

INSIGHTS

Takeaways from the FERC and CFTC Annual Enforcement Reports for Energy Companies

November 26, 2018

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The Federal Energy Regulatory Commission (FERC) and the Commodity Futures Trading Commission (CFTC) each issued their annual enforcement reports last week. As always, these reports highlight priorities and attempt to quantify enforcement efforts by the agencies during the prior fiscal year.¹ In both cases, it might be tempting for energy companies to walk away thinking their potential exposure at either agency is substantially reduced under the current leadership: [FERC's report](#) is dominated by old allegations wallowing in court and new inquiries closed without action while energy companies are largely absent from the [CFTC's report](#). However, the absence of new major energy cases at both agencies is more likely a matter of chance – or a reflection of market conditions and the result of effective compliance programs – than any deliberate change in policy at either agency.

Regardless of the conclusion you may reach regarding the current zeal of the agencies with respect to enforcement against energy companies, these reports continue to provide information useful for predicting the next compliance risk, big or small. Because the public cases in the annual reports have all previously been reported, the new information is in the priorities and initiatives each agency chooses to highlight and especially the new information FERC shares about its non-public activities. Below are the top five takeaways from the reports for energy companies.

#1: The Law Is Not Retreating. Putting aside the ongoing debate about whether the pendulum has swung away from enforcement in energy markets (and keeping in mind that pendulums by their nature always swing back), more important than knowing the level of enforcement is knowing the law. Although FERC has lost repeatedly on procedural issues in the enforcement actions it has brought in court, it has survived on its theory of the case in each motion to dismiss. Similarly, the CFTC has endured motions to dismiss in its most aggressive cases still pending in court today. And neither agency has made any public announcement or otherwise walked back its articulation of what activity constitutes a violation of its rules.

FERC's report highlights an increase in the number of investigations closed without action in recent years, but nothing in the report suggests a change in the bar against which FERC is measuring conduct. That is, all of FERC's orders during the year and its description of conduct investigated continue to look for the same types of violations and describe unlawful conduct using the same terms. The only difference has been the relative frequency with which staff has concluded that there is insufficient evidence of a violation or no violation at all.

The CFTC also has not retreated substantively in its standards for violations. It continues to use interchangeably the intent to influence price and the intent to manipulate price. It also has shown eagerness to expand, not narrow, the scope of its authority by establishing task forces to carry its flag into the realm of virtual currency and to expand upon its insider trading theory. Moreover, while there were few public energy cases during the year, the CFTC increased its overall enforcement activities by nearly every metric.

#2: Individual Accountability, Cooperation, Self-Reporting, and Whistleblowing Are in Vogue.

Consistent with a recurring message from the agency, the CFTC highlighted in the report its focus on individual accountability and the importance of cooperation and self-reporting. Whether it is companies self-reporting and exposing the violations of their employees or if it is employees or third-parties blowing the whistle on their companies or each other, the CFTC is encouraging participants to self-police its markets and embrace an environment in which every market participant faces the classic “prisoner’s dilemma” (tell or be told on, or both). In that vein, the CFTC showcased the \$75,575,113 paid pursuant to five whistleblower awards in FY2018. In fact, in a separate [Annual Report on the Whistleblower Program and Customer Education Initiatives \(Oct. 2018\)](#), the CFTC reported a substantial increase in whistleblower activity during the year.

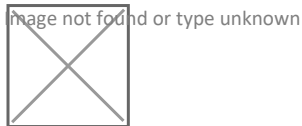


Figure 1: Whistleblower Activity FY2012 – FY2018

Likewise, FERC continues to encourage self-reporting. FERC reported that it received 137 new self-reports during the year (an increase of more than 36% over the 5-year average) and closed all but fifteen without action. The vast majority of the self-reports involved electricity tariff violations; most were minor violations reported by ISOs/RTOs.

This emphasis on personal accountability, cooperation, self-reporting and whistleblowing will naturally impact how companies and individuals approach enforcement matters, but it also

should impact compliance programs even before an inquiry begins. Companies should consider how this approach to regulation might impact their employee policies, compliance monitoring and process for internal investigations.

#3: Managing Confidential Information Should Be A Priority. The CFTC for years has highlighted insider trading as an area of interest, and in FY2018 it created an Insider Trading and Information Protection Task Force to identify and bring charges against those who improperly use confidential information in connection with jurisdictional activities. Thanks to the CFTC's aiding and abetting authority, this insider trading risk is not limited to traders. Any company with material, non-public information should make sure their employees and agents understand the confidential nature of the information and are trained on proper and improper uses of the information.

Although FERC has not yet adopted the CFTC's theory of insider trading, it does impose and/or enforce substantial limitations on the disclosure and/or use of certain information. For example, the Standards of Conduct applicable to pipelines and transmission providers pursuant to the Natural Gas Act (NGA) and Federal Power Act (FPA) restrict information sharing, the Interstate Commerce Act (ICA) protects oil pipeline customer information from disclosure, and electricity market rules and state laws can further restrict information sharing in energy markets. Breach of any of these restrictions could form the basis of a FERC violation and establish an element of a CFTC insider trading allegation.

#4: The Agencies Are Talking. Both agencies noted interagency cooperation in their reports. The CFTC emphasized it as a priority, and FERC noted it in its discussion of non-public investigations. Observing that "[b]ad actors do not conform their misconduct to the technical boundaries of different regulatory jurisdictions," the CFTC urged coordination "to ensure the entire scope of the misconduct is identified, investigated, and prosecuted." This type of coordination was represented in one of FERC's non-public investigations in which a U.S. Attorney's Office referred a public utility to FERC, which initiated an investigation into whether the entity had improperly allocated expenses and whether the allocation methodologies used by the utility's service company was consistent with FERC precedent.

This inter-agency approach has practical implications for market participants. It should force companies to break out of the compliance program that too rigidly groups and teaches risks by agency or body of law and into a world that looks at conduct holistically and considers implications of each activity for each regulator or area of law. It calls for a multidisciplinary approach to compliance, and expands the field of play in the context of investigations and enforcement.

#5: Watch Out for Foot Faults. While both agencies emphasize their intent to prevent and punish significant violations such as market manipulation and fraud, each also identified market integrity or market transparency as priorities, which can include minor, unintentional violations that undermine the accuracy of market data or even market outcomes. When market manipulation and fraud is not present or is difficult to prove, technical violations that are more common and easier to spot and prove can become an outlet for enforcement. If energy markets are performing well, as the lack of significant energy-related enforcement developments at FERC and the CFTC might imply, then that presents an opportunity for the agencies to focus enforcement on less dramatic and more mundane matters such as tariff violations, unintentional errors and reporting mistakes. As illustrated in the cases below, these

types of foot faults have filled FERC's plate.

It is worth noting that several of the inquiries described by FERC arguably are more akin to classic ratemaking than enforcement activities. While the matters were closed when staff found no evidence of fraud, several matters turned on compliance with cost allocation and rate recovery.

Specific compliance risks highlighted by FERC

The following are brief descriptions of self-reports and non-public investigations closed without action. These both give a flavor of the types of investigations FERC conducted during the period and can serve to highlight specific compliance concerns companies have faced in the prior year.

Electricity Self-Reports and Investigations Closed Without Action

- **Extreme Pricing Event Tariff Violations (Self-Reports)**
 - Tariff Violations by Generators – ten generators violated ISO/RTO tariff by submitted price-based offers exceeding cost-based offers as a result of confusion and bidding errors caused by extreme weather conditions
 - Violation of FERC Order – a public utility submitted bids that exceeded its default energy bid curve during times of price volatility
- **Electric Quarterly Report (EQR) (Self-Report)** – public utility failed to file EQRs for six months related to a power purchase agreement and for eight years related to capacity sales
- **QF Filing Violation (Self-Report)** – solar company failed to self-certify as a qualifying facility (QF) prior to making jurisdictional sales (and sought a declaratory order waiving its time value refund obligations)
- **MBR Authority (Self-Report)** – QF failed to obtain market-based rate authority after a long-term FERC-approved PURPA power purchase agreement expired
- **ISO/RTO Violations (Self-Reports)**
 - Reactive Power Payments – three instances of making incorrect payments for reactive power to transmission operators
 - Software Error – local market power calculation changed prior to effective date
 - Dispatch Tariff Provisions – dispatched generation to reduce constraints in neighboring ISO/RTO (at intertie) when tariff only permitted addressing reliability on its own system
 - Confidentiality Tariff Provision – violated requirement that market data be aggregated for no fewer than three members before disclosure

- NERC Reporting – failed to “properly calculate, report, and provide market flow relief during level 3(b) NERC Transmission Loading Relief (TLR)” events over eight months
- **Standards of Conduct (Self-Report)** – public utility inadvertently stored transmission function information on intranet sites available to all marketing function employees
- **Market Manipulation** – market monitor reported potential “capacity market arbitrage” (defined as “offering capacity in a base auction with the intent to buy back this obligation ... rather than contract with new demand response customers ... as required by the tariff”) by a Curtailment Service Provider (CSP) after receiving detailed letter from an anonymous whistleblower
- **Fraud/Misrepresentation/Tariff Violation** – U.S. Attorney’s Office referral led staff to investigation into “whether a utility improperly allocated certain expenses to transmission customers in violation of its ISO/RTO Tariff” and “whether the FERC Form No. 60 allocation methodologies used by the utility’s service company to calculate these transmission expenses, as well as the allocation system from which these methodologies were derived, were consistent with terms the Commission previously found just and reasonable”
- **Hydropower Licensing** – Office of Energy Projects referred a hydropower project operating without a license, which ceased operating upon being contacted by FERC staff
- **Reliability/Market Manipulation** –market monitor reported potential violation of capacity obligations based upon bids during high-load periods in 2016, but staff found no evidence of a violation
- **Failure to Respond to Dispatch** – market monitor reported potential tariff violation where natural gas generator informed ISO that if it ran as dispatched then it might not be available (due to fuel procurement issue) in the near future when demand was expected to be higher
- **Reactive Power Payments** –public utility owners investigated to determine if improperly received reactive power revenue on a fleet basis after the composition of the fleet changed

Oil and Gas Self-Reports and Investigations Closed Without Action

- **Form No. 552 (Self-Report)** – failure to report price reporting on Form No. 552
- **Shipper-Must-Have-Title (Self-Report)** – oil and gas production company reported it transported affiliate-owned gas on an interstate pipeline
- **Operational Sales Tariff Violation (Self-Report)** – pipeline accidentally failed to follow its tariff when it sold operational gas without posting it as required by the tariff

- **Posting Violation (Self-Report)** – oil pipeline inadvertently disclosed confidential shipper information due to a security misconfiguration
- **Misrepresentation to FERC** – inquiry into natural gas pipeline’s representations in abandonment proceeding based upon allegations from shippers that the pipeline had misrepresented its ability to continue to accommodate the shippers’ needs

In each of the examples where a violation was self-reported, the market participants involved took some combination of the following actions, which FERC used to justify for closing the matters without action:

- Self-reporting the violation to FERC
- Immediately ceasing the violation and/or correcting the error
- Engaging outside counsel to conduct independent inquiry into potential violations
- Working diligently with staff to address/remedy the violation to the extent possible
- Undertaking remedial measures (e.g., additional training, new procedures) to prevent future occurrences

Lessons from Audits

The report reiterated compliance best practices like the ones illustrated in the self-reports above, and the Division of Audits and Accounting highlighted areas where it has found “consistent compliance concerns or noncompliance of significant impact.” Companies should review the following areas to confirm that their practices are in line with FERC audit findings and consider other similar cost allocation and tariff compliance issues to ensure accurate recordkeeping and reporting and compliance with FERC orders:

- Transmission Rate Incentives
- Allocation of Labor
- Calculation of Allowance for Funds Used During Construction (AFUDC)
- Formula Rate Matters
 - Income Tax Overpayments
 - Storm Damages
 - Investment Tax Credits
 - Internal Merger Costs
 - Asset Retirement Obligation (ARO)

- Commitment Fees
- Formula Rate Errors
- Merger Goodwill
- Administrative and General (A&G) Expenses
- Unused Inventory and Equipment
- Open Access Transmission Tariffs (OATT), including improper use of network transmission service, improper sales from designated network resources, transmission capacity not released in accordance with tariff, inaccurate capacity data posted, and use of expired transmission service agreements
- Natural Gas Accounting and Tariff Matters
 - Compliance with Tariff (e.g., using approved method for valuing system gas activities, enforcing stipulations in OBAs between interstate and intrastate pipelines, updating reservation credit procedures for force majeure and non-force majeure events, and reporting operational available capacity)
 - Accounting and Reporting Requirements (e.g., penalty revenues, transmission mains and compression station expenses, line pack inventory changes, imbalances and cash-outs, lost and unaccounted-for gas, and fuel use)
 - Pipeline Integrity Management Costs (misclassified)
 - Capacity Transparency and Allocation (posting requirements)
- Oil Pipelines (Page 700)
- Nuclear Decommissioning Trust Funds
- Consolidation
- Untimely Filing of Commission Reports

In sum, energy companies should take advantage of this lull in major enforcement matters to identify the new risks, such as information management and increased use of whistleblower tips, to update their practices and procedures to meet the next wave of compliance challenges. In particular, physical players subject to FERC jurisdiction should think about compliance risks beyond trading and consider where they might have enforcement exposure in more classic FERC ratemaking spaces, such as cost allocation or compliance with FERC orders authorizing activities on a conditional basis.

¹ The reports cover fiscal year 2018 (FY2018), which began October 1, 2017 and ended September 30, 2018.