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FERC Regulation of Banks Proposing to Qualify as Power Marketers

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Wholesale electricity markets present a significant opportunity for financial institutions, and a number of banks have qualified as ''power marketers'' approved by the Federal Energy Regulatory Commission (''FERC'' or the ''Commission'') to buy and resell power in wholesale electricity markets.[1] Qualifying as a power marketer is the entry ticket for banks to participate in emerging wholesale markets, including day-of and day-ahead wholesale spot markets in the Mid-Atlantic (PJM), New York, New England and Midwest regions.

From the perspective of banking organizations, electricity intermediation presents a favorable business opportunity. From the perspective of other market participants, banking organizations are attractive counterparties due to their strong credit, derivatives expertise, and experience in commodities transactions. FERC has taken action to improve the functioning of electricity markets by promoting price transparency, establishing stringent new anti-manipulation rules, and promoting much needed investment in transmission.

This article provides an overview of how to qualify as a ''bank power marketer,'' and of the main regulatory requirements imposed under the FERC regime.

Qualifying as a Bank Power Marketer

The Office of Comptroller of the Currency (the ''OCC'') and the Federal Reserve Board (the ''FRB'') have issued rulings and regulations that allow banking organizations to expand their financial intermediation business to include participation, as principal or agent, in customer-driven electricity transactions. These include not only transactions that are cash-settled but also those involving the taking and relinquishment of ''transitory title.''[2]

FERC has adopted a regime that makes it relatively easy for banks and other financial institutions to qualify as ''power marketers'' — entities authorized to buy and resell electricity at market-based rates — under Section 205 of the Federal Power Act (''FPA''). Becoming a power marketer is a pre-condition to a bank's ability to engage in electricity derivatives transactions that contemplate the possibility of physical settlement.

[1] Bank of America, Barclays, Citigroup, Credit Suisse, Deutsche Bank, JPMorgan Chase and UBS have all become power marketers (directly or through affiliates), joining other financial institutions such as Morgan Stanley Capital Group.

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[2] The OCC has made clear that commodity-linked transactions are part of or incidental to the business of banking and permissible activities for national banks. *See*, *e.g.*, note 14 *infra;* OCC Interpretive Letter No. 1025 (Apr. 6, 2005), CCH Fed. Banking L. Rep. ¶ 81-554; OCC Interpretive Letter No. 962 (Apr. 21, 2003), CCH Fed. Banking L. Rep. ¶ 81-487; OCC Interpretive Letter No. 949 (Sept. 19, 2002), CCH Fed. Banking L. Rep. ¶ 81-474; OCC Interpretive Letter No. 937 (June 27, 2002), CCH Fed. Banking L. Rep. ¶ 81-462; OCC Interpretive Letter No. 892 (Sept. 13, 2000), CCH Fed. Banking L. Rep. ¶ 81-411; OCC Letter from Ellen Broadman, Director, Securities and Corporate Practices Division, to Barbara Moheit, Regional Counsel, FDIC (Oct. 20, 1998) (unpublished); OCC Interpretive Letter No. 632 (June 30, 1993), CCH Fed. Banking L. Rep. ¶ 83,516. The FRB concurs. *See*, *e.g.*, 12 C.F.R. § 225.28(b)(8).

See generally Tortoriello & Glotzer, *Guide to Bank Underwriting, Dealing and Brokerage Activities* (11th ed., Thomson LegalWorks, 2006) at Part II.E.

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A banking organization that wishes to become a power marketer must first decide on its preferred structure. To date, about half have a subsidiary or affiliate that has become the FERC-jurisdictional ''public utility'' engaged in the resale of power. Others have chosen a ''bank parent'' power marketer structure and conduct power marketing within the bank itself (or within the U.S. branch of a foreign bank). The latter structure is often preferred by banks that already conduct oil, gas and other commodity intermediation directly. FERC is indifferent to choice of structure, but bank parent power marketers are subject to additional requirements because the bank parent becomes a utility when it becomes a power marketer. To enable bank parent power marketers to continue their normal activities notwithstanding the limits on acquisition by one utility of another utility under FPA Section 203(a)(1), FERC has granted relief from the need for bank parent power marketers to obtain prior approval when they, or their affiliates, acquire securities of another utility. FERC has granted special relief authorizing a bank power marketer to hold as *principal* up to 5 percent of the voting equity of utilities and any amount of debt and debt securities, as well as unlimited holdings as *fiduciary*, and certain holdings in the context of underwritings and hedging derivative transactions.[3] FERC has not, however, extended an unlimited fiduciary holding carve-out to non-bank financial institutions.[4]

Obtaining power marketer status requires submission of an application to FERC that includes identification of any ownership or affiliation with utilities and assurances that the power marketer will not be able to erect barriers to entry or engage in market manipulation. The applications are subject to public notice and comment, and FERC typically acts on them within 60 days. FERC's approval process focuses on assuring that the applicant cannot exercise market power with respect to the generation or transmission of electricity and cannot erect barriers to entry. Since bank power marketers are not affiliated with transmission-owning utilities, they are considered ''independent'' and likely to increase competition in the industry.

FERC evaluates market power of utilities that choose to sell power at market-based rates by assessing ''horizontal'' market power (market power in generation) and ''vertical'' market power (market power applicable to transmission-owning utilities). To date, these screens have tripped up a handful of transmission-owning utilities, but not independent power marketers (including bank power marketers) that typically do not hold substantial generation capacity. FERC recently has made several changes to its policies for assessing market power, including further delineation of the geographic markets in which market power is assessed and removal of a prior exemption for generation constructed after July 1996,[5] but the requirement to establish lack of market power should continue to be a straightforward exercise for banks and other financial institutions that apply for power marketer approval.

Requirements Applicable to Power Marketers

Although FERC does not impose onerous registration requirements on power marketers, becoming a power marketer does subject a banking organization to FERC's light-handed but not insubstantial regulatory regime. Power marketers thus become subject to various reporting requirements and standards of conduct intended to prevent market manipulation. Moreover, while utility acquisitions and divestitures and holding companies are regulated under FPA Section 203, under the statutory and regulatory relief granted under the Energy Policy Act of 2005, these provisions generally do not inhibit the normal investment and derivative activities of banking organizations.

Reporting Requirements

Power marketers must comply with several reporting requirements:

■ *Quarterly Transaction Reports*. By the last day of the month following the close of each calendar quarter, all power marketers must submit Electric Quarterly Reports (''EQR'') which summarize the terms and conditions of agreements for ''jurisdictional services'' (*e.g.*, market-based power sales, cost-based power sales and transmission service) and include detailed transaction information for short-term and long-term power sales for the preceding calendar quarter, consistent with the procedures the Commission adopted in Order No. 2001.[6] The Commission maintains a web page devoted to the EQR requirements.[7]

■ *Quarterly Holdings Reports*. A banking organization that has adopted the bank parent power marketer structure must, within 45 days after the close of each calendar quarter, report (i) its holdings of public utility voting equity securities held as principal, and (ii) its total holdings of public utility voting equity securities irrespective of the capacity in which such securities are held within. The reports are subject to a *de minimis* threshold of one percent for each public utility company whose securities are held by the bank parent power marketer.

■ *Change of Status Notification*. Power marketers must report any changes in the facts relied upon by FERC when granting market-based rate authority. Changes in status include acquisition of controlling interests in generation above a 100-megawatt (''MW'') threshold,[8] affiliation with a transmission owner, and

[3] *See, e.g.*, Bank of America/UBS, 101 FERC ¶ 61,098 (2002), 101 FERC ¶ 61,312 (2002), *order on reh'g* 103 FERC ¶ 61,284 (2003), *second order on reh'g* 105 FERC ¶ 61,078 (2003); Barclays Bank PLC, Letter Orders, FERC Docket No. ER04-734 (June 2, 2004 and June 4, 2004); JPMorgan Chase Bank NA, Letter Order, 110 FERC ¶ 61,292 (Mar. 18, 2005). The 5% limitation applies per utility company held and is subject to the additional requirement that the bank power marketer obtain no right to control the operation or management of the utility.

[4] *See* The Goldman Sachs Group Inc., 114 FERC ¶ 61,118 (2006).]

[5] *See* Order No. 697, 119 FERC ¶ 61,295 (2007).

[6] Order No. 2001, Revised Public Utility Filing Requirements, FERC Stats. & Regs. ¶ 31,127 at P11-12, 18-21 (2002) (codified at 18 C.F.R. pts. 2 & 35), *reh'g denied*, Order No. 2001-A, 100 FERC ¶ 61,074 (2002), *reconsideration and clarification denied*, Order No. 2001-B, 100 FERC ¶ 61,342 (2002), *order directing filings*, Order No. 2001-C, 101 FERC ¶ 61,314 (2002).

[7] http://www.ferc.gov/docs-filing/eqr.asp.

[8] Order No. 652, Order on Reporting Requirements for Change of Status, FERC Stats. & Regs. ¶ 31,175, 110 FERC ¶ 61,097 at P68, *order on reh'g*, 111 FERC ¶ 61,413 (2005). Multiple increases of control of generation that do not individually exceed the 100 MW threshold must be reported once the aggregate amount reaches or exceeds 100 MW. Decreases in

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first affiliation with an entity that owns or controls inputs to power production.[9] While a consortium of banks may acquire syndicated interests in distressed generation as part of their financing activities, this is not reportable as a change in status provided there is no acquisition of control over the dispatch or sale of power.

■ *Interlocking Position Reports*. An annual report must be filed by any person who was an officer or director of a public utility who also held a comparable position with any bank, investment bank, bank holding company, foreign bank, savings and loan association, other institution providing financial services, or underwriter.[10] The short form report, filed on Form 561 (Annual Report of Interlocking Positions), is due on April 30 of each year, covering interlocking positions held during the preceding year. Several banks have interpreted this provision to apply to senior vice presidents with policy-making responsibility rather than all vice presidents. By virtue of the Gramm-Leach-Bliley Act, FPA § 305(b), a person who is a director of a public utility and a financial institution is excused from the need to seek prior FERC authorization to hold interlocking positions provided that he or she does not participate in utility deliberations to select an underwriter or that the selection occurs via a competitive process.

■ *Regional Market Power Update Reports*. Pursuant to a specified triennial schedule, a power marketer generally is to submit an updated market power analysis to affirm that the analysis conducted by FERC in initially granting market based rate authority continues to apply. Under Order No. 697, however, a power marketer that owns 500 MW or less generation per region (Northeast, Southeast, Central, Southwest Power Pool, Southwest, and Northwest), that does not own transmission, and that is not affiliated with anyone that owns transmission in the same region as the power marketer's generation assets, is newly excused from the current requirement to file triennial updates. Rather, through change in status filings and FPA Section 203 filings applicable when jurisdictional facilities are transferred, FERC will track whether such power marketers (referred to as ''Category 1'' marketers) have acquired market power. FERC may grant Category 1 status in its order granting power marketer approval or upon a filing explaining why the power marketer meets the Category 1 criteria that includes a list of all generation assets (including nameplate or seasonal capacity amounts) owned or controlled by the power marketer and its affiliates grouped by balancing authority area. Absent Category 1 status, power marketers that own or control generation assets in each region must file for that region every three years based on a rotating schedule.[11]

Anti-Manipulation Rules

Apart from reporting requirements, power marketers are also subject to anti-manipulation rules imposed in the wake of Enron abuses and wash trades. FPA Section 222 prohibits the use of ''manipulative or deceptive devices or contrivances'' in sale of electric energy or transmission. FERC has adopted Market Behavior Rules to implement this authority.[12] Under FERC's rules, an entity is prohibited from:

1. using a fraudulent device, scheme or artifice, or making a material misrepresentation or a material omission as to which there is a duty to speak under a Commission-filed tariff, Commission order, rule or regulation, or engaging in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity;
2. with the requisite scienter;
3. in connection with the purchase or sale of natural gas or electric energy or transportation of natural gas or transmission of electric energy subject to the jurisdiction of the Commission.

FERC's June 2007 enforcement action against Amaranth — the first under FERC's enhanced authority to address market manipulation under the Energy Policy Act of 2005 — is not directly relevant to electricity power marketers in that the specific allegations relate to alleged hedge fund manipulation of the settlement price for natural gas futures contracts. However, the action signifies an aggressive legal position that where there is manipulation in energy markets, FERC has statutory authority to proceed against any ''entity,'' not just jurisdictional utilities.[13]

Relaxed Rules for Acquisition Pre-Approval

In 2005, Congress repealed the outmoded Public Utility Holding Company Act of 1935 that largely precluded non-utilities from acquiring more than a 10% voting interest in utilities. The new regime established by the Energy Policy Act of 2005 allows substantial new opportunities for investment in utilities. FERC allows ''holding companies'' to acquire more than a 10% voting interest in utilities if the acquisition is consistent with the ''public interest.'' While FERC exercises oversight with respect to the books and records of holding companies, banking organizations typically do not have to worry about this requirement because of a number of exemptions that may apply. *First*, by statutory exclusion, banks and their operating subsidiaries are not ''holding companies'' with respect to utility investments made in a fiduciary capacity, as collateral for debt, or in the course of liquidation. Broker-dealers are similarly ex-

ownership or control are generally not reportable to the extent they reduce the utility's market power. *Id*. at P40.

[9] Reports are due 30 days after the legal or effective date. *See* Order No. 652, note 8 *supra*. Order No. 697, Final Rule on Market Based Rates, 119 FERC ¶ 61,295 (2007), provides that a change of status must be filed when a power marketer first affiliates with an entity that owns or controls inputs to power production (including gas storage, distribution or transportation, sites for new generation, or coal supplies or coal transportation facilities). However, FERC no longer requires that power marketers report a change in ownership or control of natural gas and oil supplies, or affiliation with an entity that owns or control such fuel supplies.

[10] 18 C.F.R. § 46.4(a); *see also* FPA § 305(c).

[11] Order No. 697 establishes the following schedule for filings of either Category 1 status or the next triennial power marketing update, by region: June 2008: Northeast; December 2008: Southeast; June 2009: Central; December 2009: Southwest Power Pool; June 2010: Southwest; December 2010: Northwest. For power marketers not granted Category 1 status, the schedule would repeat every three years. *See* Order No. 697, 119 FERC ¶ 61,295 (2007).

[12] *See* Order No. 670, 115 FERC ¶ 61,165 (2006).

[13] FERC proposed penalties and disgorgement of profits totaling $291 million from Amaranth and two of its traders. *See* http://www.ferc.gov/news/news-releases/2007/2007-3/07-26-07.asp.

empt with respect to utility securities that they do not beneficially own or that are acquired in the course of normal underwriting activity. *Second*, FERC has clarified that the parent of a power marketer without physical generation — such as a bank power marketer — is not subject to regulation as a holding company.[14] *Third*, a bank with market-based rate authority as a power marketer may be able to rely on exemptions for (i) passive investments in utilities through mutual fund and similar holdings, and (ii) investments in wholesale generation.[15]

More recently, on July 20, 2007, FERC issued a supplemental policy notice and accompanying notice of proposed rulemaking that further relax the triggers for FERC pre-approval of utility acquisitions under FPA Section 203.[16] FERC determined that an acquisition of up to 10% of voting securities generally does not constitute the acquisition of ''control'' that would be subject to Section 203 pre-approval. With these reforms, Section 203 approval issues for banking organizations are most likely to arise in the context of distressed generation, where the utility would have to obtain FERC approval to transfer a controlling interest to the secured lenders.

ANPR to Improve Competitive Environment

FERC has acknowledged problems and concerns over the quality of competition in the organized regional electricity markets — those operated by ''regional transmission organizations'' and ''independent systems operators'' — which now cover more than half of the country and in which banking organizations participate.[17] On June 22, 2007, FERC issued an Advance Notice of Proposed Rulemaking to address four areas where FERC acknowledges improvements are needed: (i) enhancing the role of demand response;[18] (ii) increasing opportunities for long-term power contracts; (iii) strengthening the independence and caliber of market monitoring; and (iv) improving governance of the organized markets to assure that independent suppliers and consumers have adequate stakeholder input.[19] Enactment of regulations that further enhance competition in national and regional markets for electricity may increase the attractiveness of power marketing to banks and other financial institutions.

Banking organizations have for years engaged in derivative transactions in other commodities; the loosening of regulatory barriers and FERC's ongoing efforts to promote competitive markets provide new opportunities in electricity as well.

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[14] Order No. 667, Public Utility Holding Company Act of 2005, 113 FERC ¶ 61,248 at ¶ 28 (2005).

[15] Additional exemptions exist for single-state holding company systems and for entities that are holding companies solely with respect to ''exempt wholesale generators'', ''qualifying facilities'', or ''foreign utility companies''. Order No. 667-A, Public Utility Holding Company Act of 2005, *order on reh'g*, FERC Stats & Regs. ¶ 31,213 (2006), 115 FERC ¶ 61,096 (2006): Order No. 669-A, Transactions Subject to FPA Section 203, *order on reh'g*, FERC Stats & Regs. ¶ 31,214 (2006).

[16] FPA Section 203 Supplemental Policy Statement, 120 FERC ¶ 61,060 (2007); Notice of Proposed Rulemaking on Blanket Authorization Under FPA Section 203, 120 FERC ¶ 61,062 (2007).

[17] *See*, *e.g.*, OCC Interpretive Letter No. 1071 (Sept. 6, 2006), CCH Fed. Banking L. Rep. ¶ 81-603.

[18] ''Demand response'' refers to changes in electricity usage by end-use customers from their normal consumption patterns in response to changes in the price of electricity over time, or to incentive payments designed to induce lower electricity use when wholesale prices are high or reliability is threatened.

[19] Advance Notice of Proposed Rulemaking on Wholesale Competition in Regions with Organized Electric Markets, 119 FERC ¶ 61,306 (2007).

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