

**Testimony of Larry D. Gasteiger  
Acting Director, Office of Enforcement  
Federal Energy Regulatory Commission  
Before the Permanent Subcommittee on Investigations  
United States Senate  
November 21, 2014**

Mr. Chairman, Ranking Member McCain, and Members of the Subcommittee:

Thank you for inviting me to testify today. My name is Larry Gasteiger, and I am the Acting Director of the Office of Enforcement of the Federal Energy Regulatory Commission (FERC, or the Commission). I appear before you as a staff witness, and the views I present are not necessarily those of the Commission or any individual Commissioner. In my testimony, I will summarize the Commission's authorities and responsibilities regarding its ability to investigate manipulation of electricity prices and markets, ensure just and reasonable energy prices, and support grid reliability, and in so doing will respond to the Subcommittee's specific questions in its hearing invitation.

**I. FERC Responsibilities and Authorities**

**a. Prohibition on Market Manipulation**

The Commission's statutory authority and responsibility to investigate market manipulation in FERC-jurisdictional energy markets is the Energy Policy Act of 2005 (EPAcT 2005). Following Enron's manipulation of the Western energy markets, Congress passed EPAcT 2005, which broadly prohibited market manipulation in FERC-regulated wholesale physical natural gas and electric markets. Congress patterned EPAcT 2005's

fraud and manipulation prohibition on the similarly broad anti-fraud and anti-manipulation provisions in the Securities and Exchange Act of 1934. Shortly after EAct 2005 was passed, the Commission implemented its new statutory authority through its anti-manipulation regulations, codified at 18 C.F.R. Section 1c. The Commission relies on the anti-manipulation authority granted in EAct 2005 to investigate potential fraud or market manipulation and, when a matter cannot settle on terms found to be within the public interest, bring enforcement actions against companies or individuals who engage in fraud or manipulation affecting FERC-regulated markets.

In EAct 2005, Congress also significantly enhanced the Commission's ability to impose civil penalties for violations of FERC rules, including fraud and manipulation, by increasing maximum civil penalties from only \$10,000 per violation per day, to up to \$1 million per violation per day. These changes strengthened FERC's ability to carry out a robust enforcement program. To date, the Commission has imposed and collected approximately \$902 million in civil penalties and disgorgement following EAct 2005. This consists of over \$602 million in civil penalties, which were distributed to the U.S. Treasury, and almost \$300 million in disgorgement of unjust profits, which were returned to affected market participants and consumers. (This amount does not include fines in electric market manipulation matters to be reviewed in federal court, for example, the approximately \$453 million civil penalties assessed by the Commission in the pending *Barclays* market manipulation matter.)

## **b. Ensure Just and Reasonable Energy Prices**

The Commission also has the fundamental responsibility, under the Federal Power Act (FPA) Sections 205 and 206 and Natural Gas Act (NGA) Sections 4 and 5, to ensure “just and reasonable” prices in wholesale power and natural gas markets and other jurisdictional transactions. FPA Section 206 and NGA Section 5 authorize the Commission to investigate, on its own motion or upon complaint, jurisdictional rates and terms of service. If the Commission determines that such rates or terms of service do not meet the statutory standard, it must determine and establish the just and reasonable rate or term of service to be observed.

## **c. Protect Grid Reliability**

Another aspect of FERC’s authority is to protect the reliability of the nation’s bulk power system, which it carries out through review and approval of mandatory reliability standards, as well as through audits of reliability programs and investigations of potential violations of the standards. Pursuant to Section 215 of the Federal Power Act, the Commission certified the North American Electric Reliability Corporation (NERC) as the “Electric Reliability Organization.” There are also eight Regional Entities, to which the Electric Reliability Organization may delegate authority for proposing regional reliability standards and enforcing all reliability standards, and carrying out day-to-day reliability responsibilities. Under the structure established by Congress in Section 215, NERC proposes mandatory reliability standards for the bulk power system, and the Commission

has the authority to approve the standards. In 2007, in Order No. 693,<sup>1</sup> the Commission approved the initial Reliability Standards, which became mandatory and enforceable that year. NERC and the Commission may carry out investigations together, or the Commission may do so independently.

To date, the Commission has completed and assessed civil penalties in eleven reliability investigations, nine of them conducted jointly with NERC. The eleven penalties assessed in reliability settlements range from \$50,000 to \$25,000,000 and total \$47.1 million. The most recent three reliability settlements arose out of the 2011 blackout of San Diego, Yuma, Arizona, and Baja California, Mexico, which left at least 5 million individuals without power for up to 12 hours.

## **II. Enforcement Cases Regarding Manipulation Schemes Involving Banks**

The Subcommittee has specifically asked about the Commission's investigation and enforcement efforts related to electricity price manipulation schemes involving financial institutions. A number of such cases have been part of our efforts in the past few years. Although the mechanics of a manipulative scheme can be highly detailed and complex, in many of these investigations, the market manipulation scheme at issue follows the same general pattern—a trader moves prices of physical energy in the Commission's jurisdiction in order to benefit a related position held in the financial markets. This type of manipulation scheme is possible because prices in the physical

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<sup>1</sup> *Mandatory Reliability Standards for the Bulk-Power System*, Order No. 693, FERC Stats. & Regs. ¶ 31,242, *order on reh'g*, Order No. 693-A, 120 FERC ¶ 61,053 (2007).

energy markets can serve as the basis for the prices of related financial products, such as swaps, futures contracts, other derivatives, or Financial Transmission Rights. Because the physical and financial markets are interrelated, transactions of physical energy can be used to manipulate a physical price either up or down for the purpose of increasing the value of a related financial position whose value is tied to (and indeed may settle directly on) that physical price. The trader may lose money in the physical markets as part of his manipulative scheme, but nonetheless profit overall because his financial position is more highly leveraged than his physical position—that is, his gains in the financial markets outweigh (sometimes significantly) the physical losses incurred to produce those gains.

Understanding the purpose behind the physical and financial transactions is one of the key elements of a manipulation case. If the subject intended, or acted recklessly, to move prices or distort the proper functioning of FERC-jurisdictional energy markets, that satisfies the fraudulent intent element of a manipulation case. If the subject, however, engaged in transactions based on the supply and demand fundamentals of the market, or based on hedging risk, those circumstances, absent more, do not constitute manipulative intent and therefore do not violate the Commission’s anti-manipulation rule. Our approach to market manipulation cases (like other potential violations of Commission rules, regulations, and orders) is to pay rigorous attention to the specific facts of a case—and just as we do not hesitate to seek penalties and bring enforcement actions against market manipulators, we do not hesitate to close investigations where the facts show there was no violation.

Given the importance that Congress has placed on FERC's role in policing market fraud and manipulation—rightfully so, given the wide disruption such schemes can cause to wholesale energy markets and harm to consumers—the Office of Enforcement's effort to combat fraud and market manipulation has been and will continue to be its top priority. Of the settlements Enforcement has reached in the past three years, approximately one-third involve fraud and manipulation.

Let me turn to the three cases that you asked me to discuss, which involved JP Morgan Chase, Deutsche Bank, and Barclays.

Fraud and manipulation can take other forms than the physical trading-financial position framework described above. A notable example is the Commission's July 2013 settlement with a wholly-owned subsidiary of JP Morgan which, among other terms, required JP Morgan to pay a combined \$410 million in civil penalties and disgorgement to ratepayers.<sup>2</sup>

The JP Morgan case involved gaming of two regional electric markets. This settlement resolved the Office of Enforcement's investigation into 12 manipulative bidding strategies designed to make profits from power plants that were usually out of the money in the marketplace. In these manipulative strategies, which are described in greater detail in the settlement agreement and order approving it, the JP Morgan subsidiary defrauded market operators in California (the California Independent System

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<sup>2</sup> See *In Re Make-Whole Payments and Related Bidding Strategies*, 144 FERC ¶ 61,068 (2013).

Operator, known as CAISO) and the Midcontinent ISO (MISO) by making bids into these markets that were not grounded in the normal forces of supply and demand, and were expected to, and did, lose money at market rates. The JP Morgan subsidiary's purpose in submitting these bids was not to make money based on market fundamentals, but to create artificial conditions that would cause the CAISO and MISO systems to pay the company outside the market at premium rates. Enforcement staff also determined that JP Morgan knew that the CAISO and MISO markets received no benefit from making these inflated payments and, thus, the company defrauded these market operators by obtaining payments for benefits it did not deliver.

Another recent settlement, our January 2013 settlement with Deutsche Bank, resolved our investigation into conduct that more neatly fits the physical trading-financial position framework.<sup>3</sup> Deutsche Bank held a type of energy contract commonly used to hedge against, or profit from, the “congestion” on a transmission line that occurs when the line cannot carry all the electricity needed at a particular supply or delivery point on the grid. These contracts are often called Financial Transmission Rights or FTRs—though in the CAISO market at issue in the *Deutsche Bank* matter, they are called Congestion Revenue Rights (CRRs). In early 2010, Deutsche Bank began to lose money on its CRR contracts. The company initially sought to limit its losses by purchasing new CRRs in the CAISO market to reduce its exposure to congestion. But these new CRR

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<sup>3</sup> See *Deutsche Bank Energy Trading, LLC*, 142 FERC ¶ 61,056 (2013).

purchases did not fully cover its losses. So Deutsche Bank's energy traders devised and implemented a manipulative scheme that involved buying and selling physical electricity so as to alter congestion levels, and resulting market prices, at the same point corresponding to its CRR contracts. These physical transactions (in addition to violating the CAISO tariff) were unprofitable and inconsistent with market fundamentals, but did have the effect of increasing the value (*i.e.*, by limiting losses) of Deutsche Bank's CRRs.

In short, Deutsche Bank used physical energy transactions to affect congestion levels and corresponding energy prices within CAISO in order to increase the value of its CRR contracts—in violation of EAct 2005 and the Commission's anti-manipulation rule.

The Commission's July 2013 Order Assessing Civil Penalties in *Barclays* addressed conduct that also fit this framework.<sup>4</sup> The Commission's assessment of civil penalties and disgorgement in *Barclays* is currently under review in federal district court in Sacramento, so the litigation is ongoing. That being said, I can provide a brief description based on published Commission orders.

Barclays and its energy traders amassed substantial positions of physical electricity contracts through their transactions on the IntercontinentalExchange (ICE) trading platform. Barclays and its traders also assembled a financial swaps position at four

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<sup>4</sup> See *Barclays Bank, PLC, et al.*, 144 FERC ¶ 61,041 (2013).



important trading points in Western energy markets, whose value was pegged to published electricity price indices set by the physical electric contracts Barclays traded. The Commission found that Barclays engaged in manipulative physical trades to “flatten out” the physical electricity positions it had amassed on its trading books in a manner designed to influence the index prices that determined the value of its swaps. Barclays’s physical trading was uneconomic and not based on market fundamentals; indeed, the company often lost money in the physical markets. But Barclays’s physical trading nonetheless profited the company overall because its trades helped move the index price that set the value of its larger financial swaps benefiting position.

### **III. Surveillance Efforts to Identify Manipulation in the Electricity Markets**

The Subcommittee has asked about FERC’s efforts to identify price manipulation in both physical and financial markets related to electricity. In the last few years, FERC has enhanced its abilities in this area by adding surveillance tools, expert staff, and new analytical capabilities. In 2012, the Commission established a dedicated unit for market surveillance and analysis, called the Division of Analytics and Surveillance (DAS) in the Office of Enforcement. There are approximately 45 professionals in our DAS unit, including economists, energy industry analysts, former traders, and former risk managers. They develop surveillance tools, analyze transactional and market data to detect potential manipulation and anticompetitive behavior, and assist in the analytical rigors of market manipulation investigations.

DAS employs sophisticated market screens as the centerpiece of its surveillance program. Based on statistical analysis and behavioral patterns, staff has built automated processes that it uses to evaluate market data to identify suspicious trading activity. For example, market screens can help staff identify problematic trading by monitoring the interactions between bidding strategies and potentially benefiting physical and financial positions. Other screens identify patterns in offers for physical energy which result in abnormal out of market payments. As Commission rulemakings in the last few years have expanded data sources, DAS has incorporated new information into its screens and gained greater visibility into trading between markets.

In the past year, FERC's surveillance and enforcement efforts have been enhanced by information-sharing with the Commodity Futures Trading Commission (CFTC). Because the electric markets are interrelated with financial markets containing power-based products and indices, relevant financial data in manipulation cases is often found in markets regulated by the CFTC. This past January, FERC and the CFTC signed a Memorandum of Understanding to enable the agencies to share surveillance-related information. So far this year, the implementation of the MOU has assisted FERC's investigative efforts. Also this year, FERC began receiving a daily feed of data from the CFTC's Large Trader Report (LTR), which includes participant-level open financial positions for certain energy products. The LTR has proven to be very useful to our surveillance work, especially for identifying potentially manipulative conduct. Going forward, the LTR will continue to be a significant resource for our surveillance and

enforcement efforts.

In addition to their surveillance work, DAS staff works closely with the Division of Investigations, which includes approximately 45 attorneys and other staff who conduct investigations and bring enforcement actions. DAS refers suspicious conduct for possible investigation, provides data analysis in ongoing investigations, and gives other expert assistance.

Thus, the Office of Enforcement is in a better position than ever to identify and enforce the Commission's rules when violations occur. Our DAS unit has developed into a sophisticated, well-staffed operation that has been able to continually refine its surveillance of the markets. Our Division of Investigations has a top-notch staff of attorneys and support professionals to carry out the mandates in EPAct 2005 and bring enforcement actions under those new authorities. Increased cooperation with other regulators, including the CFTC, but also the Department of Justice, United States Attorneys' Offices, the Securities and Exchange Commission, the Federal Trade Commission, and the Federal Reserve, has also advanced our mission.

The Subcommittee has asked about any impediments to FERC's surveillance and investigative efforts. On the whole, FERC has the resources and tools it needs to effectively police FERC-regulated markets. One limitation, however, follows from the decision by the U.S. Court of Appeals for the District of Columbia Circuit last year in *Hunter v. FERC*, 711 F.3d 155 (D.C. Cir. 2013). In *Hunter*, FERC brought an

enforcement action against the market manipulation by a trader at the Amaranth hedge fund. After the Commission assessed a \$30 million penalty, the court ruled that the CFTC's exclusive jurisdiction over futures contracts deprives FERC of authority to bring an action based on manipulation in the futures market, even if the activity affected prices in the physical markets for which FERC has exclusive jurisdiction. Although the Commission reads the *Hunter* decision as narrow in scope, some market participants interpret the decision more broadly to cover not only manipulation in the futures market, but also many additional transactions and products, including those squarely within FERC's jurisdictional markets. Accordingly, a legislative fix to eliminate uncertainty on this matter could ensure that FERC has the full authority needed to police manipulation of wholesale physical natural gas and electric markets.

#### **IV. Reliability Compliance**

I know the Subcommittee is also interested in patterns of grid reliability compliance or other reliability efforts in connection with bank owners or bank operators of power plants. While we have not discerned any patterns regarding official enforcement actions for reliability failures in connection with bank owners or operators, there is at least one instance in which a bank's actions had the potential to impact reliability efforts.

In summer 2012, the California grid system operator, CAISO, identified a need for additional voltage support in Southern California for the following summer due to the

outage of a generating station during a time of peak demand.<sup>5</sup> CAISO designated two generating units in Huntington Beach, which had been taken out of service, as “reliability must-run units,” and sought to convert the units in order to produce the needed voltage support, which CAISO pursued as the only feasible option given the short time frame. A JP Morgan Chase subsidiary had an agreement with the owner and operator of those two generating units, and though the owner agreed to the conversion project, it did not believe it could move forward without the consent of JP Morgan, which refused its consent. CAISO pressed JP Morgan to allow the reliability project to proceed, but the bank protested. When CAISO sought relief from the Commission, JP Morgan responded that the dispute was essentially a private dispute over a business contract, over which the Commission held no jurisdiction.

In January 2013, the Commission issued an order, determining that JP Morgan’s agreement for the sale at wholesale of capacity and energy produced by those units was within the Commission’s jurisdiction. Moreover, it determined that JP Morgan’s consent was not necessary for the reliability project to proceed, and that the bank’s questions about CAISO’s reliability decisions were beyond the scope of the proceeding because CAISO’s solution was feasible and well within its authority. Ultimately, JP Morgan transferred its agreement regarding the two plants, among others, to Southern California

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<sup>5</sup> *Cal. Indep. Sys. Operator Corp.*, 142 FERC ¶ 61,016 (Order on petition for declaratory order) (2013).

Edison Company, which consented to the reliability project.<sup>6</sup>

## **V. Role of Financial Institutions**

Another topic the Subcommittee has asked about is whether financial holding company involvement with physical energy production has affected how those financial institutions approach the power plant business. The Commission has not taken any view on the participation in its regulated markets by financial holding companies (or any trading firm, bank, or other financial institution) versus more traditional energy companies like generators or utilities. Instead, the Commission's general view has been that financial institutions of all kinds, as well as energy companies of all kinds, can benefit markets in numerous ways. However, the Commission expects financial institutions, like all other participants in FERC-regulated markets, to have good compliance programs, transact in a manner that follows market rules in letter and spirit, work cooperatively with grid operators and the Commission when there are concerns, and self-report potential violations.

With regard to reliability, the model is structured in such a way that all users, owners, and operators of the Bulk Power System must register with NERC for the defined functions each performs. By this registration, each entity's roles and responsibilities are clearly defined, as are the specific reliability standards to which each

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<sup>6</sup> *Cal. Indep. Sys. Operator Corp.*, 145 FERC ¶ 61,004 (Order on rehearing) (2013). The transfer of rights mooted the issue, which was Commission's rationale in dismissing JP Morgan's additional litigation. *Id.*

must comply.<sup>7</sup> The reliability standards require generators to operate their units (provide more or less power) as needed and directed by system operators (i.e., reliability coordinators, transmission operators, and balancing authorities). So long as the generator owners devote the time, effort, and resources required to be in compliance with the applicable reliability standards, the Commission has not found it necessary to restrict ownership of individual generation projects to traditional generators or affiliates.

In conclusion, I want to thank the Subcommittee for the invitation to testify today. I look forward to answering any questions you may have.

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<sup>7</sup> See NERC Statement of Compliance Registry Criteria, [http://www.nerc.com/FilingsOrders/us/RuleOfProcedureDL/Appendix\\_5B\\_RegistrationCriteria\\_20140701\\_updated\\_20140602%20\(updated\).pdf](http://www.nerc.com/FilingsOrders/us/RuleOfProcedureDL/Appendix_5B_RegistrationCriteria_20140701_updated_20140602%20(updated).pdf)