

The Chasm between Following Market Rules and Fraud

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There is a chasm between “following rules” and fraud

- **A common point raised by many accused in manipulation cases is that the alleged behavior did nothing that violated market rules:**
 - Tariffs are designed to protect against the wrongful exercise of market power, not fraud
- **Acts used in combination, none of which violate a tariff, can nonetheless violate the FERC’s Rule 1c:**
 - Nothing inherently wrong with executing trades at a loss
 - Nothing inherently wrong with holding positions that benefit from directional price movements
 - However, FERC (and/or the CFTC) may have a problem if there is a linkage between these two actions
- **There are valid reasons for this chasm to exist:**
 - Enron exposed the need for a fraud-based manipulation standard
 - Fraud-based manipulation inhibits valid price formation and results in unwarranted wealth transfers that ultimately get passed to consumers
 - The limits of fraudulent behavior are constrained only by the ingenuity of the traders involved

Example-based enforcement could work in theory...

- Agencies are focused on using settlements as the key mechanism for informing the market as to what behavior is manipulative
- Settlements obtained to date have involved two types of behavior:
 - Uneconomic trading (transactional fraud)
 - Outright fraud
- Manipulation cases can also be brought for using market power (withholding) to benefit cross-market positions
- The settlements obtained to date generally pursued behavior that was inefficient:
 - *J.P. Morgan*: Alleged running of inefficient power plants out-of-merit
 - *Constellation, LDES*: Alleged divergence of Day-Ahead/Real-time prices
 - *Rumford Paper*: Allegedly fraudulent setting of DR baseline
- **Consistent enforcement over time provides clarity as to behavior that is illegal, thus assisting compliance:**
 - Uncertainty re manipulative behavior diminishes, improving compliance
 - Certainty re legitimate behavior improves market transparency & liquidity

...**IF** the definition of “fraud” is consistent over time

- **Consider the oft-cited language in Deutsche Bank:**
 - “...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).” DBET settlement, ¶ 20.
- **Two alternative interpretations of this language:**
 - Trades that are profitable on an accounting basis can nevertheless be considered uneconomic if they ignore the trader’s opportunity costs (*e.g.*, FERC’s allegations against BP)
 - Whether trades are profitable or not is irrelevant; if the intent of the trader is to affect the value of another position, the behavior is prosecutable as a market manipulation
- **The latter interpretation is *highly* problematic:**
 - Tantamount to a *per se* rule, where the agency unilaterally can determine (and adjust) what it considers “fraud”
 - Lack of explicit safe harbors leaves traders to forego profitable trading opportunities for fear of reprisals
 - This robs the firms of profits and the market of efficiency

An example: The danger of a per se approach

- Consider the following three transactions, all of which assume that an identical, profitable physical transaction is made in good faith to make the best available profits:
 - **Jack** buys power at hub A and sells power at hub B for a \$10,000 gain, holding no benefitting positions:
 - Jack cannot be found guilty of manipulation, for there is no position to manipulate
 - **Jill** executes the same A-to-B sale, not cognizant that her firm also holds a financial position that is short to the price at hub B:
 - Jill cannot be found guilty of manipulation, for there is no intent to manipulate
 - **Johnny** executes the same A-to-B sale, fully-cognizant that he also holds a financial position that is short to the price at hub B that may benefit from the sale:
 - Johnny is potentially liable for market manipulation for he knowingly executed a trade that he knew could manipulate the value of his related position

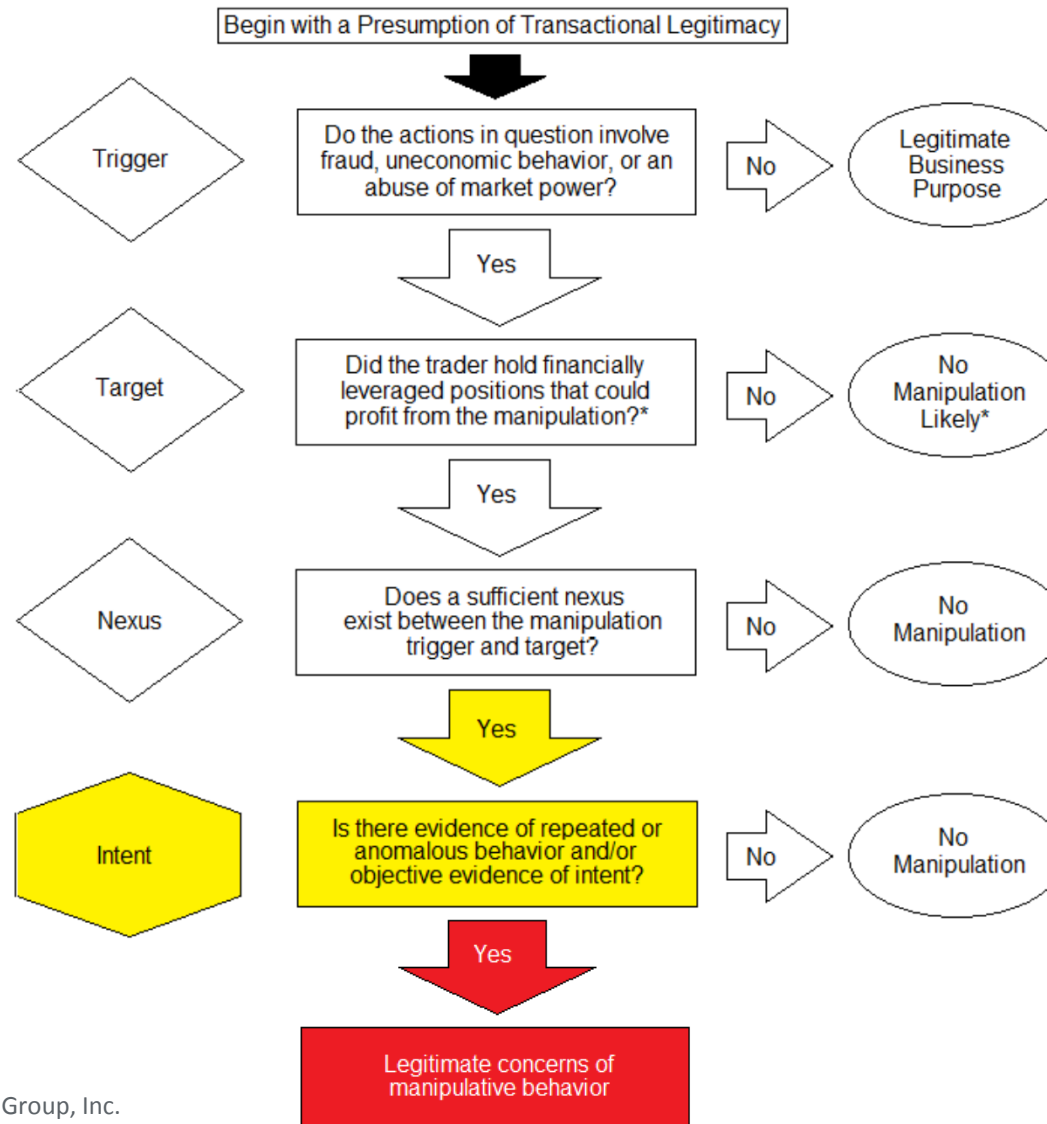
Per se approach illogically thwarts legitimate trades

- **The fact is, in all three of these circumstances, the A-to-B physical trade at issue would be made by any rational, profit-maximizing market participant:**
 - This trade would enhance economic efficiency by transferring the power to the hub where it is most valued
- **If the economic assumptions of competition actually applied:**
 - It would be guaranteed that some market participant would make the same physical trade
 - If Jack or Jill places the trade, the exact same benefit to Johnny's financial position will accrue
- **That one market participant is allowed to pursue a profit-seeking, efficient transaction while another is precluded is an economically unsupportable proposition:**
 - Needlessly drives liquidity from the marketplace
 - Robs all market participants of the benefits competition provides
- **Such transactions are neither fraudulent (FERC, CFTC) nor do they create an artificial price (CFTC):**
 - Thus, the market manipulation rules do not (should not) attach

Per se approach widens chasm, frustrates compliance

- **The string of settlements garnered thus far by the agencies can be useful to furthering long-term compliance:**
 - Clarity as to the behavior that is viewed as manipulative:
 - Caveat: Settlements arise for many reasons & have no legal effect
 - Less clarity as to what behavior is legitimate
- **However, such example-based enforcement is far less useful if the bar of what is considered “fraud” continues to move:**
 - Settlements (perceived by the agency as wins) embolden pushing the envelope further toward a per se enforcement posture
 - Per se approach circumvents the need for questioning the legitimate business/economic purpose (intent) behind trades
 - Lack of certainty regarding how far the bar will continue to be pushed deters legitimate trading & frustrates compliance
- **The only likely solution to this issue is litigation:**
 - Current cases in court may not adequately address these concerns
 - Several pending public/non-public cases may

A framework for analyzing market manipulation



Additional Resources

- “Using Virtual Bids to Manipulate the Value of Financial Transmission Rights,” coauthored with Hannes Pfeifenberger. *The Electricity Journal*, vol. 26, issue 9, pp. 9-25 (November 2013).
- “Uneconomic trading and market manipulation.” *Energy Risk Magazine*, p. 32 (July 2013).
- “A Framework for Analyzing Market Manipulation,” coauthored with Paul Carpenter. *Review of Law & Economics*, vol. 8, issue 1, pp. 253–295, ISSN (Online) 1555-5879, DOI: 10.1515/1555-5879.1577 (September 2012).
- “Rummaging through the Bottom of Pandora’s Box: Funding Predatory Pricing through Contemporaneous Recoupment,” coauthored with Wesley Health. *Virginia Law and Business Review*, v. 6, No. 3, pp. 509-568 (April 2012).
- “A Comparison of Anti-Manipulation Rules in U.S. and EU Electricity and Natural Gas Markets: A Proposal for a Common Standard,” coauthored with Dan Harris, *Energy Law Journal*, vol. 33, p.1 (April 2012).
- Other documents are available at www.brattle.com.

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Dr. Ledgerwood specializes in issues of market competitiveness with an emphasis on the economic analysis of market manipulation. He previously served as an economist and attorney for the FERC in its enforcement proceedings involving Energy Transfer Partners, L.P., Amaranth Advisors, LLC, and several other cases. He has built upon these experiences to develop a framework for defining, detecting and analyzing manipulative behavior. He has worked as a professor, economic consultant, attorney, and market advisor to the regulated industries for over twenty years, focusing on issues including ratemaking, power supply, resource planning, and electric asset valuations. In his broader practice, he specializes on issues in the analysis of liability and damages for actions based in tort, contract or fraud. He has testified as an expert witness before state utility commissions and in federal court.

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