

March 2008

Energy Update:

Recent Developments in FERC Enforcement

The Federal Energy Regulatory Commission (“FERC” or “Commission”) has recently shed more light regarding the manner in which it will exercise the enhanced enforcement authority granted in the Energy Policy Act of 2005 (“EPAAct 2005”). EPAAct 2005 amended the Natural Gas Act (“NGA”), the Federal Power Act (“FPA”), and the Natural Gas Policy Act (“NGPA”) to provide the Commission with the ability to levy civil penalties for violations of these statutes, or any rule, regulation, or order imposed by the Commission under these statutes up to a maximum of \$1 million per violation per day.

Expanded Commission Authority over LDCs and Natural Gas Marketers

The Commission’s recent actions are of special interest to natural gas local distribution companies (“LDCs”) and natural gas marketers. Historically, the Commission’s authority over LDCs, intrastate natural gas pipelines, and natural gas marketers has been limited and its focus has primarily been upon interstate natural gas pipelines over which it has plenary jurisdiction under the NGA. As a result of EPAAct 2005 and other recent Commission initiatives, the Commission’s authority over LDCs and natural gas marketers has expanded to include the following:

- Section 4A of the NGA and Section 1c.1 of the Commission’s regulations now make it unlawful, for any entity, directly or indirectly, to use or employ, in connection with the purchase or sale of natural gas or the purchase or sale of transportation services subject to the jurisdiction of the Commission, any manipulative or deceptive device or contrivance, in contravention of such rules as the Commission issues. Prior to adopting its regulations on market manipulation, the Commission had adopted market behavior rules which prohibited similar conduct by market participants. The Commission has applied its market rules against an intrastate natural gas pipeline, Energy Transfer Partners, L.P.¹, and a natural gas commodity investment company and its affiliates, Amaranth Advisors, L.L.C.² The Commission has proposed civil penalties against these entities of \$82 million and \$200 million respectively, as well as seeking disgorgement of tens of millions of dollars of alleged unjust profits.
- Pursuant to Section 23 of the NGA and Order No. 704, the Commission will require natural gas market participants engaged in wholesale, physical natural gas transactions greater than 2,200,000 MMBtus to file an annual report of natural gas transactions, beginning in 2008. The Commission issued a Show Cause Order in February 2007 against numerous jurisdictional entities for failure to timely file reports and thus left little doubt that any such actions could be subject to enforcement action.³

Recent Commission Enforcement Action Against LDCs and Marketers

In addition to the new requirements above, the Commission has placed a renewed emphasis on ensuring compliance with its existing regulations and rules regarding capacity release, shipper-must-have-title, and buy-sell transactions. In October 2007, the Commission fined BP Energy Company (“BP”) \$7 million for violations of these requirements.⁴

¹ *Energy Transfer Partners, L.P., et al.*, 120 FERC ¶ 61,086 (2007), *reh’g denied*, 121 FERC ¶ 61,282 (2007).

² *Amaranth Advisors, LLC, et al.*, 120 FERC ¶ 61,085 (2007), *reh’g denied*, 121 FERC ¶ 61,224 (2007).

³ *Compliance with Financial Forms Filing Requirements*, 118 FERC ¶ 61,107 (2007), Order Terminating Proceedings, Directing Further Filing, and Referring Matter to Office of Enforcement, 119 FERC ¶ 61,054 (2007).

⁴ *In re BP Energy Company*, 121 FERC ¶ 61,088 (2007).

The Commission held that by engaging in a series of repeated short-term capacity releases to two or more affiliated shippers, a practice known as “flipping,” BP violated the posting and bidding requirements for capacity releases. The Commission further found that, in its capacity as an asset manager, BP violated the shipper-must-have-title requirement and engaged in prohibited buy-sell transactions (*i.e.*, buying gas at the direction of one party and transporting such gas using its own pipeline capacity with the gas later resold to the party at the delivery point).

The shipper-must-have-title violations against BP were not the first to be assessed by the Commission. The same day that it issued its order against BP, the Commission fined MGTC, Inc., a small intrastate pipeline in Wyoming, \$300,000 for self-reported violations of the shipper-must-have-title requirement.⁵ In March 2007, the Commission fined Bangor Gas Company, LLC, a small LDC in Maine, \$1 million for self-reported violations of the shipper-must-have-title requirement.⁶ Likewise, in May 2007, the Commission fined Calpine Energy Services, L.P. \$4.5 million for self-reported violations of the shipper-must-have-title requirement.⁷

Even more recently, on March 11, 2008, the Commission issued two enforcement orders addressing these same issues. The Commission fined Constellation NewEnergy-Gas Division, LLC, \$5.0 million and required it to disgorge \$1.9 million in unjust profits for violating the capacity release rules by engaging in flipping, violations of shipper-must-have-title, and engaging in prohibited buy-sells. The Commission also fined Entergy New Orleans, Inc. \$400,000 for violating the shipper-must-have title rule.

The Commission Responds to Concerns

These cases, particularly the *Bangor Gas* case, aroused concern among the regulated community — and in particular entities like LDCs and marketers not traditionally regulated by FERC — that FERC was applying its new penalty authority too harshly and not giving adequate credit for self-reports. This concern was highlighted with the release of a White Paper prepared by most of the major energy industry trade groups, including the American Gas Association, Interstate Natural Gas Association of America, Edison Electric Institute, and Natural Gas Supply Association. The White Paper offered several suggested revisions to FERC’s enforcement process, including amnesty to encourage self-reporting, establishing gradations of civil penalties to match the severity of the violation, and better educating market participants about FERC’s policies and rules.

In November 2007, the Commission issued a *Report on Enforcement* (“Enforcement Report”). For the first time, the Commission sought to shed light on how it has administered the new penalty authority granted by EPAAct 2005. The Enforcement Report summarizes enforcement activity to date, including the fact that approximately 50 percent of self-reported violations have been closed without conducting an investigation, particularly if the entity: (1) brought its conduct into compliance; and/or (2) voluntarily undertook increased internal procedures, training and oversight to prevent the recurrence of the misconduct.

The Enforcement Report also provided further guidance to entities on actions that they can take to prevent or minimize penalties for non-compliance. More specifically, in addition to having an effective compliance program in place, the manner in which a company presents a self-report to the Office of Enforcement Staff can materially influence whether a non-public investigation is required to resolve the matter. Key elements of a good self-report are: prompt notice that the company is reviewing a compliance problem, an expected timetable for a full report, progress

⁵ *In re MGTC, Inc.*, 121 FERC ¶ 61,087 (2007).

⁶ *In re Bangor Gas Company*, 118 FERC ¶ 61,186 (2007).

⁷ *In re Calpine Energy Services, L.P.*, 119 FERC ¶ 61,125 (2007).

reports while the internal investigation is ongoing, and a detailed written report that identifies key personnel and provides relevant documents.

In addition to releasing the Enforcement Report, on November 16, 2007, the Commission held a public conference to discuss its enforcement policy. The Commission invited several practitioners to address its enforcement policy to date and to make suggestions on how the process can be improved. Barbara K. Heffernan, Schiff Hardin's Co-Chair of its Energy Practice Group, was one of the invited practitioners. Ms. Heffernan emphasized the need for the Commission to conduct open-minded investigations and to not pre-judge the outcome of an investigation. More specifically, Ms. Heffernan suggested that, if an investigation cannot be resolved by settlement, the Commission should not adopt the findings of its Office of Enforcement Staff and set forth the maximum possible penalty that could be imposed in its order establishing further proceedings. Rather, the findings of the Office of Enforcement Staff should be viewed as allegations that must be established in any subsequent proceedings ordered by the Commission.

At the November conference, the Commissioners were particularly interested in how the enforcement process could be improved to ensure fairness, but were not responsive to suggestions that pre-set penalties be set for various violations or blanket amnesty for self-reported violations. Generally, the key message at the conference was that companies should: (1) have a top-notch compliance program in place; (2) know the rules of the road; and (3) when violations are found, properly investigate the totality and reasons for the violations and provide a detailed, comprehensive self-report to the Commission. Chairman Kelliher emphasized the last point best when he stated that not all self-reports are equal.

The Commission Adopts Some Suggested Reforms

On December 20, 2007, the Commission announced that it was amending some of its procedures "to eliminate any perception of unfairness or prejudgment."⁸ The Commission stated that when the Office of Enforcement Staff completes an investigation, a report will be transmitted to the Commission with recommended findings and conclusions of law and fact. The Commission then will issue a Show Cause Order to the entity being investigated. The Office of Enforcement Staff report will be attached to the Show Cause Order and the entity being investigated will have an opportunity to respond to the Office of Enforcement Staff's recommended findings. The Commission will not make any other findings, preliminary or otherwise, until it has considered the response. In addition, designated Office of Enforcement Investigative Staff will become non-decisional employees for purposes of participating in the remainder of the enforcement proceeding.

Lessons to Be Drawn

As the Commission continues to set its sights on ensuring compliance with its myriad rules and regulations, all regulated entities (including LDCs and marketers that engage in limited jurisdictional activities) must: (1) have a comprehensive and thorough compliance program in place and a culture of compliance supported by senior management; (2) educate their employees on the FERC's many rules, regulations and reporting requirements that are applicable to jurisdictional activities; and (3) promptly and properly investigate any known or suspected violations to determine the full scope and cause of the violations and provide a detailed, comprehensive self-report to the Commission.

Schiff Hardin has substantial experience with planning and implementing corporate compliance programs for pipelines, electric utilities, LDCs and energy marketers under the statutes and regulations administered by FERC.

⁸ *Energy Transfer Partners, L.P., et al.*, 121 FERC ¶ 61,224 at PP 88-90 (2007).



We also represented several entities in navigating the process of internal investigation, self-reporting and negotiating settlements with the Office of Enforcement Staff.

For Further Information

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