

ORAL ARGUMENT IS NOT YET SCHEDULED

**IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT**

No. 04-1168

(Consolidated with Nos. 04-1170, 04-1188, 04-1235, 04-1237, 04-1238)

**CINERGY MARKETING & TRADING, LP, *et al.*,
PETITIONERS,**

v.

**FEDERAL ENERGY REGULATORY COMMISSION,
RESPONDENT.**

**ON PETITION FOR REVIEW OF ORDERS OF THE
FEDERAL ENERGY REGULATORY COMMISSION**

**BRIEF FOR RESPONDENT
FEDERAL ENERGY REGULATORY COMMISSION**

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GLOSSARY

CA Petitioners	Petitioners California State Parties and Consumer Advocates
Electric Rehearing Order	<i>Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorization</i> , 107 FERC ¶ 61,178 (2004)
Electric Rules Order	<i>Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorization</i> , 105 FERC ¶ 61,218 (2003)
FPA	Federal Power Act, 16 U.S.C. § 824 <i>et seq.</i>
Gas Rehearing Order	<i>In the Matter of Amendments to Sales Certificates</i> , 107 FERC ¶ 61,174 (2004)
MBR regime	Market-based rate regime
MP Parties	Market Participant Petitioners
NGA	Natural Gas Act, 15 U.S.C. § 717, <i>et seq.</i>
NGPA	Natural Gas Policy Act, Pub. L. 95-621 (Nov. 8, 1978), 92 Stat. 3350, <i>codified at</i> 15 U.S.C. § 3301 <i>et seq.</i>
Order No. 644	<i>Amendments to Blanket Sales Certificates</i> , FERC Stats. * Regs. ¶ 31,153 (2003)
Proposed Rules Order	<i>Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorization</i> , 103 FERC ¶ 61,349 (2003)
Western	Petitioner Western Resources, Inc.

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**ON PETITION FOR REVIEW OF ORDERS OF THE
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**BRIEF FOR RESPONDENT
FEDERAL ENERGY REGULATORY COMMISSION**

STATEMENT OF THE ISSUES

1. Whether the Federal Energy Regulatory Commission ("Commission" or "FERC") properly found that, to be just and reasonable, market-based rate tariffs of public utilities and natural gas companies subject to FERC jurisdiction under the Federal Power Act ("FPA"), 16 U.S.C. § 824 *et seq.*, and the Natural Gas Act ("NGA"), 15 U.S.C. § 717 *et seq.*, respectively, must include, among other things, a provision that prohibits any type of market manipulation.

2. Whether the Commission properly determined that certain natural gas sales do not meet the definition of “first sales” within the meaning of the Natural Gas Policy Act of 1978 (“NGPA”), Pub. L. 95-621 (Nov. 8, 1978), 92 Stat. 3350, *codified at* 15 U.S.C. § 3301 *et seq.*, and thus fall within the scope of FERC’s NGA jurisdiction.

3. Whether the Commission adopted appropriate remedies and procedures to resolve alleged violations of the market behavior rules.

4. Whether FERC’s market-based rate regime satisfies the Commission’s statutory consumer protection responsibilities.

PERTINENT STATUTORY AND REGULATORY PROVISIONS

Pertinent sections of the NGA, the NGPA, and the FPA, and the regulations thereunder, are set out in an addendum to this Brief. In addition, Appendix A includes the Market Behavior Rules and the Remedy and Complaint Procedures at issue.

STATEMENT OF THE CASE

I. Nature of the Case, Course of Proceedings, and Disposition Below

This case resulted from Commission concern that existing tariffs and blanket certificates allowing for market-based rates did not sufficiently assure the consumer protection that is at the heart of FERC’s responsibilities under the FPA and the NGA. In response to that concern, the Commission in late 2001 “proposed to condition all new and existing market-based rate tariffs and authorizations to include a provision

prohibiting the seller from engaging in anticompetitive behavior or the exercise of market power.” *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 103 FERC ¶ 61,349 at P 1 (2003)(“Proposed Rules Order”).

The instant proceeding, commenced under FPA § 206, *id.* at P 10, JA , proposed tariff provisions designed to protect against problems encountered as part of the implementation of organized energy markets around the country, particularly those encountered in the California energy markets during 2000-01. *Id.* at P 4, JA . Paper hearing procedures were established with comments and reply comments; in addition, FERC Staff held a technical conference in March 2001 to address the proposed tariff provisions that was followed by more comments. *Id.* at P 12, JA .

The Proposed Rules Order put forward a set of market behavior rules for inclusion with all market-based rate tariffs and authorizations, *see generally id.* at pp. 62,375-78 and 62,380-81, JA and , and invited comments and reply comments. *Id.* p. 62,380 at P (D). On November 17, 2003, the Commission established market behavior rules: on the electric side, the rules were set out in *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 105 FERC ¶ 61,218 (2003)(“Electric Rules Order”), JA ; and, on the natural gas side, comparable regulations were set in *Amendments to Blanket Sales Certificates*, FERC Stats.& Regs. ¶ 31,153 (2003)(“Order No. 644”), JA . Both orders set out, *inter alia*, a general

prohibition against market manipulation. *See* Order No. 644 at P 27, JA (setting out proposed 18 C.F.R. §284.288(a)) *and* Electric Rules Order at P 35, JA (setting out Rule 2).

Parties sought rehearing of both orders, which were generally denied, albeit with modifications to Rule 2's language. *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 107 FERC ¶ 61,175 (2004) ("Electric Rehearing Order")JA , and *In the Matter of Amendment Sales Certificates*, 107 FERC ¶ 61,174 (2004)("Gas Rehearing Order"), JA .

The petitions for review followed.

II. STATEMENT OF FACTS

A. Statutory and Regulatory Background

FERC has been delegated authority to set just and reasonable rates for the wholesale sale of: (1) electric energy by FPA §§ 205 and 206, 16 U.S.C. §§ 824d and 824e, and (2) natural gas by NGA §§ 4, 5, and 7, 15 U.S.C. §§ 717c, 717d, and 717f. The underlying proceeding arose from FERC's concern that the then-existing language of the tariffs and blanket certificates authorizing sellers to employ market-based rate pricing was inadequate to assure the level of customer protection required by the FPA and the NGA. Proposed Rules Order at P 1, JA . To remedy those concerns, the

Commission instituted proceedings under FPA § 206 and NGA § 5 to promulgate market behavior rules applicable to all sellers with market-based rate authority.

The primary goal of customer protection had to be balanced against the need for notice and a fact-specific resolution process in the promulgation of the rules:

first, the need to provide for effective remedies on behalf of customers in the event anticompetitive behavior or other market abuses occur; second, the need to provide clearly-delineated ‘rules of the road’ to market-based rate sellers while, at the same time, not impairing the Commission’s ability to provide remedies for market abuses whose precise form and nature cannot be envisioned today; and third, the need to provide reasonable bounds within which conditions on market conduct will be implemented so as not to create unlimited regulatory uncertainty for individual market participants or harm to the marketplace in general.

Electric Rules Order at P 4, JA .

B. Events Leading To And the Orders On Review

A paper hearing was conducted as part of the rules’ promulgation, with parties having an opportunity to file comments, reply comments, and to participate in a technical conference that led to another round of comments. *See* Electric Rules Order, Appendix C, JA and Order No. 644, Appendix A, JA (both listing parties that filed comments). The comments “generally concurred that establishing a clear set of market behavior standards governing sellers’ conduct in the wholesale markets is necessary.” Electric Rules Order at P 8, JA . Nonetheless, parties took issue with different aspects of the proposed rules.

1. Market Behavior Rule 2

Rule 2 prohibits manipulative conduct, and was envisioned “to capture manipulative conduct in all its forms. . . [and] to prohibit market-based rate sellers from taking actions which interfere with the prices that would otherwise be set by competitive forces, or from manipulating market conditions or market rules.” *Id.* at P 36, JA (footnote omitted). Comments questioned inclusion of “legitimate business purpose” as a part of Rule 2, but its inclusion would allow “sellers acting in a pro-competitive manner [to] have the opportunity to show that their actions were not designed to distort prices or otherwise manipulate the market.” *Id.* at P 37, JA ; *see id.* at P 44, JA (same); *see also* Order No. 644 at P 35, JA (stating term is “intended to give sellers some latitude in determining their business actions, while safeguarding market participants against market manipulation for which there can be no legitimate business purpose”).

Responding to comments questioning the need for Rule 2 given other tools available to protect energy markets, the Commission found it “reflects the reality that [FERC] oversee[s:] a dynamic and evolving market where addressing yesterday’s concerns may not address tomorrow’s.” *Id.* at P 39, JA . Rule 2 along with the other

Rules¹ serve a dual purpose: a step “to assure just and reasonable rates for a specific transaction” as well as a means of “providing guidance to sellers in general.” *Id.* Reconciling those purposes for violations would occur during the remedy analysis where FERC “will take into account factors such as how self evident the violation is and whether such violation is part of a pattern of manipulative conduct.” *Id.*

When a violation of Rule 2 is alleged, the threshold question would be whether “the facts presented appear to warrant further inquiry into whether the transaction appears to be of a questionable purpose,” such as “whether the action was designed to lead to (or could foreseeably lead to) a distorted price not reflective of a competitive market.” *Id.* at P 42, JA . Such “case-by-case” analysis would seek to determine “when, and if, a strategy employed by a seller lacks a legitimate business purpose.” *Id.* at P 44, JA . When a Rules violation is alleged as grounds to abrogate a contract, another element of the required showing is “to demonstrate that such a violation had a direct nexus to contract formation and tainted contract formation itself.” *Id.* at P 45.

Petitioners and others sought rehearing on grounds that Rule 2 was vague and overbroad, was too narrow, and should not require a direct nexus showing for contract

¹ Notwithstanding that as presented (*see* Appendix A hereto) Rule 2 encompasses several subsections, each subsection is treated as a separate Rule. *See, e.g.*, Electric Rules Order at PP 46-58, JA (discussing Market Rule 2(a) –wash trades).

