ELECTRICITY MARKET DESIGN:
Energy Trading and Market Manipulation (Continued)

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ELECTRICITY MARKET Trading and Manipulation

The continuing story of how to define and prevent market manipulation raises important questions about market design, the role of trading and traders, and public policy to support competitive wholesale markets under a framework of open access and non-discrimination.

- How did the successful market design arise and why is it important?

- What is the role of financial contracts and forward trading?

- What are the implications for defining market manipulation?
The case of electricity restructuring presents examples of fundamental problems that challenge regulation of markets.

- **Marriage of Engineering and Economics.**
  - Loop Flow.
  - Reliability Requirements.
  - Incentives and Equilibrium.
  - Physical and Financial Transactions.

- **Devilish Details.**
  - Market Power Mitigation.
  - Coordination for Competition.
  - Transmission Expansion.

- **Jurisdictional Disputes.**
  - European Subsidiarity Principle.
The path to successful market design can be circuitous and costly. The FERC “reforms” in Order 890 illustrate “path dependence,” where the path chosen constrains the choices ahead. Early attempts with contract path, flowgate and zonal models led to design failures in PJM (’97), New England (’98), California (’99), and Texas (’03). Zonal aggregation creates conflicts with system operations. Successful market design integrates the market with system operations.
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A Consistent Framework

The example of successful central coordination, CRT, Regional Transmission Organization (RTO) Millennium Order (Order 2000) Standard Market Design (SMD) Notice of Proposed Rulemaking (NOPR), “Successful Market Design” provides a workable market framework that is working in places like New York, PJM in the Mid-Atlantic Region, New England, the Midwest, California, SPP, and Texas. This efficient market design is under (constant) attack.

“Locational marginal pricing (LMP) is the electricity spot pricing model that serves as the benchmark for market design – the textbook ideal that should be the target for policy makers. A trading arrangement based on LMP takes all relevant generation and transmission costs appropriately into account and hence supports optimal investments.” (International Energy Agency, Tackling Investment Challenges in Power Generation in IEA Countries: Energy Market Experience, Paris, 2007, p. 16.)
A critical challenge in market design with unbundled transactions was to provide a framework and a capability to arrange longer term contracts between generators and loads.

The vertically integrated system provided long-term arrangements by utilities owning generation on behalf of load. The unbundled competition model required replacements that would allow for contracts connecting generation and load.

- **“Contracts for Differences” at a location.**
  - Contracts do not determine or constrain economic dispatch.
  - Contract imbalances settled at locational prices.

- **Financial Transmission Rights (FTRs) between locations.**
  - Unworkable physical rights and contract paths replaced by FTRs.
  - Settlements based on the difference between locational prices.

- **Contract durations set by market requirements.**
  - Forward contracts are financial instruments unknown to the operator.
  - Varying durations create a need and an opportunity for energy trading.
Market design in RTOs/ISOs reflects an explicit reliance on “related positions.”

- In a one settlement system, long-term FTRs settle against and hedge real-time prices.
- In markets with two settlements, a related transaction is required.
  - FTRs settle against day-ahead prices.
  - Day-ahead schedules create new transmission rights.
  - Virtual contracts day-ahead settle against real-time prices.
  - An FTR plus an equivalent day-ahead virtual contract allows the long-term FTR to settle against real-time prices.
- In a day-ahead market, the prices of the related transactions are interdependent.
  - The bid for the schedule or virtual contract increases the value of the FTR.
  - The schedule or virtual contract is necessary to transfer the FTR hedge to real-time prices.

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Successful wholesale electricity market design depends on strong interactions between physical energy trading, virtual trading and financial contracts.

- **Financial contracts interact with energy trading.**
  - Financial transmission rights substitute for unavailable physical rights.
  - Contracts for differences integrate with organized spot markets.

- **Forward markets interact with real-time trading.**
  - Financial transmission rights settle day-ahead.
  - Schedules and virtual transactions integrate day-ahead and real-time markets.

- **Market hedges are imperfect.**
  - Imbalances for financial transmission contracts.
  - Portfolios for forward contracts integrated with virtual trading.

- **Barriers to entry differ in physical and financial markets.**
  - Real-time physical markets have high short-run but lower long-run barriers.
  - Day-ahead financial markets with virtual trading have low barriers to entry.

- **Prices clear the market under economic dispatch with bids and offers.**
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Interactions among physical energy trading, market-clearing prices, and financial contracts are intended and necessary for successful electricity market design.

The mere fact that a physical transaction can affect prices to some degree, and thereby influence the prices of related financial contracts, cannot be a per se definition of price manipulation.

Nearly every physical transaction can have some impact on prices. This is basic supply and demand economics.

If holding a financial contract that benefits from the price impact of a physical transaction were to be deemed all that is required to establish price manipulation, then the entire foundation of successful electricity market design would be destroyed with one stroke.

A FERC solution for distinguishing economic transactions from price manipulation is, has been, and should be an application of a stand-alone profitability test.

“...HQ Energy did not use a combination of market power and trading activity to act against its economic interest in one market in order to benefit its position in another market by artificially moving the market price. There is no evidence that HQ Energy acted against its economic interest in any market. Rather, the facts of this case show that HQ Energy made price-taker bids and used [Transmission Congestion Contracts] to hedge congestion risk in a manner explicitly contemplated by the Commission.”

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Electricity markets are unlike other commodity markets. Real-time physical and forward financial markets interact. But the lack of storability, the market-clearing process and easy entry imply that market power cannot be sustained in forward markets without manipulating real-time markets.

“Because of non-storability, manipulators of power markets must be producers of power, so speculative corners are not possible. Moreover, a manipulator must have market power in generation.”

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<table>
<thead>
<tr>
<th>Real-Time Physical Transactions</th>
<th>Real-Time Prices</th>
<th>Forward Prices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue: Monopoly and Monopsony, Energy Withholding.</td>
<td>Forward contracts leverage incentives, but real-time mitigation and easy entry in forward markets leave workably competitive conditions.</td>
<td></td>
</tr>
<tr>
<td>Policy: Mitigation with Offer Caps, Must-Run Requirements.</td>
<td>Day-ahead price should approximate expected real-time price, with transaction costs and small possible risk premium.</td>
<td></td>
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<tr>
<td>Workably competitive.</td>
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</tbody>
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<tr>
<th>Forward Financial Transactions</th>
<th>Issue: Unit Commitment?</th>
<th>Policy: Reliability Unit Commitment.</th>
<th>Negligible competitive effects?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward transactions do not create physical real-time energy withholding; cannot sustain manipulation of forward prices.</td>
<td>Workably competitive.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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A stand-alone profitability test does not require perfection, and is compatible with a workably competitive market.

“...HQ Energy did not use a combination of market power and trading activity to act against its economic interest in one market in order to benefit its position in another market by artificially moving the market price. There is no evidence that HQ Energy acted against its economic interest in any market. Rather, the facts of this case show that HQ Energy made price-taker bids and used [Transmission Congestion Contracts] to hedge congestion risk in a manner explicitly contemplated by the Commission.” [emphasis added]

- Conventional application with unique market-clearing price.
  - Taking the market price as given.
  - Not “against economic interest.” Profitable, or at least not loss making.

- Generalized application with degenerate case of multiple market-clearing prices.
  - Taking market prices as given.
  - Not “against economic interest” for all prices in the degenerate range. In other words, meets the stand-alone test for some price in the degenerate range. A symmetric rule would apply for evaluating transactions not undertaken (i.e., withholding).

Passing the stand alone test should provide a safe harbor. Failing the stand-alone test would raise a question of possible price-manipulation “to act against its economic interest in one market in order to benefit its position in another market by artificially moving the market price.”
Ledgerwood proposed a framework to analyze price-based manipulation.

A framework to analyze price-based manipulation

The basic Ledgerwood framework provides a logical sequence to guide consideration of possible market manipulation.

Hypothetical analysis of an alleged manipulation

**ELECTRICITY MARKET**  

**Market Manipulation Framework**

Important elements such as knowledge, intent, and the underlying market theory are implicit in Ledgerwood’s framework. All the elements are necessary, and no subset is sufficient.

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### Expanded Ledgerwood Framework

- **Scienter**: Did the parties act deliberately and knowingly?
  - Yes
  - No Manipulation
  - No

- **Trigger**: Do the actions in question involve fraud, uneconomic behavior, or an abuse of market power?
  - Yes
  - Legitimate Business Purpose
  - No

- **Theory**: How, and how much? Does a reasonable estimate of the price impact indicate a material effect?
  - Yes
  - No Manipulation
  - No

- **Target**: Did the trader hold financially leveraged positions that could profit from the manipulation?*
  - Yes
  - No Manipulation Likely*
  - No

- **Nexus**: Does a sufficient nexus exist between the manipulation trigger and target?
  - Yes
  - Legitimate concerns of manipulative behavior.
  - No

* Not all financial positions may be observable.
FERC Enforcement actions are taking place behind a shroud of opaque settlements. Recent apparent changes in policy are both poorly understood and alarming. An interpretation of current practice has necessary elements ignored and remaining components both (i) recast independent of market theory and (ii) deemed to be sufficient to trigger an enforcement action.

One View of Recent FERC Enforcement Actions

- **Trigger**
- **Theory**
- **Target**
- **Nexus**

**Scienter:** Did the parties act deliberately and knowingly?
- Yes
- No → No Manipulation

Non-fraud fraud and bad acts. "I know it when I see it"?
- Yes
- No → No Manipulation

Did the trader hold financially leveraged positions that could profit from the manipulation?*
- Yes
- No

Manipulative behavior.

* Not all financial positions may be observable
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Market Manipulation

The Duetsche Bank FERC settlement announced a policy fundamentally at odds with the FERC HQ Energy position and the requirements of successful market design for wholesale electricity markets:

“Enforcement concluded that Deutsche Bank’s CRR traders acted with the requisite manipulative intent because, among other reasons, they engaged in the physical transactions with the intent to increase the value of Deutsche Bank’s CRR position. Specifically, as stipulated by Deutsche Bank, the CRR traders sought for the exports at Silver Peak to change the price to benefit the bank’s losing CRR position. Deutsche Bank’s physical transactions were not profitable. *Even if these physical transactions had been profitable, however, profitability is not determinative on the question of manipulation and does not inoculate trading from any potential manipulation claim (although profitability may be relevant in assessing the conduct).* Rather, as we have recognized, the elements of manipulation are ‘determined by all the circumstances of a case.’ (footnote in original) Here, based on all the facts and circumstances, Enforcement determined that Deutsche Bank’s conduct constituted manipulation.”

This policy strikes at the heart of the necessary solution for successful wholesale electricity markets.

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No market design is perfect. The problem of poor market design should be remedied through notification, improvements in the market design, and ex ante rules. It should not be the case that price-taking, profit-maximizing behavior is treated as manipulation and pursued through an enforcement action.

- **Competitive Market Theory.** The theory of competitive markets assumes that participants make profit maximizing decisions; for a well-designed market the result is an efficient outcome. It should not be the responsibility of market participants to deviate from competitive behavior to advance undefined broader social objectives.

- **Electricity Market Practice.** Enforcement actions that deem it manipulative when profits arise from indirect collateral payments rather than direct energy payments confront inherent complications. For example, what principles distinguish:
  
  - **Uplift Payments.** Energy market transactions that avoid or receive tariff defined uplift payments have been the object of enforcement actions.
  
  - **Green Payments.** Energy market transactions to receive green production tax credits (e.g. wind and negative energy prices) or demand-response double payments (FERC Order 745) are lauded as good public policy.

- **Notification Obligations.** Market participants benefit from many aspects of good market design. It would be reasonable to enforce a fiduciary responsibility to notify FERC and system operators of market design features that might be flaws. This should be coupled with an enforceable safe harbor provision for market participants who provide such confidential notification, or when the design element has been publicly vetted and is well known.
Electricity markets are unlike other commodity markets. Real-time physical and forward financial markets interact. But the lack of storability the market-clearing process and easy entry imply that market power cannot be sustained in forward markets without manipulating real-time markets.

- If there is a claim of sustained manipulation of forward markets, there must be some barrier to entry for financial participants utilizing virtual contracts. The focus should be on removing the barriers and increasing liquidity, not on undoing the market design. The barriers create, but also limit, the potential manipulation.

- Offer caps address the problem of generator market power mitigation for physical transactions and real-time markets.

- Interactions among physical energy trading, market-clearing prices, and financial contracts are intended and necessary for successful electricity market design.

- The mere fact that a physical transaction can affect prices to some degree, and thereby influence the prices of related financial contracts, cannot be a per se definition of price manipulation.

- A FERC solution for distinguishing economic transactions from price manipulation is, has been, and should be an application of a stand-alone profitability test.

- Passing an appropriate stand-alone profitability test should provide a safe harbor. Otherwise, the entire foundation of successful electricity market design would be destroyed with one stroke.