



February 4, 2009

FERC Issues Two Show Cause Orders Alleging That “Multiple-Affiliate Bidding” Constitutes Market Manipulation

On January 15, 2009, over strongly-worded dissents from two of the five commissioners, the Federal Energy Regulatory Commission (FERC) issued two orders¹ directing the respondents to show cause why they should not be found to have violated FERC’s regulations prohibiting market manipulation² and other FERC requirements by submitting bids from multiple affiliates in an open season for interstate pipeline capacity and why civil penalties totaling nearly \$9 million should not be assessed. Attached to each order is a report of FERC’s Office of Enforcement (OE) Staff (OE Staff Reports)³ that sets forth the facts and legal analysis supporting OE Staff’s allegations against the respondents, Seminole Energy Services, LLC (Seminole), along with four of its affiliates (collectively, the Seminole Companies), and National Fuel Marketing, LLC (National Fuel), along with three of its affiliates (collectively, the National Fuel Companies,⁴ and together with the Seminole Companies, the Respondents).

Perhaps the most significant issue in these orders is whether the Respondents’ conduct—multiple-affiliate bidding—violates FERC’s anti-manipulation rule, notwithstanding past FERC orders finding such bidding to be permissible. In finding that such bidding constitutes fraud, the OE Staff Reports emphasize the following factors:

- Seminole and National Fuel used multiple-affiliate bidding to acquire more capacity for themselves than they could have acquired on their own, thereby “gaming” the pipeline’s *pro rata* allocation rules;
- The affiliates had no legitimate need for the capacity; and
- Respondents violated other FERC rules (namely, the prohibition of buy-sell transactions and the shipper-must-have-title requirement) to perfect their alleged frauds.

For more information, contact:

Neil L. Levy
(202) 626-5452
nlevy@kslaw.com

David G. Tewksbury
(202) 626-5454
dtewksbury@kslaw.com

Bruce L. Richardson
(202) 626-5510
brichardson@kslaw.com

Brandon C. Johnson
(202) 626-5409
bcjohnson@kslaw.com

King & Spalding
Washington, DC
1700 Pennsylvania Avenue, NW
Washington, DC 20006-4706
Tel: (202) 737-0500
Fax: (202) 626-3737

www.kslaw.com



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The OE Staff Reports acknowledge that FERC has permitted multiple-affiliate bidding in the past, but reject Respondents' arguments (and by extension, the positions of the two dissenting Commissioners) that OE Staff's position is an unannounced departure from long-standing FERC policy and that it is therefore inappropriate to impose civil penalties without first providing notice of the new policy.

I. FERC's Anti-Manipulation Rule

Congress granted FERC the authority to prohibit market manipulation in the Energy Policy Act of 2005 (EPAAct 2005).⁵ FERC's anti-manipulation rule, which is codified in Section 1c.1 of FERC's regulations, prohibits any entity from: (1) using a fraudulent device, scheme or artifice, or making a material misrepresentation, or engaging in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity; (2) with the requisite *scienter*; (3) in connection with the purchase or sale of natural gas subject to FERC jurisdiction.⁶ FERC may assess civil penalties of up to \$1,000,000 per day per violation of the anti-manipulation rule or other FERC rules, regulations and orders.⁷

II. OE Staff Reports

A. Factual Background

OE Staff initiated its investigation of bidding in the open season conducted by Cheyenne Plains Gas Pipeline Company LLC (Cheyenne) in March 2007 (Cheyenne Open Season) after the FERC Enforcement Hotline received calls from other market participants claiming that some bidders submitted multiple bids through affiliated companies. According to these callers, multiple-affiliate bidding was used to game the *pro rata* mechanism used by Cheyenne to allocate capacity among bidders to obtain multiple shares of Cheyenne capacity at the expense of market participants who submitted only a single bid.⁸

B. Multiple-Affiliate Bidding Constitutes "Fraudulent" Conduct

1. Multiple-Affiliate Bidding Used to Game *Pro Rata* Allocation Method

The OE Staff Reports conclude that the multiple-affiliate bidding at issue in these investigations violates FERC's anti-manipulation rule because Respondents used their respective affiliates' bids to "game" the pipeline's *pro rata* allocation rules. In OE Staff's view, this allowed Seminole and National Fuel to acquire more capacity for themselves than they could have acquired on their own and gave them an unfair advantage over competing bidders who submitted a single bid.

2. Affiliates Had No Legitimate Need for Cheyenne Capacity

In OE Staff's view, the bids by the affiliates of Seminole and National Fuel were not made to satisfy any "legitimate" needs of these affiliates, but rather to obtain more capacity for Seminole and National Fuel, respectively, at the expense of other open season bidders. OE Staff contrasts this purportedly illegitimate use of multiple-affiliate bidding with what it considers a legitimate use by two affiliated companies, which OE Staff chose not to prosecute. The first affiliate was a natural gas exploration and production company



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that bid for capacity on Cheyenne to deliver its gas to markets in the Midwest, while the second was a marketer that bid on capacity to serve its wholesale customers. This conduct was not improper because, in OE Staff's view, the bids were independent and based on satisfying the legitimate needs of each affiliate.

3. Fraud Perfected By Violating Other FERC Rules

In asserting that Respondents' multiple-affiliate bidding was fraudulent, OE Staff also emphasizes that the Respondents violated other FERC requirements. The Seminole Companies allegedly violated FERC's prohibition against buy-sell transactions insofar as Seminole allegedly purchased gas in the market and sold the gas to its affiliates at the Cheyenne receipt point, which the affiliates transported using the capacity awarded to them in the Cheyenne Open Season. Seminole then allegedly repurchased the same gas from its affiliates at the Cheyenne delivery point and resold the gas into the market. The National Fuel Companies allegedly violated FERC's shipper-must-have-title requirement because National Fuel held legal title to the gas transported by its affiliates using the capacity they were awarded in the Cheyenne Open Season.

The OE Staff Reports further emphasize that multiple-affiliate bidding conflicts with FERC's open access policies, which seek to ensure that interstate pipeline capacity is allocated to the shippers who value it most. In OE Staff's view, Respondents' multiple-affiliate bidding (in conjunction with the related violations described above) frustrated this policy by preventing other bidders who valued the capacity equally to share it equally by way of *pro rata* allocation.

C. FERC Precedent on Multiple-Affiliate Bidding

The OE Staff Reports acknowledge that FERC has explicitly permitted multiple-affiliate bidding in the past.⁹ Nevertheless, OE Staff concludes this precedent is not controlling and does not prevent such conduct from violating the anti-manipulation rule because, at the time these previous instances of multiple-affiliate bidding occurred, FERC lacked the anti-manipulation authority granted in EPAct 2005. In OE Staff's view, Order No. 670, which defines fraud generally "to include any action, transaction, or conspiracy for the purpose of impairing, obstructing or defeating a well-functioning market,"¹⁰ placed all market participants on notice that fraudulent conduct is prohibited. The OE Staff Reports thus reject Respondents' claims that they had not been put on notice that such conduct violated FERC rules.¹¹

D. Civil Penalties and Disgorgement

The OE Staff Reports recommend the Seminole Companies be assessed \$4,250,000 in civil penalties and disgorge over \$450,000 and the National Fuel Companies be assessed \$4,500,000 in civil penalties and disgorge any payments received from any of the parties to the Settlement Order. The National Fuel Companies would be assessed the maximum penalty of \$1,000,000 per day per violation (*i.e.*, one violation for each of the National Fuel Companies on the single day the bids were submitted) and the Seminole Companies would be assessed \$750,000 for each of Seminole's and its four affiliates' single violation, which reflects the discount for seeking the advice of counsel.¹² According to OE Staff, these amounts are appropriate because: the violations involved fraudulent conduct, one of the most serious types of violations;



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the conduct was deliberate and intentional; other bidders were harmed because they received less capacity than they would have in the absence of multiple-affiliate bidding; and, because the Respondents maintain their innocence, they have done nothing to remedy the harm caused.¹³

III. Next Steps

The show cause orders direct the Seminole Companies and the National Fuel Companies to provide their answers within 30 days. Following submission of the answers to the show cause orders, FERC may issue an order on the merits, request briefs or set specified issues for a trial-type hearing with full discovery before a FERC administrative law judge (ALJ), request a recommendation or report from an ALJ, or provide for any other process that would justly and efficiently resolve the matter. FERC will also determine the amount of any penalties and disgorgement, if appropriate.¹⁴

Dissents of Commissioners Moeller and Spitzer

The Seminole and National Fuel Show Cause orders were both approved by a 3-2 majority, over the dissenting opinions of Commissioners Moeller and Spitzer.¹⁵ In Commissioner Moeller's view, these two show cause orders violate fundamental principles of fairness and due process, as they each seek to penalize companies millions of dollars for conduct that reasonably may be viewed as consistent with FERC policy. Commissioner Moeller emphasized that the long-standing FERC policy has been to permit multiple affiliated entities to bid on capacity in an open season and the FERC has had multiple opportunities in the past to prohibit such conduct and has chosen not to. Commissioner Moeller added that, although he could support OE Staff's new definition of "legitimate" bids, this interpretation was not disclosed to the Respondents until after OE Staff had concluded the conduct in question violated FERC rules and sought millions of dollars in penalties from them to settle the violations. Finally, Commissioner Moeller stressed that fraud universally requires concealment or misrepresentation, whereas the OE Staff Reports do not include any such allegations.

Commissioner Spitzer's dissenting opinion similarly emphasized that civil penalties are not warranted in light of FERC's approval of multiple-affiliate bidding in the past.¹⁶ In Commissioner Spitzer's view, nothing in EPC Act 2005 or Order No. 670 implicitly or explicitly repealed or reversed FERC's previous policies regarding this practice. Because a reasonable mind could thus have concluded that multiple-affiliate bidding was lawful, Commissioner Spitzer concluded that these proceedings should provide guidance to regulated entities regarding FERC's new policy, rather than assess civil penalties.

¹ See *Seminole Energy Servs., LLC*, 126 FERC ¶ 61,041 (2009); *National Fuel Mktg., LLC*, 126 FERC ¶ 61,042 (2009) ("*National Fuel*"). On the same day, FERC issued an order approving stipulation and consent agreements with several other entities to settle alleged violations arising from similar conduct. See *Tenaska Mktg. Ventures*, 126 FERC ¶ 61,040 (2009) ("*Settlement Order*"). Commissioner Phillip D. Moeller and Commissioner Marc Spitzer issued dissenting opinions for all three orders.



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- ² See 18 C.F.R. § 1c.1 (2008). See also *Prohibition of Energy Market Manipulation*, Order No. 670, FERC Stats. & Regs. ¶ 31,202 (2006).
- ³ Pursuant to recent changes to FERC's enforcement policies and procedures, FERC provides details regarding the factual background of the investigation and proposed findings of fact, conclusions of law, and sanctions in an attached report by OE Staff, rather than in the body of the show cause order itself. See *Enforcement of Statutes, Regulations, and Orders*, 123 FERC ¶ 61,156 (2008) ("*Revised Enforcement Policy Statement*"). There, FERC emphasized that it makes no findings of fact in the order and that FERC will not make any such findings until it has received the response to the show cause order. *Id.* at PP 35-37.
- ⁴ The National Fuel Companies are not affiliated with National Fuel Gas Company. See *National Fuel* at n.1.
- ⁵ EPAAct 2005 § 1281, Pub. L. No. 109-58, 119 Stat. 594 (2005) (*codified at* 16 U.S.C. § 824t (Supp. V 2005)).
- ⁶ 18 C.F.R. § 1c.1 (2008).
- ⁷ 16 U.S.C. § 825o-1 (2000 & Supp. V 2005).
- ⁸ Cheyenne's tariff required open season capacity to be awarded to the shipper submitting the highest bid, up to the maximum tariff rate. Where shippers submitted maximum rate bids for volumes in excess of the available capacity, the Cheyenne tariff required the available capacity to be allocated *pro rata*. So, for example, if ten shippers submitted maximum rate bids for the full amount of available capacity, then each shipper would be awarded one tenth of the available capacity.
- ⁹ See generally *Pacific Gas Transmission Co.*, 56 FERC ¶ 61,192 at 61,721 (1991) ("*PGT*"); *Trailblazer Pipeline Co.*, 103 FERC ¶ 61,225 at P 71 (2003) ("*Trailblazer*"), *order on reh'g and compliance filing*, 108 FERC ¶ 61,049 (2004). The OE Staff Reports further state that the regulations governing open seasons for the Alaska natural gas pipeline had put market participants on notice that FERC would closely monitor multiple-affiliate bidding used to game the open season process. See *Regulations Governing the Conduct of Open Seasons for Alaska Natural Gas Transportation Projects*, Order No. 2005, FERC Stats. & Regs. ¶ 31,174 at P 99 (2005).
- ¹⁰ Order No. 670 at P 50.
- ¹¹ OE Staff rejected Seminole Companies' claim that it lacked the requisite *scierter* because it was acting in good faith reliance on the advice of counsel that bidding by multiple affiliates did not violate FERC rules, but claimed that it gave the Seminole Companies substantial credit for seeking advice of counsel when considering the appropriate civil penalty amount to be levied.
- ¹² The remaining amounts of civil penalties were to be assessed for the other violations discussed above.
- ¹³ See *Revised Enforcement Policy Statement* at PP 54-71 (setting forth the factors that FERC considers in assessing civil penalties).
- ¹⁴ See generally *Statement of Administrative Policy Regarding the Assessment of Civil Penalties*, 117 FERC ¶ 61,317 at PP 6-8 (2006).
- ¹⁵ Former Chairman Joseph T. Kelliher cast the third vote in favor of issuing the two show cause orders. Commissioner Kelliher has recently announced his intention to resign, at which point the remaining Commissioners will be split 2-2.
- ¹⁶ Commissioner Spitzer issued a lengthy dissent to the Settlement Order. He also issued a separate dissenting opinion for each show cause order incorporating by reference his dissent to the Settlement Order.

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