HARVARD ELECTRICITY POLICY GROUP
SIXTY-SEVENTH PLENARY SESSION

Manipulation of Electricity Markets: 
What is the State of the Law?

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Cambridge, Massachusetts
May 31, 2012
Overview

Current Legal Topics -- FERC

• Triggers and Targets
• Monitoring and Analyzing Trading and Communications
• Open Questions
• Where Are We Now?
Triggers and Targets

• Ledgerwood *Proposed Framework*: causative nexus between
  – Triggers: Uneconomic trading, fraud, or market power
  – Target: any position (physical or financial) that derives its value from a market price affected by the triggers

• Uses: market monitoring & improved compliance programs

• Assumes:
  – Definition of “uneconomic trading”
  – Simplified market
  – Shifting burden of proof
FERC’s Attention

- 18 C.F.R. § 1c.2 – fraud, scienter, in connection with . . .
- Loss leader / uneconomic trading
  - “do not trade uneconomically on one position in order to benefit the value of another.” FERC Chairman Wellinghoff (3/15/12)
- Related, cross market / product trading
- High volume or large positions
- Note about Texas
FERC Notices of Alleged Violations

• *BP America* (July 28, 2011): allegation that BP used transportation capacity between HSC and Katy uneconomically -- with early, repeated sales and high market concentration -- contributing to lower HSC indices benefiting its swap spread positions in 2008.

• *Deutsche Bank Energy Trading* (December 15, 2011): allegation that DBET scheduled energy in CAISO to benefit its CRR positions, and used wheeling-through transactions in which no power flowed, during Q1 2010.

• *Barclays* (April 5, 2012): allegation that Barclays and four named individuals at certain western U.S. points assembled physical positions in the opposite direction of its ICE financial swap positions, which were flattened in the DA fixed-price physical markets to move the ICE daily index to benefit its swap positions.
Constellation Energy Settlement

- On March 9, 2012, FERC approved a Settlement regarding market manipulation and inaccurate information claims.
  - FERC approved the CCG and Exelon merger the same day
  - CCG neither admitted nor denied the Staff’s allegations
  - CCG press release: lawful portfolio risk management transactions
- Allegation that CCG traded during 2007 and 2008 in the NYISO virtual and DA physical markets to move DA zonal prices to benefit CCG’s financial positions settling against those DA prices.
  - Settlement indicates the Staff concluded “intent” because the virtual trades & DA schedules were: (1) high volume; (2) entered into without regard to their economics or market fundamentals; and (3) “persistently repetitive” despite unprofitability.
Settlement Penalties

- CCG disgorged profits of $110 M, paid a civil penalty of $135 M. Three individuals banned from trading at the company.

- Pre-Settlement: CCG monitors profit and loss concentrations in virtual transactions and physical schedules of electric energy, and reviews and documents the purpose of all virtual transactions.

- CCG must:
  - Develop and enforce policies which require communications by traders to be retained and monitored.
  - Adopt enhanced compliance policies.
  - Make semi-annual compliance monitoring reports to FERC OE.
Client Considerations

- Monitor P&L not only on a portfolio, but also on an individual product basis as well as margining, and review often
- Monitor position size, trading volume, frequency, direction
- Monitor physical and financial trading that may settle in the same or related markets, even if the products are associated with different strategies, affiliates or traders
- Communications
- Develop method to flag, elevate, analyze and contemporaneously document strategies and purposes
- Client Question: Does monitoring make sense given business strategies and realities?
  - How to determine what is lawful or not
Press Statements

“We believe Constellation’s trading practices in question were lawful portfolio risk management transactions. The company admits no wrongdoing in this case.”

- Mayo A. Shattuck III, Chairman, President and CEO of Constellation Energy

“The severity of Constellation’s conduct is demonstrated by its agreement to pay a civil penalty of $135 million and to disgorge unjust profits of $110 million for a total settlement amount of $245 million.”

- Jon Wellinghoff, FERC Chairman
What Is It?

- How to detect and determine what is lawful or unlawful:
  - Proprietary trading
  - Arbitrage
  - Hedging
  - Diversification
  - Other risk management techniques

- Filters: triggers, targets, P&L, positions, volume, frequency, related trading, business purpose, prices, contemporaneous documentation, current tariff provisions and practices
  - Result
Day-Ahead Market Characteristics

• Day-Ahead Market (DAM) and Manipulation
  – Open market, and ease of entry and participation
  – Rational expectation that market reacts
  – But are all conditions as expected?

• Nature of DAM
  – Financial market
  – No transmission or wholesale sale of electric energy?
Price Effect

- Penalty Guidelines: market impact or pecuniary gain
- Without correlation, no causation
- Re-running markets
  - Cannot assume a new price removing suspect trades and holding all else equal – assumes a static market
  - Market participants will pursue their interests
  - Case law: Illogical, because the market reacts
Where Are We Now?

Analogy to Volcker Rule

• Similar: Don’t lean on FERC’s regulated markets for proprietary risk-taking and, ultimately, do not create risk for ratepayers
  – Assembling large, proprietary positions
  – Definition of hedging

• Dissimilar: Notice to the Marketplace
  • Legislation/rulemaking
  • Non-public enforcement inquiries and settlements