The Energy Law Advisor

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A Practical Examination of the Regulatory Oversight of Energy Marketing & Trading Companies in the United States

I. <u>Introduction</u>

Global energy marketing and trading companies are subject to the oversight of multiple regulatory bodies across many jurisdictions. In the United States ("US") alone energy marketing and trading firms are regulated by the:

- Commodity Futures Trading Commission ("CFTC");
- Federal Energy Regulatory Commission ("FERC");
- Federal Trade Commission ("FTC");
- Chicago Mercantile Exchange ("CME"); and
- Department of Justice ("DOJ").

Each regulator has its own rules and regulations that must be complied with; as a result energy marketing and trading companies are increasingly finding that regulatory risk is rising to the top of the list of risks impacting their business and are having to devote significant time and resources to regulatory compliance.

A good regulatory compliance program not only prevents violations of rules and regulations as well as alerting counsel and/or compliance officers to possible violations, but it curbs behavior that, although does not necessarily violate any rules or regulations, appears to do so. The optics of behavior create the same level of regulatory risk from regulatory inquiry and investigation as actual violations.

Section II of this article presents hypothetical marketing and trading scenarios, and the US law, rule and/or regulation that is applicable to each scenario. The scenarios provide practical examples of how an in-house counsel and/or compliance officer may approach everyday marketing and trading situations. In addition, the scenarios illustrate how both actual violations and behaviors that seem to be violations may be viewed by US regulators.

II. Scenarios

A. Scenario

Natural Gas Company ("NGC"), the natural gas marketing and trading division of a large integrated oil company located in Houston, Texas, would like to enter into an agency agreement to manage the full supply requirements of ABC, Co. ("ABC"), a non-affiliated local distribution company, using ABC's transportation and storage assets.

NGC intends to optimize ABC's transportation assets by utilizing the capacity to make delivered supply sales to XYZ, Co ("XYZ"), an electricity company.

Application of Legislation and/or Regulation to the Scenario

NGC would like to enter into an agency agreement (the "Agency Agreement") with ABC, which would enable NGC to utilize ABC's transportation and storage assets. In return, NGC offers to manage ABC's natural gas supply requirements. NGC also intends to use the capacity to make delivered sales to XYZ.

This type of Agency Agreement is not permissible since NGC intends to also use the capacity to make delivered sales to XYZ. This would violate the Shipper-Must-Have-Title rule. The Shipper-Must-Have-Title rule requires any entity paying for transportation or storage on an interstate natural gas pipeline must have title to the gas it is shipping or storing. Under this requirement, all shippers must hold title to the gas when it is delivered to the transporting pipeline and while it is being transported or stored by the pipeline. The FERC does not require intent to violate the Shipper-Must-Have-Title rule. NGC cannot move natural gas that it owns on capacity owned by ABC. For this to be permissible the transaction would need to be structured as an asset management agreement (the "AMA").

An Agency Agreement with respect to transportation and storage capacity permits the capacity holder to designate a third party as its agent to manage the capacity, such as handling nominations, scheduling, invoicing, etc. The agent would be authorized to interact directly with the pipeline company in managing the capacity on behalf of the capacity holder. The agent is not permitted to use the gas transportation capacity for its own purposes.

An AMA requires one party, the asset manager, to manage the gas transportation and storage assets (e.g. pipeline capacity or storage capacity) of another, coupled with other requirements. By doing so, the asset manager may utilize the transportation, or storage, assets for its own purposes. An Agency Agreement on the other hand merely permits the agent to manage the assets on behalf of the capacity holder. The agent may not use the capacity to ship any gas other than the gas to which the capacity holder has title, as per the Shipper-Must-Have-Title rule.

The FERC has specific requirements with regards to the release of transportation, or storage, capacity to an asset manager. In general, AMAs must be pre-negotiated and must allow the releasing shipper to demand delivery, or sale, of a certain volume of natural gas for a particular period of time. For AMAs of 12-month

period or more, the asset manager must, when called upon, deliver, or purchase, 100 of the daily contract amount for at least 5-months out of the 12-month period. For AMAs of less than a 12-month period, the asset manager's delivery, or purchase, obligation applies to the lesser of 5-months or the term of the AMA. A properly formed AMA allows the asset manager to utilize the transportation, or storage, assets for its own purposes.

B. Scenario

Trader A is a natural gas trader working for NG Trading Company ("NGT") located in Houston, Texas. NGT is a clearing member of the CME. As a regular supplier of natural gas to the US northeastern region, Trader A uses NYMEX Henry Hub futures contracts, which trade on the CME, to manage price risk on his supply commitments.

Though inventories have shrunk in the US northeastern region due to pipeline constraints, Trader A would like to withhold his own volume in local storage in an attempt to realize higher sales prices. With shortages expected to continue, Trader A would like to take a 1,000 lot long position in the NYMEX Henry Hub futures contract. Trader A plans to hold the long position until the expiration of the contract.

Trader A plans to sell his entire long futures position back into the market on the day of expiration.

Application of Legislation and/or Regulation to the Scenario

NGT is subject to the jurisdiction of the CFTC and the FERC. The Commodity Exchange Act ("CEA") gives the CFTC jurisdiction to regulate physical transactions and OTC contracts (e.g. swaps) and options, as well as exchange-traded futures and options on futures contracts. The Natural Gas Act ("NGA") and the Natural Gas Policy Act ("NGPA") gives FERC jurisdiction to regulate the sale for resale of natural gas in US interstate commerce.

NGT is subject to the rules of the CME. The CME requires members, like NGT, to act in accordance with certain trading and sales practices, including acting with integrity and in a manner that does not manipulate the market. The Chief Regulatory Officer of the CME is responsible for enforcing the rules of the CME and is responsible for the coordination of investigations of alleged violations of rules and market conditions. NGT, as a clearing member, must provide an accurate inventory of open positions to the CME in a manner prescribed by the CME.

NGT is permitted to use futures contracts to hedge price risk of his physical position. There is no rule prohibiting a company that holds a physical position from trading in futures and/or OTC swaps. In this scenario, NGT is selling futures to hedge against a decrease in price to the physical, underlying commodity.

NGT is permitted to withhold physical supply from the market if he has a legitimate commercial reason to do so, which is backed by his view on the direction of

the market. There is no rule that requires a physical supplier to sell physical supply into a market. NGT may attempt to profit from an increase in the physical price of the commodity.

NGT, however, should be very careful as to the optics that this may present to others in the market and/or regulators. Due to the optics, the CFTC and the FERC may bring an action for market manipulation and/or attempted manipulation.

Under the CEA and applicable CFTC precedent, to establish actual market manipulation, the CFTC must prove all of the following:

- The ability to influence market prices;
- A specific intent to create an artificial price;
- That an artificial price occurred; and
- The person accused of the market manipulation was the proximate cause of the artificial price.

The CFTC also has a cause of action called attempted market manipulation, making it unlawful to attempt to manipulate any commodity market. Attempted market manipulation occurs when:

- There is a specific intent to cause an artificial price; and
- There is an overt act in furtherance of this intent.

In circumstances prior to the effectuation of the Dodd-Frank Market Manipulation Rule, the CFTC had to, for practical reasons, allege attempted market manipulation because it did not have to prove that an artificial price had occurred and that the accused caused the artificial price. This meant that a person could have been found guilty of attempted manipulation even if his/her actions were unsuccessful or could never have been successful.

The Dodd-Frank Market Manipulation Rule makes it unlawful for any person, directly or indirectly, in connection with any swap, contract of sale of any commodity, or contract for future delivery subject to the rules of any regulated exchange or trading facility, to intentionally or recklessly:

- Use or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud;
- Make, or attempt to make, any untrue or misleading statement of a material fact or to omit to state a material fact necessary to make the statements made not untrue or misleading;
- Engage, or attempt to engage, in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any person; or
- Deliver or cause to be delivered, or attempt to deliver or cause to be delivered, a false or
  misleading or inaccurate report concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce, knowing, or acting in reckless disregard of the fact that such report is false, misleading or inaccurate. Notwithstanding the foregoing, no violation of this

subsection shall exist where the person mistakenly transmits, in good faith, false or misleading or inaccurate information to a price reporting service.

There is no guarantee that the CFTC and/or FERC will be successful in its action, but the mere bringing of an action by these regulators can be harmful to NGT. Therefore, NGT should always consider the following before engaging in certain actions:

- Does the entity have the ability to create an artificial price?
- Does the entity have the intent to create an artificial price?
- Is NGT acting recklessly in the market as to cause a fraud in the market?
- Is NGT engaging in an act, practice or course of business that could be seen as a fraud or deceit in the market?

NGT is permitted to hold a position in futures contracts. There is no rule disallowing NGT, a physical commodity supplier, for holding a position in futures contracts beyond what is needed to hedge its physical supply. NGT may buy 1,000 lots of the NYMEX Henry Hub futures contracts.

NGT is permitted to hold the 1,000 long NYMEX Henry Hub futures position so long as it is within the position limit and/or his hedge exemption. Currently the CME sets position limit levels that are applicable to each specific contract. Currently the position limit levels only apply to "spot month" contracts. The current spot month position limit for the NYMEX Henry Hub futures contract is 1,500 lots.

NGT is permitted to take a position on Inter-Continental Exchange ("ICE"), as well as holding a position on NYMEX. There is no rule requiring NGT to trade in one market. Prior to Dodd-Frank, physically-settled and financially-settled OTC energy commodity transactions were either excluded or exempt from most provisions of the CEA. This meant that entities that were Eligible Contract Participants ("ECP") were permitted to engage in OTC energy commodity swap transactions off of the regulated exchange. Under Dodd-Frank, certain energy commodity swap transactions are required to be cleared. The CFTC is in the process of identifying which swaps will be subject to mandatory clearing. Therefore, under Dodd-Frank, NGT would have no difference between its NYMEX position and its ICE position, as both would be cleared to NYMEX.

NGT may sell its entire long futures position back into the market on the day of expiration. NGT should, however, be very careful to be sure that this is not seen as banging the close. Prior to Dodd-Frank, the CME had rules that prohibited banging the close, or engaging in activity during the closing period of a futures contract in order to affect the price of the futures contract. Under Dodd-Frank, the CFTC has a rule in which it classifies banging the close as a Disruptive Trading Practice that is punishable by the CFTC.

C. <u>Scenario</u>

Trader C buys and sells physical oil for Region Oil Co. Initially Trader C plans to sell oil into the US West Coast. However, Trader C is subsequently contacted by a trader at another company seeking to buy oil into the US Gulf Coast. The trader informs Trader C that doing so will enable him to meet a delivery requirement into the Gulf Coast. There is a developing shortage of oil supplies in the West Coast area.

Trader C plans to redirect the oil from his original US West Coast deliveries and instead, deliver the oil to the Gulf Coast over the next 2 weeks.

Application of Legislation and/or Regulation to the Scenario

Although the scenario does not specify where Region Oil Co. is located, Region Oil Co. is subject to the jurisdiction of the CFTC due to its activities in the US commodities market, in addition to the FTC to the extent the FTC has jurisdiction over wholesale petroleum markets to prevent market manipulation.

Trader C may engage with traders from other companies for the purpose of negotiations in order to enter into a transaction with such trader. The US Antitrust laws prohibit the exchange of non-public, competitively-sensitive business information because exchanges of such information may reduce the incentive to compete. The other trader's divulgence to Trader C of his requirements in the Gulf Coast are questionable. Such information may be seen as non-public and competitively-sensitive.

Trader C may change his mind as to where he plans to sell his oil supply. There is no rule that requires a trader to only have one intention for a transaction and to execute that transaction with no change.

In this scenario, similar to scenario 1 and 2, Region Oil Co. needs to be careful of the optics surrounding the transaction. The shortage in the West Coast may cause an increase in price in the West Coast region, which would typically mean that Trader C would find it favorable to sell his supply in that region. If Trader C does not actually do so, the regulator has a stronger case for a violation of US Antitrust laws.

Not only would regulators have a claim for antitrust violations, the FTC and the CFTC could also bring a claim for market manipulation and attempted market manipulation (in the case of the CFTC). To bring a claim for market manipulation the FTC and the CFTC would have to prove that the entity knowingly engaged in any act, practice or course of business that operates, or would operate, as a fraud or deceit upon any person. The FTC has not yet brought a case for market manipulation; however, it could be argued that this is a fraud upon the market because Trader C is selling in a location where the supply and demand fundamentals do not warrant the sale.

The CFTC also makes it unlawful to attempt to manipulate any commodity market. Although in this hypothetical Trader C did not actually redirect the oil, as of yet; he planned to do so over the next two weeks. This may be seen as an overt act in furtherance of an intent to create an artificial price. It is irrelevant that Trader C may not

actually do so or that he may change his mind. The plan may be enough to qualify this as an overt act.

III. Conclusion

The scenarios above provide an insight into how regulatory bodies would apply their regulations to energy marketing and trading activities in the US markets. With such heightened regulatory risk, companies need to not only be aware of the rules and regulations but of the optics of certain activities.