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FERC and CFTC Enforcement Actions on Manipulation in the Natural Gas Markets

Last week, FERC and CFTC initiated separate actions against the Amaranth hedge fund and two of its traders for alleged manipulation of natural gas markets through its trading in the New York Mercantile Exchange (“NYMEX”) natural gas *futures* market. Both agencies also have commenced actions against Energy Transfer Partners, L.P. (“ETP”) for attempting to manipulate the price of *physical* natural gas at the Houston Ship Channel (“HSC”).

Significantly, these actions are the first use by FERC of its authority under the anti-manipulation rules adopted by the Energy Policy Act of 2005 (“EPAct 2005”). FERC’s actions also are noteworthy in that the agency seeks the maximum \$1 million per day per violation penalty. While FERC and CFTC are making much of their cooperation in pursuing these matters, the actions highlight the jurisdictional overlap, and potential conflict, between the two agencies when they seek to prosecute the same entities under different statutes based on the same underlying conduct and facts. The question of who has primary jurisdiction remains to be worked out by the agencies, the courts or, if necessary, Congress.

Pending such enlightenment, the trading community faces a very black cloud on the near horizon and runs the risk of being punished by several federal agencies for the very same alleged misdeeds – likely to the tune of hundreds of millions of dollars. If nothing else, these aggressive and largely unprecedented enforcement actions underscore the importance to the trading community of having in place – and implementing – effective compliance plans, policies and procedures and paying daily attention to the ever-shifting agency views of what is and what is not lawful conduct. Or put another way, as Brian Hunter formerly of Amaranth appears to be learning, there may be a great deal of money in the offing for successful energy traders, but playing in this market is not for the faint of heart in more ways than might previously have been understood.

FERC and CFTC Actions Against Amaranth

FERC Show Cause Order. On July 26, 2007, FERC issued an Order to Show Cause and Notice of Proposed Penalties against several Amaranth hedge fund-related entities and two former traders, Brian Hunter and Matthew Donohoe, based on a preliminary determination that the Amaranth entities and former traders manipulated natural gas markets through trading on the NYMEX Natural Gas Futures Contract.¹ FERC seeks \$232 million in civil penalties against the named parties and the disgorgement of \$59 million plus interest in “unjust profits” from the Amaranth entities.

FERC alleges that Amaranth manipulated the final, or “settlement,” price of the Natural Gas Futures Contract on February 24, March 29 and April 26, 2006 by selling an “extraordinary” amount of these contracts during the last 30 minutes of trading before the contracts expired (referred to as “marking the close”). These actions allegedly drove the settlement price down, thereby benefiting Amaranth’s positions in financially settled swaps and options, which were primarily traded on the Intercontinental

¹ A Natural Gas Futures Contract is a contract for future delivery of 10,000 MMBtu of natural gas over the course of the contract month to the buyer’s interconnection on the Sabine Pipe Line Co.’s Henry Hub in Louisiana.

Exchange (“ICE”). Amaranth’s position in these derivatives was several times larger than its position in the Natural Gas Futures Contracts, and the value of these derivatives increased as a result of the decrease in the settlement price of these contracts.

Preemptive Complaint. On July 23, 2007, former Amaranth trader Hunter filed a preemptive complaint in the United States District Court for the District of Columbia against FERC seeking a declaratory judgment that FERC’s then-impending enforcement action was beyond its authority. Hunter also sought a temporary restraining order (“TRO”) and preliminary injunction based on alleged damage to Hunter’s reputation and the inability of his new enterprise to operate under the cloud of a FERC enforcement action. Hunter argued that FERC lacked jurisdiction to prosecute him because Amaranth only traded natural gas *futures*, and FERC’s jurisdictional authority extends only to physical wholesale energy markets. Hunter’s request for a TRO was denied, but the complaint remains pending in District Court.

CFTC Complaint. One day prior to FERC’s enforcement action, the CFTC filed a complaint in the United States District Court for the Southern District of New York against certain Amaranth entities and Hunter for alleged violations of the Commodity Exchange Act based largely on the same set of facts relied on by FERC, although the CFTC’s complaint is limited to alleged manipulation occurring on February 24 and April 26, 2006. The complaint also alleges that, during an investigation conducted by NYMEX, Amaranth made false statements to NYMEX to cover up the attempted manipulation. The CFTC seeks permanent injunctive relief and civil penalties in an amount not to exceed \$130,000 for each violation or triple the monetary gain to defendants for each violation. The CFTC also is seeking restitution and disgorgement of any ill-gotten gains.

FERC and CFTC Actions Against Energy Transfer Partners, L.P.

FERC Enforcement Action. On July 26, 2007 (the same day as the initiation of its Show Cause proceeding against Amaranth), FERC issued an Order to Show Cause and Notice of Proposed Penalties against several Energy Transfer Partners entities and several Oasis Pipeline entities based on preliminary findings that ETP allegedly manipulated wholesale natural gas markets at HSC and Waha, Texas, at particular times in the December 2003 through December 2005 timeframe. ETP’s Oasis Pipeline subsidiary allegedly preferred affiliated shippers and discriminated against non-affiliated shippers, and charged non-affiliated shippers more than the maximum rate approved by FERC for interstate transportation service from Waha to a point near Houston.

FERC alleges that ETP artificially suppressed the Platts *Inside FERC’s Gas Market Report* HSC index, thereby benefiting its financial derivative positions (e.g., basis swaps). ETP also is alleged to have artificially suppressed the *Gas Daily Waha* index. Despite the fact that it bought back at the *Gas Daily Waha* index almost the same amount of gas that it sold at fixed price at Waha, ETP allegedly had financial derivatives that benefited from the lower *Gas Daily Waha* index price. FERC is seeking civil penalties and disgorgement, plus interest, of more than \$167 million. FERC also proposes to revoke ETP’s blanket certificate authority to sell natural gas.

CFTC Complaint. On the same day that FERC initiated its action, the CFTC filed a complaint in the United States District Court for the Northern District of Texas against ETP and three of its subsidiaries for attempting to manipulate the price of physical natural gas at the HSC delivery hub during September and November 2005 and attempting to manipulate the October and December 2005 HSC monthly index prices of natural gas published by Platts in *Inside FERC*. The CFTC is seeking permanent injunctive relief and civil penalties in an amount not to exceed \$130,000 for each violation or triple the monetary gain to defendants for each violation.

In its complaint, the CFTC alleges that ETP attempted to (1) manipulate the price of physical natural gas baseload transactions for delivery at HSC by intentionally flooding the HSC market with large quantities of physical natural gas in order to push the price down and (2) manipulate the HSC monthly index price of natural gas published in *Inside FERC* by submitting price and volume information about these transactions for use by Platts in calculating the monthly indices. The alleged scheme was intended to benefit ETP's financial basis swap contracts tied to the October and December 2005 *Inside FERC* monthly price indices at HSC.

Commentary

FERC's actions in Amaranth and ETP are highly significant, among other reasons, because they are the first exercise of its new anti-manipulation authority under the EAct 2005. Although FERC previously has assessed more than \$30 million in penalties under the civil penalty authority conferred on FERC by the EAct 2005, these penalties were for tariff violations. The FERC actions also are significant in that they seek the maximum penalty available under this new civil penalty authority (\$1 million per day per violation).

The Amaranth proceeding is also unusual in that FERC has sought to prosecute its first major case under the anti-manipulation rules not for an alleged "manipulation" occurring in FERC's primary area of jurisdiction (the physical natural gas market), but for an alleged scheme that took place exclusively in the futures markets. Relying upon the EAct 2005 amendments that empower the agency to punish manipulation by any entity "in connection with" jurisdictional transactions, FERC seeks to send the message that any manipulative activity that "affects" physical gas will be a target for enforcement scrutiny and prosecution – even when those activities fall squarely within the jurisdiction of another federal agency, in this case the CFTC. This means that the same conduct can be punished twice. Whether the courts will agree is another matter.

In initiating the action against ETP for manipulation of physical gas prices, the CFTC, for its part, seems also to have reached beyond what traditionally is understood to be its primary area of jurisdiction (futures contracts and impacts thereupon). While the CFTC's assertion of jurisdiction over purely physical markets is not new – the agency has taken similar actions recently in a case against BP involving the physical propane market and in a settlement with Marathon involving the physical WTI crude oil market – its reach into the workings of the physical natural gas markets in the case of ETP seems unusually aggressive, considering FERC's newly minted authority under the EAct 2005, and that agency's own simultaneous enforcement action involving the same facts. According to agency officials, the Amaranth and ETP actions are significant for the professed level of cooperation between the FERC and CFTC. However, whether that cooperation will continue remains to be seen as the jurisdictional issues are sorted out in litigation.

We will be following the Amaranth and ETP cases closely and will report promptly on important developments.



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