States."). Therefore, the people who know that

[16] The Report is the first time that the Staff has compared Dr. Chen's trading to anything at Enron, so it took the Staff over four years to concoct this theory.

[17] James Owens of the Staff took the Enron smear a step further during the deposition of Richard Gates, gratuitously asking him: "And then so you were aware that people went to prison as a result of the Enron trading?" Testimony of Richard J. Gates (May 7, 2012) Tr. 73:3-4.

investigation (and the dreaded "Death Star") the best do not think that Dr. Chen or Powhatan did anything wrong.

As the Report explains, the Death Star strategy allegedly involved trickery and deception. It was supposedly designed to generate payments "by 'fooling' the Cal ISO's computerized congestion management system," and could do so, for instance, because "the return leg of the Death Star transactions was scheduled on paths outside of the California ISO's control area, rendering them invisible to the ISO as a practical matter . . . ." Report at 48-49. Thus, the ISO "only sees what is happening inside its control area, so it only sees half the picture." *Id.* at 49 n.267. Dr. Chen's trading, by contrast, involved no deception whatsoever. *See, e.g.*, Sworn Statement of David Hunger, at 4 ("It is also noteworthy that there was nothing deceptive in Dr. Chen's trading behavior."); Sworn Statement of Chester S. Spatt, at 8 ("Dr. Chen and Powhatan did not attempt to hide their transactions, strategy or intent. They did not create false reports in conjunction with the trades or attempt to mislead either PJM or FERC with respect to the transactions that they undertook. Indeed, the MLSA credits provided were on a trade level basis, in accordance with the PJM tariff without any misrepresentation.").

Additionally, when commenting on the Enron trading, the Commission noted that market participants could not escape disgorgement of profits just because 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." Report at 50. That makes sense. But the situation here is totally different: it is not a case where the trader did something that the Commission did not (or could not) foresee. As explained in detail above, it is a case where the Commission had *actually foreseen* the type of trading at issue and chose not to prohibit it or indicate that there were any legal problems with such trading.

6. *Who Cares What Bob Steele Thinks?*

Obviously, what one individual UTC trader plucked out of thin air thinks about Dr. Chen's trades has no bearing on this case – especially if that trader has an ulterior motive for his opinion. Nevertheless, the Staff fixates on Bob Steele's comments that he thought Dr. Chen made manipulative trades. *See* Report at 31-32, 67-68. What the Staff does not point out, though, is that Mr. Steele is angry with and biased against Dr. Chen and Powhatan because he thinks they threatened to "kill the goose that laid the golden egg." Testimony of Robert Steele (Apr. 7, 2011) Tr. 169:12-13. Steele relied on UTC trading to make his living. *See id.* Tr. 171:17-18. In his words, that market gave him the "best risk/reward opportunity." *Id.* Tr. 171:24. He was concerned that, in response to trading like Dr. Chen's, the regulator would overreact and eliminate the UTC market altogether. *See id.* Tr. 169:14-18.

But even if he were not biased, who cares what Bob Steele thinks of the trading?[18] Powhatan could just as easily come up with another trader who thinks that the trading was legal – how about, for example, Bob Steele's business partner and friend, Bryan Hansen? What does the Report have to say about him? Nothing, of course. But Hansen submitted a sworn statement in which he observed that "I do not agree that [trading like Dr. Chen's] was 'rank manipulation.' As stated above, it is my opinion that it is not market manipulation to profit from flaws in the design of the energy markets." Bryan Hansen's Responses to Data Request, dated Dec. 8, 2014, Response No. 16c. He also stated that Dr. Chen and traders like him "were simply taking advantage of poorly designed market rules," and answered "No" in response to the Staff's question of whether Dr. Chen was a "bad egg." *Id.*, Response No. 16f. He further noted that the

[18] The only way Bob Steele's opinion would be relevant is if he were to serve as an expert for FERC in this matter, which is rather unlikely, to put it mildly. Twelve experts – many of whom are among the world's leading authorities on energy trading and/or market manipulation – have set forth their reasons why Powhatan and Dr. Chen have done nothing wrong. The Staff has not identified a single expert.

trades were not risk-free because "one could not know ahead of time that the [MLSA] allocation was going to be more than the total fixed cost of the Up-To Congestion transaction." *Id.*, Response No. 16a. Finally, in response to the question of whether Dr. Chen and Kevin Gates were gaming the system, he stated that:

> I am not sure the term "game" is appropriate. In my opinion, one of the functions of the financial-only market participants is to find issues with both the design of the power [] markets, and the day-to-day functioning of the power markets. ***Taking advantage of the Marginal Loss allocation issue is no different than taking advantage of a persistent mispricing of LMP nodes in the Day Ahead and Real Time Markets.*** These situations are resolved by more and more market[] participants taking advantage of the issue until the issue is resolved because it becomes uneconomical, or there are systemic changes made. *i.e.* changes to physical power grid or changes to the design of the market itself.

Id., Response No. 15a (emphasis added). Well said, Mr. Hansen.

7. *The Staff Has Not Identified Any Actionable "Harm."*

It is hard to tell what exactly the "harm" from Dr. Chen's trading is supposed to be because the Report spends hardly any time on this issue, despite its bloated, 84-page length. But it appears to say that the harm is the supposed "misallocation of over $10 million of MLSA." Report at 81.[19] The Staff's recent Answer in Opposition to Expedited Motion for Two-Week Extension of Time confirms this, as it points to a PJM MLSA Reallocation Simulation that runs

[19] Regarding any civil penalties for the alleged harm, Powhatan objects to any joint and several liability. The Report states that "staff believes it is appropriate to hold Powhatan and HEEP jointly and severally liable for the penalties against HEEP." Report at 82. Contrary to the Staff's proposal, joint and several liability is inappropriate because civil penalties can be apportioned between Powhatan and HEEP. The Commission has stated that "[j]oint and several liability is traditionally used where activity of multiple parties creates harms that cannot be distinguished from one another and there is no reasonable basis for determining the contribution of each in the resulting harm." *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs. Into Mkts. Operated by the Cal. Indep. Sys. Operator and the Cal. Power Exch.*, Order on Reh'g, 105 F.E.R.C. ¶ 61,066 at P 170 (Oct. 16, 2003). The Commission has further recognized that "[t]here is a general preference to avoid use of joint and several liability when apportionment is possible." *Id.* at P 170, n.101. Joint and several liability has no place here because the Commission could apportion the civil penalties among the parties – in fact, the proposed penalties are already clearly delineated for each entity on the first page of the order to show cause.

the numbers on how the rebates would have been distributed, absent Dr. Chen's trades. Thus, the "market harm" (and the dollar amounts that individual companies supposedly "lost") is a function of nothing more than spreading around the rebates in a different way.[20] Staff's Answer in Opp'n. to Expedited Mot. for Two-Week Extension of Time, at 9. In other words, the supposed harm is all about how other market participants did not get their fair share of the rebate pie because Dr. Chen and Powhatan allegedly hogged too much of it.

The problem with this formulation of "harm," however, is that nobody is entitled to any particular "share" of the rebates. Dr. Chen and Powhatan were not depriving other traders of anything that the other traders were entitled to. Rather, Dr. Chen and Powhatan were entitled to the transmission loss credits that they collected based on their payment of the transmission costs and other fixed costs of the system – and the Commission itself had previously found that no entity was entitled to receive any particular amount of credits. *Black Oak Energy, LLC,* 125 F.E.R.C. ¶ 61,042 at P 12 (***"[T]he Commission reiterated that no party is entitled to receive any particular amounts through disbursement*** [of the credit that inevitably results from using the marginal line loss methodology], since the price each is paying (based on marginal line losses) is the correct marginal cost for the energy each is purchasing.") (citing *Black Oak Energy*, Order Denying Complaint, 122 F.E.R.C. ¶ 61,208 at P 46 (Mar. 6, 2008)) (emphasis added).

Thus, the Commission has already rejected the theory of "harm" that the Staff trots out here – that certain parties should have received particular rebate amounts. But the Staff is stuck with that theory because there is no way they can show that the trading here wrongfully affected prices or harmed the market in any other way.

[20] It is both amusing and ironic that the Staff would say that the "harm" to other individual traders is that they lost out on rebate revenue when the Staff's case theory is that traders are not even allowed to pursue such revenue in the first place.

III. CONCLUSION

As we noted at the outset, the Commission has an opportunity to show true leadership and to terminate this investigation for the right reasons. This investigation has been so poorly conceived and poorly executed that it does a disservice to the Commission. If this case proceeds any further, it will be a train wreck for FERC. That serves nobody's purposes. Powhatan respectfully requests that the Commission step in here and say "no" to the Office of Enforcement and its Staff. They need to hear it.

Respectfully submitted,

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Counsel for Powhatan Energy Fund LLC

Dated: February 2, 2015

CERTIFICATE OF SERVICE

I hereby certify that on this day a copy of the foregoing response in opposition has been served upon counsel for FERC Enforcement in the above-referenced proceeding.

Dated at Philadelphia, PA, on this 2nd day of February, 2015.

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Exhibit A

S. HRG. 111–17

ENERGY MARKET TRANSPARENCY AND REGULATION

HEARING

BEFORE THE

SUBCOMMITTEE ON ENERGY

OF THE

COMMITTEE ON ENERGY AND NATURAL RESOURCES UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

TO

RECEIVE TESTIMONY ON DRAFT LEGISLATION TO IMPROVE ENERGY MARKET TRANSPARENCY AND REGULATION

MARCH 25, 2009

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JEFF BINGAMAN and LISA MURKOWSKI are Ex Officio Members of the Subcommittee

CONTENTS

STATEMENTS

APPENDIXES

APPENDIX I

APPENDIX II

ENERGY MARKET TRANSPARENCY AND REGULATION

WEDNESDAY, MARCH 25, 2009

U.S. SENATE,
SUBCOMMITTEE ON ENERGY,
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
Washington, DC.

The committee met, pursuant to notice, at 2:08 p.m. in room SD–366, Dirksen Senate Office Building, Hon. Senator Maria Cantwell presiding.

OPENING STATEMENT OF HON. MARIA CANTWELL, U.S. SENATOR FROM WASHINGTON

Senator CANTWELL. This hearing will come to order. I want to thank Senator Risch for being here today and my colleague Senator Johnson. I hope that this will be the first of many subcommittee hearings that we have working together in trying to make progress on our Nation's energy challenges.

We're here today to examine two pieces of proposed legislation that will help prevent future energy price bubbles and market manipulation. We have worked with many stakeholders in developing these bills and have received a lot of positive feedback.

For instance we've heard from the Industrial Energy Consumers of America whose membership are significant consumers of natural gas and from every major energy intensive manufacturing sector. We've also received positive feedback from other organizations that we'll make part of the record.

The first piece of legislation which was S. 672 adds real teeth for FERC's anti-manipulation authority. It provides FERC with the tools to stop bad actors before they wreak havoc on energy consumers and the economy. One of the lessons we learned from the Western Energy Crisis in 2000 and 2001.

The committee, then led by Chairman Domenici, gave the Federal Energy Regulatory Commission important anti-manipulation authority in the Energy Policy Act of 2005. To date FERC has used this new authority to conduct a 135 investigations resulting in 27 settlements totaling over almost $65 million in civil penalties. One example of FERC's work is the enforcement actions the Commission took for alleged market manipulation against AMARANTH.

These actions yielded 291 million in civil penalties along with 167 in penalties from energy trading partners. However I understand that in this case of AMARANTH the hedge fund liquidated its assets before FERC could complete its enforcement action leaving little left for FERC to collect on its penalties it originally

sought. That falls quite short of what an estimated nine billion of AMARANTH shenanigans really cost natural gas consumers.

AMARANTH is a notable example of why we need to strengthen and clarify FERC's enforcement powers to protect consumers and deter manipulation. S. 672 would empower FERC with cease and desist authority to stop manipulative schemes currently in progress. The Securities and Exchange Commission and the Commodities Futures Trading Commission already have this authority. It would allow FERC to act more like a cop stopping the robbery in progress instead of trying to piece together what happened at a crime scene after the fact.

Second, the bill empowers FERC to freeze assets of any entity that is suspected of market manipulation and creating a bright line on deterrent so that bad actors know if they attempt to manipulate the market there will be a penalty.

Finally in order to give more effectively recover unjust and unreasonable rates the law would allow a refund to occur from the time that FERC brings the case. Currently FERC can only recover damages to the time that they actually prove the case.

We're also going to consider important legislation that would increase transparency in data collection in oil markets. I know that some of you are here specifically to testify on that. Mr. McCullough as you have testified in the past before this committee.

Mr. McCullough was one of the many experts that released independent reports that helped show a bright line in these oil markets. These reports demonstrated the tight correlation between physical and financial oil markets. Thanks to several of the hearings this committee has had in previous years, we've learned that we don't have all the necessary data collection or the focus to understand what has really been going on in energy markets.

To that end the committee has drafted legislation that would establish an office within the Energy Information Administration to collect and analyze information from both the physical and paper markets. It will improve their ability to predict future energy prices which will help businesses and consumers plan for the future. It will also empower regulators to more effectively police the markets.

So I look forward to hearing the testimony of the witnesses today. Now I'd like to turn it over to the ranking member, Senator Risch for his opening statement.

STATEMENT OF HON. JAMES E. RISCH, U.S. SENATOR FROM IDAHO

Senator RISCH. Thank you very much, Madame Chairman. We all know that free markets and free people have delivered the most successful and fluent society that's ever existed on the face of this Earth. We also know that free markets only work when they're free from monopolies and from market manipulation.

So in that context I think we need to examine all these things and make sure the balance stays in place that indeed we have free markets. But at the same time that we don't have people that are involved in market manipulation.

Thank you, Madame Chair.

Senator CANTWELL. Thank you.

Senator Johnson.

STATEMENT OF HON. TIM JOHNSON, U.S. SENATOR FROM SOUTH DAKOTA

Senator JOHNSON. Thank you, Senator Cantwell for holding this important hearing to gather information in how to improve energy market transparency in regulation.

Senator CANTWELL. Thank you, Senator Johnson.

Senator Shaheen.

Senator SHAHEEN. I don't have a statement.

Senator CANTWELL. We'll turn to our witnesses. I want to welcome them.

Dr. Howard Gruenspecht, is that right? Ok. Acting Administrator of the Energy Information Agency.

Anna Cochrane, Acting Director of the Office of Enforcement for the Federal Energy Regulatory Commission.

Robert McCullough, Managing Partner at McCullough Research.

Finally, Gerry, no, sorry, Gerry Ramm, representing the Petroleum Marketers Association of America.

Thank you all for being here and for your testimony today. So we're going to start with you, Dr. Gruenspecht. I just will say for my colleagues I know there's a possibility of a vote coming up sometime in the next hour.

So we'll just have to work through that. So we ask in advance the indulgence of those testifying.

So, Dr. Gruenspecht.

STATEMENT OF HOWARD GRUENSPECHT, ACTING ADMINISTRATOR, ENERGY INFORMATION ADMINISTRATION

Mr. GRUENSPECHT. Madame Chairman and members of the committee, I appreciate the opportunity to appear before you today to discuss draft legislation entitled the Energy Market Transparency Act of 2009. The Energy Information Administration is the independent statistical and analytical agency within the Department of Energy. We do not promote, formulate or take positions on policy issues, and our views should not be construed as representing those of the Department of Energy or the Administration.

Since the proposed legislation aims to improve our understanding of the effects of interactions between energy and financial markets, I'll start by describing some of the efforts that we're already undertaking in this area. Earlier this month, EIA held a workshop on the relationships between futures and financial market activity and the underlying physical market for crude oil. Participants included staff from Federal agencies and experts from the academic community. The presentations and the discussions highlighted several points including the need for better and more accessible data on trader activity in futures markets, the importance of examining alternative theories of trader behavior, and the need to continue examining the role of supply and demand fundamentals using better and more accurate data. EIA staff also presented its research into the use of implied volatilities from the options markets as a measure of uncertainty in short-term price forecasts. Following further review by the Committee on Energy Statistics of the American Statistical Association, we plan to report these calcula-

tions in each edition of our monthly, short term outlook to provide additional context for our analysis. We plan to continue our dialog on this issue at a session on financial markets and short-term energy prices at the EIA annual energy conference in early April.

Based on our current knowledge, EIA staff believes that improved insight into the relationships between trader behavior and fundamentals in forming prices will require building insight into the full process of price formation, from developing theory through the analysis of pertinent data. Such data might in some cases be purchased from commercial sources, but additional data collection, whether by EIA or other agencies, could also be warranted. A major investment of resources and time is likely to be required, and the difficulties are such that conclusive results are unlikely to be quickly obtained.

Let me now turn to our specific comments on the March 18 draft of the Energy Market Transparency Act of 2009, focusing on three main issues: First, the feasibility of the specific data collection called for in the draft legislation; second, providing a broader perspective on other potentially relevant data sources; and finally, data confidentiality.

Our initial assessment is that the data collections proposed in subsection (n) could be both difficult and expensive. This suggests a need to consider whether other, more readily obtainable, data might provide comparable or even better insights into energy markets. In part, the answer may depend on an even more basic question—the intended uses of the data which are not described in the legislation.

A key issue with subsection (n) is the feasibility of the collection. EIA currently surveys crude and product stocks at petroleum terminals, for instance, but those stocks are held on a custody basis, and terminal operators may not know the identity of the owners. With the assistance of other agencies, EIA may be able to identify and survey at least a subset of owners, who may include entities other than the refineries, pipelines and terminal operators—who usually report to EIA. However, such an activity should be recognized as involving far more than simply adding questions about ownership to surveys that are currently completed by those having custody of inventories. We suggest that a limited threshold of respondents be used rather that owners of "all" oil and natural gas inventories.

Turning to the role of other Federal agencies, the CFTC and the Internal Revenue Service, among others, may already have some of the desired information or have lists of entities that would constitute a portion of those that would need to be surveyed in order to collect it. For example, the IRS already collects some data by ownership, such as end-of-month product inventory at petroleum terminals, for tax purposes. Ownership matters there.

The IRS has also established a Joint Operations Committee to enable State and Federal motor fuel tax compliance activities, and that committee has in turn established a national data center that provides a technical foundation for a common motor fuel data repository.

Given our lack of involvement with holders of energy futures contracts or energy commodity swaps to date, we're inclined to defer

to the CFTC regarding those types of entities. We agree therefore with the language in subsection (n) stating that the plan should be developed in consultation with other Federal agencies. However, for reasons discussed in my written testimony, the proposed timelines on page two of the legislation don't seem realistic.

Turning to confidentiality of proprietary information, the draft legislation applies Section 12(f) of the Federal Energy Administration Act of 1974. At times respondent-level data collected under this authority has been the subject of Freedom of Information Act requests including requests from private parties that anticipate opportunities for using the survey data for private gain. An alternative approach would be to make these data collections subject to the Confidential Information Protection and Statistical Efficiency Act. Ultimately the choice of which data collection authority to cite will depend on the intended uses of the data, how sensitive the reported information is to respondents, and the purposes for which the information may be shared with other agencies. These considerations are not specified in the draft legislation.

Turning finally to resources, any new mandated data collections would be handled by existing staff that would need to be pulled from previously planned activities pending the availability of additional staff and resources. This could lead to delays in current high-priority projects such as integrating ethanol into our weekly data petroleum program, collecting custody-based petroleum data at the individual terminal level rather than across an entire Petroleum Administration for Defense District, and addressing other existing data quality issues.

This concludes my statement, Madame Chairman. I'd be pleased to answer any questions you or the other Members may have.

[The prepared statement of Mr. Gruenspecht follows:]

PREPARED STATEMENT OF HOWARD GRUENSPECHT, ACTING ADMINISTRATOR, ENERGY INFORMATION ADMINISTRATION

Madam Chairman and Members of the Committee, I appreciate the opportunity to appear before you today to discuss draft legislation entitled the "Energy Market Transparency Act of 2009," received from Committee staff on March 18.

The Energy Information Administration (EIA) is the independent statistical and analytical agency within the Department of Energy that produces objective, timely, and relevant data, projections, and analyses to assist policymakers, help markets function efficiently, and inform the public. We do not promote, formulate, or take positions on policy issues, and our views should not be construed as representing those of the Department of Energy or the Administration.

Because concerns regarding volatility in oil prices and the factors that have contributed to it appear to be the motivation for the proposed legislation, I will start by briefly describing some recent and ongoing activities that EIA has undertaken to improve its understanding of the effects of interactions between energy and financial markets. I will then turn to specific comments on the draft legislation.

Earlier this month, EIA held a workshop on the relationships between futures and financial market activity and the underlying physical market for crude oil. Participants included staff from the Commodity Futures Trading Commission (CFTC), the Federal Reserve Board, the Government Accountability Office, and the International Monetary Fund, as well as staff from EIA, other Department of Energy offices and experts from the academic community. Topics discussed included: Can information obtained from futures and financial over-the-counter markets enhance the understanding of the underlying physical markets? Can activity in futures and financial over-the-counter markets cause short-term price fluctuations in spot markets, even in the absence of change in underlying oil market fundamentals? What kind of models and data are most appropriate to fully understand the relationships between financial and physical markets? The presentations and resultant discussion highlighted several points, including the following: there is a need for better and

more accessible data on trader activity in the futures markets; it is important to examine alternative theories of trader behavior; and there is a need to continue examining the role of fundamentals using better and more accurate data.

We know that members of this Committee, other EIA customers, and EIA analysts have considerable interest in quantifying the uncertainty surrounding short-term price forecasts. At the workshop, members of EIA's Short-Term Energy Outlook (STEO) team presented research into the use of implied volatilities from the New York Mercantile Exchange options markets as a measure of uncertainly in short-term price forecasts. Group discussion of this research coalesced around a particular method for calculating probability distributions for future oil prices using implied volatilities reflected in prevailing prices of options contracts. The American Statistical Association's Committee on Energy Statistics is scheduled to provide a further review of this method at its April meeting. By mid-year, we intend to report these calculations in each edition of the STEO to provide additional context for our own analysis.

EIA has also included a session on financial markets and short-term energy prices as a part of its annual energy conference, scheduled for April 7-8, 2009. We hope that the discussion among the panelists will further inform our research agenda and advance the ongoing dialogue in the broader community.

Looking ahead based on our current understanding, EIA staff believe that effective analysis of the effects of trading on resulting prices will require not only better data, but a much stronger theoretical approach as well. Analysts within and outside EIA continue to grapple with understanding the gap between very short-term and longer-term price formation. A comprehensive theory of how trader behavior affects longer-term prices is simply not well developed and without a well-developed theory, analysts are reduced to data mining and testing unformed hypotheses.

The limited availability of aggregate data that can be used to track trader strategy and behavior compounds the challenge faced by analysts In the most obvious example, the position information that the CFTC publishes is separated into categories of commercial and non-commercial traders; categories that do not map cleanly to hedgers and speculators. Without a way of identifying trades and positions taken for speculative purposes, direct analysis of the effects of speculation on price formation is not really possible. Since the EIA and CFTC staffs maintain a cooperative relationship, we know the CFTC has been struggling with this problem, and may have made some advances, but those CFTC data have not been made public.

EIA staff believe that an improved understanding of the relationships between trader behavior and fundamentals in forming prices will require the gathering and deployment of strong analytic capabilities focused on building insight into the full process of price formation, from developing theory through the analysis of pertinent data. Such data, assuming they exist, might in some cases be purchased from commercial sources. In other cases, additional data collection, whether by EIA or other agencies, may also be warranted. A major investment of resources and time is likely to be required, and the difficulties are of sufficient magnitude that conclusive results are unlikely to be quickly obtained.

COMMENTS ON THE DRAFT ENERGY MARKET TRANSPARENCY ACT OF 2009

As a Federal statistical agency, EIA strongly supports data transparency as a means of achieving its mission and agrees that additional data on physical and financial oil and natural gas markets would be helpful in increasing understanding of oil price discovery. EIA's comments, which follow, focus on three main issues: first, the feasibility of the specific data collection called for in the draft legislation; second, providing a broader perspective on other potentially relevant data sources; and, finally, data confidentiality.

Comments on Section 3

General.—EIA's initial assessment is that the data collection efforts proposed in subsections (n) and (o) could be both difficult and expensive. This does not, in itself, mean that they are inappropriate, but it does suggest the need to consider whether other, more readily obtainable, data might provide comparable or even better insights into energy markets. In part, the answer may depend on an even more basic question—the intended uses of the data, which are not described in the draft legislation. These questions are important to consider, and so are intertwined with EIA's more specific comments that follow.

Ownership of energy commodities.—A key issue with subsection (n) is the feasibility of the proposed data collection, i.e., how to determine who are the owners of "all" inventories and therefore who should report to EIA. EIA currently surveys stocks at petroleum terminals, for instance, but those stocks are held on a custody basis, not an ownership one. Terminal operators may not know who the owners of

the stocks are. These operators would know who brought the product to the terminal and who leases the tanks, but the product could have been subsequently sold—something that can occur daily—and still remain in the same tanks. Ownership would also be difficult to identify in the cases of minority position owners and joint ventures. The universe of actual owners (i.e., intended survey respondents) is unknown and perhaps unknowable, particularly outside of the physical market participants EIA usually deals with such as refiners, pipelines, and terminal operators. With the assistance of other agencies, EIA might be able to identify and survey at least a subset of owners, but such an activity should be recognized as involving far more difficulty than simply adding questions about ownership to the surveys that are currently completed by those having custody of inventories.

The universe of owners could include those entities covered by subsection (n)(2) as well, i.e., "any person holding or controlling energy futures contracts or energy commodity swaps. . . .". Some of the issues prompted by trying to identify the owners of petroleum inventories apply to natural gas inventories as well. We suggest that a limited threshold of respondents be used, rather than owners of "all" oil and natural gas inventories called for in proposed subsection (n)(1). The language in subsection (n)(1)(A) that calls for information collection "to the maximum extent practicable" is reflective of our concern but the inclusion of "all" is problematic.

Other Federal agencies.—Federal agencies such as the CFTC and the Internal Revenue Service (IRS) may already have some of the desired information and/or have lists of entities that would constitute a portion of the entities that would need to be surveyed in order to collect ownership and transaction information.

In terms of existing data sources, EIA is aware that the IRS already collects some data by ownership, such as end-of-month product inventory at petroleum terminals, for tax purposes. It is not clear, however, if the ownership definition IRS uses for tax collection would be useful for increased understanding of trading-price relationships.

It should also be noted that the IRS has established a Joint Operations Committee (JOC), a partnership of dedicated Federal and state fuel tax administration resources, to enable state and Federal motor fuel tax compliance activities, foster interagency and multi-national cooperation, and to provide strategic analyses of domestic and foreign motor fuel distribution trends and patterns. The JOC works toward those ends through the innovative use of technology and other means to collect, analyze and share information, and conduct joint compliance initiatives. To support analysis related to its missions, the JOC has established a National Data Center consisting of a technical foundation for a common motor fuel data repository. More specifically, the JOC can incrementally identify, acquire and integrate State, Federal and other commercial third-party data sources that bear on the national fuel inventory. The compiled data can be used to track and trend fuel movement within the nation's Fuel Distribution System[1] for the purpose of developing improved baselines for measuring fuel supply, fuel distribution and fuel consumption.

Since EIA has had no prior involvement with holders of energy futures contracts or energy commodity swaps, we are inclined to defer to the CFTC regarding those types of entities. We agree, therefore, that the language in subsections (n)(1) and (n)(2) that states that the plan should be developed "in consultation with other Federal agencies (as necessary)" is the appropriate approach to take. It is quite likely that an interagency task force would be needed to develop and implement the plan for the proposed collections, considering the scope of the proposal.

Timelines.—The level of effort needed to develop and implement the plan envisioned in the draft legislation would be quite substantial, and is likely to require a great deal of EIA and interagency work It also could well involve the modification of existing surveys or the creation of new ones, which are time consuming processes in their own right and include both an initial 60-day public comment period as well as a lengthy review by the Office of Management and Budget that provides an additional opportunity for public comment. Thus, the deadlines on page 2 of the legislation do not appear to be realistic and would need to be extended. It is difficult to specify alternative time periods at this early stage of consideration; one alternative would be to say "as soon as practicable after the date of enactment. . . ." and take the same approach for the time period after the date on which notice is to be provided.

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[1] The U.S. Fuel Distribution System is an extensive infrastructure that connects buyers and sellers of fuel within the financial market. The physical infrastructure encompasses a vast array of capital, including drilling rigs, pipelines, ports, tankers, barges, trucks, crude oil storage facilities, refineries, product terminals, and retail storage tanks and pumps which are used to refine, produce, and distribute fuel to the consumer.

Protection of Proprietary Information.—The legislation applies section 12(f) of the Federal Energy Administration Act of 1974 to information collected under subsection (n). This statute authorizes EIA to share company-level data with all Federal agencies as well as with the Congress and the courts. At times, respondent-level data collected under this authority has been the subject of Freedom of Information Act (FOIA) requests by private, non-governmental parties. This includes requests from private organizations that anticipate opportunities for utilizing EIA respondent-level data for private gains. An alternative approach would be to make these data collections subject to the Confidential Information Protection and Statistical Efficiency Act (CIPSEA) which requires additional safeguards for protecting the identity of reported information and for sharing individual respondent (i.e., company-specific) information. For data collected under CIPSEA, sharing company-level data is restricted to statistical use only and cannot be released for non-statistical, including regulatory or FOIA, purposes. Ultimately, the choice of which data collection authority to cite will depend on the level of protection that is required, the intended use of the data, how sensitive the reported information is to respondents in identifiable form, and the purposes for which the information may be shared with other agencies. These considerations are not specified in the draft legislation.

We cannot speak to the detailed information protection policies and statutes in place in other Federal agencies, including CFTC and IRS, which generally are more stringent than EIA's and do not require an affirmative obligation to share data with other Federal agencies. They would, of course, also have to be taken into account in the development and implementation of the proposed information collection plan, providing yet another reason for extending the deadlines mentioned previously.

Funding.—Though no cost estimate could be provided until the details of the plan required under the draft legislation are finalized, the proposed section 3 activities would likely be both time-consuming and expensive. It should also be noted that, pending the availability of additional staff and resources, these activities would be handled by existing staff that would need to be pulled from their previously planned activities, which could lead to delays in current high-priority projects such as integrating ethanol into our weekly petroleum data program, collecting custody-based petroleum data at the individual terminal level rather than across an entire Petroleum Administration for Defense District, and addressing other existing data quality issues.

Financial Markets Analysis Office.—Proposed subsection (o) creates a Financial Markets Analysis Office within EIA, the director of which reports directly to the Administrator. EIA would prefer to have the latitude to restructure EIA as necessary, rather than have a new office designated by statute. Expertise in energy markets is located across several EIA offices, the staff of which work together across office lines to produce forecasts and analyses. Cross-office teams are created as needed, including for work on financial markets.

Comments on Section 4

Section 4 of the draft legislation establishes an interagency Working Group on Energy Markets, the membership of which is composed of the Secretary of Energy (who serves as chairperson), the Secretary of the Treasury, the heads of four independent agencies (CFTC, Federal Energy Regulatory Commission, Federal Trade Commission, and the Securities and Exchange Commission), and the EIA Administrator. The Working Group is tasked with several purposes and functions, one of which is to make recommendations to the President and the Congress regarding laws and regulations that may be needed to "prevent excessive speculation in energy commodity markets. . . ." While we agree that EIA could make a valuable contribution in advancing many of the identified purposes and functions, EIA's role as a policy-neutral statistical agency may lead a future EIA Administrator to avoid taking an active role in making any recommendations on laws and regulations.

This concludes my prepared testimony, Madam Chairman. I would be pleased to answer any questions you and the other Members may have.

Senator CANTWELL. Thank you.

Ms. Cochrane, thank you for being here.

STATEMENT OF ANNA COCHRANE, ACTING DIRECTOR, OFFICE OF ENFORCEMENT, FEDERAL ENERGY REGULATORY COMMISSION

Ms. COCHRANE. I'm sorry. Madame Chairman and members of the subcommittee, thank you for the opportunity to appear before

you today. I note that I appear before you as a staff witness and do not speak for individual members of the Commission.

Transparency in our Nation's electric and natural gas energy markets is critically important to the Commission in fulfilling its statutory responsibilities to ensure just and reasonable wholesale rates for electric and natural gas customers. The subcommittee's review of this important topic is a timely one. The commission has undertaken a number of initiatives to increase transparency in the Nation's energy markets, including some that predate the Energy Policy Act of 2005 and some based on the authority Congress granted to it in EPACT 2005.

I have described these initiatives in more detail in my written testimony, but would like to highlight some of the most significant initiatives. To make electric transmission service more transparent the Commission issued regulations in 1996 requiring public utility transmission providers to implement an open access, same time information system or OASIS to share information about the electric transmission system with all users of the system at the same time. OASIS is an important tool to ensure that there is no undue discrimination in the provision of transmission services in interstate commerce and to help prevent the exercise of market power.

In 2001, the Commission issued a final rule that requires all public utilities including power marketers to file an electric quarterly report summarizing data about their currently effective contracts and wholesale power sales made during each calendar quarter including transaction specific information. This publicly available data is particularly useful for monitoring markets for indications that market power may be being exercised and provides an insight into pricing trends throughout the electric industry.

In 2003, the Commission issued a policy statement on electric and natural gas price indexes that explained the Commission's expectations of natural gas and electricity price index developers and the companies that report transaction data to them. The Commission has recently undertaken two initiatives pursuant to the new transparency authority which Congress granted the Commission in EPACT 2005. These initiatives taken together will provide the Commission with a more complete picture of the wholesale natural gas market and the supply and demand fundamentals underlying that market.

The Commission's oversight staff in the Office of Enforcement conducts daily oversight and monitoring of energy markets as well as research and analysis facilitated by customized reports prepared from the information available to us. If we discover a market anomaly we analyze the situation further to determine if it can be explained by market fundamentals. If not, we refer the matter to our investigation staff.

Staff also works closely with the RTO and ISO market monitoring units. The Commission recently enhanced the independence of the market monitors, extended their scope of reporting and required the RTOs and ISOs to provide the market monitors with adequate resources and full access to market information. Much of our oversight staff's research and analysis is shared with the public through website postings, regional monthly calls with State regu-

latory officials and presentations at open Commission meetings and other public conferences.

Transparency in energy markets is important to ensure just and reasonable rates under the FPA and NGA and to protect customers. Much has been done by the Commission to increase transparency in wholesale electric and natural gas markets especially over the last few years. The Commission will continue to be vigilant in this area.

The Commission's new market manipulation authority granted by Congress in EPACT 2005 also helps us protect customers. A few additional tools could help the Commission better ensure that customers are protected. For example, congressional action to give the Commission cease and desist authorities for violations of the FPA and NGA. The ability to freeze assets of entities that violate the market manipulation rules would give the Commission the same enforcement tools that both the SEC and CFTC have long possessed.

In addition authority to temporarily suspend market rules on file under the FPA when necessary to protect against potential abuse of market power could also be useful. If Congress determined that it was appropriate to provide the Commission with such authorities it is likely that they would be used only in rare circumstances, if at all. However their statutory existence would have a deterrent effect.

Thank you again for giving me the opportunity to appear before you today. I'd be happy to answer any questions you might have.

[The prepared statement of Ms. Cochrane follows:]

PREPARED STATEMENT OF ANNA COCHRANE, ACTING DIRECTOR, OFFICE OF ENFORCEMENT, FEDERAL ENERGY REGULATORY COMMISSION

Madam Chairman, and Members of the Subcommittee:

My name is Anna Cochrane, and I am Acting Director of the Federal Energy Regulatory Commission's (Commission) Office of Enforcement. Thank you for the opportunity to appear before you today to discuss energy market transparency and regulation. I appear before you today as a staff witness and do not speak for individual members of the Commission. Transparency in our nation's electric and natural gas energy markets is critically important to the Commission in fulfilling its statutory responsibilities to ensure just and reasonable wholesale rates for electric and natural gas customers. The Subcommittee's review of this important topic is a timely one.

THE COMMISSION'S EFFORTS TO PROMOTE TRANSPARENCY

The Commission has undertaken a number of initiatives to increase transparency in the nation's energy markets, including some that predate the Energy Policy Act of 2005 (EPAct 2005) by over a decade. It has used its Natural Gas Act (NGA) and Federal Power Act (FPA) authorities to collect information and require reporting of market information to improve transparency in wholesale natural gas and electric markets and in electric transmission and natural gas transportation. In addition, the Commission has used the specific Natural Gas Act transparency authority Congress granted to it in EPAct 2005 to improve transparency in natural gas markets. These efforts are discussed below.

To make electric transmission service more transparent, the Commission issued regulations in 1996 requiring public utility transmission providers to implement an Open Access Same-time Information System, or OASIS, to share information about the electric transmission system with all users of the system at the same time. Through the OASIS, transmission customers can view information regarding the availability of transmission capacity and the usage of the transmission system by other wholesale power customers. The terms and conditions of service are clearly posted on the OASIS, including the prices for each type of service offered and reserved. If the transmission provider discounts its price for a particular customer, it

must announce that discount to all wholesale customers through an OASIS posting. The transmission provider also must post the reason for denying any request for service, along with information regarding curtailments and interruptions of service to those that have confirmed reservations. These OASIS requirements were patterned on similar requirements that had been earlier implemented for interstate natural gas transportation. OASIS requirements remain an important tool to ensure that there is no undue discrimination in the provision of transmission services in interstate commerce and to help prevent the exercise of market power.

The Commission also has taken several important steps to increase the transparency of electricity and natural gas commodity prices. For example, in 2001, the Commission issued a final rule that requires all public utilities, including power marketers, to file an Electric Quarterly Report (EQR) summarizing data about their currently effective contracts and wholesale power sales made during each calendar quarter, including transaction specific information. EQR data is public and available for use on the Commission's website. EQR data is particularly useful for monitoring markets for indications that market power may be being exercised and provides an insight into pricing trends throughout the electric industry. For example, the information reported in the EQR (1) assists in corroborating or refuting evidence of market power submitted by sellers seeking market-based rate authority, (2) assists addressing on the record protests involving regional market conditions, and (3) helps determine whether sellers are complying with Commission-imposed price mitigation measures.

In addition, in 2003, the Commission issued a Policy Statement on Electric and Natural Gas Price Indices that explained the Commission's expectations of natural gas and electricity price index developers and the companies that report transaction data to them. The Policy Statement, among other things, directed the Commission's staff to continue to monitor price formation in wholesale markets, including the level of reporting to index developers and the amount of adherence to the Policy Statement standards by price index developers and by those who provide data to them. In adhering to this directive, Commission staff documented improvements in the number of companies reporting prices from back offices, adopting codes of conduct, and auditing their price reporting practices. These efforts resulted in significant progress in the amount and quality of both price reporting and the information provided to market participants by price indices.

In 2005, the Commission issued Order No. 668 which, among other things, revised its Uniform System of Accounts (USofA) to accommodate the restructuring changes that are occurring in the electric industry and to provide uniformity and transparency in accounting for and reporting of transactions and events affecting public utilities, including Regional Transmission Organizations (RTO). These changes in accounting and financial reporting should improve cost recovery practices by providing details concerning the cost of RTO functions, and increased assurance that the costs are both legitimate and reasonable. In addition, in 2008, the Commission further enhanced the transparency of the business activities of natural gas companies and public utilities by requiring them to provide greater detail in their annual financial forms filed with the Commission. Public utility customers, state commissions, and the public now have more detailed information on wholesale sales to allow them to better assess the justness and reasonableness of interstate natural gas pipeline and electric utility rates.

In EPAct 2005, Congress enhanced the Commission's authority to facilitate price transparency in both the electric and natural gas markets. Such authority was given to the Commission "for the public interest, the integrity of . . . markets, fair competition," as well as for the protection of consumers. New Section 23 of the NGA and new section 220 of the FPA enhance the Commission's authority to ensure confidence in the nation's electric and natural gas markets. The Commission's market-oriented policies for the wholesale electric and natural gas industries require that interested persons have broad confidence that reported market prices accurately reflect the interplay of legitimate market forces. Without confidence in the fairness of price formation, the true value of transactions is very difficult to determine. Further, price transparency makes it easier for the Commission to ensure that jurisdictional prices are "just and reasonable."

Pursuant to its new transparency authority under NGA section 23, the Commission issued Order No. 704-A to require natural gas wholesale market participants, including a number of entities that may not otherwise be subject to the Commission's traditional NGA jurisdiction to identify themselves and annually report summary information about their physical transactions that contribute to natural gas price indices. The reported information will make it possible for the Commission to assess the formation of index prices and the use of index pricing in natural gas mar-

kets. The first annual reports will be filed on May 1 for transactions that occurred during the 2008 calendar year.

Also pursuant to the NGA section 23 authority, the Commission recently revised its regulations to improve the transparency of wholesale natural gas markets in the United States, by requiring the dissemination of greater information about scheduled natural gas flows throughout the national pipeline network. The Commission has long required interstate natural gas pipelines to post on their internet web sites substantial information about their natural gas transportation business. On November 28, 2008, the Commission issued Order No. 720, in which it found that it is also necessary to obtain information from major non-interstate natural gas pipelines in order to obtain a complete picture of the wholesale natural gas market and the supply and demand fundamentals underlying that market.

Specifically, Order No. 720 required major non-interstate pipelines to post on their publicly accessible websites daily operational information, such as scheduled volume information and design capacity for each receipt and delivery point with a design capacity greater than 15,000 MMBtu per day. Order No. 720 defined a major non-interstate pipeline as a pipeline that is not classified as a natural gas company under the Natural Gas Act and delivers on average more than 50 million MMBtu of gas annually over a three-year period. Order No. 720 also required interstate pipelines to post similar information regarding their no-notice transportation services. Order No. 720 is currently pending on rehearing. Major non-interstate pipeline companies are currently required to comply with the new rules 150 days after the issuance of an order on rehearing.

While the Commission does not regulate financial commodity market trading, activities in financial commodity markets can affect the electric and natural gas physical markets that the Commission regulates. It is therefore important that the Commission coordinate closely with the Commodity Futures Trading Commission (CFTC), which is responsible for the day-to-day regulation of commodity futures. In an effort to ensure coordination of overlapping jurisdiction between these two agencies, Congress directed in EPAct 2005 that the two Commissions execute a Memorandum of Understanding (MOU) related to information sharing. Specifically, it directed that the MOU include provisions ensuring that information requests to markets within the respective jurisdiction of each agency are properly coordinated to minimize duplicative information requests, and provisions regarding the treatment of proprietary trading information. The agencies signed an MOU shortly after enactment of EPAct 2005. Pursuant to the provisions of this MOU, the staffs of the two agencies have worked closely together to help ensure that both have the information necessary to perform their statutory functions. These efforts have contributed to more effective enforcement and oversight by our Commission over the physical energy markets.

The Commission's oversight staff within the Office of Enforcement conducts daily oversight of energy markets through regularly scheduled morning meetings, as well as research and analysis conducted throughout the day and as part of long-term projects. This research is facilitated by customized reports prepared from the information available to the oversight staff as well as information and analysis developed by third-party information providers. The oversight staff's long-term projects include developing tools to automate and enhance analysis of the information that will become available through the Commission's transparency efforts, like Order No. 704-A and Order No. 720.

In addition to maintaining an oversight staff, the Commission requires all RTOs and Independent System Operators (ISOs) to maintain a market monitoring function to analyze the state of the markets and refer to the Commission any suspected market violations. In October 2008, the Commission took action through Order No. 719 to enhance the independence of the market monitors and extend the scope of reporting required of the market monitors. The Commission's independence reforms included requiring the market monitors to report to the RTO or ISO board of directors rather than to management and requiring the RTOs and ISOs to provide the market monitors with adequate resources and full access to market information. The Commission's reporting reforms required production of a quarterly report that broadened the scope of recipients of market data produced by the market monitors, and shortened the lag time for release of bid and offer data.

In addition to the formal reporting required of the RTO and ISO market monitors, Commission oversight staff have almost daily contact with the market monitors to discuss issues identified during the oversight staff's market monitor activities. In addition to routine contacts with the RTO and ISO market monitors, the Commission's oversight staff have several structured interactions with the market monitors including semi-annual meetings with all of the market monitors and regularly

scheduled monthly meetings between the Commission staff and individual market monitors.

Finally, it is important to note that the information collected by the Commission is analyzed and, when appropriate, is shared with the public. The staff does this by posting material on the oversight section of the FERC website and making presentations at open Commission meetings and other public conferences. The information posted on the oversight website includes a monthly "snapshot" report that provides information about market outcomes during the previous month. The Commission staff use the "snapshot" report as the basis for monthly conversations about energy markets with state regulatory officials. During these calls, state regulatory officials often share their insights into factors influencing their local energy markets. In addition, the oversight staff publishes an annual State of the Markets report that summarizes major events in natural gas and electricity markets during the previous year. The oversight staff present the findings from its State of the Market report, as well as its Winter and Summer Assessments, at open Commission meetings.

POTENTIAL IMPROVEMENTS TO THE COMMISSION'S ABILITY TO PROTECT CUSTOMERS

In addition to the role of transparency in energy markets to help ensure just and reasonable rates for wholesale sales and transmission of electric energy and wholesale sales and transportation of natural gas, there are other tools the Commission uses to help monitor markets and protect customers. Among those are the market rules the Commission approves or establishes under its FPA section 205 and 206 authority for organized electric markets administered by ISOs and RTOs and the implementation of the Commission's new market manipulation authority granted by Congress in EPAct 2005. In this regard, there are certain additional legislative changes that could further facilitate the Commission's ability to protect against market manipulation and more timely ensure that market rules contained in FERC tariffs do not cause unexpected harm to the marketplace. If Congress determined it appropriate to provide the Commission with such authorities, it is likely that they would be used only in rare circumstances, if at all. However, their statutory existence would have a deterrent effect.

First, Congress could give the Commission "cease and desist" authority under both the FPA and NGA. The Commission could use this authority if it determines that a market participant's behavior was ongoing and significantly harming the public interest. While the Commission currently has the ability to seek United States District Court injunctive relief, direct cease and desist authority would expand the Commission's enforcement tool box to match those of the SEC and the CFTC.

Second, Congress could consider giving the Commission authority that would allow it to prevent the dissipation of assets by a company under investigation for violating market manipulation rules under the FPA or NGA. If the Commission had the authority to freeze assets, it could prevent a company from frustrating the Commission's ability to order disgorgement or restitution after determining that there was a violation of the anti-manipulation rule. The SEC and the CFTC have comparable authority.

Third, Congress could consider giving the Commission authority, in emergency circumstances, to temporarily modify or suspend market rules on file at the Commission under the FPA if those market rules were unexpectedly allowing market power to be exercised or causing other serious problems in the organized markets. This could be followed by normal FPA procedures for long-term changes to the market rules.

CONCLUSION

In summary, transparency in energy markets is important to ensure just and reasonable rates under the FPA and NGA and to protect customers. Much has been done by the Commission to increase transparency in wholesale electric and natural gas markets, especially over the last few years, and the Commission will continue to be vigilant in this area. In addition to transparency, there are other regulatory tools that could be used by the Commission to help ensure that customers are protected. For example, Congressional action to give the Commission cease and desist authority for violations of the FPA and NGA, and the ability to freeze assets of entities that violate the market manipulation rules, would give the Commission the same enforcement tools that both the SEC and the CFTC have long possessed. In addition, authority to temporarily suspend market rules on file under the FPA when necessary to protect against potential abuse of market power could be useful.

Thank you again for giving me the opportunity to appear before you today. I would be happy to answer any questions you may have.

Senator CANTWELL. Thank you very much.
Mr. McCullough, thank you for being here.

STATEMENT OF ROBERT F. MCCULLOUGH, JR., MANAGING PARTNER, MCCULLOUGH RESEARCH, PORTLAND, OR

Mr. MCCULLOUGH. Good afternoon. Thank you very much for the opportunity to be here today.

In preparing for this I went back to page 485 of the Wealth of Nations. That's the page that uses the term "invisible hands." It's been often quoted. It's been seldom read.

The passage was not simply praise of the market. It was warning against market participants who say that they are performing their trades for the public good. The point is without understanding the market, without the data to review the market, we don't know whether they're telling the truth or not.

Two centuries ago Adam Smith was worried enough about it to write a page on this issue. I think we should actually make a few people read the full page, not just the one quote. I'm talking today about the oil peak that we had last year. At our office we've taken to calling that the "Pickens' Peak." I've put it up on a poster board today.

We lived through the price of oil doubling and then falling back by a factor of four. That is a level of volatility we'd never seen in our history. At the time we had variety of explanations. We were told it was having to do with the Chinese and the Indians who apparently are easy to blame for things, exchange rates, surging demand.

Luckily the Energy Information Administration provides a lot of data. It's very useful data. It is extremely important in this process.

Can I get the next poster board?

We've been through this process trying to review. Now that we have the data what has occurred?

The first thing that we discover is that there was no demand spike. In point of fact the EIA's forecast of quantities was exceedingly good. It was, frankly, astonishingly good.

We had a net increase in production, production over our requirements in the spring. Then we had a decrease in inventory, production less than requirements in the fall. That may surprise some people since it goes the wrong direction.

Let's turn to the next slide which shows the price forecast of the EIA. The problem with this slide is that that the EIA's price forecast was just flat wrong. Now when I say that, it's not to make fun of them, I had no possible explanation of the spike either.

But what we had was a spot on forecast of quantities and an absolute inability to forecast prices. This is in spite of the fact that we've got a large staff of very bright people who had followed every barrel of oil as closely as they could. The difficulty we have is not that someone did a bad job. The difficulty is that we don't have the right model.

Economists will tell you that this could not happen in perfect competition. If we were talking about farmers in Iowa raising rye and wheat, it wouldn't happen. However if we're talking about an oligopoly, relatively few players, it makes perfect sense.

You intend to hold inventory when prices were increasing hoping to be able to sell it at a much higher price. It may not be criminal. It could in fact simply be even cagey.

But the key is that we have almost no data to follow this through. In reviewing the legislation before you I was very pleased to find that you'll be accumulating inventory data. Because with the increases in world inventory it would have been very interesting to find out who actually were the players that held that inventory.

We found out mid-summer by the CFTC reclassifying one player that a single firm of brokers from Switzerland held a very high percentage of the foreign contracts on the NYMEX. That amazed all of us. Not one of us had considered that they had taken such a strong position.

We'd be very interested to find out that they'd had a strong position in inventory as well. Quite frankly until we start tracking the numbers, we're not going to know what's happening. The worst part is because we don't think oil will become more plentiful in the near future we are likely to see more of these spikes with high volatility and even more unfortunate those travel through the entire economy directly to natural gas which is a competing energy source and then on to electricity.

We're in the midst of the most major recession of our lifetimes. A large component of that was the destruction of the automobile industry. The impact on low income homeowners of heating prices that doubled last winter. If I had my way I would go much further than this bill.

I would certainly praise FERC for the quarterly electric reports. That's a very valuable tool. The best way to discourage bad actions is to make them public. The quarterly reports do that. I think they've had a tremendous impact on the industry. I'd like to see an extension all the way through the energy industry, through natural gases and certainly to oil.

Thank you very much.

[The prepared statement of Mr. McCullough follows:]

PREPARED STATEMENT OF ROBERT F. MCCULLOUGH, JR., MANAGING PARTNER, MCCULLOUGH RESEARCH, PORTLAND, OR

Thank you for the opportunity to testify today before the Energy Subcommittee.

America's most significant import, crude oil, has such strong connections with natural gas and electricity that it affects the entire economy. It is also the import we know the least about. U.S. regulators do not collect data on any spot transactions, and data is available on only a portion of forward transactions. Although we fear that the oil market may have become dominated by speculators, we do not know who they are, or their possible impacts. We do know that oil prices are frequently anomalous. For example, on March 15, 2009, OPEC decided to maintain output at levels agreed to before the onset of the current recession. This was good news for oil consumers. Unfortunately, however, oil prices have risen significantly in the ensuing ten days.

On January 30, 2008, T. Boone Pickens predicted that oil prices would reach $100.00 a barrel during the first half of 2008.[1] By July 23, he predicted that oil prices would reach $300.00 a barrel by the year 2018.[2]

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[1] T. Boone Pickens shares his views on energy, politics, the Olympics, OSU's new president, The Daily Oklahoman, January 30, 2008.

[2] Pickens warns of $300 oil, Herald News Services, July 23, 2008.

But oil prices in 2008 did not obey Mr. Pickens. On July 3, oil peaked at $146.00 a barrel, only to fall precipitously to a yearly low of $31.00 a barrel on December 22.

At McCullough Research, we have taken to calling the anomalous prices in 2008 the "Pickens' Peak" in honor of Mr. Pickens' forecasting initiatives.

Because of the linkages among the nation's fuel markets, retail gasoline, natural gas, and electricity followed similar trajectories during 2008. Pressure on household budgets accentuated the subprime financial crisis, and the change in automobile economics brought a steep decline in car sales.

While oil is arguably the U.S. economy's most important commodity, it is ironic that no agency of the U.S. government has been assigned the task of investigating and explaining the extraordinary price changes of last year.

Current responsibilities are allocated among the Federal Energy Regulatory Commission (pipelines), the CFTC (some, but not all, forward contracts), and the EIA (forecasting.) On June 10, 2008, the CFTC announced the formation of an interagency task force, including the CFTC, the Federal Reserve, the Department of the Treasury, the SEC, the DOE, and the Department of Agriculture, to study commodity markets. The task force expeditiously published an interim report, but apparently stopped its activities soon thereafter.[3]

It is surprising that not one of the three lead federal agencies has expressed much in-terest in Pickens' Peak. A review of materials issued by FERC, which regulates natural gas and electricity trades, but not oil trades, also reveals little interest in the dramatic run-up in the price of oil in the first half of 2008.

Like the market surveillance of electricity and natural gas prices, reviews of pricing anomalies largely rely upon third parties, such as McCullough Research, that are retained to examine whether the markets are reflecting fundamental supply and demand conditions.

THE EIA'S SHORT TERM ENERGY OUTLOOK (STEO) FORECASTS

The preeminent independent forecast of world oil markets is performed monthly at the Energy Information Administration. Curiously, this resource was largely ignored by apologists for the 2008 price spike, who relied instead on anecdotes concerning exchange rates, Chinese and Indian oil imports, and surging U.S. demand. Now that data from 2008 is in hand, it is useful to compare the EIA's quantity forecasts with actual historical quantities.

On January 8, 2008, the STEO forecasted supply shortfalls at the beginning and the end of 2008.

The chart* shows the EIA's forecasted additions (blue line) to world oil inventories in the spring and early summer of 2008, followed by drawdowns in the fall and winter of 2008. Actual data (red line) shows that while the EIA accurately predicted the basic pattern, it underestimated the inventory build-up during the price spike and the reduction in inventories during the autumn when oil prices were falling.

It is worth noting that the EIA had correctly forecasted all of the fundamentals that supposedly drove up last year's market prices, including:

- Demand from China (which did not change materially during the run-up in prices)[4]
- Demand from the U.S. (which declined during the run-up in prices)[5]

Yet the EIA's price forecast was very poor.

Examining the numbers the way a statistician would approach this problem, the EIA's forecast of quantities is statistically significant at 99%, i.e. very good. The EIA's forecast of prices, however, is not statistically significant at any level.

We may conclude therefore that the basic assumptions underlying the EIA's forecast require careful examination. It appears likely that price responses to changes in supply and demand are more complex than those modeled in the EIA's price forecast.

THE ECONOMIC THEORY OF OLIGOPOLISTIC MARKETS

The heart of the problem is the assumption that the global crude oil market reflects a competitive market with a large number of buyers and sellers. Very little research has been performed concerning the degree of competition in the oil market.

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[3] Interim Report on Crude Oil, Interagency Task Force on Commodity Markets, July 23, 2008.
*Charts have been retained in subcommittee files.
[4] EIA STEO Table 3a, http://www.eia.doe.gov/emeu/steo/pub/contents.html
[5] Ibid.

Although we know that mergers have reduced the number of very large players, there is almost no real data about the degree of market concentration.

Understanding the degree of competition is crucial, because economic theory gives very different predictions under different market structures:

1. Perfect Competition

In perfect competition the presence of many buyers and many sellers make it impossible for any one supplier (or a small group of suppliers) to set prices. To forecast prices in perfect competition, economists rely upon the years of experience that have established the use of supply and demand curves.

1. Oligopoly

Oligopoly is a market with relatively few sellers. Forecasting prices in an oligopoly is far more complex since a few large players can—and do—exert control over prices.

Inventories are important in an oligopoly. A market with only a few large participants is likely to experience situations where market participants will accumulate inventory rather than sell their products at prices they see as less than their long-term prospects.

An extreme case of oligopoly is a market with a few pivotal suppliers. A pivotal supplier can exert strong control over prices because its output is absolutely required to meet demand even after all alternative supplies have been purchased.

In a dynamic economic model we would expect an oligopolist in a market with increasing prices to accumulate inventory to sell during later periods. If the market for oil experienced prices increasing 6% per month—as happened in the first six months of 2008—only a very altruistic competitor would not be tempted to increase its inventory in anticipation of higher prices later. If other competitors made similar decisions, their inventory changes would also alter the supply of oil available to the market and increase oil prices.

If a pivotal supplier was present, its inventory decisions could directly set the price in the market. Decisions to withhold supply are frequently observed in the nation's wholesale electricity markets. This was the case during the Western Market Crisis of 2000-2001 when major suppliers in California reported only 50% availability for their plants during periods of high demand.

Given the data now available from the EIA, the assumption of oligopoly is a better candidate for a model of the world oil market than perfect competition. Inventories rose during the period of rising prices and then fell when prices were falling.

Statistically, the relationship between prices and net world production has been positive since 2006.

Increases to world inventories—production larger than current needs—has been correlated with higher prices. This is more consistent with oligopolistic behavior than perfect competition. Given the extreme levels reached during July 2008, it is very possible that the oil market had one or more pivotal suppliers.

RECOMMENDATIONS

The inability of the federal government to fully investigate oil price behavior in 2008 is fundamentally a data problem. Perhaps it is not a coincidence that oil is the most opaque of our nation's energy supplies.

The transparency legislation that you are discussing today is a step in the right direction, because it will expand the EIA's ability to track oil inventories within the U.S. by owner.

We know so little at this point that any information is useful. There are, however, limitations to having only a small amount of the information available. The oil inventories in the U.S. in 2008 averaged only 37% of total OECD inventories. They do not include data from either Russia or OPEC.

As with the current problems with the CFTC's oversight being limited to just a fraction of the total forward markets, inventory data for the U.S. will not identify inventory decisions from our major trading partners. I recommend that another useful step is to direct the EIA to identify data-sharing arrangements with our OECD partners, including Canada, our single largest oil supplier.

Over the last decade, and especially after 9-11, Americans have been told that the concept of secrecy applies to many types of energy transactions. There has been little public debate about the heightened levels of secrecy in energy transactions, or studies of the impact of this secrecy on energy prices and on our national economy.

The American economist, Paul Samuelson, always included transparency in markets as one of the conditions for perfect competition. If we are seeking more efficient

oil markets that are less vulnerable to manipulation, we may want to re-examine a concept of secrecy that may be taking us in the opposite direction.

My testimony before the Senate Energy and Natural Resources Committee on September 18, 2008 stated that we have a double standard for reporting market data. While some energy sources are relatively transparent, other competing energy sources are largely opaque. FERC's Web site openly publishes the electricity trades within the U.S. on a quarterly basis, and is a good model for reporting other energy sources.[6] The creation of an Oil Quarterly Report modeled after FERC's Electric Quarterly Report would give regulators, decision-makers, and the public a better sense of whether oil markets are dysfunctional.

This completes my testimony today.

Senator CANTWELL. Thank you, Mr. McCullough.

Mr. Ramm, welcome to the committee. Thank you for being here.

STATEMENT OF GERRY RAMM, SENIOR EXECUTIVE, INLAND OIL COMPANY, EPHRATA, WA, ON BEHALF OF THE PETROLEUM MARKETERS ASSOCIATION OF AMERICA

Mr. RAMM. Chairman Cantwell, Ranking Member Risch and distinguished members, I want to thank you for this invitation. I appreciate the opportunity to provide some insight. Draft legislation entitled, Energy Market Transparency Act is a good start toward a lot of the things that we've been trying to do as an industry.

I'm also pleased to speak to the detrimental effects that inadequately regulate the commodity markets and the abusive trading practices that have had a devastating effect on the independent fuel markers in the Nation. I want to thank the chairwoman and the committee for your efforts to bring greater transparency and accountability to the commodity markets. Without your dedication this issue would never get any attention that it needs.

I serve as Vice Chairman of the Petroleum Marketers Association of America. PMAA is a national federation of 47 State and regional trade associations representing over 8,000 independent fuel marketers. These marketers account for approximately half of the gasoline sold in the United States and nearly all the distillate fuels consumed by motor vehicles and home heating oil users.

Chairwoman, it was 4 years ago when PMAA members first sat in your office to discuss our concerns regarding this price volatility. The correlations that we were seeing in the under regulated energy commodity market and we appreciate your strong commitment to resolving this issue. Unlike the other panelists, I'm just a small businessman. I'm not an economist. I don't work for the Federal Government, just a small business person in Eastern Washington.

Large scale institutional investors speculating in the energy markets are a driving force behind energy prices today. The rising crude oil prices, which reached $150 a barrel for December delivery in July of last year only to fall dramatically to as low as $33 when that fuel was delivered on the spot price in December, was not completely a result of supply and demand fundamentals, but was unduly influenced by excessively leveraged speculators, index investors and hedge funds. Futures prices should operate on real data and not to be driven by surges in buying.

Last week futures prices on motor fuel went up 20 cents a gallon. In Iraq prices also rose 20 cents a gallon. Did supply and demand

[6] Depending On 19th Century Regulatory Institutions to Handle 21st Century Markets, http://www.mresearch.com/pdfs/355.pdf

in Seattle, L.A., Houston or New York change? That price increase happened when supplies are at an all time high. Just this last week, distillate fuels went up another 10 cents.

According to the hedge fund managers, Michael Masters, during the first 6 months of 2008 index speculators in hedge funds poured about 55 billion into commodity indexes which resulted in the buying of between 130 to 170 million barrels of West Texas intermediate crude oil in the futures market. However by late July and early August index speculators began to pull out money of the commodity indexes. Approximately $70 billion were withdrawn from these commodity indexes resulting in the selling of around 230 million barrels of crude oil by the end of the year.

Oil should not have skyrocketed to previously mentioned records last year only to see prices dramatically collapse a few months later. Investors were looking not to actually buy oil futures, but to make a fast buck in a paper trade. This practice caused oil prices to rise faster and fall harder than could ever be explained by ordinary market forces.

Consumers, small businesses and economy were forced into a roller coaster ride of greed and fear. The commodity markets need the ability to determine a fair and predictable price for energy. Commodity markets were not designed as investment classes. They were set up for price discovery and for physical hedgers to manage risk by entering into a futures contract in order to lock in a price for future delivery.

Index funds managers who believe commodities are an asset class are speculators. They are so large and generally lack fundamental commodity market knowledge that they have dramatically distorted these markets we rely on. This abuse of this original intent must end now.

Often times you hear the argument that for every buyer there is a seller to justify that there is a market for any price. Even though that is true, oftentimes the buyer and seller are both speculators, who set the commodity price determined by the enthusiasm of the buyer compared to the enthusiasm of the seller. Unfortunately for consumers they have to buy that commodity both gasoline and diesel fuel.

When the prices have ratcheted up by speculators thus drivers and farmers and all consumers have to buy this fuel at today's price and that has been driven up by speculators playing a futures game. PMAA member's companies rely on these markets to provide the consumer with a quality product that a price reflective of market fundamentals.

Traditional speculators serve an important role by providing liquidity in the commodity markets for this to be accomplished. However investment in hedge funds have wreaked havoc on the price discovery mechanism that commodity futures markets provide to bonafide physical hedgers. PMAA urges Congress to expedite commodity markets reform legislation through the legislative process. If Congress does not act and another excessively leverage speculative bubble occurs again, how do you think that's going to affect our economy?

Regarding the draft legislation, PMAA strongly supported language in the 2005 Energy Policy Act that required DOE to examine

the amount of useable storage that is available in the United States. We believe there has been a dramatic reduction of useable storage and that policymakers may not be aware of the extent of that reduction. Part of the reduction has been caused by overly aggressive underground storage tank requirements, specifically related to spill regulations that render much storage unusable. Therefore PMAA supports efforts to obtain data on storage availability.

Regarding section three, enhanced information on ownership of critical energy supplies, data collection would have to occur on a frequent basis. Reporting requirements on the amount of commercially held oil should have a minimum threshold. Particularly in regard to heating oil contracts which should not be included in the reporting requirements that we believe.

We support the intent of the committee's legislation to bring transparency to help eliminate excessive speculation in the energy commodity markets. In addition beyond the committee's jurisdiction in order to bring greater transparency to the energy commodity futures market legislation must impose aggregate position limits on non-commercial traders including over the counter markets. Distinguish between legitimate hedgers in the business of actually delivering the fuel to the consumer and those in the market purely for speculative purposes.

We need to close the end in the swaps loopholes and increase staff and resources at the CFTC. PMAA and our customers need our public officials to take a stand against abusive trading practices that artificially inflate energy prices and severely damage our economy.

We support free interchange on community futures markets in an open, well regulated and transparent exchange that are subject to the rules of accountability and law. Reliable futures markets are crucial to the entire petroleum industry and the American economy. Let's make sure that these markets are competitively driven by supply and demand and not purely the speculative limits and the whims and greed of Wall Street.

I want to thank you for this opportunity to testify. I'll answer any questions I can.

[The prepared statement of Mr. Ramm follows:]

PREPARED STATEMENT OF GERRY RAMM, SENIOR EXECUTIVE, INLAND OIL COMPANY, EPHRATA, WA, ON BEHALF OF THE PETROLEUM MARKETERS ASSOCIATION OF AMERICA

Honorable Chairwoman Cantwell, Ranking Member Risch and distinguished members of the committee, thank you for the invitation to testify before you today. I appreciate the opportunity to provide some insight on draft legislation entitled the "Energy Market Transparency Act of 2009." I am also pleased to speak to the detrimental effects that inadequately regulated commodities markets and abusive trading practices have had on our nation's independent fuel marketers and home heating fuel providers.

I thank the Chairwoman and the committee for your efforts to bring greater transparency and accountability to commodity markets. Without your dedication, this issue would never have gained the attention it deserved.

I serve as Vice Chairman of the Petroleum Marketers Association of America (PMAA). PMAA is a national federation of 47 state and several regional trade associations representing over 8,000 independent fuel marketers. These marketers account for approximately half of the gasoline and nearly all of the distillate fuel consumed by motor vehicles and home heating equipment in the United States.

Chairwoman, it was four years ago when PMAA members first sat in your office to discuss our concerns regarding price volatility and the correlations that we were seeing in the under-regulated energy commodity market, and we appreciate your strong commitment to resolving the issue.

Large-scale, institutional investors speculating in the energy markets are a driving force behind energy prices. The rise in crude oil prices, which reached $150 a barrel for December delivery in July of last year, only to fall dramatically to as low as $33 in December, was not completely a result of supply and demand fundamentals. But was unduly influenced by excessively-leveraged speculators, index investors and hedge funds.

Futures prices should operate on real data and not be driven by surges in buying. Last week futures prices on motor fuel went up 20 cents and rack prices also rose 20 cents. Did supply and demand change in Seattle, L.A., Houston, and New York? And that price increase happened when supplies are at an all time high.

According to hedge-fund manager Michael Masters, during the first six months of 2008, index speculators and hedge funds poured around $55 billion into commodity indices which resulted in the buying of between 130 and 170 million barrels of West Texas Intermediate crude oil in the futures market; however, by late July and early August, index speculators began to pull money out of commodity indices. Approximately $70 billion dollars were withdrawn from these commodity indices resulting in the selling of around 230 million barrels of crude oil by the end of the year.

According to a January 11, 2009 CBS News' 60 Minutes investigation titled, "Did Speculation Fuel Oil Price Swings?," oil should not have skyrocketed to previously mentioned record levels last year, only to see prices dramatically collapse a few months later. The piece highlighted how investors were looking not to actually buy oil futures, but to make a fast buck in a "paper trade." This practice caused oil prices to rise faster and fall harder than could ever be explained by ordinary market forces alone. American consumers, small businesses and the broader economy were forced onto a roller coaster ride of greed and fear. However, the greatest victim of the 2008 energy crisis was consumer confidence in these markets' ability to determine a fair and predictable price for energy.

Commodity markets were not designed as an investment class—they were set up for physical hedgers to manage price risk by entering into a futures contract in order to lock in a price for future delivery. These index funds managers who believe commodities are an asset class, are really unwitting speculators. They are so large and lack fundamental commodity market knowledge, that they have dramatically distorted these markets we rely on. This abuse of this original intent must end now.

Oftentimes you hear the argument that for every buyer there is a seller to justify that there is a market for any price. Even though that is true, oftentimes the buyer and seller are both speculators who set the commodity price determined by the enthusiasm of the buyer compared with the enthusiasm of the seller. Unfortunately for consumers, they have to buy the commodity (gasoline, distillates) when the price has been ratcheted up by speculators. Thus, drivers, farmers, and all consumers have to buy the fuel at today's price that has been driven by speculators playing a futures game.

PMAA member companies rely on these markets to provide the consumer with a quality product at a price reflective of market fundamentals. Traditional speculators serve an important and healthy role by providing needed liquidity in the commodities market for this to be accomplished. However, investment and hedge funds have wreaked havoc on the price discovery mechanism that commodity futures markets provide to bona-fide physical hedgers.

Congress should act quickly to restore the transparency and oversight needed for secure and stable commodities markets and help restore the confidence in these markets that physical hedgers and consumer once had. If Congress does not act, and another excessively leveraged speculative bubble occurs again, how do you think it will affect the economy?

Therefore, PMAA urges Congress to expedite commodity markets reform legislation through the legislative process. Please do not allow the bill to be stalled by the financial services regulatory overhaul debate.

Specifically regarding the draft legislation, PMAA strongly supported language in the 2005 Energy Policy Act that required DOE to examine the amount of useable storage that is available in the U.S. We believe there has been a dramatic reduction in the amount of useable storage in the U.S., and that policy makers may not be aware of the extent of the reduction. Part of the reduction has been caused by overly aggressive under-ground storage tank requirements, specifically related to spill regulations that render much storage un-useable. Therefore, PMAA supports efforts to obtain data on storage availability.

Regarding Section 3, Enhanced Information on Ownership of Critical Energy Supplies, data collection would have to occur on a frequent basis and reporting requirements on the amount of commercially held oil should have a minimum threshold. We support the Committee's legislation. In addition, beyond the Committee's jurisdiction, in order to bring greater transparency to the energy commodities futures market, legislation must:

- Impose aggregate position limits at the control entity level on non-commercial traders, and across all trading environments, including over-the-counter markets that do not have physical connection to the underlying commodity;
- Distinguish between legitimate hedgers in the business of actually delivering the fuel to consumers, and those who are in the market for purely speculative purposes;
- Close the "London Loophole" by requiring foreign exchanges with energy contracts for delivery in the U.S. and/or that allow U.S. access to their platforms to be subject to comparable U.S. rules and regulations;
- Close the "Swaps Loophole" which allows so-called "index speculators" (who now amount to one-third of the market) an exemption on position limits which enable them to control unlimited amounts of energy commodities;
- Increase staff and other resources at the CFTC.

PMAA and our customers need our public officials to take a stand against abusive trading practices that artificially inflate energy prices and severely damage our economy. We strongly support the free exchange of commodity futures on open, well regulated and transparent exchanges that are subject to the rule of laws and accountability. Reliable futures markets are crucial to the entire petroleum industry and the American economy. Let's make sure that these markets are competitively driven by supply and demand and not purely the speculative whims and greed of Wall Street.

Thank you again for allowing me the opportunity to testify before you today.

Senator CANTWELL. Thank you, Mr. Ramm. Thank you for again, for all the witnesses being here. I know some of you have been before the full committee before or other committees talking about this important issue. So we appreciate your expertise and knowledge on it.

I think we're going to do 5-minute rounds. Hopefully we can get through a few questions before the votes occur this afternoon. But Ms. Cochrane, I think I'll start with you because in 2009 then Chairman Kelliher recommended to the committee several of these legislative proposals that we are considering as part of a larger energy package, the cease and desist authority, the dissipation in assets, the emergency authority.

I'm sitting here with my colleague from Idaho thinking about what if we would have had these powers in place prior to the Western energy crisis. What do you think would have happened in that instance as opposed to what transpired there over a several year period of time, if we would have had these kinds of authorities?

Ms. COCHRANE. I think specifically with regard to the authority that would allow us to, on an emergency basis, modify or revise market rules. That would have been a useful tool to have at the time. Specifically during the Western energy crisis when the Commission found significant market flaws such as the requirement for the three IOUs to buy 100 percent of their energy in spot markets. We had to first propose market rule changes. Then allow notice and comment before requiring the changes.

So I think that rule in particular would have helped with the energy crisis.

Senator CANTWELL. How long a period of time was that?

Ms. COCHRANE. I don't have an answer.

Senator CANTWELL. From the comment period and the rule, was that several months or?

Ms. COCHRANE. It would have been several months, yeah. We would have had to go through a process, a notice and comment process before changing a rule.

As far as the other language, during the Western energy crisis, we didn't have the authorities that we have now under EPACT 2005 to police against market manipulation. I think it was because of that crisis that the Congress gave us that authority in 2005. So the other two authorities of, in particular the freezing assets, we would only apply if market manipulation was found. So that wouldn't have been availing at the time.

Senator CANTWELL. FERC has brought several cases. I can't remember the number right now. So what are you finding in these cases that FERC has been successful in bringing forward?

Ms. COCHRANE. As far as in all our enforcement actions we have. I would note that we have an annual report on enforcement that we provide. We look at what we do each fiscal year. I note that during fiscal year 2008, we did open 20 investigations involving allegations of market manipulation.

Many of those investigations and the numbers that you provided are still ongoing. So they're non-public investigations that I can't really talk about at this time.

Senator CANTWELL. How many have been settled?

Ms. COCHRANE. I do have these numbers. We have settlements with 27 companies for a total of 64.67 million. Many of those were involved tariff violations or other violations in addition to market manipulation.

Senator CANTWELL. Ok. Mr. McCullough, on this point of information and how valuable in can be on the data collection, do you know of any government reporting right now that informs regulators, both about the, you know, the interconnection between the financial and physical market. I mean the reason why I ask that is because so much of the physical aspects of the oil market are also connected, you know, to the holders on the futures side.

So do you know anybody that is connecting that information now as far as government reporting?

Mr. MCCULLOUGH. No. The best we have at the moment are the EIA statistic report of the STO. They're good. They're very useful.

But the fact is no one is following the spot oil market. There's a fair amount of academic research including in the interesting paper recently brought out by the CFTC concerning the impacts of term structures. I think most of us believe that spot and forward are highly correlated.

What that means is that we are only watching one door of the Department's door. The shoplifters have figured out which door to leave by. It's not a good situation at all. It's not a practical solution to understanding why we had these sudden shifts in oil prices.

There's just too much we're not following on. I believe, frankly, I was going to say day to day basis, on any basis.

Senator CANTWELL. What, in the collection of this data will allow us to do what? What will it allow us to see?

Mr. MCCULLOUGH. We are still hypothesizing why we had to run up to 143. By the way we all have a different number for that high peak. But I think we'd all agree it was big.

There are a variety of things that could have happened there. If I had a quarterly oil report what I would have been looking for is a fair amount of concentration in oil. I would have certainly been looking for major players who had changed their purchasing strategies in the spring of last year.

If this was in fact a spot for a gamut and we've seen a fair number of those over the years that I would have expected to have seen the inventories increasing because traditional suppliers, major suppliers, were actually choosing to sell less during that high price period. Now let me stress that might not be criminal. It's only criminal if there's a conspiracy. Since we don't have a clue what's going on, we have not a clue to know whether it's a conspiracy.

But in terms of public policy, even if it isn't criminal it would be critical for us to understand that behavior so that we could prepare for it and perhaps create measures to discourage it.

Senator CANTWELL. Thank you.

Senator Risch.

Senator RISCH. Thank you, Madame Chairman. Mr. McCullough, excuse me for not knowing more about the details of this. This is a complex area. It's hard for us to keep on the simple stuff, let alone the complex stuff.

But let me ask you this. Why is this done in the oil market, but yet not in copper or wheat or something like that? I mean it seems to me that there's so much trading and so much bigger in oil that it would be harder to do than in one of the smaller markets. Help me out.

Mr. MCCULLOUGH. It is, Don. We're all used to the Hunt Brothers attempt to corner the silver market 20 years ago. There's nothing new to this.

The United States has the CFTC and the Department of Agriculture have reviewed commodity markets for many years. We've seen efforts to corner commodity markets in many years. We have however seen a shift in oil. We used to have seven sisters and now depending on how you count it, we have four or five. So we've leveled concentration there.

We've seen a dramatic shift in where the oil is produced. We used to be the major oil producer in the entire world for a long period in our history. Now we're major importers.

So we've seen enough changes that we begin to suspect that we might have a market shift. The one thing I comment on was last summer the CFTC had changed their statistics enough that we could puzzle through what one player was. We were amazed to find that that player had 20 percent of the net long positions in the NYMEX.

This is a Swiss broker. They're probably fine people and not proposing anything criminal. I'm just noting people most of us had never heard of before suddenly turned out to be major players in the entire U.S. oil market.

That's in sort of information that's useful for us to have.

Senator RISCH. Ms. Cochrane, help me out here. Tell me where the breaking point is? Where do you cross the line between being

a legitimate trader who is trying to make the biggest profit that they possibly can. I mean, that's what traders do verses a market manipulator?

Where does somebody cross the line?

Ms. COCHRANE. The big difference is the legal definition of speculation, I mean of market manipulation. It's really a fraud statute. So what we have to show is that the trader had an intent to manipulate the market if the trader is taken advantage of a market rule or a market loophole then we don't have authority to go after them. But if they're intentionally trying to manipulate the market then that's where we can go after them.

Senator RISCH. So this all comes down to a matter of intent.

Ms. COCHRANE. Yes, it does.

Senator RISCH. A trader who is trading and happens to manipulate the market just because their idea is going here, going there doesn't commit an offense. It's only a person who sets out to actually manipulate the market. Is that what you're telling me?

Ms. COCHRANE. We view it that if they knew or should have known that their actions could have had an impact on the physical markets that are under our jurisdiction then they acted recklessly and resulted in the manipulation that would also be market manipulation. We could also look at reckless——

Senator RISCH. I'm losing something in the definition because by its very nature every trade is going to have an effect, some way, on the market, is it not?

Ms. COCHRANE. Our authority is only over manipulation of the physical markets under our jurisdiction. So a trade, you know, again if they have legitimate reasons. If they're hedging or they're just engaging in, you know, speculative behavior.

Hedging, in and of itself, is not illegal and is not necessarily bad for the market. It can increase liquidity and increase transparency. But it's a very fact intensive inquiry to determine whether it's a fraud in fact, is taking place.

Senator RISCH. Indeed really, every market needs market makers. Thank you very much. Thank you.

Senator CANTWELL. Thank you, Senator.

Senator Shaheen.

Senator SHAHEEN. Thank you, Madame Chairman, thank you all for being here this afternoon. I especially appreciate hearing and seeing the graphs that show the market and the manipulation of the market. Because for many of us who, particularly in the Northeast in New Hampshire where we live through the high heating oil prices and saw the impact of those on families and on people trying to keep their cars operating.

It's reassuring to see that what some of said was happening at the time is actually, given the analysis, what we see did happen because, as you know, there's been a lot of debate about that. To pick up a little bit on Senator Risch's questions about, you know, how do you determine whether fraud was involved and, you know, where do you cross the line with manipulation. Shouldn't the goal of our oversight of markets be to avoid or prevent the kind of manipulation that we saw over the last year, regardless of whether there was intent involved or not?

I mean, shouldn't the goal be to avoid that kind of manipulation of the markets? I would direct that at whoever would like to answer.

Mr. MCCULLOUGH. Regulating markets retroactively is the single most expensive and most inefficient way to do it. With all due respect to Ms. Cochrane, who I hope will protect me in many different ways.

I don't want to see her go into action. I want to see the market be just and reasonable on the way in. The best possible way to avoid manipulation is to bring that market in the light of day.

Senator Risch, you asked is there a bright shining light on fraud? Often there is. Case in point, throughout the electric and gas markets we've had many cases where traders will create artificial trades.

In fact ENRON had a book. They called it the fake trade book. That was used to fool market price indexes either put together by the Federal Government or put together by individual sources. That's simple fraud.

They lied to the press. They lied to the Federal Government to set prices at the wrong level, people thought and then to take a profit from it. Those people should go to jail.

How do I find out if they're lying? I find out if we have a quarterly electric report. I could actually see what the trades were.

If they said one thing here and they did another thing there. It's self evident. It's also self enforcing. You're not going to make that lie if you're going to be discovered immediately.

When we don't have that transparency then we have people lying. You know, we used to say good neighbors and good fences. But I will tell you, bad fences make bad neighbors. So when we don't have the data we're encouraging people to undertake those manipulations.

Senator SHAHEEN. Just to follow up a little bit on that. Given the fluidity of financial markets and the commodities markets that we're talking about, how do we ensure that the data that's collected is accurate and timely?

Mr. MCCULLOUGH. There's always a chance that people will be lying under oath on their submissions to the U.S. Government. I think that's a possibility. But once we have that in place we know the person signing those reports is putting his freedom on the line.

So I think to the degree we make those reports enforced by the full weight of the law we're going to have an impact. At the moment in many of these markets we never know whether any of the data is correct. So we will never have a way of finding out if they're lying or not.

But in a few cases and the EQR is one of them. We do have a chance, later on, to figure out whether they were telling the truth or not.

Senator SHAHEEN. I am almost out of time, but just very quickly because the recommendation by a couple of you has been to close the loopholes on London and on the swaps market. Is it your assessment that closing the ENRON loophole has been successful in addressing the abuses that we saw with that loophole? Again, I'm happy to have any of you respond or is there more we need to do there?

Mr. RAMM. As far as the ENRON loophole of course that does with electrical markets end. But it does plan to a little bit more of the fact that of the electronic trading that happened in the commodity markets at the time that the Commodity Modernization Act was enacted in 2000. What we've seen and maybe to speak to your first question was these markets were not designed to have all of the speculative money poured into them.

They aren't an equity market. So when you pour all of this money in, it's hard for the market to respond in a way that's fundamental in the ways that it happened before. If you look at the commodity trading that happens in the NYMEX even. You look at what gets traded on the floor verses what gets traded electronically.

Electronically is happening fast and furious and with a lot of money. I think that in some of the questions about fraud and manipulation in general the markets weren't designed for this excessive speculation in the marketplace. There was always a balance.

The CFTC has an obligation to see that speculation doesn't injure price discovery. I would offer that speculation has injured price discovery of what the markets were designed for.

Senator SHAHEEN. Thank you.

Senator CANTWELL. Senator Dorgan, thank you for joining us.

Senator DORGAN. Thank you very much. I'm sorry I was late. But thank you to all of the witnesses.

I think, Mr. McCullough when I walked in you said something that I think is prescient. You said we don't have a clue. I thought, well that's accurate. I don't think any of us in this room have a clue as to what drove the price of oil up like a roman candle to $147 a barrel in day trading 1 day, then back down.

We've had hearing after hearing on this. Energy Information Administration, I have pounded you like you were on a meat rack trying to get out of you what do you think happened because we're spending $100 million on your agency for information. The answer with Mr. Caruso is a, we don't know. We think it's the fundamentals, kind of.

But there was nothing in the fundamentals that could ever justify the run up in these prices and the run back down. What we know is that 37 percent of the oil future market traders in 2,000 were speculators. In a few short years 80 percent were speculators.

Mr. Ramm, I think you said it. That market was not designed for that kind of unbelievable speculation. I think that the Commodity Futures Trading Commission did, in my judgment, a shameful job of regulating. They actually provided their own blind folders, which is pretty bizarre for a regulatory agency.

So I think the purpose of this hearing is to find out what do we do about all this to prevent it from happening again? We don't have a clue. You're right about that.

That's because so much of what has happened is on the dark money side of things. We can't see it. We don't know where it is.

It's so dark out there. We ought to bring it all into the light to be able to understand it. Who's trading what? What are the consequences?

We do know just little snippets. We know that at a time when investment banks still apparently had a little money, they were

buying oil storage capability to buy oil and take it off the market and store it and sell it later. So you know, we knew some of the players. But we knew just snippets of information.

But there's much more we don't know then what we do know. Senator Cantwell has done a lot of work on this, as have I. I've chaired hearings on this subject.

I hope we can find a way to effectively establish regulation transparency and then have regulators who care about their work so that we have a market that works. We need an oil futures market that works. You can't get rid of the market.

You must have a market. It's a very important market. Normal hedging is an important part of what we're doing.

But when you run speculators up from 37 percent of the market to 80 percent of the market, that changes the oil futures market in a very significant way, and not for the better. That's why we had, I think, this huge spike.

Mr. McCullough, are you speaking for all of us in this room when you said we don't have a clue?

Mr. MCCULLOUGH. I found that at 58 I know a lot less than I did when I was 21, Senator. Can I show you one chart?

Senator DORGAN. Yes.

Mr. MCCULLOUGH. The next chart up here. Yes. This is an x/y chart. Along the horizontal axis we've put the net contribution to world inventories. Along the vertical axis we've put the price of WTI crude.

Now we believe that when we've got more supply, the price should be going down. This is a statistical analysis over the last 2 years. Over that period the world has turned on its head.

By the way, this is significant at 99 percentile which in statistics taught me would say, oh wow, results. What we've ended up with for the last 2 years is the exact opposite of the relationship we would expect. Now if we were talking about dark energy and dark matter and a physicist came into here and said my new super accelerator is giving the exact wrong answer. You'd be saying I'm about to create new science. This would be a Nobel Prize moment.

For us, either analysts or policymakers, this is a very exciting result. It says that our basic hypothesis about the market is wrong. We're not talking about Ma and Pa Kettle rising over a week. We're talking about a very, very different world from the one we saw before.

Senator DORGAN. But we're not talking about dark matter. We're talking about dark money.

Mr. MCCULLOUGH. We're talking about—I'm sorry, Senator.

Senator DORGAN. Go ahead. No, that's fine.

Mr. MCCULLOUGH. We're talking about something that indicates that we desperately need to know about this because every prediction we're making is going to be wrong until we get to the bottom of why having a surplus of production in world markets is getting correlated with rising prices.

Senator DORGAN. Yes. Dr. Gruenspecht, my time is up, and I really owed you a question. But you've testified before.

Mr. GRUENSPECHT. That's all right, sir.

[Laughter.]

Senator DORGAN. I understand you're pleased my time is up.

[Laughter.]

Senator DORGAN. Yes, but thank you for being with us. We're expecting some real help out of Energy Information Administration. I found that through the Energy and Water Subcommittee that I chair in Appropriations. We need some real help.

What I got from Mr. Caruso, who is an awfully nice guy. But he was just sitting there saying, you know what? It's the fundamentals.

That is sheer nonsense. Nothing had changed in the fundamentals to justify what happened. The American people are the victims of what happened.

Let me say this, Senator Cantwell. Thanks for holding the hearing and hanging on to this subject because we need to fix it.

Senator CANTWELL. Thank you, Senator Dorgan. I know you have chaired many hearings on this subject as well. So we appreciate your leadership and your attention to this as well.

I want to go back to the issue about once we actually find somebody at fault of market manipulation. How do we stop them from dumping all their assets? Because we can see from the AMARANTH case that once the penalties were assessed the ability to collect on them, which I would assume if people in the marketplace don't think that there really is a strong deterrent.

I mean there isn't a strong issue there, they might continue these practices. So how do we actually stop them from dumping these assets?

Ms. COCHRANE. Senator, currently we don't have the authority to stop them from dumping their assets.

Senator CANTWELL. How would this new authority help you in that?

Ms. COCHRANE. Oh, yes. The new authority would allow us, at some point during the process the Commission would be able to issue an order directing them to freeze their assets and would help us preserve the status quo in order to ultimately disclose profits and perhaps settle a penalty.

We would issue an order and direct them to, you know, basically cease and desist.

Senator CANTWELL. So FERC would issue the order. At that point in time——

Ms. COCHRANE. Yes.

Senator CANTWELL [continuing]. They would have to freeze their assets until any resolution of the situation.

Ms. COCHRANE. Right.

Senator CANTWELL. So unlike AMARANTH who by that point in time had already gone through a process of liquidating their assets, so to speak.

Ms. COCHRANE. Right.

Senator CANTWELL. In this case, AMARANTH would have been stopped at an earlier point by FERC on concerns of their activities in the natural gas market and would have been required then to set aside revenue in fact if they were found guilty of those actions. Is that correct?

Ms. COCHRANE. Right. We would have been able to take action to prevent the dissipation or dispersion of the assets if the Commis-

sion had the authority at that time and had chosen to do so would have been able to.

Senator CANTWELL. Do other agencies have any authority to stop manipulators from avoiding penalties that you know of?

Ms. COCHRANE. In my understanding is that the CFTC and the SEC also have this authority.

Senator CANTWELL. So it's authority that has been used and used successfully by those agencies?

Ms. COCHRANE. My understanding is that these authorities are used very rarely. As far as the CFTC, my understanding is that they've used the cease and desist authority only about four times in the last 20 years. So it is used rarely.

Senator CANTWELL. Who did you say?

Ms. COCHRANE. The CFTC.

Senator CANTWELL. I think maybe we could say with some conjecture they should have been using it a little more aggressively given what's transpired.

I want to go back to the data question again, Mr. McCullough because this information you've provided in your latest chart. Is this information that you collected, your organization, McCullough Research?

Mr. MCCULLOUGH. This is taken from a short term electric outlets of the EIA. It's available on about a 1-month flag. So we didn't have it in front of us in September.

Senator CANTWELL. So how would this information been collected in a more timely basis or shared? Are you saying this is EIA responsibility?

Mr. MCCULLOUGH. It's good data. It's EIA data. We rely on it. It's very important for forecasting, you know, the status of overall world production levels.

What it doesn't tell us is the case that Senator Dorgan just raised which is if people were trying to acquire storage facilities in order to store physical product in order to create a short term corner. If that was true that was the sort of thing then we would be able to turn over to the Department of Justice or the CFTC. But at the moment all I know is that on this very high level summary data, we have a situation where the net production levels appear to be completely opposite everything we've ever learned about economics in terms of their impact on price.

If we found that there was a major player who seemed to be at the scene of each crime, so to speak. Then we would actually know that we would have to pursue that and get an explanation why. If we'd have had that data for ENRON, for example, we might have caught some of the times that they had spot forward gamuts back in 2000 and 2001.

Senator CANTWELL. Is this information that CFTC is collecting because you know, there's been a little dispute about, you know, roles and responsibilities here. Is this information being collected or analyzed by someone?

Mr. MCCULLOUGH. No. You know, we have talked about AMARANTH. I'm very glad that FERC took a role in AMARANTH. But the fact is that AMARANTH took manipulations were in forward markets.

It would not have been accessible to FERC to have intervened at the appropriate moment because that was data that was sitting in CFTC files. The CFTC itself didn't react until AMARANTH went under. So the manipulations at AMARANTH, they effectively tried to corner North American natural gas for certain months, would not have been accessible to the regulators to move on in a timely fashion.

So we really need to get that data out there as well as giving people the power to react to it.

Senator CANTWELL. So the data collection in this case would have been EIA's responsibility but shared with agencies like FERC is what you're saying.

Mr. MCCULLOUGH. For AMARANTH it would have been CFTC. Then I would hope it would be shared with FERC because frankly the only way we found out about this is when we found out that Mr. Hunter had tried to corner the market and failed. His entire hedge fund went under.

Senator CANTWELL. I meant on this actual.

Mr. MCCULLOUGH. Oh, on this one.

Senator CANTWELL. Yes, on the WTI market.

Mr. MCCULLOUGH. Unfortunately FERC doesn't have oil authority. It's oil's responsibility at the top of the pipeline as I understand it. I don't want to get in trouble with different Federal agencies, but I would love them to have oil authority.

Frankly they've got some of the skills they've built up in the agency for electric and gas. These are, when all is said and done, in Siamese twin commodities. Natural gas prices and oil prices are very highly correlated.

Electricity prices and natural gas prices are very highly correlated. I think I've just proposed something rather beyond my ability to affect unfortunately.

Senator CANTWELL. Yes. Thank you. There is a vote on. So I want to see if my colleagues have further questions.

Senator RISCH. You know there is a vote. We're going to need to run in a minute. But can somebody answer this question briefly?

What is the oil market like compared to other commodities in number of traders, number of dollars and what have you? Who can take a run at that real quick? I mean how does it compare to wheat or corn or whatever the biggest?

Mr. GRUENSPECHT. I think it's very big for a commodity market, and small relative to something like the currency markets. But relative to other commodities, I think there's a significant amount of trading.

Senator RISCH. Ok. Mr. McCullough? Thirty seconds. How'd this happen that the market turned upside down, exactly the opposite prices for supply and demand?

Mr. MCCULLOUGH. My hypothesis is real straight forward. We had a market with a lot of players, many buyers, many sellers that's evolved over time. We now have a fewer number of buyers and sellers and they are larger entities.

This looks like oligopoly strategies being played out in the market as opposed to the perfect competition of our college courses.

Senator RISCH. Very good. Thank you.

Senator CANTWELL. Thank you. Thank you. I want to thank all the witnesses for their testimony today and to share with my colleagues that if they any follow up questions we can submit them to the witnesses and if they could respond to us.

These legislative proposals are things we're going to be considering as part of the mark up on energy legislation. So we appreciate your response to that. This meeting is adjourned.

[Whereupon, at 3:15 p.m. the hearing was adjourned.]

APPENDIXES

APPENDIX I

Responses to Additional Questions

RESPONSES OF ANNA COCHRANE TO QUESTIONS FROM SENATOR BINGAMAN

Question 1. Please describe the benefits that the Commission has seen from the Open Access Same-time Information System (OASIS), with emphasis on the number of alleged violations that OASIS has detected that the Commission has then gone on to pursue.

How many of the violations that the Commission pursues are the result of FERC discovery, and how many are the result of self-reports?

Answer. The Commission generally requires public utilities subject to its jurisdiction to maintain Open Access Same-time Information Systems (OASIS). OASIS systems are electronic databases that provide information regarding available transmission capacity and prices as well as an ability to request transmission service. This data is regularly updated and provided simultaneously to all users of the utility's OASIS system. The purpose of OASIS systems is to ensure that existing and potential transmission customers have non-discriminatory access to relevant transmission data from the transmission provider.

The primary benefit of OASIS postings is market transparency. Market participants should have simultaneous access to data relevant to making transmission purchasing decisions. Our OASIS regulations also prohibit transmission providers from providing transmission data on a preferential basis, including to an affiliate or business partner. OASIS therefore plays a key role in our mission to ensure that our regulated transmission markets are fair and transparent. Therefore, OASIS is not designed so much to detect violations as it is to prevent them, by making the transactions so transparent that would-be violators are deterred. Though OASIS data sometimes evidences violations of Commission requirements, the Commission's enforcement activities relating to OASIS more often have to do with ensuring that market participants timely and materially comply with the OASIS system requirements.

Violations of our regulations related to OASIS systems are varied. For example, through our normal auditing functions within the Office of Enforcement, we have uncovered instances in which a transmission provider has failed to provide all of the information required on OASIS. In fiscal year 2008, we found 13 such instances of noncompliance with our regulations through our auditing process. The data was promptly corrected or supplied on the OASIS by the transmission provider in response to the auditors' report.

Other types of potential violations are related to FERC's policies prohibiting undue discrimination among transmission customers by the transmission provider, touching upon OASIS postings. For example, FERC imposed a $10 million civil penalty under a consent agreement with PacifiCorp related to several self-reported violations of the company's Open Access Transmission Tariff and OASIS postings. In re PacifiCorp, 118 FERC ¶ 61,026 (2007). Similarly, our investigations of SCANA Corporation and Otter Tail Power Company revealed that the companies had been erroneously utilizing network transmission service to make off-system power sales. In re SCANA Corporation, 118 FERC ¶ 61,028 (2007) (consenting to imposition of civil penalty without admitting or denying violation); Otter Tail Power Company, 123 FERC 1161,213 (2008) (consenting to imposition of civil penalty without admitting or denying violation). Commission audit staff uncovered non-compliance at MidAmerican Energy Company involving preferential transmission service to the company's wholesale merchant function. MidAmerican Energy Company, 112 FERC

¶ 61,346 (2005). The Commission penalized Arizona Public Service Company $4 million for OASIS posting violations and for making off-system power sales without purchasing transmission service. Arizona Public Service Company, 109 FERC ¶ 61,271 (2004).

Question 2. Are the Electric Quarterly Reports (EQRs) audited for accuracy?

Answer. Yes. Commission staff reviews over 1,200 Electric Quarterly Reports (EQR) filings each quarter for accuracy and completeness. Commission staff determines whether sellers have timely complied with the requirements set forth by the Commission through the use of software tools designed to identify inconsistencies in the data. Once identified, staff contacts EQR filers to determine whether the information filed is correct and, if not, assists filers in revising their EQRs to come into compliance with Commission requirements. During FY2008, Commission staff contacted over 300 filers regarding issues with their EQRs.

In addition, Commission staff has completed 18 audits of EQR data during FY2004-09. The Commission will consider conducting audits of EQR data in future audit planning cycles.

Question 3. In your written testimony, you stated that EQRs are helpful in determining "whether sellers are complying with Commission-imposed price mitigation measures." Could you describe how the Commission decides when to impose price mitigation?

Answer. In organized markets, each regional transmission organization (RTO) and independent system operator (ISO) has established market rules which govern when and how price mitigation is imposed. These market rules are stated in the RTO's or ISO's tariff, which is filed with the Commission and subject to public comment before the market rules go into effect. Proposals on when to impose price mitigation may come to the Commission from the RTO or ISO, from any market participants (e.g., through complaints filed with the Commission), from other interested participants in a proceeding (e.g., state regulatory commissions), or from the Commission itself. In many cases, these market rules are the subject of stakeholder deliberations before they are submitted to the Commission for approval. The decision on when to approve price mitigation rules is a case-by-case determination that is made after reviewing the record in a particular case. The Commission may accept the rules in whole or in part, reject them, or establish further proceedings.

Different RTOs/ISOs apply mitigation in their organized energy markets using one of two methods. Under the first, bid caps are applied when a structural market power screen is failed, such as when there are few or no competing bids for service, and the seller's bid must be accepted due to a transmission constraint. Under the second, bid caps are applied when a seller's bid exceeds an estimate of its marginal costs by an established threshold and as a result, the market price is increased by another established threshold. The thresholds vary among RTOs and ISOs.

Also, in either traditional or RTO/ISO markets, public utilities that make wholesale sales of electric energy, capacity or ancillary services under market-based rates authority granted by the Commission are subject to Commission-imposed mitigation on a seller-specific basis in instances where a market power problem has been identified. Such mitigation includes, but is not limited to, various forms of price mitigation which can be tailored to address the specific market circumstances of the applicant. Section 35.38 of the Commission's regulations also provides for default price mitigation in instances where the seller fails to provide alternative mitigation that is sufficient to address the identified market power problem.

Question 4. Please describe how cease-and-desist authority, such as proposed in S. 672, could have altered any cases that have been pursued, or are currently being pursued, by the Commission.

Answer. The cease-and-desist authority proposed in S. 672 would permit the Commission to order any entity that may be committing a violation or may have committed a violation to cease and desist from the violation. Such authority would be utilized by the Commission to temporarily prohibit practices that it preliminarily determines are likely to result in significant harm to consumers or significant harm to the public interest, until such time as the Commission has concluded its investigation of the matter.

Once an investigation commences, subjects almost always promptly and voluntarily stop the activities that gave rise to the investigation so as to limit their potential exposure to penalties should FERC determine that violations have occurred. For this reason, we have not yet encountered many situations where cease and desist authority would have been utilized. However, as our investigations, particularly investigations into market manipulation, continue, the Commission could face a situation where a subject continues the activity after we commence an investigation, especially if such a violation is particularly profitable. The ability to quickly and flexibly respond to such an event is the primary benefit of the cease and desist authority

provided in S. 672. In addition, the Commission's current ability to file in district court for an injunction is limited to ongoing violations or suspected future violations, yet our investigations necessarily focus on conduct that occurred in the past and there may be circumstances where the nature and extent of past violations give rise to a concern that violations may recur. This authority makes clear that the Commission can order a subject to cease specific conduct based on its past behavior.

I also want to distinguish between cease and desist authority and the related authority under S. 672 to order an entity subject to investigation for possible manipulation to preserve its assets. This latter authority would be utilized when the subject is in the process of dissolving its business or monies are being distributed to owners or creditors. In these instances, the Commission could act to ensure that monies will be available should there be an ultimate order requiring disgorgement and/or penalties. The Amaranth matter is an example of a situation where the prohibition of dissipation of assets authority could have been used to good effect.

RESPONSES OF ANNA COCHRANE TO QUESTIONS FROM SENATOR MURKOWSKI

Question 1. Could you clarify the status of the Amarenth case, since statements in the hearingeemed to indicate that Amarenth has already been found liable?

Answer. The Amaranth proceeding is currently in litigation before an administrative law judge at the Commission. On July 26, 2007, the Commission issued an order that directed the Amaranth respondents to show cause why they should not be found to have violated the Anti-Manipulation Rule promulgated by the Commission under section 315 of the Energy Policy Act of 2005, and why they should not be assessed civil penalties and disgorge unjust profits associated with their actions. Responses were submitted along with briefs on the merits by the respondents and trial staff within the Commission's Office of Enforcement.

On review of those responses and briefs, the Commission on July 17, 2008, issued an order ruling on certain preliminary legal issues raised by the parties and setting for hearing issues involving disputes of material fact. Specifically, the Commission directed an administrative law judge to determine, based on the allegations contained in the Show Cause Order and in the brief submitted by the Office of Enforcement, whether any of the respondents violated the Anti-Manipulation rule and whether they unjustly profited from their activities, and if so the level of unjust profits. The Commission reserved for itself the issues of whether civil penalties should be imposed for the respondents' alleged violations and the method by which the respondents should disgorge any unjust profits. The Commission stated that it would make those determinations based on the record developed at the hearing.

The judge presiding over the hearing has established a procedural schedule requiring the conclusion of discovery and the submission of written testimony by July 23, 2009. The hearing is scheduled to begin on August 4, 2009, followed by an initial decision by the judge on or before December 1, 2009.

Question 2. Can you provide a breakdown of how many cases FERC is pursuing that deal directly with market manipulation, in terms of both number and percentage?

Answer. Currently, the Division of Investigations has open 23 investigations (some involving multiple subject companies) in which market manipulation is a potential violation. These 23 investigations constitute approximately 45% of all investigations currently open.

Question 3. What other enforcement proceedings is FERC currently undertaking?

Answer. FERC engages in a number of enforcement activities beyond matters involving opened investigations regarding market manipulation. For example, the Commission is handling four manipulation proceedings in which orders to show cause have been issued. These proceedings, involving Amaranth (Docket No. IN07-26), Energy Transfer Partners (Docket No. IN06-3), National Fuel Marketing Company (Docket No. IN09-10), and Seminole Energy Services, Inc. (Docket No. IN09-9) are in various procedural stages at the Commission.

Additionally, the Office of Enforcement's Division of Investigations currently has 28 investigations (some with multiple subject companies) pending which do not involve market manipulation. These cases run the gamut of the Commission's regulatory authority, including pipeline capacity release activities, the allocation of network transmission service, potential undue discrimination, possible standards of conduct violations, and pipeline and electric utility tariff violations. Notably, investigations of potential violations of new Electric Reliability Standards authorized by EPAct 2005 are an emerging and increasingly significant proportion of the Commission's investigative activity.

The Office of Enforcement also receives self-reports of potential violations from the regulated community. Such reports are reviewed by staff attorneys to determine

whether an investigation is warranted. In fiscal year 2008, the Commission received and reviewed 68 self-reports and 36 were subsequently opened as investigations.

Further, the Division of Audits within the Office of Enforcement conducts both financial and non-financial audits of the entities subject to the Commission's regulations. For fiscal year 2008, this division conducted 60 audits resulting in 156 recommendations for corrective action. Our auditors address a wide range of enforcement issues, including open access transmission tariff compliance, interconnection rules, standards of conduct, and Commission filing requirements.

Additionally, the Office of Enforcement operates a publicly-accessible Enforcement Hotline. The Enforcement Hotline is staffed during all business hours by attorneys within the Division of Investigations. Where warranted, the Office utilizes information obtained through the Hotline as a basis to begin an investigation.

Question 4. Considering the separate notion of modifying Section 5 of the NGA, have you assessed the degree to which retroactive refunds, and the resulting insecurity of pipeline revenues, would have on the ability of pipelines to access the capital markets?

Answer. We have not done a quantitative assessment. However, the current proposals to modify section 5 of the NGA are similar to section 206 of the FPA. Among other limitations, these provisions set a refund effective date no earlier than the date a complaint is filed or the Commission issues a notice of its intent to initiate such a proceeding. There is no evidence that refund liability under Section 206 of the FPA has significantly impaired access by the electric utility industry to the capital markets.

Question 5. Is the proposal for retroactive refunds limited to cost of service or does it also apply to rate design and cost allocation? If the latter, how can you justify making it retroactive?

Answer. The proposal to revise NGA section 5 to permit the Commission to establish a retroactive refund effective date would apply to all refunds, including refunds that result from a finding that the pipeline's existing rate design or allocation of costs among its customers is unjust and unreasonable. Currently, when the Commission finds under NGA section 5 that a pipeline's rate design or existing allocation of costs among its shippers is unjust and unreasonable, the Commission allows the pipeline to implement any offsetting rate increases at the same time as it implements the rate decreases. This ensures that the Commission's action under NGA section 5 does not cause the pipeline to under recover its cost of service. Similarly, if NGA section 5 is amended to be consistent with section 206 of the FPA, the Commission could nonetheless continue this practice of ensuring that changes in rate design or cost allocation do not cause a shortfall for the pipeline. It should also be noted that refunds are discretionary under this provision and that, if they are ordered, they are limited to 15 months.

Question 6. Isn't it true that markets determine the ultimate price for natural gas (i.e. it is not a compendium of segmented costs along the way). Thus, retroactive refunds would have little or no impact on the delivered price of gas. Rather, it's just a quest between market participants, including producers, to capture the netback.

Answer. It is true that the price of natural gas is market-determined. Some customers purchase their gas in locations close to the market where it will be consumed, such as Chicago. However, other customers purchase their gas at market hubs or producing areas, and pay to transport that gas to the market where it will be resold or consumed.

For any specific transaction, the party which acts as shipper on the interstate natural gas pipeline could be a local distribution company, a producer, a marketer, another interstate pipeline, or an end-user. Retroactive refunds would go initially to whichever of the numerous parties in a chain of commercial transactions was the actual shipper, if that shipper was paying the maximum tariff rate. But a number of shippers enter into negotiated rate transportation contracts under which retroactive refunds may be reduced or relinquished, in exchange for a mutually-agreeable rate; whether refunds apply is a matter of the specific contract terms.

Many local distribution companies (LDCs), regulated by state public service commissions, continue to hold sufficient long-term capacity to ensure adequate deliveries to their markets, and the state public service commissions most likely would require those LDCs to flow through any retroactive refunds they receive to their customers, including residential consumers. In the case of a producer which held long-term firm pipeline capacity for the transportation of its gas to market, the producer would receive the retroactive refund; this refund would defer some of the producer's transportation costs, and may result in an increase in its effective revenues from the transaction.

Regardless of whether the shipper is a producer, marketer, pipeline, LDC, or end-user, the shipper's transportation payments support the transmission infrastructure

needed to allow a healthy competitive natural gas market to function, and it is these shippers and their customers who receive the benefit of any retroactive refunds pipelines are ordered to make.

Question 7. Isn't adequate pipeline capacity key to keeping delivered costs low? For example, during the New England cold snap of 2004 it was a lack of pipeline capacity—not a lack of natural gas—which resulted in prices spiking over $50 per mmbtu. If retroactive refunds impair the ability of pipes to access capital markets and continue robust construction aren't we running the risk of repeating that example?

Answer. Adequate pipeline capacity is certainly a key element in keeping delivered natural gas costs low. Since the New England cold snap of 2004, over 3,600 MMcf per day of pipeline delivery capacity and 800 MMcf of liquefied natural gas deliverability has been placed in service in the Northeast with Commission approval. An additional 2,000 MMcf per day of pipeline capacity to the region is currently under construction. The additional new capacity—along with generally milder weather—is one reason why price spikes during the winter of 2008-09 were less frequent and less severe than those in the recent past.

The Commission diligently reviews the proposed rates associated with new construction to assure that rates are just and reasonable. The Commission would only order rate refunds in cases where those rates are determined, after considerable review, not to be just and reasonable. Additionally, in those cases the Commission is limited in its ability regarding the refunds ordered.

Question 8. Most of the merchant generators who operate gas fired generation facilities do not hold firm transportation capacity on the natural gas on the pipelines that serve them. During the cold snap of 2004 this very nearly resulted in an inadequacy of electric power generation. Have you evaluated the degree to which the failure to hold firm capacity jeopardizes electric reliability on a larger scale?

Answer. A number of factors contributed to conditions in the New England electricity market during the 2004 cold snap. Commission staff began an assessment even while the cold snap continued and identified many areas that contributed to market events. ISO-NE and state agencies, at the urging of the Commission, took several steps to reduce the risk of winter disruptions. Those steps included:

- Altering bidding schedules during cold snaps so generators know their power commitment before gas trading and pipeline scheduling deadlines.
- Improving operations to allow for increased power imports.
- Restricting economic outages during cold snaps.
- Including fuel and pipeline data in the unit commitment and forecasting process.
- Working with states to clarify emissions rules and make them more flexible.

Reserving firm capacity directly from a pipeline on a year round basis can be costly and may not always benefit the public. The Commission has created conditions where those that value capacity the most from day to day can acquire it at a market price through a transparent posting system. This market price tells generators the value of capacity during times of constraint; it tells the power system operators that other resources may be more economic; and it tells pipeline companies when sufficient demand exists to justify new construction. During the winter of 2008-09, independent power providers purchased 20% of the pipeline capacity released in the Northeast.

Question 9. When is the last time the Commission updated its policy on incremental pricing of gas transmission capacity, as compared to rolled in pricing? Don't we now have a system with wildly variant prices for the same essential service? How do you justify that result?

Answer. The last generic policy review of the Commission's incremental and rolled-in pricing policies was completed in 2000. Certification of New Interstate Natural Gas Pipeline Facilities, 88 FERC ¶ 61,227 (1999), order on clarification, 90 FERC ¶ 61,128 (20000), order on clarification, 92 FERC ¶ 61,094 (2000) (collectively we refer to these orders as the "Certificate Policy Statement"). Under this policy, pipelines and shippers have significant flexibility to negotiate rates which provide a fair balance between the pipeline and individual shippers dealing with both price and risks, such as the risk of future cost overruns, while ensuring that other shippers who do not benefit from newly constructed capacity do not bear the costs. As a result, shippers who enter into long-term contracts for pipeline transportation service may pay different rates, depending on when they entered into their contract, and other factors (such as how much must be invested in new facilities to provide the requested service).

In addition, shippers also have the opportunity to seek released capacity from other shippers or interruptible capacity from the pipeline itself. This allows competi-

tion to take place between the pipeline and releasing shippers. This competition creates short-term market prices which reflect the relative surplus or scarcity of capacity on individual pipelines and gives all interested shippers opportunities to acquire short-term spot market gas supplies and the pipeline capacity necessary to deliver their gas to market. On a nation-wide basis these opportunities allow shippers to seek the most cost-effective supplies of natural gas delivered to their markets.

Question 10. In testimony you stated that if FERC detects market manipulation, it has no meanso order a stop to such manipulation until the administrative proceeding results in a finding of liability. Isn't it true that FERC does have that ability through the federal court system?

If so, is this ability truly inadequate to deal with manipulation or is it simply a bit less convenient for FERC to obtain judicial injunctive relief?

Answer. To be clear, under Section 20 of the Federal Power Act (FPA) and Section 314 of the Natural Gas Act (NGA), the Commission has the authority to seek an injunction from the federal district courts to stop actions that constitute or will constitute a violation of our regulations, the acts, or our orders. Such an injunction will be issued by the courts "upon a proper showing." Proceedings under FPA Section 20 and NGA Section 314 are subject to the same scheduling, procedural requirements, legal standards, and burden of proof as those faced by private litigants seeking injunctions from the federal courts. And, as noted above, the authority is limited to situations where the Commission has a basis to find that ongoing or future conduct violates or will violate the law.

The proposals contained in S. 672 would permit the Commission itself to issue an order to companies subject to investigation to temporarily cease and desist from potential violations based on past, ongoing, or suspected future conduct. Notice and hearing would be required prior to the issuance of such an order, except in the circumstance where such procedures are impracticable or contrary to the public interest. Upon issuance of such a temporary cease and desist order, the subject of the order could request reconsideration by the Commission or proceed immediately to the Circuit Courts of Appeals to obtain review of the order. Moreover, the related asset freeze authority remedy may not clearly be available even in a district court injunction proceeding under Rule 64 of the Federal Rules of Civil Procedure, absent an express federal statutory authority. The procedure provided for in S. 672 allows for much quicker action to stop prohibited conduct or the dissipation of assets than going to federal district court while also allowing for immediate access to appellate court review.

Further, the existing authority to seek injunction from the courts would not reach the situation posed by Amaranth. Section 20 of the FPA only allows the Commission to seek an injunction of acts or practices that "constitute or will constitute a violation" of the FPA or the Commission's regulations or orders. Amaranth's conduct was completed by the time the investigation commenced and its distribution of assets was not, itself, an action that is a violation of the Act or the Commission's regulations or orders.

The proposals would bring FERC's authority and practices more in line with the authority and practices in place at CFTC and SEC. It would also expand our ability to stop potential violations. Under existing authority, the Commission would need to demonstrate the subject is engaged or is about to engage in violations to obtain an injunction. However, under S. 672, the Commission may, as a precautionary measure, issue an order to prohibit any actions the subject would take that would harm the public interest without proving the likelihood that the violation would be repeated. Perhaps most importantly, the proposals would allow the Commission to act rapidly and flexibly to deal with potential violations, including market manipulation, by ensuring that the public interest is protected while investigations are pending. The proposals strike an appropriate balance between the need to quickly respond to potential violations and important due process rights.

RESPONSE OF HOWARD GRUENSPECHT TO QUESTION FROM SENATOR MURKOWSKI

Question 1. Do you think that there are certain duties and functions that are fundamentally inconsistent with EIA's mission and capacity that would be better left to the CFTC?

Answer. Yes, EIA's mission is to provide policy-neutral data, forecasts, and analyses to promote sound policy making, efficient markets, and public understanding regarding energy and its interaction with the economy and the environment. The CFTC's mission is to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options, and to foster open, competitive, and financially-sound futures and option mar-

kets. For both EIA and the CFTC, knowledge and understanding of the market are very important. EIA's work focuses on extracting information from the data available through its surveys and third-party providers. CFTC's market oversight is directed to supporting its policy-related activities, including development and enforcement of regulations. The institution of processes for sharing data, expertise and insights on a more timely basis—some of which has already begun—will help both agencies. However, given the policy neutrality of EIA's mission, it should not directly engage in the policy-related functions of the CFTC that include regulation and enforcement.

APPENDIX II

Additional Material Submitted for the Record

NATURAL GAS SUPPLY ASSOCIATION,
March 27, 2009.

Hon. MARIA CANTWELL,
Chair, Subcommittee on Energy, Committee on Energy and Natural Resources, U.S. Senate, Washington, DC.

DEAR CHAIR CANTWELL: The Natural Gas Supply Association ("NGSA") requests inclusion of these comments in the record for the Subcommittee on Energy's hearing on draft legislation to improve energy market transparency and regulation held on March 25, 2009. In particular, NGSA recently became aware of the proposed Amendment to the Natural Gas Act ("NGA") giving the Federal Energy Regulatory Commission ("FERC") cease-and-desist authority, and would like to submit brief initial comments on the proposed language.

NGSA represents integrated and independent companies that produce and market domestic natural gas. Established in 1965, NGSA encourages the use of natural gas within a balanced national energy policy and promotes the benefits of competitive markets to ensure reliable and efficient transportation and delivery of natural gas and to increase the supply of natural gas to U.S. consumers. NGSA strongly opposes market manipulation and believes that FERC should have sufficient enforcement tools to deter and stop such conduct. As NGSA stated as part of an industry coalition in a white paper submitted to FERC in Docket No. AD07-13, we believe that the vitality of the markets regulated by FERC depends on the agency's vigorous, firm and fair use of its enforcement authority.

However, it is also important that FERC's enforcement tools provide the proper checks and balances, giving all parties due process rights. FERC's authorities have already been significantly broadened in recent years, and NGSA believes the tools already at the commission's disposal are sufficient. To date, there has been only one reported instance in which a company distributed its assets, "frustrating the agency's ability to collect civil penalties." (January 21, 2009 letter from Chairman Kelliher to Senator Bingaman). If it is determined that FERC requires additional enforcement authority beyond the existing court injunction powers provided for in both Section 717s(a) of the NGA and the Energy Policy Act of 2005, NGSA believes certain modifications are needed to clarify and enhance the proposed language in order to ensure that any additional enforcement authority is also coupled with a balanced approach to due process. NGSA's suggestions with regard to Senate Bill 672 titled "Natural Gas and Electricity Review and Enforcement Act" include the following:

1. GIVEN THE NATURE OF ANY TEMPORARY CEASE-AND-DESIST AUTHORITY, IT SHOULD ALSO INCLUDE OTHER ENFORCEMENT LIMITS

NGSA believes the language in Section 2(e)(1) of the proposed amendment should be further tailored to limit the types of pre-emptive enforcement actions that FERC will have authority to employ. NGSA is concerned that the current language is overly broad and may give FERC the authority to unnecessarily hinder, or even stop, companies from operating their businesses (e.g. revocation of blanket certificate authority). NGSA suggests modifying the proposed language in Section 2(e)(1) so that the remedy within any cease-and-desist order is narrowly tailored to address the alleged violation. As stated below regarding emergency orders, the amount of assets that can be frozen should be commensurate with the level of penalty that ultimately may be assessed. Failure to incorporate this limit could unreasonably result in a company no longer being able to operate its business, potentially impairing the supply of natural gas to the market.

2. REQUIRE DE NOVO COURT REVIEW

To ensure the fairness of due process, the judicial review of a FERC cease-and-desist order should provide all parties, including FERC, with equal deference. Specifically, the proposed language should be modified to grant explicitly de novo jurisdiction to the reviewing district courts, thus allowing the court to make an independent determination of all of the facts and all of the issues surrounding the agency's actions. As courts have previously recognized in cases involving other agencies, such de novo review is appropriate in analogous circumstances where the agency has the ability to serve as the prosecutor, judge and jury in the proceeding. (See NRC v. Radiation Tech, Inc., 519 F. Supp. 1266, 1286 (D. N.J. 1981); FCC v. Summa Corp., 447 F. Supp. 923, 925 (D. Nev. 1978). In situations where an emergency cease-and-desist order is issued without a prior hearing, it is critical that on judicial review, the district court is able to independently review the facts and circumstances in order to determine whether the order was appropriate.

3. EMPLOY THE CFTC MODEL FOR ANY IMMEDIATE EMERGENCY ACTIONS

The proposed language for the cease-and-desist authority appears to be modeled after Section 21(c) of the Securities Exchange Act of 1934 ("SEA"). Instead, NGSA believes that the U.S. Commodity Futures Trading Commission's ("CFTC") model provides the most effective due process procedures for addressing undesirable behavior. In particular, for emergency situations, NGSA supports adopting language modeled after Section 6c of the Commodities Exchange Act ("CEA"), which states that,

> Whenever it shall appear to the Commission that any registered entity or other person has engaged, is engaging, or is about to engage in any act or practice constituting a violation of any provision of this chapter or any rule, regulation, or order thereunder, or is restraining trading in any commodity for future delivery, the Commission may bring an action in the proper district court of the United States or the proper United States court of any territory or other place subject to the jurisdiction of the United States, to enjoin such act or practice, or to enforce compliance with this chapter, or any rule, regulation or order thereunder, and said courts shall have jurisdiction to entertain such actions. (emphasis added)

One of the primary functions of the CFTC is to enforce laws which ensure that market participants do not engage in actions that manipulate the marketplace. Conversely, the SEC is primarily responsible for supervising fiduciary responsibility between market participants, which ensures that all market participants are treated fairly and without discrimination. Given that the enforcement activities of the FERC and the CFTC are similar, it follows that to the extent FERC's enforcement powers should be broadened, the laws governing the CFTC enforcement activities could serve as an appropriate model rather than the laws which govern the responsibilities of the SEC.

Moreover, FERC has the authority under Section 717s(a) of the NGA to seek an injunction through the district courts. Modifying the proposed language to mirror the CFTC approach in those instances where FERC has not yet held a hearing reinforces Section 717s(a) and will help safeguard against any tendency by the agency to serve as prosecutor, judge and jury prior to full fact-finding. This will guarantee parties an independent adjudication of findings that protect the public interest.

NGSA further favors the CFTC model in those situations in which a prior hearing is not practical because certain cease-and-desist provisions in the current language fail to provide parties with sufficient due process protection, give the Commission unlimited discretion, or provide a low threshold for action. The proposed legislation, unlike the CFTC model, would allow the agency to issue a cease-and-desist order without notice and hearing. Specifically, the areas of concern with the proposed approach are as follows:

- No Limits on the Power to Freeze Assets. In Section 2(f), the proposed language gives FERC the ability to prevent the dissipation or conversion of assets. If FERC is granted this ability, the assets subject to being frozen should not be unlimited. Instead, the amount of assets that can be frozen should be commensurate with the level of penalty that ultimately may be assessed. The failure to limit this amount could unreasonably result in an unjustified inequity or a company that is no longer able to operate its business.
- The Standard Is Too Low for Issuing an Emergency Order without Hearing. In Section 2(f)(2), the proposed language gives FERC authority to bypass a hearing prior to issuing a cease-and-desist order in instances where FERC determines

that a prior hearing would be "impracticable or contrary to the public interest." In contrast, courts have a higher standard for issuing a restraining order to preserve the status quo. For example, in district court a restraining order will only be granted, without a prior hearing, in situations where the moving party can plead and prove: (1) reasonable probability of success on the merits; (2) irreparable injury; and (3) a balance of equities in favor of the moving party. A similarly high standard should apply when considering whether use of cease-and-desist authority by FERC is appropriate.

- No Deadline is Specified for FERC Action Once an Emergency Cease-and-Desist Order Issues. Section 2(g)(2)(B) states that an applicant can request a hearing within 10 days of an emergency order and FERC shall hold a hearing and render a decision "at the earliest practicable time." Given that a cease-and-desist order can have significant consequences for a company, FERC action on a hearing and decision in an instance where a cease-and-desist order has already been issued should be expedited and not left unspecified. A hearing should take place within 10 days of the order and a decision should be issued within 30 days of the order.

To the extent any further FERC enforcement authority is warranted, NGSA strongly endorses the CFTC model for cease-and-desist authority, and asks that the Committee consider modifying Section 2(f) to require a court injunction in instances where an immediate cease-and-desist order must be issued.

Thank you for the opportunity to provide these comments. In closing, we appreciate the Committee's efforts to consider whether FERC has sufficient enforcement authority in order to prevent market manipulation, and believe the tools already at the commission's disposal are sufficient. To date, there has been only one reported instance in which a company reportedly distributed its assets in order to avoid pending penalties. In the event Congress decides to move forward with this legislation, NGSA hopes you will give our suggestions serious consideration so that balanced due process benefits are provided to all potentially affected parties.

Sincerely,

R. SKIP HORVATH.

AMERICAN PUBLIC GAS ASSOCIATION,
March 25, 2009.

Hon. MARIA CANTWELL,
U.S. Senate, 511 Senate Dirksen Building Washington, DC.

DEAR SENATOR CANTWELL: On behalf of the American Public Gas Association (APGA), I want express our strong support for S. 672—The Natural Gas and Electricity Review and Enforcement Act which you recently introduced. I commend you for your efforts on behalf of natural gas consumers.

APGA is the national association for publicly-owned natural gas distribution systems. Of the some 1,200 local distribution systems in the United States, approximately 1,000 are public gas systems located in 36 states; over 700 of these systems are APGA members. Publicly-owned gas systems are not-for-profit, retail distribution entities owned by, and accountable to, the citizens they serve. They include municipal gas distribution systems, public utility districts, county districts, and other public agencies that have natural gas distribution facilities.

Your legislation will bring parity to the manner in which electric customers versus gas customers are treated when it comes to the ability of the Federal Energy Regulatory Commission (FERC) to review and timely set just and reasonable rates. Correcting this inequity in Section 5 of the Natural Gas Act to allow the FERC to set a refund-effective date commensurate with the date on which a consumer complaint is filed and will allow FERC to treat regulated pipelines just as it currently treats regulated electricity transmission providers. This is a critical consumer protection tool that the current and past FERC Chairmen and sitting Commissioners have themselves recognized that FERC is lacking.

Your legislation will also provide the FERC with cease and desist authority. Currently, if FERC wants an entity to refrain from certain offensive activities, such as market manipulation, it must go to court to obtain an order, which can be a time-consuming exercise. By contrast, Congress has provided other federal agencies, such as the Commodity Futures Trading Commission and the Securities Exchange Commission, with cease and desist authority, which gives the agency the authority to order a bad actor to cease its offensive behavior immediately. This authority would significantly enhance the FERC's ability to protect consumers by providing it with the ability to stop market manipulation and other market abuses in a timely fashion.

I thank you for your efforts on behalf of natural gas consumers and look forward to working with you and others towards passage of these critical consumer protection provisions.

Sincerely,

BERT KALISCH,
President and CEO.

AMERICAN PUBLIC GAS ASSOCIATION,
March 25, 2009.

Hon. JEFF BINGAMAN,
Chairman, Committee on Energy and Natural Resources, U.S. Senate, Washington, DC.

DEAR CHAIRMAN BINGAMAN: On behalf of the American Public Gas Association (APGA), I request your support to eliminate the wide disparity that currently exists in the manner that electric customers are treated versus natural gas customers. Under the Federal Power Act (FPA), the Federal Energy Regulatory Commission (FERC) has the ability to review and timely set just and reasonable rates because the complaint section of the FPA provides for refunds. There is no corresponding protection for consumers under the Natural Gas Act (NGA).

Yesterday, Senator Cantwell introduced legislation, S. 672, that would correct this inequity (by putting gas customers on the same footing as electric power customers), and I urge your support of this legislation that provides FERC with this critical consumer protection tool—a tool that the FERC Chairman and all sitting Commissioners have outspokenly supported.

APGA is the national, non-profit association of publicly-owned natural gas distribution systems. Nationwide there are approximately 1,000 public gas systems in 36 states. Public gas systems range in size from Philadelphia Gas Works, the largest and longest-operating public gas utility in the U.S., to Wagon Mound Municipal Gas Department in New Mexico that serves approximately 80 customers.

Under the FPA, if a complaint is filed and FERC rules that the rate the customers have paid was unjust and unreasonable, FERC has the authority to order refunds from and after the date the complaint case was filed. By contrast, FERC does not have the same authority under the NGA to provide for the reimbursement to a gas customer that is determined to have been paying an unjust and unreasonable rate after a complaint has been filed. Under NGA Section 5, FERC can only rule that a rate reduction take effect prospectively after FERC's order is issued, which more often than not occurs years after a complaint is filed. Given the time and expense of a complaint proceeding and the pipeline's obvious and strong incentive to delay the proceeding (since no refunds can be ordered under NGA Section 5), the absence of a refund-effective date provision in NGA Section 5 completely undermines its effectiveness, as the FERC Commissioners themselves have expressly recognized.

Last week the Natural Gas Supply Association (NGSA) released a study (copy attached) that analyzed the cost recovery of 32 major pipelines based on financial data that they are required to file annually with the FERC. The study shows, among other things, that "over a 5-year period [from 2003-2007], pipelines earned roughly $3.7 billion more than they would have collected on an average 12% allowed return on equity. While pipelines have clearly performed effectively for their shareholders, it is just as clear that returns are at a point where FERC oversight is necessary." The study also shows that seven of the 32 pipelines earned on average equity returns in excess of 20%. In fact in the case of one pipeline, Natural Gas Pipeline Company of America, its 5-year average return on equity was 34.4% (ranging from a low of 29% to a high of 40%).

One of the arguments raised in the past by the pipeline lobby against providing FERC with this consumer protection tool is that it would have a negative impact upon a pipeline's ability to attract new capital, and this in turn would have an adverse impact on infrastructure investment. This argument is a red-herring with no basis in fact. The FERC in establishing just and reasonable rates provides for the recovery of all costs, including debt costs and a fair return on equity. And a fair return on equity must, as the Supreme Court long ago mandated, permit the regulated utility to go to the marketplace to raise capital at reasonable rates. In addition, many infrastructure projects are undertaken by pipelines, as identified in the NGSA study, that are not in the egregious overcollection category.

Ironically, the pipelines never argue that they are not over-recovering their costs—only that if caught they should not have to refund the overcharges. The FERC Commissioners, all of whom support infrastructure improvement and the

amendment of NGA Section 5 to provide for the establishment of a refund-effective date, understand that this is not an "either-or" proposition.

As the Committee considers developing an energy package, I hope you will support much-needed legislation that provides natural gas consumers with the same level of protection from overcharges that currently exists for electric consumers. The current economic climate, not to mention the NGA's requirement that rates be just and reasonable, demands nothing less.

Sincerely,

BERT KALISCH,
President & CEO.

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