COMMENT SECTION

OLG Düsseldorf Decides that E.ON and RWE are to be Considered a Duopoly and Prohibits Further Vertical Integration

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LT Dominant position; Electricity generation; Electricity supply industry; Germany; Market definition; Oligopolies

On June 6, 2007, the Higher Regional Court of Düsseldorf[1] confirmed the decision of the German Federal Cartel Office (*Bundeskartellamt*) issued to E.ON Co, prohibiting it from acquiring a minority share in the municipal utility Stadtwerke Eschwege via its affiliate EAM Energie AG (EAM).

Stadtwerke Eschwege purchases its electricity almost exclusively from EAM. EAM sources its electricity from the E.ON group. The Court had to investigate in particular whether E.ON and RWE had established a duopoly on the German electricity market and whether the frequent acquisition of shares in municipal utilities results in a foreclosure of the German electricity markets and consolidation or increase of their market power.

In the course of the proceedings, the *Bundeskartellamt* modified its previous market definitions. The Court confirmed this new approach.

According to the Court, the only categories for the market definition are the generation market and the final customer market. The generation level comprises the initial distribution of electricity by all utilities which have their own generation capacities or which import electricity.

On the final customer level, the Court distinguishes between the market for supplying small customers (households, small and medium-sized commercial customers), which is geographically limited to the distribution grid of the respective supplier; and the market for electricity supply to industrial and major commercial customers, which is nationwide.

As a result of the fact that electricity cannot be stored, the distribution level always depends on the generation level, which determines the electricity volumes available and the price of sale. Companies which dominate the market for the generation of electricity are also dominant in the initial distribution of electricity to retail suppliers and as far as the supply to final customers is concerned. The actual trading in electricity does not have an independent competitive function for the electricity market; therefore it can be disregarded.

The Court found that if E.ON were to hold a stake in Stadtwerke Eschwege, this would reinforce the dominant market position of the duopoly E.ON/RWE on the market for the initial distribution of electricity and on the market for supplying major industrial and commercial customers. According to the Court, the joint share of E.ON and RWE in the German electricity generation capacities amounts to approximately 52 per cent. Both companies have an outstanding market position over and above their own supply area in relation to their competitors. EAM's minority stake in Stadtwerke Eschwege would ensure EAM's position as electricity supplier of Stadtwerke Eschwege because the majority shareholder (the municipality) would consider EAM's interests. With increasing probability, further electricity supply contracts would be concluded with EAM. This would strengthen EAM's and thereby E.ON's market position and would contribute to market foreclosure.

Furthermore, EAM's stake in Stadtwerke Eschwege would reinforce the dominant market position of the regional natural gas distributors on the market for supplying local distributors. Due to the fact that E.ON holds shares in the regional distributor Gasunion GmbH, which in turn supplies Stadtwerke Eschwege with gas, the Court expects that future natural gas supply contracts would be concluded with Gasunion.

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FERC Flexes Its Muscle: Amaranth and Energy Transfer Partners

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LT Energy policy; Market abuse; Natural gas; Penalties; Regulatory bodies; United States

In the Energy Policy Act of 2005 (EPAct), Congress amended the Natural Gas Act (NGA), the Natural Gas Policy Act (NGPA), and the Federal Power Act (FPA) to give the Federal Energy Regulatory Commission (FERC) authority to impose civil penalties of up to $1 million per day per violation for violations of those statutes, or of the Commission's rules, regulations, and orders promulgated thereunder.[1] On July 26, 2007, FERC proposed for the first time to exercise that authority in contested proceedings, in two separate show cause orders—*Amaranth Advisors LLC, et al.* (*Amaranth*) and *Energy Transfer Partners, LP, et al.* (*ETP*)[2]—setting forth preliminary findings of

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1 This authority is codified in the following US Code sections: 15 U.S.C. § 717t-1 (NGA); 15 U.S.C. § 3414 (NGPA); 16 U.S.C. § 825o-1(b) (FPA).

2 *Amaranth Advisors LLC, et al.*, 120 FERC para.61,085 (2007); *Energy Transfer Partners, LP, et al.*, 120 FERC para.61,086 (2007).

alleged manipulative conduct in natural gas markets and proposing a combined $458 million in civil penalties and profit disgorgement for entities and individuals involved.[3] At present, FERC's conclusions remain preliminary, and the respondents will have an opportunity to present evidence to rebut the allegations.[4] However, these orders illustrate the manner in which FERC intends to exercise its recently gained civil penalty authority, particularly where the underlying allegations concern market manipulation, and the proceedings established by these orders should be watched carefully by participants in both natural gas and electric markets.

The alleged manipulative schemes

Both show cause orders are the result of lengthy investigations by FERC's Office of Enforcement, and also reflect co-operation between FERC and the Commodity Futures Trading Commission. The details of the alleged manipulative schemes in *Amaranth* and *ETP* are complex, but may be briefly summarised. In *Amaranth*, FERC made a preliminary finding that Amaranth Advisors LLC, several other Amaranth entities, and two former Amaranth natural gas traders manipulated the price of FERC-jurisdictional transactions through trading on the New York Mercantile Exchange (NYMEX) Natural Gas Futures Contract (Futures Contract) on certain dates in 2006. According to FERC, Amaranth traders manipulated settlement prices of the Futures Contract by selling ''extraordinary'' amounts of these contracts within the last 30 minutes of trading before the contracts expired. The resulting artificial decrease in the settlement prices allegedly increased the value of various financial derivatives in which Amaranth had taken long positions, resulting in gains to Amaranth's derivative financial positions.

Although trading in the Futures Contract is not subject to FERC's jurisdiction, FERC asserts that Amaranth's manipulation of the settlement prices directly affected FERC-jurisdictional natural gas transactions where the price of the transactions is directly tied to the settlement price of the Futures Contract. According to FERC, the manipulation occurred ''in connection with the purchase or sale of natural gas . . . subject to [its] jurisdiction'', and therefore falls within the purview of the anti-manipulation rule recently adopted by FERC in compliance with EPAct.[5]

FERC's preliminary findings in *ETP* involve allegations that ETP violated the pre-EPAct anti-manipulation rule, Market Behavior Rule 2, by manipulating wholesale natural gas markets at Houston Ship Channel and Waha, Texas on certain dates from December 2003 through December 2005. The alleged scheme, as in *Amaranth*, was to drive the price of fixed-price gas down in order to increase the value of the company's financial derivative positions. FERC also determined preliminarily that ETP's intrastate pipeline subsidiary, Oasis Pipeline, LP (Oasis), which provides interstate transportation service pursuant to s.311 of the NGPA[6]: (1) engaged in preferential and unduly discriminatory conduct by favouring affiliated shippers and disfavouring non-affiliates; (2) charged non-affiliates more than the maximum rate approved by FERC for interstate transportation service from Waha to Katy, Texas; and (3) failed to file an amended operating statement to reflect an agreement that changed how it operated the pipeline.

Factors considered in assessing civil penalties

The alleged manipulation at issue in *Amaranth* and *ETP* is of less significance to the energy industry as a whole than that these cases are the first contested proceedings in which FERC has proposed to assess civil penalties for market manipulation under its Enforcement Policy Statement.[7] In EPAct, Congress mandated that FERC, in determining the appropriate amount of civil penalties to be assessed for a particular violation, should consider the seriousness of the violation and the remedial actions, if any, taken by the violator in response to the violation. In the Enforcement Policy Statement, FERC identified eight factors to be considered with respect to the seriousness of a violation:

- harm caused by the violation;
- whether the violation was the result of manipulation, deceit or artifice;
- whether it was wilful, reckless, or deliberately indifferent to the results;
- whether it was part of a broader scheme;
- whether it was a repeat offence or part of a history of violations by a company;
- whether it was related to actions by senior management;
- how the wrongdoing came to light;
- the effect of potential penalties on the financial viability of the company.

FERC also identified three factors to be considered with respect to the violator's remedial actions that could mitigate the otherwise applicable penalties:

- internal compliance;
- self-reporting;
- co-operation.

Proposed civil penalties: Amaranth

In *Amaranth*, FERC determined that there were a total of 219 separate violations involved, each consisting of an executed trading floor transaction, such that the

3 In addition, FERC proposes to revoke ETP's blanket certificate authority to sell natural gas for a period of one year.

4 Responses to the show cause orders were originally due on August 27, 2007, but FERC subsequently granted extensions of time for responses until September 25, 2007 (in *ETP*) and September 28, 2007 (in *Amaranth*).

5 18 C.F.R. § 1c.1 (2007).

6 15 U.S.C. § 3371 (2000).

7 Enforcement of Statutes, Orders, Rules, and Regulations, 113 FERC para.61,068 (2005). FERC has imposed civil penalties under consent agreements, in which the violator agrees to pay in order to forestall issuance of a show cause order and possible litigation. See, e.g. *In re Gexa Energy, LLC*, 120 FERC para.61,175 (2007); *In re Calpine Energy Servs., LP*, 119 FERC para.61,125 (2007); *In re Bangor Gas Co., LLC*, 118 FERC para.61,186 (2007).

maximum civil penalty for the alleged manipulation would be $219 million.[8] In determining the civil penalty to be assessed, FERC first concluded that Amaranth was responsible for the activities of its employees, officers and directors, and that the various Amaranth entities should be treated as a single entity for purposes of civil penalty assessment.[9] FERC then reviewed the factors concerning the seriousness of the alleged violations. It first noted that the case was very serious in that it involves the rule against market manipulation, which is a critical element in fulfilling FERC's mandate to ensure that markets are fair and competitive.[10] FERC then highlighted four factors in its analysis:

(1) *There was significant harm to the market.* Consumers are harmed when prices are the result of manipulation; manipulation dilutes the price discovery and hedging functions that the markets are supposed to provide; producers who sold under contracts pegged to the Futures Contract were paid significantly less than the market price for their gas; and the pecuniary interests of the state and federal governments were affected, in so far as they sell rights to produce gas from public lands based on royalties to tied to the NYMEX settlement price.[11]

(2) *The violations were the result of wilful and deceitful conduct.* The violations were wilful with respect to the effect on the Futures Contract settlement price, and at least reckless with respect to the impact on FERC-jurisdictional transactions. Moreover, instant messages showed that traders knew their conduct was suspect, and suggest that subsequent explanations for their conduct were either disingenuous or false.[12]

(3) *Senior management was either aware of the traders' manipulative conduct, or wilfully blind to it.* One of the Amaranth traders was a company Vice President at the time of the offences, and the traders' conduct should have alerted more senior management that the traders were likely engaged in manipulation or other improper conduct. Nevertheless, the wrongdoing was discovered only by virtue of Commission inquiry, not as a result of discovery or correction by management. The failure of more senior management to supervise and prevent manipulative activity by the traders was viewed by FERC as a particularly significant factor in determining the amount of civil penalties to be assessed.[13]

(4) *Amaranth retained sufficient assets to satisfy a maximum assessment of civil penalties.* Thus, there was no reason to be concerned about Amaranth's financial viability.[14]

FERC noted that the only factor arguably favourable to Amaranth was the absence of prior similar behaviour, but it did not view this as a significant consideration. FERC went on to conclude that there was little to be cited in mitigation of the offences: the company did not self-report the violations, its internal compliance policies were weak, and its co-operation with the investigation was acceptable, but not exemplary. FERC proposed to assess a civil penalty of $200 million against the Amaranth entities, concluding that the balance of considerations warranted a penalty of close to the maximum amount.[15] In addition, FERC preliminarily determined that Amaranth should disgorge $59 million in alleged unjust profits, plus interest.[16]

FERC also imposed additional civil penalties against two Amaranth traders that it considered to have been personally and directly involved in the manipulation, Brian Hunter and Matthew Donohoe. FERC concluded that the traders' conduct was more egregious due to their personal involvement, and that Hunter, after initially co-operating with the investigation, subsequently became unco-operative. However, FERC found that the traders were less able to pay, though both still had significant resources.[17] FERC preliminarily assessed a $30 million civil penalty against Hunter, based on his higher net worth, and a $2 million civil penalty against Donohoe, based on his lesser net worth and the fact that he did not stand to benefit so greatly from the manipulative scheme. FERC further emphasised that it considers it important to impose high levels of sanctions on individual traders, both for enforcement against past manipulation and as a means of deterring future manipulation.[18]

Proposed civil penalties: ETP

In *ETP*, FERC addressed multiple violations, and its penalty analysis was less detailed. FERC concluded that ETP should be assessed the maximum possible civil penalty of $79 million for its price manipulation at Houston Ship Channel,[19] asserting that ETP's manipulations: (1) harmed the market; (2) were the result of manipulation, fraud or deceit; (3) were wilful; (4) were directed, or at least permitted, by senior management; and (5) were not self-reported or remedied in a timely manner.[20] FERC further noted that ETP is readily able to pay appropriate civil penalties, and that it did not provide exemplary co-operation in FERC's investigation.[21] In addition, FERC concluded that ETP should disgorge $67,638,416 in unjust profits, plus interest, for this manipulation.[22] However, FERC took a different approach with respect to ETP's price manipulation at Waha, discounting the maximum civil penalty of $58 million down to $3 million, even though its analysis of the civil penalty factors was much the same as in the case of the alleged Houston Ship Channel manipulations.[23] The show cause order provides no explanation for the reduction.

8 *Amaranth*, 120 FERC pp.116–118.
9 *Amaranth*, 120 FERC p.121.
10 *Amaranth*, 120 FERC p.122.
11 *Amaranth*, 120 FERC p.123.
12 *Amaranth*, 120 FERC p.124.
13 *Amaranth*, 120 FERC p.125.
14 *Amaranth*, 120 FERC p.132.
15 *Amaranth*, 120 FERC p.134.
16 *Amaranth*, 120 FERC p.139. FERC noted that this was a conservative estimate, and that Amaranth may have profited by as much as $168 million.
17 *Amaranth*, 120 FERC p.135.
18 *Amaranth*, 120 FERC p.138.
19 *ETP*, 120 FERC pp.74, 127.
20 *ETP*, 120 FERC pp.73, 126.
21 *ETP*, 120 FERC pp.73, 126.
22 *ETP*, 120 FERC pp.75, 128.
23 *ETP*, 120 FERC pp.146–147. FERC also ordered ETP to disgorge $2,228,550 in unjust profits, plus interest. *ETP*, 120 FERC p.147.

FERC also made preliminary determinations with respect to remedies against Oasis. FERC proposed to assess $15 million in civil penalties against Oasis for its allegedly unduly preferential and unduly discriminatory actions, which it noted was considerably less than the maximum that could be assessed, and to require disgorgement of $267,122 in unjust profits, plus interest.[24] FERC based this on a review of the relevant factors, noting that: (1) discriminatory treatment of affiliates and non-affiliates is a serious violation; (2) the violations were wilful; (3) the violations harmed non-affiliated interstate shippers, as well as their customers and suppliers; (4) Oasis did not self-report; and (5) its co-operation was not exemplary, in that it failed to make employees available for depositions in a timely manner and initially provided incorrect data to investigators.[25] Finally, FERC proposed to assess a civil penalty of $500,000 against Oasis for its failure to amend its operating statement to reflect accurately the manner in which it operated the pipeline, and further required Oasis to amend its current operating statement within 60 days of the order.

Conclusion

As noted, the show cause orders reflect only ''preliminary'' findings by FERC, which may be subject to revision based upon the responses submitted by the parties. However, these preliminary findings are couched in very strong language, indicating that FERC's conclusions are far more than tentative. Several requests for rehearing have been filed in response to *Amaranth* and *ETP*, raising a variety of jurisdictional and procedural issues. Amaranth argues that FERC lacks jurisdiction over natural gas futures trading, and therefore lacks jurisdiction to impose penalties for alleged manipulation of the Futures Contract.[26] ETP argues that due process requires that civil penalty liability be determined through a de novo review by a federal district court, rather than by FERC acting alone as prosecutor and judge, and further suggests that independent review is particularly necessary in light of the adversarial tone of the show cause order.

FERC has been subjected to considerable pressure from legislators with respect to its exercise of its investigatory and enforcement powers. The *Amaranth* and *ETP* show cause orders indicate that where FERC is unable to reach consent agreements with alleged violators, FERC intends to be aggressive in using its authority to order civil penalties as it seeks to bring about what it has characterised as a ''culture of compliance''.[27] This is particularly the case where the alleged violations involve market manipulation. Moreover, FERC's review of the factors that go into its determination of the amount of civil penalties that should be assessed highlight the importance of internal compliance policies and self-reporting as crucial mitigating elements. Companies that trade in natural gas and electric markets—and related derivatives markets—should be highly alert to these considerations as FERC continues to exercise its new enforcement and remedial authority.

24 *ETP*, 120 FERC p.186.
25 *ETP*, 120 FERC p.185.
26 In addition, former Amaranth trader Brian Hunter has launched a separate challenge to FERC's jurisdiction in the US District Court for the District of Columbia. Hunter seeks injunctive relief to prevent FERC from proceeding against him. That action remains pending as of the time of writing.
27 See Kevin J. Lipson and Lee A. Alexander, '''Coercing' a 'Culture of Compliance?''' (2007) 1(4) *Energy Review* 17.