Seeking Standards Through a Proactive Compliance Initiative

Presentation to Harvard Electricity Policy Group
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What is Market Manipulation?

- FERC's Anti-Manipulation Rule
  - 18 C.F.R. § 1c.1 and 2
    - Unlawful for any entity, directly or indirectly, in connection with the purchase or sale of products subject to FERC jurisdiction to:
      - use or employ any device, scheme, or artifice to defraud;
      - make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances, not misleading; or
      - engage in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity;
      - when the entity acts with requisite scienter.
Anti-Manipulation “Rule” As Applied

- We think the test of manipulation must largely be a practical one . . . . The methods and techniques of manipulation are limited only by the ingenuity of man. *Cargill v. Hardin*, 452 F.2d 1154 (8th Cir. 1971).

- Borders of manipulative activity are not clearly defined

- Anti-Manipulation Rule framed broadly to allow FERC latitude

- FERC unwilling to be limited to “textbook” economic analysis but will account for practical realities of how markets work. Order No. 745.
While this may be changing given the Hunter case and Deutsche Bank’s announced intention to litigate, enforcement actions historically have settled.

- Leads to Lack of Sufficient Transparency: One side of the story appears in settlement orders.
- Much of the Area Characterized by Grey: Not Black and White.
- FERC historically recognized that its anti-market manipulation rules “may present interpretation challenges”. Docket No. PL06-4 (Nov. 18, 2005)
Pair This Uncertainty With Increasing Enforcement Tools

- On Feb. 16, 2012, FERC announces that Office of Enforcement to add Division of Analytics and Surveillance

- Order No. 760 requires each RTO electronically to deliver to FERC non-public data to enhance its ability to detect anti-competitive or manipulative conduct, including virtual offers and bids, FTR data and supply offers and demand bids

- Order No. 768 requires reporting of additional data in Electric Quarterly Reports
Some FERC Guidance

- Inquiry into potential market manipulation violations is fact intensive and “will depend on the facts and circumstances of each case” – Order Affirming Penalty – Brian Hunter, 135 FERC ¶ 61,054 (2011)

- Fraud is defined generally to include “any action, transaction, or conspiracy for the purpose of impairing, obstructing or defeating a well-functioning market” – Order No. 670 (2006)

- Physical trades violate the Anti-Market Manipulation Rule when they are “not in accordance with the normal interplay of supply and demand” and instead are intended to benefit financial positions – Order Affirming Penalty – Brian Hunter, 135 FERC ¶ 61,054 (2011)
Chairman Wellinghoff’s 2012 Statement to Wholesale Market Participants

- First, do not trade uneconomically on one position in order to benefit the value of another.

- Second, senior management will be held accountable. Senior management has an obligation to proactively monitor for market manipulation and to pursue concerns once brought to their attention.

- Third, tell the truth, the whole truth, and nothing but the truth when questioned.

- Finally, understand that the Commission will be vigorous in using its anti-market manipulation authority to protect consumers.
The Problem

- The law surrounding manipulation is complex and uncertain and the contours of the regulatory landscape are changing continually.

- Distinctions between prohibited manipulative trading activities and legitimate open-market trading activities are nuanced and subtle and conflicting legal authorities exist.

- Civil penalties ever increasing: the current highest - Constellation Energy Commodities Group’s settlement to pay $135M and disgorge $110M - eclipsed by proposed Barclay’s fine of $435M and $34.9M disgorgement.
The Problem (Cont’d)

- Fine Amounts May Dwarf Total Value of a Business Line
- Fear May Deter Market Participation, Reduce Liquidity
- Concepts in Flux
  - For example “textbook” definition of market power is ability to raise price above competitive level for a non-transitory period of time
  - Recent FERC order on CAISO tariff filing addresses “temporal market power” (e.g. ability to change bid to cap during exceptional dispatch event duration). FERC opened a non-public investigation in Docket No. ER12-2539.
The Options

- Trade Conservatively: the “Avoid Inquiry” Standard
- Push the envelope and be prepared for an investigation and its consequences
- Contemporaneously document reasons for trading activity and hope for the best
- Await results of litigation for further clarity
The Options (Cont’d)

- Seek to obtain guidance from FERC through No-Action Letter Process, 18 C.F.R §388.104(e)
  - Informal, advance advice by staff available on transactions that otherwise could lead to enforcement action
  - Seek to temper the need to use powers by increasing regulatory certainty and providing notice
  - SEC and CFTC both provide no-action letter processes
  - Advice does not bind the agency, but agency staff who issue letters are well-acquainted with requirements
  - Specifically contemplates advice on whether particular transactions would violate Prohibition of Energy Market Manipulation Rules
  - Intended to assist regulated entities in seeking guidance on the real world application of regulations and orders

- Other?
The Problem

- Physical trades have an effect on financial contracts

- Portfolio Profit Maximization is Goal but could be perceived as manipulative

- Attempts to make money can go south

- But Standard remains: First, do not trade uneconomically on one position in order to benefit the value of another
Simplified Example of Problem

- LMP expected to be $19/MWh, less than Generator A cost
- FTR position at Generator A will pay $3/MWh if Generator A runs
- No FTR position at Generator B
- Would not be economically rational to run Generator A on a stand-alone basis
- Can XYZ decide to run Generator A instead of Generator B or is this manipulative?