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

FEDERAL ENERGY REGULATORY COMMISSION	:	
Plaintiff,	:	
v.	:	CIVIL ACTION NO. 3:15-CV-00452-MHL
POWHATAN ENERGY FUND LLC, HOULIAN "ALAN" CHEN, HEEP FUND, INC., and CU FUND, INC.	:	
Defendants.	:	

REBUTTAL BRIEF IN SUPPORT OF
POWHATAN ENERGY FUND'S MOTION TO DISMISS THE COMPLAINT

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INTRODUCTION

As predicted, FERC spends most of its Opposition discussing things that are irrelevant. Because the specific trumps the general, all that matters when assessing fair notice is what the *Black Oak* orders have to say about the trading at issue. General pronouncements about "fraud" or "deceit" in the anti-manipulation rule are of no consequence to the question here when FERC has specifically addressed the exact trading at issue. Similarly, any analogies that FERC tries to draw between Dr. Chen's trading and "wash trading" or the so-called "Death Star" are also irrelevant. Although it tries mightily to change the subject, FERC cannot escape the significance of the *Black Oak* orders. Those orders require dismissal of this case.

ARGUMENT

This case must be dismissed if the *Black Oak* orders do not provide "clear notice" that trading designed to increase MLSA payments was illegal. *United States v. Hoechst Celanese Corp.*, 128 F.3d 216, 224, 227 (4th Cir. 1997); *First Am. Bank of Virginia v. Dole*, 763 F.2d 644, 651 n.6 (4th Cir. 1985). Thus, Powhatan does not have to show that its interpretation of the *Black Oak* orders is correct and that FERC's interpretation is wrong. Rather, it simply has to show that the situation was unclear. In other words, the case must be dismissed if there is any ambiguity in the orders. *First. Am.*, 763 F.2d at 652 n.7 (holding that "the responsibility to promulgate clear and unambiguous standards is upon the administrative agency alone") (internal quotations and citations omitted).

I. IT CERTAINLY IS NOT "CLEAR" FROM THE *BLACK OAK* ORDERS THAT IT WOULD BE ILLEGAL FOR DR. CHEN TO MAKE TRADES THAT WERE DESIGNED TO INCREASE HIS MLSA PAYMENTS.

There are many reasons why the relevant orders do not "clearly" prohibit the trading at issue. Most of these reasons have to do with what the orders do (and do not) say, which is

discussed in more detail below. But the final nail in the coffin is what FERC actually *did* in response to the trading: FERC changed the relevant tariff. If it had already been "clear" that Dr. Chen's trading was illegal, "there would have been no reason" for FERC to have changed the rules. *Id.* at 650 n.5. There is no getting around this fact – which explains why FERC says nothing about it in its Opposition.

A. FERC Itself Cannot Even Decide What The *Black Oak* Orders Mean.

The only relevant part of FERC's Opposition is found on pages 18-24, which discuss the *Black Oak* proceedings. FERC focuses on what it calls the "broad proposal" (under which all virtual traders would receive the transmission loss credits) and the "narrower approach" (under which only those virtual traders who paid transmission costs would receive the credits). The Opposition contrasts these two approaches and concludes that by adopting the so-called narrower approach, the orders did not address the incentives that would exist under that approach. Opposition at 21-22 ("That is, the Commission made clear that it believed that the *broad* distribution proposal (MLSA paid to all virtual traders) was objectionable because it could lead to abusive trading simply to collect MLSA, and for that reason directed PJM to consider a *narrow* approach (MLSA paid only to trades with paid transmission) that would address that problem.") (emphasis in original); *id.* at 23 ("That is, the Commission believed that the broad distribution method would create perverse incentives, which would not arise under the narrower distribution method.").

There are some obvious textual problems with this interpretation, which are discussed in more detail in the next section. But as an initial matter, it is worth noting that this is a brand new theory that FERC has concocted. From the beginning of this five year investigation, Powhatan has been telling FERC that the *Black Oak* orders did not provide fair notice. Despite many

written responses to Powhatan's fair notice arguments, never before has FERC advanced this broad/narrow theory of the *Black Oak* orders in which it claims that the volume trading incentives applied only to the broad proposal and not to the narrower one. *E.g.*, Enforcement Staff Report and Recommendation ("Report") at 59-71, attached to the complaint as Appendix A to Exhibit 2 (discussing the *Black Oak* proceedings); Order Assessing Civil Penalties ("Order") ¶ 122, attached to the complaint as Exhibit 1 (same).

Disturbingly, FERC has in the past said the *exact opposite* of what it is saying now about the *Black Oak* orders. In the middle of its discussion of the *Black Oak* proceedings and fair notice, the Enforcement Staff Report and Recommendation ("Report") concludes that the Commission's ***"concern about volume trading necessarily applies equally to the subset of virtual trades that later became eligible for MLSA, namely UTC trades with paid transmission."*** Report at 66 (emphasis added). That is a jaw-dropping sentence. After a multi-year investigation, the 84-page Report that forms the basis for recommending charges against Powhatan for tens of millions of dollars in civil penalties and disgorgement flatly states that the volume trading incentives discussed in the *Black Oak* orders "necessarily appl[y]" to virtual trades *with* paid transmission. But now that FERC is in this Court, it has done a complete about-face and claims that the Commission was saying in the *Black Oak* orders that these incentives applied only to virtual trades *without* paid transmission.

This is no accident or miscommunication among different sets of FERC lawyers. Some of the lawyers who drafted the Report are the same lawyers who drafted the Opposition. It is bad enough that this contradiction exists at all – because it shows the shifting (indeed, exact opposite) interpretations of the *Black Oak* orders that FERC has adopted over time. If FERC can do a complete 180 degree turn on the orders, how can FERC possibly maintain that the orders were

"clear"? Specifically, how can Powhatan and Dr. Chen have possibly received fair notice that the incentives discussed in the orders supposedly applied only to virtual trades without paid transmission and *not* to the trades they were making that included paid transmission? There was no fair notice here. But what is shocking is that FERC did not itself bring this contradiction to the attention of the Court, instead leaving it to Powhatan to expose it.

B. FERC's New Theory About The Meaning Of The *Black Oak* Orders Misses The Forest For The Trees.

FERC's new theory about the meaning of the *Black Oak* orders is entirely off the mark. As discussed above, FERC does not even believe its own new theory. It knows full well that the Commission's "concern about volume trading necessarily applies equally to the subset of virtual trades that later became eligible for MLSA, namely UTC trades with paid transmission." Report at 66. This is because the orders discuss the incentives in general and do not limit them only to the situation in which virtual traders do not pay transmission costs. *E.g.*, *Black Oak Energy, LLC v. PJM Interconnection, LLC*, Order Denying Complaint, 122 F.E.R.C. ¶ 61,208 at P 51 (Mar. 6, 2008) ("[A]rbitrageurs create their own load by the volume of their trades. If arbitrageurs can profit from the volume of their trades, they are reacting not only to perceived price differentials in LMP or congestion, and may make trades that would not be profitable based solely on price differentials alone."); *Black Oak Energy*, Order Denying Reh'g in Part & Granting Reh'g in Part, 125 F.E.R.C. ¶ 61,042 at P 38 n.46 (Oct. 16, 2008) ("We are also concerned that since arbitrageurs, unlike [purchasers of physical energy], control their [trading volume] by virtue of the number of transactions into which they enter, [paying them transmission loss credits] would provide an incentive for the arbitrageurs to conduct trades simply to receive a larger credit.").

The reasonable, objective take-away from the *Black Oak* orders is that the Commission

recognized that virtual traders (unlike purchasers of physical energy) control their own trading volume by virtue of the number of transactions into which they enter and therefore virtual traders would have an incentive to conduct trades simply to receive a larger credit if such trades were, indeed, eligible to receive the credit. This is obviously true regardless of whether the virtual traders have to pay transmission costs or not. The incentive to capture the rebate exists if the trader has to pay something up front in order to make the trade (*i.e.*, if he has to pay transmission costs). And the incentive exists if the trader does not have to pay something up front in order to make the trade (*i.e.*, if he does not have to pay transmission costs). In either scenario, he controls his own trading volume simply by virtue of the number of transactions into which he enters.[1]

Thus, it makes no sense to claim – as FERC now does in its Opposition – that the incentives discussed in the orders did not apply to the situation in which virtual traders paid transmission costs (like the situation with Dr. Chen's trading). Moreover, we know that FERC does not even believe this; it is merely a self-serving litigation strategy based on the false hope that Powhatan would not expose FERC's contrary interpretation in the Report. Finally, this new interpretation relies heavily on alleged assurances from the "Financial Marketers," who

[1] In its Opposition, FERC criticizes Powhatan for supposedly never seeking an interpretation of the Commission's position regarding its trading, and even claims that Powhatan and Dr. Chen "explicitly discussed making inquiries about their trading – but apparently decided not to do so," which FERC characterizes as "calculated, self-serving willful blindness." Opposition at 6, 9. This issue is irrelevant to whether FERC provided fair notice. As the *First American* court put it, "[t]he responsibility to promulgate clear and unambiguous standards is upon the administrative agency alone." *First Am.*, 763 F.2d at 652 n.7 (internal quotations and citation omitted). Moreover, there are no facts alleged in the complaint about what Powhatan did or did not do in terms of seeking guidance about the trading, so FERC cannot point to unalleged "facts" in attempting to resist a motion to dismiss. (Indicative of FERC's loose approach to the facts, there is no Statement of Facts in the Opposition at all.) Finally, the *Black Oak* orders themselves already provided all the guidance necessary to know that the trading at issue was not illegal.

supposedly told the Commission that no UTC virtual traders would attempt to "capture a larger share of the surplus." Opposition at 22. But as Powhatan has already pointed out, what the Financial Marketers did or did not say is entirely irrelevant because the Commission speaks through its orders, not through what certain parties may or may not have said to it. Opening Brief at 11-12; *see also Bangor Gas Co., LLC v. H.Q. Energy Servs. (U.S.) Inc.*, 695 F.3d 181, 190 (1st Cir. 2012) (observing that "FERC itself has warned that . . . "[t]he Commission speaks through its orders.") (internal quotations and citation omitted).

In sum, FERC's new interpretation of the *Black Oak* orders is illogical, contrary to the text of the orders, misses the forest for the trees and relies on irrelevant statements outside the orders themselves. And, of course, we know that FERC does not even believe its new litigation-inspired interpretation.

C. The *Black Oak* Orders Never Mention "Gaming," "Manipulation," "Sham Trading," "Wash Trading" or the "Death Star."

In its Opening Brief, Powhatan explained that if the Commission really meant to signal in the *Black Oak* orders that trading designed to capture a larger share of the transmission loss credits would be considered "market manipulation" or "gaming," it simply would have said so. Opening Brief at 12-14. Likewise, if the Commission believed that such trading was analogous to "wash trading" or to Enron's "Death Star," it would have said so. In the past, when concerned about the potential for manipulation, the Commission has routinely put the regulated community on notice by explicitly discussing "manipulation" or "gaming" in its orders or by taking steps like directing the market monitor to be on the lookout and to report such conduct. *Id.* at 12-13.

The *Black Oak* orders do none of this. Nowhere do the words "manipulation" or "gaming" appear (nor does any similar phrase, such as "sham" trading). They say nothing about

"wash trading" or the "Death Star." They do not ask the market monitor to be on the lookout. By failing to include any of this cautionary language, when the Commission has regularly done so in the past, the *Black Oak* orders strongly signaled that the Commission did not consider the conduct at issue to be manipulation. *Id. at* 14. At the very least, the absence of any such cautionary language means that the relevant orders did not "clearly" prohibit the trading at issue.

The Opposition says nothing about this. It does not even attempt to reconcile the silence of the *Black Oak* orders with the Commission's routine practice of warning about manipulation when it believes that the potential for manipulation is present. Instead, true to form, the Opposition tries to mislead the Court by suggesting that the orders contain words (and judgments) that they do not. FERC repeatedly states, without any support, that the Commission had concluded that the trading at issue was "sham" trading or "abusive" trading, in response to "perverse" incentives. Opposition at 21-24. Those words do not appear anywhere in the orders.

While FERC has taken the position *now* that the trading at issue was manipulative, the Commission did not take that position in the *Black Oak* orders. As discussed more fully below, FERC changed the tariff in September 2010. It now attempts in this case to "retroactively impose" that tariff on Powhatan and Dr. Chen – an attempt that the Constitution forbids. *First Am.*, 763 F.2d at 652.[2]

[2] In its Opposition, FERC attempts to deal with the avalanche of fair notice case law arrayed against it by dividing it into six categories and then claiming that none of those categories is present here. Opposition at 8-9. Powhatan disagrees with FERC's over-simplified list, but notes that even under FERC's list, category 5) ("retroactive application of a new regulation") would apply to this case.

D. The Final Nail In The Coffin Is That FERC Immediately Changed The Rule In Response To Trading Designed To Increase MLSA Payments.

In its Opposition, FERC congratulates itself for taking "immediate action" to change the tariff "upon discovering the conduct at issue." Opposition at 9, *see also* Report at 68 (stating that "the Commission . . . acted immediately once [it] became aware of the conduct"); *id.* at 70 (stating that "the Commission . . . immediately took action to stop [the trading]" once it was discovered). It also states, over and over again, that it was obvious that the trading was prohibited at the time – either because the *Black Oak* orders prohibited it, or because it was the equivalent of prohibited wash trading, or because it was the equivalent of prohibited Death Star trading. Opposition at 1-2, 7, 9, 16-18, 22-24.

Rather than helping FERC's case, these statements bury it once and for all. If it had already been "clear" that the trading was prohibited, there would have been no reason for FERC to change the tariff. Specifically, in the words of the Fourth Circuit, "there would have been no reason" for FERC "to have proposed any regulatory changes." *First Am.*, 763 F.2d at 650 n.5. Just as in *First American*, "[w]e cannot believe" that FERC's new tariff was "utterly superfluous." *Id.* Instead, what FERC and PJM did by enacting a new tariff – while simultaneously pretending that the anti-manipulation rule prohibited the conduct at issue all along – was attempt to apply a new duty on Dr. Chen and Powhatan retroactively. That is forbidden by *First American*. *Id.* at 652. Although a duty preventing Dr. Chen from considering the rebates might be "desirable and salutary" from FERC's perspective, neither FERC nor a court may "retroactively impose such a duty." *Id.* As the *First American* court explained, "[t]hat duty must await another day" – which is exactly what happened when FERC and PJM enacted the new tariff *after* the trading at issue. *Id.* In short, the more FERC jumps up and down about

how the trading was obviously illegal at the time, the more it confirms that the case must be dismissed.

Finally, a short response is warranted to FERC's offensive analogy, comparing Powhatan to a robber who cannot enter the front door (because it is bolted) and then enters through a window that has been left open unwittingly. FERC finds it absurd to think that somebody who bolts his door would have no objection to being robbed so long as the thief enters through the window. True, but it would be just as absurd for the homeowner, in response to the robbery, to demand that his legislature enact a law preventing homeowners from being robbed when the thief enters through a window. When the prohibition is already "clear," we do not need new laws prohibiting what is already illegal. Unless, of course, the conduct at issue was *not* clearly prohibited – which is exactly the situation here, and is exactly why FERC rushed to enact its new tariff.

CONCLUSION

Whatever else may be said about the trading at issue, it certainly was not "clear" in the summer of 2010 that it would be illegal for Dr. Chen to make trades designed to increase his MLSA payments. The *Black Oak* orders did not clearly prohibit the trading. And the fact that FERC immediately scrambled to change the tariff as soon as it learned of the trading confirms that the trading was *not* prohibited at the time. This case should be dismissed.

Respectfully submitted,

Dated: November 9, 2015.

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PROOF OF SERVICE

I hereby certify that on this day the foregoing Rebuttal Brief in Support of Powhatan Energy Fund's Motion to Dismiss the Complaint was filed electronically with the Clerk's Office for the U.S. District Court for the Eastern District of Virginia, and a copy was served via electronic mail to counsel for the plaintiff Federal Energy Regulatory Commission listed below:

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