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The Importance of Energy Marketing Compliance

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Thomas L. Rudebusch
Shareholder
Duncan Weinberg Genzer Pembroke
TLR@dwgp.com
202-467-6370



William Rust
Director, Energy Marketing Compliance
The Energy Authority, Inc.
wrust@teainc.org
904-360-1426





Overview

- If you transact in wholesale energy markets a compliance program is a must
- FERC has extensive regulations for wholesale energy transactions. Regulators can scrutinize your every move
- Here we present what is required of a compliance program and review areas that need special attention
- We will review several case studies

FERC Market Regulation

- Anti-Market Manipulation Rule, Order 670, 18 C.F.R. §18.c
 - Unlawful, in connection with a jurisdictional energy transaction, to act to defraud, make an untrue statement or omit a material fact that would mislead
 - Success of scheme not required / rule applies to Section 201(f) entities
- Market Behavior Rules, Order 674, 18 C.F.R. §35.41
 - Sellers must operate units according to rules and must provide accurate information
 - Sellers must retain records for 5 years
- Investigations by Office of Enforcement – Enforcement Hotline
- Goal is to prohibit conduct inconsistent with market fundamentals



FERC Penalties for Violations

- Civil Penalties – EPA Act allowed up to \$1.0 million per violation per day
- Disgorgement of Profits – historic baseline remedy
- Revoke or Condition Sellers' Market-Base Rate Authority
- Imposition of an internal Compliance Program
- Require independent audits

○ Source: 16 U.S.C. §823, 16 U.S.C. §825o-1



Mitigating Factors for Penalties

- Seriousness of violation and resulting harm
- Involvement of Senior Management
- Self-reporting of violation
- Cooperation with investigation
- **Existence of effective Compliance Program**

○ Source: Revised Policy Statement on Penalty Guidelines, 132 FERC ¶61,126 (2010)



Establishing a Compliance Program

- Importance of a program
- No one-size-fits-all approach
 - Not every recommendation will fit your organization
- Factors for mitigation consideration
 - Structure of program
 - Senior management support
 - The scope and depth of employee training
 - Auditing
 - Response to misconduct

Elements of an Effective Program

- Organizational Structure
 - Legal, regulatory or operational?
 - Independence
 - Compliance imbedded into operations
 - Adequate resources for the compliance role
- Hiring
 - Background checks
 - Hire for your culture
 - Compensation structure



Elements of an Effective Program

- Training
 - Tailor to your organization
 - Use a variety of styles
 - Hold staff accountable for training goals
- IT Resources
 - Budget for compliance resources

Elements of an Effective Program

- Establishing Rules and Restrictions
 - Establish clear limits on products, volumes, locations
 - Document strategies
- Monitoring Activity
 - Review profit and loss, including make-whole payments
 - Monitor trader communications
 - Review transactions against a list of prohibited activities

Elements of an Effective Program

- Enforcing Rules
 - Document areas of potential noncompliance
 - Establish penalties for noncompliance
- Assessing Performance
 - Review the compliance program on a regular basis



JP Morgan, 144 FERC ¶61,068 (2013): Gaming Market Rules

- Manipulative to take unfair advantage of market rules by submitting bids not based on market fundamentals, but to create artificial conditions for the purpose of receiving collateral benefits to the detriment of the market
- JP Morgan used 12 strategies over two years to submit bids to CAISO and MISO that appeared economic to the software, but were far above market price
- One example: it bid -\$30/MWh at end of Day 1 to get day-ahead awards, but then bid \$999/MWh in hours 1 and 2 of Day 2. This 'tricked' the software into giving ramp-down awards for the first two hours of Day 2, priced at \$999, when the actual market price was \$12.
- FERC noted multiple CAISO and MISO market monitor referrals and emergency tariff filings prompted by these bidding practices.
- Stipulation: \$285 million civil penalty, plus \$125 million profits disgorged



JP Morgan: Establishing Appropriate Trading Rules

- A Compliance Program can reduce the risk of noncompliance through rules that limit the ability and incentive for misconduct
 - *Document trading strategies* – helps compliance understand activities and permits reference for review of trading activities
 - *Maintain a list of prohibited strategies* – based FERC orders and the experience of the business unit, compliance can maintain a list of strategies that have been deemed improper or that appear similar to known prohibited activities
 - *Require approval of new products and strategies* - from compliance officer and management
 - *Establish position limits* – not just to limit exposure to risk, but to set a threshold that triggers compliance review.
 - *Maintain an active training program* – One that is up to date and flexible
- Compliance personnel must stay informed of regulatory developments, assess activities that present risk and design rules that limit those risks



Holyoke Gas & Elec., 137 FERC ¶61,159 (2011): Misrepresenting or omitting facts

- Manipulation can occur through misrepresenting or omitting material factual information; Market Behavior Rule, 18 C.F.R. §35.41(a)
- Holyoke serves 13,000 customers and owns 72 MW of generation
- On three occasions, Holyoke conducted planned outages, but it did not schedule the outages with the ISO or otherwise notify the ISO
- In fact, Holyoke offered the out-of-service units into the energy market, so that it could receive capacity payments, and it accepted over \$300,000
- ISO sent next-day dispatch instructions and Holyoke declared a forced outage; ISO called Holyoke and operator volunteered the units were out
- Settlement: Holyoke admitted it misrepresented or omitted material facts
- Agreed to disgorge \$389,000 and committed that it have a compliance program

Holyoke: Monitoring Trading Activities

- Once an organization has established appropriate rules, it needs to monitor market activities. Obviously, what is appropriate for a Big Bank Trader is not going to work for a smaller municipal utility.
- For larger organizations:
 - *Record and retain trader communications for five years* – may include emails, taped telephone conversations, IMs and other media. Traders may only use company-controlled devices, not personal devices
 - *Regularly review employee communications* – monitoring program needed, recognize retained communications can be identify legitimate business activities as well as risks
 - *Periodically review cost-based offers into ISO markets to ensure compliance with rules*
 - *Monitor for changes in volume of make-whole or out-of-market payments*
 - *Create an environment that encourages employees to discuss compliance concerns*
 - *Provide a forum for employees to report possible noncompliance*



PSEG, 163 FERC ¶61,056 (2018): Failing to detect errors

- PJM Tariff permits cost-based offers into the energy market which “shall not exceed the variable cost of producing such energy” plus a 10% adder
- PSEG self-reported inaccuracies in its cost-based offers in 2012-14, which lead to FERC Office of Enforcement non-public investigation
- Multiple errors from 2005-14: including CO₂ adders after NJ withdrew from RGGI program; including seasonal NO_x adders out of season; overstating fuel needed to maintain minimum operation; providing incorrect data on heat rates; and other errors on reporting variable costs
- PSEG’s compliance program did not detect the errors
- Civil penalty of \$8 million, disgorgement of over \$31.4 million

PSEG: Enforcing Rules and Restrictions

- In its Stipulation, PSEG was required to:
 - Adopt procedures to double-check cost-based offers
 - Revise fuel policy to conform to PJM rules
 - Retain independent auditor to advise on new trading procedures
- In general, compliance-related rules must be enforced to be effective
 - Follow up on alerts of potential noncompliance
 - Document the resolution of all alerts
 - Establish and enforce consequences for noncompliance

TAKEAWAYS

- A Compliance Program is a must if you trade or generate in a wholesale energy market ... because “they” are watching!
- An effective Compliance Program:
 - Establishes appropriate rules for transactions
 - Monitors market activities
 - Assesses performance and enforces the rules



QUESTIONS?

Tom Rudebusch



William Rust

