

**Hearing before the Committee on Energy and Commerce,  
Subcommittee on Energy and Power**

**United States House of Representatives**

**2322 Rayburn House Office Building**

**“Discussion Draft on Accountability and Department of Energy Perspective on Title IV:  
Energy Efficiency”**

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Chairman Whitfield, Ranking Member Rush, other members of the Subcommittee, I am William S. Scherman, Chair of the Energy, Regulation and Litigation Group at Gibson, Dunn & Crutcher LLP. I want to thank you for inviting me here today for this important hearing.

At the outset, it is important to note that my testimony today is my own, and I am not speaking on behalf of any of our firm’s clients.

For the last twenty years, I have represented numerous regulated entities in, among other things, numerous enforcement matters and energy market formation issues, both before the Federal Energy Regulatory Commission (the “FERC” or the “Commission”) and before the Federal Courts. I am a former FERC General Counsel, Chief of Staff and Senior Legal and Policy Advisor to the Commission.

Through both my public and private service, I have become extremely familiar with the challenges and efforts of both the Commission and the industry to ensure that our nation’s energy markets and grid remain the most reliable, the most robust and the most efficient in the world. In addition, much of my career has focused on bringing greater competition to our nation’s natural gas and electricity markets.

A great deal of what FERC has done over the last few years to inject greater competition into the nation's natural gas and electricity markets has been successful. But I, along with many other members of the regulated community, energy bar and leading economists, have becoming increasingly concerned that we have recently hit some stumbling blocks, especially as it relates to our nation's electricity markets and how they are regulated. Experience teaches us that it is important that we not rest on our laurels, and that we do everything in our power to ensure the reliability, robustness, and efficiency of our electric grid and that we take all reasonable step to see that the nation's energy markets continue to thrive into the future.

As I will discuss in more detail, an important part of ensuring that competitive markets can continue to grow and flourish is to give regulated entities a meaningful ability to seek advice and guidance from regulators as they attempt to comply with often complex Commission regulations. Equally important, regulated entities that are subject to FERC investigations or enforcement actions must be treated in a manner that fully respects their due process rights – both in practice and perception. FERC investigations and enforcement actions must be conducted in a fair and transparent manner. I have written and spoken extensively on the reality that the subjects of FERC investigations are not being afforded due process of law, and that FERC Enforcement matters are not being administered in a fair and even handed manner.<sup>1</sup> Simply put, the FERC enforcement process is no longer an unbiased exercise of the prosecutorial authority Congress gave FERC in 2005. This has profound implications not only to subjects of investigations, but also for the long term competitive health and liquidity of our markets.

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<sup>1</sup> See, e.g., William Scherman, John Shepherd & Jason Fleischer, *The New FERC Enforcement: Due Process Issues in the Post-EPA 2005 Enforcement Cases*, 31 ENERGY L.J. 55 (2010); William Scherman, Brandon Johnson & Jason Fleischer, *The FERC Enforcement Process: Time For Structural Due Process and Substantive Reforms*, 35 ENERGY L.J. 101 (2014).

As a result, I support the concept contained in discussion draft Section 320 that would help regulated entities achieve greater compliance with FERC regulations. And I strongly support the proposed reforms to the FERC Enforcement Process in Section 4212. The discussion draft is a very good start in restoring fairness and impartiality to the FERC Enforcement Process. These specific proposed reforms, along with several others I will recommend below, are vital to the long term competitiveness of our nation's gas and electric markets.

Finally, as a long-time supporter of competitive and efficient markets, I am concerned that the RTO/ ISO markets around the country have become so complicated and restricted that they no longer bear any resemblance to the true competitive markets they were designed to simulate. While the FERC Office of Enforcement is adamant that market participant actions must be driven by the economics of supply and demand, FERC's piecemeal approach to developing markets rules appears to permit RTO/ISOs to adhere to this basic economic principle in name only. Indeed, it is time for Congress and the FERC to review whether these markets are continuing to produce just, reasonable, and/or not unduly discriminatory results. Indeed, there is a strong case to be made that these markets may no longer fairly and reasonably price the goods and services transacted within the markets. While FERC has attempted to address some of these concerns, they have not been able to achieve any meaningful reforms to date. Therefore, in the absence of FERC action in the very near future, the general market reforms in Section 4221 of the Discussion Draft should be enacted as soon as possible.

It is also time for the Congress to review whether PURPA has outlived its usefulness. Continuing to have a class of generator with a statutory granted advantage has and will continue to cause market dislocations. The Congress should be concerned about the continued inefficiencies created by PURPA's must-purchase obligation, and the resulting above-market

rates paid by consumers. Despite amendments promulgated in EPAAct 2005, utilities still find it increasingly difficult to obtain relief from the must-purchase obligation even when they participate in organized markets and, outside of organized markets such relief is virtually impossible. This is true even where it is clear that those contracts tend to be at above-market prices and for long periods of time, resulting in increased prices for consumers. I agree with the discussion draft's proposed reforms in Section 4231. Combined with certain additions I discuss below, these changes to PURPA would go a long way towards addressing those inefficiencies.

In sum, I applaud the Subcommittee for holding this hearing and addressing the important issues and reforms contained in the proposed discussion draft. I address each of the four key areas below: Improving Transparency in FERC Investigations, the formation of an Office of Compliance Assistance, Energy Market Reforms and PURPA Modifications.

#### **Sec. 4212: Improving Transparency in FERC Investigations**

Over the last few years, FERC's Office of Enforcement has drastically increased in size from less than twenty full time employees to more than two hundred. The Office of Enforcement now has four separate divisions: Investigations, Audits, Energy Market Oversight, and Analytics and Surveillance. The Division of Investigations, arguably the workhorse of the Office of Enforcement, has opened, on average, between 15 and 20 investigations per year over the last five years.<sup>2</sup> Improving the transparency of the Office of Enforcement's efforts is a

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<sup>2</sup> The Office of Enforcement releases an annual Report on Enforcement. These reports are available at <http://www.ferc.gov/enforcement/enforce-res.asp>. According to those reports, the Division of Investigations opened 14 investigations in 2010, 15 in 2011, 16 in 2012, 24 in 2013 and 17 in 2014 for a total of 86 investigations over the last five years that statistics are available. This does not include matters that were self-reported by regulated entities.

laudable and important effort needed to ensure that the subjects of those investigations “receive due process both in perception and in reality.”<sup>3</sup>

Unfortunately, the FERC Enforcement process is no longer fair or a reasonable exercise of prosecutorial authority. It is becoming a common belief among the regulated community and the enforcement bar that entities subject to investigations and enforcement actions do not receive due process either in perception or reality.

For example, entities subject to investigations and enforcement proceedings are completely denied any discovery rights, including access to relevant witnesses, the right to discover documents and data and, at times, even the right to inspect or procure copies of the transcripts of their own depositions. Further, even though the Commission has a policy requiring the disclosure of exculpatory materials, the Office of Enforcement applies the wrong law, leading to such a narrow and restrictive test to such disclosures, that in the more than five years since the policy has been in effect, with more than 85 investigations opened, FERC’s Office of Enforcement has apparently only disclosed exculpatory materials *twice* in public investigations. This lack of due process has effectively barred investigation subjects from obtaining the documents, data and testimony needed to adequately respond to Commission allegations.

Moreover, entities subject to FERC investigations and enforcement proceedings are also routinely denied access to the Commission such that, even if they had access to the information needed to prepare a defense, they would be unlikely to have that defense fairly heard and

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<sup>3</sup> See FERC’s Revised Policy Statement on Enforcement, Enforcement of Statutes, Regulations and Orders, 123 F.E.R.C. ¶ 61,156 at P 21 (2008) (asserting that the Commission’s goal is to “ensur[e] the fairness of [the] investigatory process from the commencement of an investigation until the time it is completed, [and]...to ensure that the subjects of an investigation receive due process both in perception and reality.”).

considered. Entities subject to investigations are specifically denied comparable access to the decision maker—the Commission itself—that Enforcement Staff enjoys for literally years during the investigatory process. While Enforcement Staff is free to hone their case through repeated oral presentations and conversations with the Commission, investigation subjects are limited to written petitions to the Commission that often go unanswered except for “messages” passed on by Staff of the Office of Enforcement. Indeed, this same prohibition exists even during Settlement discussions. While Staff of the Office of Enforcement continues to enjoy unfettered—and unrecorded—access to the Commission, investigation subjects may only engage with the Commission in writing. This is particularly concerning, because the FERC’s rules of practice and procedure specifically bar application of the Commission’s settlement privilege (and other rules and procedures) in investigations. As such, an entity subject to a FERC investigation cannot enter into a frank and open settlement discussion without fear that the Commission may use those written communications against it in the future if settlement negotiations fail.

Simply put, the current FERC Enforcement process is unfair to subjects of investigations and will, if not reformed, hinder if not undermine the long term competitiveness of our natural gas and electricity markets. Therefore I strongly support the four proposed requirements of Section 4212 “Improving Transparency in FERC Investigations.”

The discussion draft would require the Commission to promulgate final rules in four areas that would assist in the reform effort, including requiring the Commission: (1) to disclose all exculpatory, potentially exculpatory or “helpful” materials, to the defense to an investigation subject (2) to disclose transcripts of depositions “within a reasonable period of time” after a deposition is concluded to the deponent, (3) to ensure the establishment of an adequate record by requiring that communications between the Office of Enforcement and the Commission and its

advisory staff be in writing, and (4) to allow investigations subjects equal access to the Commission as that enjoyed by the Office of Enforcement during settlement negotiations. These are important reforms that Congress should pass as soon as possible.

A fifth area that would benefit from a final rule, but that is not included in the discussion draft, would be a requirement that the Commission clarify what actually constitutes “market manipulation” under the Commission’s rules, and memorialize that acting in accordance with a Commission approved tariff, rule or regulation cannot be manipulative activity. In my judgement the Commission is not currently providing “fair notice” of what constitutes market manipulation and is not complying with EPCRA’s requirement that FERC find “fraud” in its investigations, as that term has been defined by the Congress.

In addition, and as I will discuss in more detail below, I make one other recommendation: That the civil penalty assessment provisions of the Natural Gas Act<sup>4</sup> be amended so that it conforms with Section 31(d) of the Federal Power Act.<sup>5</sup>

*Section 4212(1): Disclosure of Exculpatory, Potentially Exculpatory or “Helpful” Materials.*

In 2009, I was lead counsel to Energy Transfer Partners in a much-publicized FERC investigation. In what was a case of first impression at the Commission, we sought from the Commission on behalf of Energy Transfer Partners the disclosure of exculpatory materials subject to the standard set forth in *Brady v. Maryland*<sup>6</sup> that would have been helpful to the defense of that case.

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<sup>4</sup> See 15 U.S.C. 717t-1(b).

<sup>5</sup> As discussed below, FERC Enforcement Staff has recently taken the litigation position that Section 31 (d) of the FPA does not require a full trial de novo in federal district court. This position is plainly inconsistent with the statutory language, prior FERC rulings, and controlling precedent.

<sup>6</sup> 373 U.S. 83 (1963).

In *Brady v. Maryland*, the U.S. Supreme Court held that the government has a constitutional obligation to disclose all evidence that is “favorable to an accused” or that “would tend to exculpate him or reduce the penalty.”<sup>7</sup>

As stated by Judge Friedman of the DC District Court:

The meaning of the term “favorable” under *Brady* is not difficult to discern. It is any information in the possession of the government - broadly defined to include all Executive Branch agencies - that relates to guilt or punishment and that tends to help the defense by either bolstering the defense case or impeaching potential prosecution witnesses. It covers both exculpatory and impeachment evidence.<sup>8</sup>

In *Energy Transfer Partners*, we successfully argued before a FERC administrative law judge that *Brady* applied to administrative agencies, and that the Office of Enforcement had failed to disclose materials that it was required to disclose.<sup>9</sup> While that case settled, the Commission did go on in December of 2009 to issue a policy statement requiring the Office of Enforcement to disclose “exculpatory evidence ‘material to guilt or punishment’ known to the government but unknown to the defendant” or that would otherwise need to be disclosed under *Brady*.<sup>10</sup> Unfortunately, the Commission’s application of that policy has not lived up to the standards of *Brady*. Indeed, in my judgement, the Commission is not complying with *Brady* or its own policy.

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<sup>7</sup> *Id.* at 87-88 (holding that the obligation to disclose “favorable” information is rooted in the Due Process Clause of the Fourteenth Amendment of the U.S. Constitution). The failure to disclose exculpatory materials “violates due process...irrespective of the good faith or bad faith of the prosecution.” *Id.* at 87. The Supreme Court subsequently found that the Fifth Amendment’s Due Process Clause also requires *Brady* disclosure in the context of prosecutions by the federal government. *United States v. Agurs*, 427 U.S. 97, 114-15 (1976).

<sup>8</sup> *United States v. Safavian*, 233 F.R.D. 12, 16-17 (D.D.C. 2005).

<sup>9</sup> *Energy Transfer Partners, L.P.*, FERC Docket No. IN06-3-003, Order Confirming Rulings at Hearing, at 3 (June 9, 2009).

<sup>10</sup> See Policy Statement on Disclosure of Exculpatory Materials, Enforcement of Statutes, Regulations, and Orders, 129 F.E.R.C. ¶ 61,248 at P 2 (2009).

Based upon recent Congressional testimony,<sup>11</sup> the FERC has basically conceded that since the establishment of the Commission's *Brady* Policy, the Office of Enforcement has only disclosed what they consider to be *Brady* materials in *two* public cases, even though the Office of Enforcement's Reports on Enforcement suggest that there have been more than 85 investigations opened during that same period.

Based on this testimony and other statements by Enforcement Staff, along with observations I have made in numerous cases, it is clear that the Office of Enforcement is employing a highly restrictive, *post-trial* standard to its disclosure of exculpatory materials. In other words, the Office of Enforcement is employing the same standard that a court applies *after a trial*, to determine whether there is reversible error. Under the post-trial standard used by the Office of Enforcement, after a trial has concluded, a court can look back on a particular piece of evidence that wasn't disclosed, and determine with some degree of certainty whether having that particular piece of evidence would have changed the outcome of the trial. If the court cannot conclusively say that the piece of evidence would *materially* alter the outcome of the trial, then no reversible error occurred.

But, because no trial has taken place in a FERC investigation, there is no way that the Office of Enforcement can reasonably apply that post-trial standard – and the result is the failure to disclose exculpatory and potentially exculpatory materials to the subjects of investigations that would be useful to the defense.

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<sup>11</sup> See June 17, 2014 Clarification Letter from Norman Bay to Senator Mary L. Landrieu; see also June 12, 2014 Supplemental Responses of Norman Bay to the Committee on Energy and Natural Resources, United States Senate.

As Judge Levine of the CFTC explained:

[T]he pre-trial, post-trial distinction rests on the different circumstances that exist at each stage. An appellate court, applying a post-trial standard, “has the benefit of hindsight, i.e., it can assess the significance of the requested, but not disclosed, evidence against the backdrop of precisely what facts were introduced at trial which demonstrate the defendant's guilt.” This hindsight relates not only to the information presented at trial, but the Court's impressions regarding the eventual strength of the cases presented. . . . The Division, like any other prosecutor, lacks the luxury of hindsight. It cannot accurately predict all the pre-trial decisions of the Court, predict what cases all parties will present, and, finally, predict the Court's evaluation of the relative strength of each party's case and ultimate determinations based on these predictions. Simply put, the Division cannot sensibly and fairly apply its proffered post-trial standard.<sup>12</sup>

The proposed rule, contained in Section 4212(1) of the discussion draft, would require the Commission to disclose “exculpatory materials, potentially exculpatory materials, or materials helpful or potentially helpful to the defense” early enough in the process to be of use to the subject of an investigation. This would bring the Commission closer to compliance with the proper pre-trial standard of *Brady v. Maryland* and would help to ensure due process for investigation subjects. It is an important reform that the Congress should pass.

Section 4212(2): Disclosure of Deposition Transcripts “Within A Reasonable Period of Time” After a Deposition Concludes

Read literally, the Commission's current regulations grant a witness in a FERC enforcement proceeding the right to procure or inspect the official copy of her own deposition transcript:

Transcripts, if any, of investigative testimony shall be recorded solely by the official reporter, or by any other person or means designated by the investigating officer. A witness who has given testimony in an investigation shall be entitled, upon written request, to procure a transcript of the witness' own testimony on payment of the appropriate fees, except

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<sup>12</sup> *In re Matter of Bilello*, 1997 CFTC LEXIS 244, \*18-19 (Oct. 10, 1997).

that in a nonpublic formal investigation, the office responsible for the investigation may for good cause deny such request.

In any event, any witness or his counsel, upon proper identification, shall have the right to inspect the official transcript of the witness' own testimony. This provision supersedes §385.1904(b) of this chapter.<sup>13</sup>

Thus, the plain meaning of the FERC regulations allows FERC to restrict a witnesses' right to procure a transcript *of their own prior testimony* only for "good cause" and there is no limitation of any kind, other than a requirement for the provision of proper identification, that may be placed on the right of a witness inspect a transcript.

These rights track what Congress set forth in Section 555(c) of the Administrative Procedure Act:

A person compelled to submit data or evidence is entitled to retain or, on payment of lawfully prescribed costs, procure a copy or transcript thereof, except that in a nonpublic investigatory proceeding the witness may for good cause be limited to inspection of the official transcript of his testimony.<sup>14</sup>

Despite the plain language of the APA and the FERC's own regulations, the Commission has taken the position in a number of cases that it can deny deponents both their procurement and inspection right until the Commission decides to release the transcript.<sup>15</sup> Indeed, the Commission has taken the position that it need not provide transcripts until well after an investigation is over, and has even asserted that it may *never* need to turn over such transcripts if it decides not to pursue action against that particular deponent. In one case, a witness I represented was deposed

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<sup>13</sup> 18 C.F.R. § 1b.12 (2014).

<sup>14</sup> 5 U.S.C. § 555(c) (2014).

<sup>15</sup> *See. e.g.,* Thomas Olson et al., THE FERC ENFORCEMENT PROCESS, 35 ENERGY L.J. 283, 310 (2010) ("[T]he Commission has decided to balance the witness' needs for immediate access against the risk to the investigation posed by such access. As a result, a majority of the Commission explicitly has affirmed Enforcement's ability to temporarily withhold a transcript, or access to a transcript, in appropriate circumstances."). This interpretation is directly at odds with the plain meaning of the APA and the Commission's own regulations.

by Enforcement Staff *more than ten times* over a two year period, but was denied the right to both procure a copy of or even to inspect the transcripts of his prior depositions. In another example, another client retained me shortly after his first deposition, which was attended by his previous counsel. Despite my repeated requests to inspect a copy of that prior deposition transcript, in order to understand what had occurred previously, the FERC refused to provide a copy or allow access, even though neither I nor any member of my firm had been present for the first deposition. This was a blatant interference in the attorney-client relationship. In yet other cases, including those relating to reliability issues—this behavior is not limited to market manipulation cases—FERC has denied access to transcripts, and has even denied counsel the right to retain copies of exhibits used and provided to counsel during the depositions.

Even more disturbing, FERC has also attempted to restrict the right of counsel to take reasonable notes during depositions. For instance, in some cases, Enforcement Staff has objected to the practice of having legal assistants present during a deposition to take notes, claiming that such note taking is, in effect, creating a duplicate transcript and thus not allowed under section 1b.12 of the Commission’s regulations. Enforcement Staff has also suggested that any note taking with laptops, even by defense counsel, is not permitted for the same reason, and note taking should therefore be restricted to pen and paper.

No reasonable purpose or explanation can be made for denying a witness the right to procure or inspect the transcript *of their own testimony*. Indeed, shortly after its formation, the Commission acknowledged that it would be exceedingly “rare” for the procurement right to be

denied, let alone the unlimited right to inspect.<sup>16</sup> Still, these things occur with troubling frequency.

The proposed rule contained in Section 4212(2), by requiring the provision “of any deposition involving such entity or person within a reasonable period of time after the conclusion of such deposition,” will help to ensure that the Commission provides entities subject to investigations with all of the materials necessary to prepare a defense with sufficient time in which to utilize those materials. I urge the Congress to pass this provision.

*Section 4212(3): Establishing a Record by Requiring Communications between the Office of Enforcement and the Commission to be in Writing.*

The vast majority of FERC investigations and enforcement actions are resolved at the agency level. Moreover, many investigations resolve themselves through settlements between the investigated entity and the Commission. Only a relative handful of cases have progressed to the courts, particularly in the post-EPA 2005 era. As such, often it is the Commission that ends up being the decision maker in most investigations and enforcement actions. Thus, in many cases, the Commission ends up both administering the investigation and settlement processes, and, if cases do not settle, then decides whether to issue a show cause order and assess a civil penalty. In doing so, the Commission acts as prosecutor, judge and jury in enforcement cases.

Throughout most of this process, the Office of Enforcement has unfettered access to and can spend literally years communicating the elements of its cases directly with the Commission. Unfortunately, such communications are generally oral in nature and are not included in the record. And even when they are in writing, the Commission will not disclose the

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<sup>16</sup> *Delegation of the Commission’s Authority to Various Staff Office Directors*, 8 F.E.R.C. ¶ 61,299, at p. 61,888 (1979) (stating that there will only be “rare instances in which a denial [of copies] may be appropriate”).

communications. Thus, Enforcement Staff can say what it wants, when it wants, directly to the Commission about any aspect of an investigation or settlement process with no record kept of any kind.

As a result, the subject of an investigation or enforcement proceeding may never know with any degree of certainty what was said to the Commission, what information was provided to the Commission, nor whether that information might have influenced their decision making process on whether to proceed with a case, or when and how to settle a matter.

It is simply unfair to allow only one side in an enforcement matter to have unfettered access to the Commission. Investigatory subjects should have the right to have notice to, and respond, to such one-sided communications.

These potentially countless communications between the Office of Enforcement and the Commission should be in writing and included in the record so that the target of an investigation can receive them through discovery, and understand what information the Commission was provided before it made its decisions. This would grant investigation subjects comparable access to the information presented to the Commission and allow subjects some opportunity to respond. This would also actually create a meaningful and complete record for de novo or judicial review purposes.

The proposed draft, contained in Section 4212(3) achieves this important fairness goal by requiring such communications to be in writing and included in the record. This common sense approach simply levels the playing field between the Office of Enforcement and the subjects of investigations, and preserves the possibility that an investigation subject may someday discover relevant materials.

Section 4212(4) Allowing Investigation Subjects to Communicate With the Commission on an Equal Footing with the Office of Enforcement During Settlement Discussions

Similar to the issue of requiring the Office of Enforcement's communications with the Commission to be in writing so that a proper record is maintained, is the issue of ensuring that both the Office of Enforcement and the subject of an investigation have equal access to the Commission to present the merits of their case during settlement. This too, is simply a question of leveling the playing field.

Currently, and as discussed above, the Office of Enforcement has the unfettered ability to make oral and written presentations to the Commission up to the issuance of a show cause order.<sup>17</sup> Those oral presentations and any similar communications are not preserved in the record. The subject of an investigation, on the other hand, is only permitted to make *written* presentations to the Commission.<sup>18</sup> Those written presentations are preserved in the record. But, at no time can the subjects directly talk to or converse with the Commission.

For instance, during settlement negotiations, the Office of Enforcement routinely communicates with the Commission to establish a "settlement range." In order to do this, they obviously need to discuss the merits of their case with the Commission and, presumably, the merits of the defense. At the same time, there is no direct avenue for subjects to have their settlement views discussed directly with the Commission. Instead, any such views are communicated through and presented by the Enforcement Staff. The Office of Enforcement simply discusses privately with the Commission the merits and explanations of an entity's

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<sup>17</sup> See generally Notice of Proposed Rulemaking, *Ex Parte Contacts and Separation of Functions*, 123 FERC ¶ 61,158 at PP 7-8, 11 (2008).

<sup>18</sup> See, .e.g., 18 C.F.R. § 1b.18 (2014) ("Any person may, at any time during the course of an investigation, submit documents, statements of facts or memoranda of law for the purpose of explaining said person's position or furnishing evidence which said person considers relevant regarding the matters under investigation.")

settlement position, and can provide their own explanations and responses to the Commission without offering the entity any opportunity to respond to their counter arguments. Such one-sided communications simply do not result in due process for the subject of an investigation.

Exacerbating matters, unlike other adjudications at the Commission, before an order to show cause no settlement protection exists.<sup>19</sup> As a result, because the subject of an investigation is limited to presenting its position to the Commission in writing, while the Office of Enforcement is entitled to present its position orally, the investigation subjects' own submissions can be used against them if settlement negotiations fail and the matter continues, while the Office of Enforcement's presentations are simply not preserved.

The proposal contained in Section 4212(4) will help to ensure a level playing field by requiring the Commission to apply the same requirements to both the Office of Enforcement and the subject of an investigation during settlement negotiations. This will ensure that subjects of investigations are provided the ability to present the merits of their positions on an equal footing with the Office of Enforcement, which should result in fairer, more equitable settlements. In addition, the proposal will serve as a useful method for ensuring that settlement negotiations are conducted properly, and without undue influence, while also ensuring that a sufficient record of the proceedings exists in the event of judicial review.

#### **Other Enforcement Reforms that the Subcommittee Should Consider**

While the reforms suggested under Section 4212 are important ones the Congress should pass, I also urge the subcommittee to consider several additional enforcement reforms.

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<sup>19</sup> See, e.g., Revised Policy Statement on Enforcement, 123 FERC ¶ 61,156, P 38 (2008) ("Following issuance of the Order to Show Cause, potential settlement may proceed in accordance with the requirements of Rule [385.]602 of the Commission's Rules of Practice and Procedure."); see also 18 C.F.R. § 385.101(b) (2014) (exempting investigations under 18.C.F.R. § 1b from the requirements of the Commission's Rules of Practice and Procedure under Part 385).

First, I strongly recommend that this subcommittee also require that the Commission promulgate a final rule to clarify precisely what “market manipulation” means under its rules, and establish safe harbors against enforcement for entities acting in accordance with a Commission-approved tariff, rule or regulation.

This is an issue of increasing concern to entities subject to Commission enforcement proceedings as well as members of the energy bar. This subcommittee is currently considering reforms to FERC-organized markets, but participants in such markets need clarity to ensure that what would otherwise be considered to be reasonable behavior is not subject to an enforcement action because of a lack of clarity as to what constitutes market manipulation.

In EPAct 2005, Congress expanded the FERC’s enforcement authority, enabling it to assess penalties of up to one million dollars per day per violation. Congress also granted FERC new market manipulation enforcement authority, but explicitly required that such enforcement actions must make a finding of fraud. Indeed, the authority granted to FERC closely tracks the similar authority granted to securities and commodity enforcers.

FERC, however, has “defined fraud generally ... to include any action, transaction, or conspiracy for the purpose of impairing, obstructing, or defeating a well-functioning market.”<sup>20</sup> In other words, FERC asserts that actions taken, even actions that are fully in compliance with the applicable tariffs, regulations or rules, may be manipulative solely based on FERC’s after-the-fact determination of fraudulent intent. Moreover, FERC has also asserted that otherwise legitimate actions may be manipulative if they result in consequences that were unintended or unexpected by the market administrator. Such definitions of “fraud” and after-the-fact

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<sup>20</sup> Order No. 670, Prohibition of Energy Market Manipulation, FERC STATS. & REGS ¶ 31,202 at P50, 71 Fed. Reg. 4244, 4253 (2006).

determinations of what is, or is not, permissible simply do not provide market participants with fair notice of what is, or is not, market manipulation.

A recent case illustrates the need for reform in this area. Several days ago the Commission issued an Order Assessing Civil Penalties against Powhatan Energy Fund, LLC and several other entities.<sup>21</sup> In that Order, the Commission describes the manipulation as “a fraudulent ... trading scheme to receive excessive ... payments.” “Excessive.” Not unlawful payments, not unjustified or even undeserved payments, but “excessive” payments. In other words, the Commission has, after the fact, determined that actions taken in accordance with a Commission-approved tariff that result in “excessive” payments was somehow manipulative in nature. There was, of course, no fair notice of what constitutes excessive payments, even if this can be considered market manipulation – which is highly doubtful. At worst, this is evidence suggesting that a Commission-approved tariff is *not* just and reasonable because it results in legitimate payments that are greater than those that the market designers intended or believe are justified. Such after the fact subjective determinations should not be the basis for a market manipulation enforcement case that has the potential to cause lasting harm to persons and entities.

Moreover, the Commission itself has stated on the record in federal court, when pressed to explain its market manipulation standard, “it’s very much in the lines of the famous pornography quote [by Justice Potter Stewart] that you know it when you see it.” The judge

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<sup>21</sup> *Houlian Chen, et al.*, 151 FERC ¶ 61,179 (May 29, 2015).

responded directly: “I don't think our administrative law depends on that proposition, or it'd better not.”<sup>22</sup>

Clarification on this issue is needed desperately, and I urge the subcommittee to act.

Second, it is important that the Congress recognize that the Commission is not currently following the plain language and meaning of the *de novo* review provisions of Section 31(d) of the Federal Power Act. Under the plain language of Section 31(d), entities subject to enforcement action continue to have the right to elect either hearing at the Commission subject to the Administrative Procedure Act, or a *de novo* trial in Federal District Court subject to the Federal Rules of Civil Procedure.

This permits the subject of an enforcement action to elect one of two procedural paths once the Commission has made an initial assessment that a penalty may be assessed. The subject of an enforcement action can elect *either*: (a) an adjudication before a FERC administrative law judge, followed by a Commission determination of penalty, *or* (b) a summary assessment of a penalty by the Commission, followed by a full trial and adjudication before a Federal District Court. All of the prior precedent, legislative history and FERC's prior course of action agree that the election by an investigation subject of the federal district court procedure “lead[s] to a trial *de novo*.”<sup>23</sup>

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<sup>22</sup> See Oral Argument Transcript, 39:22-40:30, *FERC v. Lincoln Paper & Tissue, LLC*, No. 1:13-CV-13056 (D. Mass. July 18, 2014).

<sup>23</sup> 1988 FPA Section 31 Procedures, at 32,038 (election of Section 31(d)(3) “lead[s] to a *de novo* trial”); see also *Consumers Power Co.*, 68 FERC ¶ 61,077 at 61,380 (1994) (“[S]ection 31(d)[(3)] requires . . . a trial *de novo* in federal court.”); *Energy Transfer Partners, L.P.*, 121 FERC ¶ 61,282, PP 34, 77 (2007) (the same language as in Section 31(d)(3) of the FPA gives a party “an *affirmative right* to receive review of the Commission's assessment in a *trial de novo in district court*.”) (emphasis added); S. REP. NO. 100-70, at 23 (June 12, 1988); see also H.R. CONF. REP. NO. 95-1752, at 121 (Oct. 10, 1978) (the same language used in Section 31(d)(3) results in “a trial *de novo* in the appropriate district court of the United States”).

That notwithstanding, in several currently active cases, the FERC Litigation Staff has set forth the novel interpretation that the election of district court procedures under Section 31(d) leads only to a deferential review of FERC's summary penalty assessment order, and that the subject of the enforcement action is not entitled to a trial de novo including the right to discovery or any of the other traditional trappings of a real federal district court trial.

The Congress should be aware of the Commission's position, and advise the Commission that the language in Section 31(d) of the Federal Power Act unequivocally establishes the right to a full trial de novo of the law and facts.

Once this is done, the similar provision of the Natural Gas Act should be amended so that it follows the exact same procedures as the Federal Power Act. This was supposed to have occurred during the final days of EAct 2005 but got lost in the last minute editing process. I note that Senator Murkowski has introduced legislation in S. 1216 to amend the Natural Gas Act in precisely this fashion. I strongly support Senator Murkowski's initiative and recommend that this subcommittee do the same and also promulgate additional legislation to amend the Natural Gas Act in a similar fashion. There is simply no reason to have different procedures for the two main statutes – the FPA and NGA – the Commission administers. And allowing for full and comprehensive de novo review in all gas and electric cases provides an important due process and constitutional safeguard that subjects will get a fair day in court should they so choose.

#### **Sec. 320: Office of Compliance Assistance**

The discussion draft also recommends the creation of an Office of Compliance Assistance at FERC which would help to “promote improved compliance with Commission rules and orders” through, in part, “providing entities regulated by the Commission the opportunity to obtain timely, including real-time, compliance guidance.”

Currently at the Commission, regulated entities often can get informal advice and guidance from the advisory staff on a variety of subject matters. This can be very helpful and should continue. However, it is more difficult to get and *rely on* informal guidance on compliance issues on non-enforcement matters in the absence of the advisory staff being able to point to Commission precedent. Far more problematic, however, it is that it is very difficult to get meaningful compliance advice from the Enforcement Staff. Enforcement Staff will routinely refuse to opine on the legality of particular activities, even when such activities are actively under investigation. For instance, in certain trading cases, the Office of Enforcement has refused to opine on whether a particular trade or market strategy would be in compliance with the governing tariff or rule. This can partly be explained by the Office of Enforcement's belief that a violation of the Commission's rule against market manipulation does not necessarily need to also include a violation of a rule or tariff.

Moreover, there have been several industry efforts in recent years to present the Enforcement Staff with model compliance manuals or plans. These have represented best practice approaches from a broad and diverse group of industry members. While the Enforcement Staff has been willing to receive such proposed best practices, they have been unwilling to respond to the proposals in any meaningful way. For instance, the Office of Enforcement has not been willing to say whether any entity that had complied with the model compliance plan or a best practice would be entitled to a rebuttable presumption that they were in compliance with relevant FERC regulations. Nor has the Office of Enforcement been willing to say whether the model plans or best practices would create any kind of safe harbor against potential enforcement proceedings.

There are obvious strong public policy reasons for the Commission to spend more of its time and resources ensuring up front compliance with its regulations. This approach promotes regulatory certainty and ultimately a more stable market environment for efficient transactions and investments

As a result, it would be sound to adapt a process that would work with the existing informal process that now exists with the advisory staff while providing a meaningful process on compliance matters, especially with OE. The ability to acquire “real-time,” meaningful guidance will assist entities in making sure that they are in and remain in compliance with the Commission’s rules and regulations.

#### **Sec. 4221: Evaluating and Improving Wholesale Electricity Markets**

As the Subcommittee is aware, the nation has come to rely on the efficient operation of the natural gas and electric markets that FERC oversees. For instance, the competitiveness of our natural gas market is the envy of the world and has benefited consumers and industry alike for many years. The competitive benefits realized from introducing competition to the gas markets underpinned much of the FERC’s thinking in introducing and promoting greater competition in the electric markets. FERC plays a critical role in regulating these markets on a day to day and long term basis.

While the organized electric markets have served consumers well,<sup>24</sup> since their inception the Commission has not taken a hard and holistic review of whether each market continues to function properly and produce just and reasonable results. Yet as far back as 2006, FERC stated that it “will continue to monitor wholesale markets as they evolve and will consider changes in

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<sup>24</sup> This is not to suggest that bi-lateral electricity markets do not produce efficient and reasonable results. Parts of the West and South regions of the country operate bi-lateral electric markets that provide significant consumer benefits.

its regulations as may be necessary to assure that wholesale markets are well-functioning and result in just and reasonable energy prices.”<sup>25</sup> The lack of such a global market review has creating a policy vacuum. In turn, efforts at reforming the markets have been piecemeal, inefficient and ineffective in my view.

For instance, prior recent efforts have looked in a piecemeal manner at either the energy markets or capacity markets and whether each continues to remain just and reasonable. But to date, the Commission has not considered both in unison. These markets, however, are inextricably linked (by design as well as effect) and one should not be reviewed and reformed in isolation. Such piecemeal approaches to date have been unsuccessful at addressing market imperfections. But as market dislocations continue to grow, piecemeal efforts at reform have resulted in constant changes to the rules such that participants enjoy no rule stability, and thus, no ability to reasonably predict market outcomes. This lack of stability stifles investment and growth and, by derivation, long-term reliability.

As the RTO/ ISO markets have become more and more complicated and restricted, a strong argument can be made that they no longer bear any resemblance to the competitive markets they were designed to simulate. While FERC appears to insist that market participant actions must be driven by the economics of supply and demand, FERC’s piecemeal approach to developing markets rules appears to permit RTO/ISOs to often adhere to this basic economic principle in name only. The result is that the markets may be no longer producing results that are just, reasonable, and/or not unduly discriminatory.

These market distortions adversely impact sellers and consumers, creating long-term risks for the viability of the markets. An “Economics 101” principle is that uncertainty adversely

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<sup>25</sup> 114 FERC ¶ 61,165 at P 54.

harms markets. But it appears that market distortions brought about by the current layer of complicated administrative “market” rules may be having a similar adverse impact as uncertainty suppresses investment in both generation and transmission. Generation investment is suppressed as entities cannot forecast with reasonable certainty whether new investment will earn a reasonable return in the energy markets. Transmission investment is suppressed insofar as economic-based, as opposed to reliability-based, projects depend on market price forecasts and market dynamics. Lack of infrastructure investment adversely affects consumers through lower supply and more aged supply. Of course, all of this is occurring at a time when there is a national consensus that the country needs significant new energy infrastructure.

The proposed discussion draft would, as proposed, bring much needed reforms to electricity markets to ensure that the market rules in each RTO/ISO market continues to result in well-functioning and efficient markets. These reforms should result in reasonable and fair rates for the goods and services being provided by market participants and paid for by consumers, and improve the reliability of the nation’s electric grid. I strongly support these much-needed reforms.

First, the proposal would require regional entities to revise market rules such that they would encourage fair rates for both ratepayers and market participants by “result[ing] in just and reasonable rates for rate payers,” “properly valu[ing] generation facilities that have reliability attributes,” and “provid[ing] accurate price formation in energy markets” through a number of specific, yet important requirements. Currently, many RTO/ISO pricing mechanisms do not properly value capacity resources. And while the Commission has an ongoing “price formation” inquiry, it is not clear whether that effort will produce any meaningful reform without Congressional action and prodding.

The proposal in Section 4221 would also require that out-of-market payments and dispatches are minimized, and improve transparency where and when they occur. Out of market dispatches typically occur when a generation unit or other asset is needed for reliability purposes but would otherwise not be called upon in the ordinary course. Such dispatches allow a market operator to “skip” over other units that may be more economic, but may not have the same ability to address a particular reliability or system need. However, there is strong evidence in several of the RTO/ISOs that some market operators are over using out of market intervention for a variety of reasons. And there is evidence that some RTO/ISOs are using these out of market dispatches to attempt to keep energy prices artificially low, rather than solely to address reliability or other legitimate market needs. The proposal would limit such dispatches and would, therefore, likely result in more accurate price signals and price discovery. This would minimize distorted market prices and provide a more realistic assessment of the true value of the goods and services being offered.

The proposal would also benefit system reliability by requiring energy market rules to “facilitate fuel diversity, resource adequacy, and reliability,” “promote the equitable integration and treatment of generation resources, business models, and advanced grid technologies” and “facilitate the development of necessary natural gas and electric transmission infrastructure.”

While these issues speak for themselves, I note that the energy industry is currently under pressure on multiple fronts to increase reliability while simultaneously reducing emissions and reducing costs. A fair and measured approach—such as that in the discussion draft—will hopefully enable FERC and regional entities to continue to improve system reliability while simultaneously addressing the other pressures they face.

And finally, the proposal in Section 4221 would also aid in on-going efforts to improve the energy markets by requiring regional organizations to “identify and address regulatory barriers to entry, market-distorting incentives, and artificial constraints on competition” by “ensur[ing] fairness and improved transparency in governance structures and stakeholder processes, including meaningful participation by both voting and non-voting stakeholder representatives” and by “mitigate[ing], to the extent practicable, any disruptive effects of tariff revisions on the economic decision-making of market participants.” The current governance structures of the RTO/ISO, especially the so-called stakeholder processes, have become quite cumbersome and inefficient. This often leads to least common denominator decision-making that stifles truly efficient market reforms and competitive outcomes.

It is time to determine whether the current market design rules of each RTO/ISO are continuing to produce competitive results that are just and reasonable. The Commission has the ability to do this now under its existing authority. Unfortunately, Commission efforts to date have been unsuccessful at making these vital determinations and addressing these market imperfections. Hopefully the reforms in Section 4221 will spur Commission action sooner rather than later. If not, Congress will need to step in.

#### **Sec. 4231: PURPA Modernization**

Before addressing the specific proposal regarding proposed amendments to the Public Utility Regulatory Policies Act of 1978 (“PURPA”), it is important to take a step back and ask a key question: Has PURPA has outlived its usefulness? Answering that question should start by understanding the original purpose behind PURPA.

Almost 40 years ago, Congress approved PURPA in conjunction with the Natural Gas Policy Act which, in part, imposed certain price controls on natural gas while simultaneously deregulating portions of gas wellhead markets. PURPA’s goal was to promote conservation of

energy, the optimization and efficient use of electric generation facilities and resources, and to ensure equitable rates for consumers. More specifically, Congress used PURPA to encourage growth in the renewable energy sector, in part through the same mandatory purchase obligation that would be amended by the proposal in the discussion draft.

PURPA's mandatory purchase obligation, found in Section 210, requires utilities to purchase electricity generated from certain qualifying facilities ("QFs") that have less than 80 megawatts of installed capacity. The utilities are required to purchase this electricity regardless of whether it is needed or not, or whether it is the most cost-effective or efficient means of procuring that electricity.

In EPAct 2005, Congress amended PURPA to limit the mandatory purchase requirement in cases where FERC finds that the QF has nondiscriminatory access. As a result FERC created a rebuttable presumption that QFs with an installed capacity *larger* than 20 MWs have nondiscriminatory access to at least one of the seven ISO/RTO markets. FERC also created a rebuttable presumption that QFs with an installed capacity *smaller* than 20 MWs lack nondiscriminatory access, even where they are located in an RTO/ISO. As a general rule, utilities have been relieved of the must purchase obligation in each of the seven RTO/ISO markets for QFs larger than 20 MWs, but only in very rare instances, and never to my knowledge on a utility-wide basis, have they been relieved of the must-purchase obligation for QFs smaller than 20 MWs. Utilities outside the RTOs/ISOs have little to no ability to avoid the mandatory purchase obligation for QFs of any size.

Therefore, despite the EPAct 2005 amendments, many utilities have incurred significant and unnecessary costs associated with the must-purchase obligation. In many instances, the power produced by the QFs is either not needed by the utility, or must be purchased at a price

higher than the utility could otherwise procure the electricity on the open market or generate it itself. When the “avoid cost” rate under must-purchase contracts are higher than current market rates, resulting in electricity consumers are paying more for electricity than they otherwise would. These “subsidies” have begun to shift rising power costs to customers and begun to undermine the competitive markets.

Thus, it is time for the Congress to review whether PURPA has outlived its usefulness. Continuing to have a class of generator with a statutory granted advantage has and will continue to cause market dislocation and undermine long term competitive outcomes.

The discussion draft’s proposals contained in Section 4231 are a good start. However, the Congress should consider adding the words “Transmission, Interconnection Services, and” before both instances of the word wholesale, so that the subsection would read:

(8) PRESUMPTION OF NONDISCRIMINATORY ACCESS TO TRANSMISSION, INTERCONNECTION SERVICES, AND WHOLESALE MARKETS.—For purposes of paragraph (1), a qualifying cogeneration facility of any size or a qualifying small power production facility of any size is presumed to have nondiscriminatory access to transmission, interconnection services, and wholesale markets described in sub paragraph (A), (B), or (C) of such paragraph if the facility, in the relevant market—

This additional language will provide greater clarity and likely reduce litigation by more closely mirroring the language FERC uses to describe the access QFs need to both transmission and competitive market elements.

## **Summary**

In summary, I would like to stress a few points.

First, there must be structural and due process reforms to the FERC enforcement process. It is imperative that the subjects of FERC investigations and enforcement proceedings receive true and meaningful due process of law—both substantively and procedurally. Too often, those subject to such proceedings believe that they are confronted by an Agency that not only continues to redraw the playing field, but also tries to hide the ball by refusing to turn over or disclose relevant and important information. Unless there are structural and procedural reforms to the process, competitive markets will be harmed and market participants will continue to flee from participation. The resulting reduction in liquidity and price discovery will not sustain these markets in the long run.

The proposed reforms do nothing more than try to level the playing field. It is simple fairness to require FERC to disclose exculpatory or potentially exculpatory information, to turn over transcripts of witnesses' own depositions, and to allow equal access to the Commission by both the Office of Enforcement and the subject of an investigation. If FERC truly believes that its rules and regulations have been violated, then there is no reason why they would want to restrict the subject of an investigation or enforcement proceeding from having a full and fair trial on the merits where FERC's views can be fairly tested.

Second, it is also imperative that our nation's electric grid and energy markets continue to be both reliable and fair, in order to ensure continued service at just and reasonable rates. There is strong evidence that the RTO/ISO markets are no longer truly balancing supply and demand and that they no longer reflect bedrock economic principles that are the hallmark of true competitive markets. While FERC has attempted to address some of these fundamental

problems, the suggested reforms will either prompt FERC to act on its own sooner rather than later or will be truly necessary to restore these markets to their initial competitive promise.

Third, PURPA reforms will provide greater efficiency in electricity generation around the country and should be adopted.

Thank you, and I am happy to answer any questions you may have.