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Court Allows FERC Market Manipulation Claim to Proceed Based on Theory of Deceptive Trading

By Charles R. Mills, Daniel A. Mullen, Natty Brower, Shaun Boedicker, Karen Bruni, and Thomas C. Kirby*

A federal district judge in Ohio recently denied the defendants' motion to dismiss the Federal Energy Regulatory Commission's action to enforce civil penalties for alleged market manipulation. The authors of this article discuss the decision and its implications.

In *FERC v. Coaltrain Energy, L.P.*,[1] a federal district judge in Ohio denied the defendants' motion to dismiss the Federal Energy Regulatory Commission's ("FERC") action to enforce civil penalties of $42 million for alleged market manipulation. The case is one of several in which FERC has attacked trading allegedly designed to qualify for out-of-market payments under regional transmission organization tariffs while incurring no risk of loss and providing no value to the market.

BACKGROUND

In *Coaltrain*, FERC alleged that the defendants' trades of Up-To Congestion ("UTC") financial contracts in the PJM day-ahead market violated FERC's anti-manipulation rule because they were designed solely or primarily to generate marginal loss surplus allocation ("MLSA") payments while incurring no market risk of loss. The court upheld FERC's legal theory that such trades could be a deceptive practice sufficient to support a market manipulation claim, without any need for FERC to allege that the defendants made any material misrepresentations or omissions.

FERC also was allowed to proceed on its claim that defendants violated 18 C.F.R. § 35.41(b), the Commission's rule prohibiting false and misleading statements to the agency, based on the company's alleged omissions and inaccurate statements in responding to data requests. In one of the favorable aspects of the order for the defendants, the court held that the Federal Power Act's provision for *de novo* review of FERC's administrative assessment of sanctions entitles a defendant to full discovery rights under the Federal Rules of

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[1] Case No. 2:16-cv-732, ECF No. 45 (S.D. Ohio Mar. 30, 2018).

Civil Procedure. All seven district courts that have ruled on this issue have upheld the defendants' rights to discovery.

UTCs allow traders to bet on the spread between day-ahead and real-time prices for congestion at particular locations (nodes) within PJM. They are effectively an arbitrage of day-ahead and real-time congestion prices: a purchaser of a UTC will pay the difference between the day-ahead sink locational marginal price ("LMP") and source LMP and be paid the difference between the real-time sink and source LMPs. FERC has recognized that UTCs can be used to hedge exposure to real-time congestion charges between the source and the sink for physical transactions in PJM.

UTC traders must reserve transmission on the day-ahead market. At the time of Coaltrain's conduct, transmission reservations could either be paid or unpaid, but only trades that used paid transmission were eligible to receive a share of MLSA payments. PJM distributes MLSAs to eligible market participants from the excess funds collected from network service users and transmission customers to compensate generators for electricity lost during transmission. Because PJM distributes MLSA payments *pro rata* to purchasers of transmission based on transaction volumes, a trader could increase its share of MLSA payments by increasing its volume of transmission-paid UTC trades.

FERC'S ALLEGATIONS

As alleged by FERC, in the summer of 2010, the defendants placed large UTC trades on paths where there was "little to no price spread between the day-ahead and real-time markets." FERC claimed that the defendants knew these trades would not yield any profits from price arbitrage, but would nevertheless be profitable from their receipt of MLSA payments. Coaltrain allegedly referred to these trades internally as its "OCL Strategy" (Over-Collected Losses), distinguishing them from other trades made pursuant to a price arbitrage strategy. According to FERC's theory, these OCL trades diverted MLSA payments from other market participants and made the reserved transmission unavailable for other, legitimate trades.

FERC alleged that Coaltrain's UTC trades at issue constituted a deceptive scheme in violation of the FPA's market manipulation provision[2] and FERC's anti-manipulation rule.[3] FERC acknowledged that UTC trades that are intended to profit from the price arbitrage are lawful and that the defendants did not engage in conduct that altered the market risk of the trades, such as engaging in wash sales. Nonetheless, FERC alleged that the trades constituted

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[2] 16 U.S.C. § 824v(a).

[3] 18 C.F.R. § 1c.2.

market manipulation, because they were made solely or primarily for the purpose of increasing the defendants' receipt of MLSA payments.

THE COURT'S DECISION

The court held FERC's theory sufficient to state a claim, and rejected the defendants' argument that they did not engage in deception because they provided complete and accurate information for each transaction to PJM. The court opined that FERC can satisfy the required element of deception by alleging a deceptive "scheme" without any need to show a misrepresentation. The court held that trading for an improper purpose is one such deceptive scheme, pointing to securities fraud case law holding that "trades made without 'any legitimate economic reason[] . . . can constitute market manipulation.' " For the same reason, the court rejected Coaltrain's argument that its trades could not be manipulative because FERC had expressly authorized traders to collect MLSA payments on UTC trades that utilized paid transmission reservations.

On the element of scienter, the court concluded that FERC was not required to show that the defendants knew when they made the OCL trades that FERC would consider them manipulative. Rather, the court concluded that FERC had to allege only that the defendants knowingly or recklessly participated in a scheme to make UCL trades for the sole or primary purpose of collecting MLSA payments.

CONCLUSION

Defining the proper scope of FERC's anti-manipulation rule and what is deemed to be unlawful trading remains a difficult exercise that will require substantially more judicial scrutiny before it is resolved. For litigants, however, the *Coaltrain* decision, although limited to the particular allegations in the case, reflects the deference a court might accord FERC's allegations and theories of liability at the motion to dismiss stage. For traders, the decision suggests the danger that FERC can treat even non-collusive trades that comply with market rules as violations of the agency's anti-manipulation rule if their sole or primary intent is to profit from out-of-market payments without assuming market risk or providing value to the market. This danger underscores the prudence of carefully analyzing new and existing trading strategies against the theories of liability announced in FERC's administrative orders.