Navigating the System

HERE ARE TIPS ON HOW TO BEST HANDLE MARKET MANIPULATION ENFORCEMENT.

Energy companies have long contended with the perception of some legislators, regulators and consumers that they manipulate energy prices. For decades, government and private plaintiffs used the antitrust laws to try to force changes in pricing practices that appeared manipulative or looked like "price gouging," but were rebuffed. Such defeats prompted legislators to close "loopholes" in antitrust laws with new statutes prohibiting market manipulation. With this newly expanded toolkit, enforcers like the Department of Justice (DOJ), the Federal Trade Commission, the Commodity Futures Trading Commission and the Federal Energy Regulatory Commission (FERC) are now actively surveying energy markets to identify and punish conduct violating these new statutes.

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Energy companies now face a thicket of statutes and regulations so new there have been no court decisions providing guidance. This uncertainty increases legal risk for many common and legitimate business strategies. But pragmatic risk avoidance strategies can be designed to recognize conduct most likely to spark a government investigation or private lawsuit.

Enforcement Changes

Compliance with antitrust and market manipulation laws used to be relatively straightforward:

- Do not reach agreement – or take actions that give the appearance of agreement – with competitors on price, output or supply;
- Comply with market rules and be truthful in business communications, but no duty exists to disclose information on which business strategies are based;
- Hedging and trading strategies may be used to optimize the value of energy commodity portfolios, provided the strategies aren't accomplished through an exercise of market power; and
- Unilateral decisions to withhold product from a market for legitimate reasons, even with a significant market share, are permissible.

These bedrock compliance principles reflect antitrust and market manipulation laws circa 2010. Enforcement agencies racked up hefty fines for legal violations that couldn't have been avoided by following such principles. Private plaintiffs have also joined the hunt. For example:

- **KeySpan/Morgan Stanley** – Prosecuted by DOJ for antitrust violations based on a swap agreement that hedged KeySpan's risk in the New York City electric capacity markets with settlements of $12 million and $4.8 million, respectively.
- **J.P. Morgan** – FERC obtained a $410 million settlement for bidding strategies that allegedly manipulated the California electricity markets.
- **Royal Dutch Shell/Statoil/BP/(et al.)** – Defending a class action lawsuit alleging attempts to monopolize and/or manipulate the index price of crude oil.

Now, companies may be held liable for violations if, based on their general business experience and collective corporate knowledge of the affected markets, they should have known a transaction or business strategy would have affected market price.

They also may be accountable for failure to disclose information that would have been material to the business decisions of counterparties or other market participants.

Identifying Heightened Risk

As enforcers flex their muscles with strengthened authority, the rules are far from clear. However, "red flags" are:

- Taking large positions in illiquid markets;
- Trading that appears inconsistent with market fundamentals;
- "Unprofitable trades," including trades designed to protect other positions;
- Unique or innovative transactions, especially among players with significant market share;
- Trading or transactions that can be expected to "move the market";
- Trading strategies that are premised on profiting from flaws in market rules;
- Trading strategies predicated on profiting from congestion or disruptions in the flow of product through the distribution system;
- Significant changes in purchases, sales or bidding behavior unrelated to market fundamentals or underlying business needs;
- Conducting business outside official channels;
- Sharing non-public business information except as necessary to conclude legitimate business transactions; and
- Transactions that offset each other in price or output.

Effective Compliance Programs

Compliance measures include:

- Maintain clear, contemporaneous business records that document the business reasons for all transactions;
- Establish clear guidelines for financial trading programs linked to hedging requirements of physical commodity business;
- Maintain close contact between legal and business origination, corporate development and other market-facing business functions;
- Establish robust systems to track market positions;
- Institute clear limits on authority for physical and financial trades;
- Institute clear limits on authority to purchase or sell products from competitors;
- Establish and enforce a rigorous document retention policy;
- Invest in robust IT systems that ensure accurate and timely tracking of business transactions;
- Establish a robust corporate compliance policy with support and leadership at all levels of your organization; and
- Invest in regular compliance training for key executives, lawyers and business team members with market-facing responsibilities.

As always, the best risk management policy is an attentive executive management that provides clear direction and strong incentives for business teams to pursue pro-competitive business strategies that avoid the appearance of collusion or manipulation.

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