July 18, 2012

FERC Issues Orders Proposing Substantial Civil Penalties for Alleged Market Manipulation in New England's Load Response Program

The Federal Energy Regulatory Commission ("FERC") issued four orders, each of which directs a participant in New England's prior Day-Ahead Load Response Program ("DALR Program") to show cause why it should not be found to have violated Federal Power Act and FERC prohibitions against energy market manipulation and, as a result, to disgorge payments received and be assessed substantial civil penalties (totaling nearly $26.5 million in the aggregate). The four participants include two end-users, Rumford Paper Company ("Rumford") and Lincoln Paper and Tissue ("Lincoln"); a consulting firm, Competitive Energy Services ("CES"); and an individual, Richard Silkman, a principal of CES (collectively, "DR Participants"). The orders are based on allegations, contained in reports by the FERC's Office of Enforcement ("OE"), that DR Participants fraudulently inflated the day-to-day energy consumption values used to set a baseline from which payments for load reductions would be measured. OE alleges that the conduct of the participants named resulted in unjustified payments by all New England rate payers that should be disgorged, in addition to the proposed penalties for the DR Participants' conduct. The orders present compelling reminders and valuable lessons for all participants in FERC-regulated energy markets, and particularly the demand response markets, to ensure they have in place programs and controls carefully designed to ensure effective compliance with both the letter and the spirit of FERC rules and regulations. Failure to do so puts participants, both companies and individuals, at risk of substantial liability.

Background

During the period covered by the orders (July 2007 to February 2008), ISO New England Inc. ("ISO-NE") administered a demand response program designed to reduce demand (and prices) for electricity in New England during the hours of the day when demand for electricity was heaviest (and electricity prices highest). These demand times were defined to be between 7 a.m. and 6 p.m. on business days, and Rumford and Lincoln were to be paid for reducing demand (and thereby energy prices) in New England during those peak hours. Payments under the DALR Program were based on the amount of reduction bid and accepted into the day-ahead energy market and actually reduced during the peak periods. "Actual" reduction was measured as the difference between the amount of energy Rumford and Lincoln would have used absent participation in the program, which is referred to as their baseline, and the amount that was actually used during the periods when the DR Participant committed to reduce.

The Orders

The orders allege that during the 2007-08 period, Lincoln and Rumford (at the suggestion and with the assistance of CES and Silkman) adopted and implemented plans to intentionally inflate the baselines submitted to ISO-NE, and to maintain those inflated baselines in order to maximize payments for reductions from their usual load (which in fact were not reductions at all). Pursuant to those plans, OE alleges Lincoln and Rumford participated in the DALR Program, operated normally, yet claimed to be reducing load from their inflated baselines, and were compensated for such claimed (but alleged to be phantom) energy reductions. As a result of this participation in the DALR Program, Lincoln, Rumford and CES (by way of commissions) received payments totaling nearly $3.4 million.

Proposed Penalties & Disgorgement

The orders direct DR Participants to demonstrate why their alleged violations should not result in the following civil penalties and disgorgements (plus interest), as applicable:

	Civil Penalty	*Disgorgement*
Rumford Paper Company	$13.25 million	$2,836,419
Lincoln Paper and Tissue	$4.4 million	$379,016
Competitive Energy Services	$7.5 million	$166,841
Richard Silkman	$1.25 million	n/a

Investigative and Administrative Processes

The orders were preceded by lengthy investigative and administrative processes. Following a nonpublic preliminary investigation of DR Participants' activities, OE issued on January 25, 2011, notices of alleged violation ("NoV") identifying its preliminary determinations that each of the DR Participants had violated the FERC's prohibition against electric energy market manipulation. The NoVs were issued pursuant to an earlier FERC order intended to increase the transparency of OE staff's investigations.[1] That order requires NoVs be issued only after the subject of an enforcement investigation has either responded or had the opportunity to respond to a preliminary findings letter detailing OE staff's conclusions regarding the subject's conduct.

The DR Participants' NoVs were among the first issued by the FERC under that new procedure. OE reported that it engaged DR Participants in settlement discussions following the NoVs but was unable to reach a settlement with any of them. Subsequent to issuing the NoVs and continuing its investigations, on April 17, 2012, almost 15 months after issuing the NoVs, OE submitted to the Commission OE's reports and recommendations (a copy of which was included as an appendix to the order issued in each case). The Commission responded three months later with these orders.

DR Participants have until August 16, 2012, to file their respective answers to the show cause orders. In their answers, DR Participants must choose to either (i) have the case heard before a FERC-appointed administrative law judge, or (ii) be assessed an immediate penalty by the FERC.

Lessons

The orders are among the first in which the FERC applies its penalty guidelines in a show cause order, and they contain an informative discussion about the application of those guidelines. Commissioner Cheryl A. LaFleur's concurrences in the Rumford, Lincoln and CES orders take exception to the specific application of those guidelines, explaining her view that the DR Participants were being double penalized by adders designed to account for duration of the alleged manipulation. Commissioner LaFleur would have preferred that the majority exercise its discretion in its application of the guidelines so as not to double count for the particularly long duration of the alleged misconduct.

It is instructive to note that OE investigated and FERC affirmed the plans to hold all persons and organizations involved in FERC-jurisdictional transaction(s), including the ultimate consumers themselves, responsible for compliance with FERC anti-market manipulation requirements, on the view that all such conduct and manipulation is "in connection with" a FERC-jurisdictional transaction.

It is worth noting also that, in each of the Rumford, Lincoln and CES orders, OE found the lack of an effective compliance program at the time of the violations. Specifically, there were no procedures in place to detect compliance violations, no training of employees regarding the regulatory requirements governing DALR Program participation, and no individual ultimately responsible for ensuring compliance with regulatory requirements. Even smaller companies, OE noted, should have basic policies in place to ensure employees act in a manner consistent with FERC regulatory requirements.

These orders provide another reminder that all market participants would be well-served to ensure their compliance programs are structured to minimize the risk of market conduct that regulators might reasonably view as manipulation. OE has indicated it is placing a priority on addressing market manipulation concerns, and our own experiences working with clients on compliance matters reinforce this fact. Strong compliance programs reduce not only the risk of missteps but also the possible penalties if missteps occur.

Our attorneys have significant experience advising clients on designing, assessing, and implementing compliance programs that mitigate and ameliorate energy market compliance risks, as well as on the specific operation and requirements of the New England markets in general and on demand response markets in particular. If you have any questions concerning the orders specifically or energy market compliance issues generally, please contact any of the attorneys listed in this alert.

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[1] Enforcement of Statutes, Regulations, and Orders, 129 FERC 61,247 (2009), order on reh'g, 134 FERC 61,054 (2011).