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FERC Assesses Penalties for Alleged No-Risk UTC Trading Against City Power and Its Founder

Earlier this month, the Federal Energy Regulatory Commission (FERC) issued an Order Assessing Civil Penalties against City Power Marketing, LLC (City Power) and its founder and sole owner, K. Stephen Tsingas[1] (collectively, Respondents) for violating section 222 of the Federal Power Act (FPA) and section 1c.2 of the Commission's regulations, which prohibit energy market manipulation.[2]

According to FERC, Respondents entered into fraudulent "no risk" Up-to-Congestion (UTC) trades in PJM's market to earn excessive amounts of Marginal Loss Surplus Allocation (MLSA) payments made to transmission customers. The Commission also found that City Power and Mr. Tsingas, in writing and orally, denied the existence of relevant and material instant messages (IM) when responding to the Office of Enforcement (OE) Staff's (Staff) investigation in violation of section 35.41(b) of the Commission's regulations, which prohibits a seller, such as City Power, from submitting false or misleading information or omitting material information to the Commission and its Staff unless it exercises due diligence to prevent such occurrences.

Accordingly, following Staff's recommendations, the Commission assessed a civil penalty of $14,000,000 against City Power and $1,000,000 against Mr. Tsingas, and disgorgement of unjust profits of $1,278,358 against City Power and Mr. Tsingas, jointly and severally. As with the UTC trading in Powhatan,[3] this OE investigation was initiated after an August 2010 PJM referral to OE of a market participant's complaint identifying as potential "gaming" unusually high volumes of transmission reservations by certain market participants on PJM's OASIS, which lead to a review of specific UTC trading.

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[1] Also known by the IM handle: "traderyoda".

[2] 152 FERC ¶ 61,012 (2015) ("*City Power*"); see also Order to Show Cause and Notice of Proposed Penalty, 150 FERC ¶ 61,176 (March 6, 2015). FERC Chairman Norman Bay did not participate in the decision.

[3] 151 FERC ¶ 61,179 (2015) ("*Powhatan*").

Not-So-"Funny" "Loss Trades" with an Alleged Fraudulent Purpose

FERC found that from July 4 to July 30, 2010, Respondents implemented their fraudulent trading scheme by intentionally placing high-volumes of three categories of UTC trades: (1) "round-trip" trades that canceled each other out (locations A to B, and simultaneously equal volumes from B to A); (2) trades between two PJM nodes (SOUTHIMP-SOUTHEXP) that are import and export pricing points of the same PJM interface designed to have equivalent prices; and (3) trades between two PJM nodes (NCMPAIMP-NCMPAEXP) that historically had a very small price spread that would not exceed the trade costs (including transmission service secured to obtain MLSA payments) (together, the Loss Trades). Respondents did not transact in this manner prior to July 2010.

The Loss Trades, according to FERC, were not designed to exceed their costs and profit from the arbitrage between day-ahead and real-time market prices at two locations and thereby promote price convergence as encouraged by PJM. Instead, the Loss Trades were understood by the traders to be without meaningful risk and unprofitable, implying that the trades were not bona fide transactions or positions. As evidenced by electronic communications, testimony, and trade data, FERC found that the Loss Trades were solely designed to reserve transmission service to allow the Respondents to collect excessive MLSA payments.

FERC cites incriminating IM communications, including where a City Power trader observed to Mr. Tsingas that it was "nuts" to be paid losses (the MLSA) on these zero spread trades, he felt "really funny about them" (the Loss Trades), and such trades could be great "ammo" for the PJM market monitor. Mr. Tsingas admitted that while the Loss Trades paid well, it felt "sleazy." Indeed, according to FERC, the Respondents switched from one to the other Loss Trades patterns when Mr Tsingas' partner became concerned about potential market monitor scrutiny in an attempt to conceal the nature of their trading scheme and to "stay below the radar."

Defeating the Purpose of PJM's UTC Instrument

FERC determined that the UTC trades were uneconomic and fraudulent by design because the Loss Trades failed to connect or otherwise pursue an arbitrate spread opportunity. By creating this false impression, City Power and Mr. Tsingas deceived PJM into paying City Power the MLSA to the detriment of other market participants that were legitimately entitled to such payments.

FERC disagreed with Respondents' argument that their Loss Trades did not constitute fraud because the trades did not inject false information or give a false impression to the market or other market participants. As it did in Powhatan, FERC found that City Power's UTC trades were contrary to the market design purposes for which PJM offered the UTC product. The Commission stated that when used appropriately to arbitrage market prices between two locations in the day-ahead and real-time markets, UTC trades in PJM, benefit PJM's market by encouraging convergence between day-ahead and real-time market prices.

According to FERC, the Loss Trades did not promote market efficiency by converging the day-ahead and real-time prices, but rather intentionally subverted the allocation of payments provided by PJM's tariff.[4] FERC found that Respondents fraudulently placed high-volume round-trip UTC trades without regard to market fundamentals and with the intent to benefit not from a spread on UTC trades (there was no spread), but solely from the improper allocation of MLSA payments.[5] Moreover, FERC also found that City Power's round-trip UTC trades were wash trades (transactions which are (1) prearranged to cancel each other out; and (2) involve no economic risk), which the Commission has long-recognized are per se fraudulent and manipulative.[6]

[4] 152 FERC ¶ 61,012 at P 92 ("The evidence demonstrates that Respondents engaged in their round-trip UTC transactions, as well as their one-way transactions from SOUTHIMP-SOUTHEXP and from NCMPAIMP-NCMPAEXP, not for hedging or arbitraging price spreads but instead to receive large shares of MLSA payments that otherwise would have been allocated to other market participants.").

[5] 152 FERC ¶ 61,012 at P 61.

[6] *Id*.

It's Not Black Oak, Lake Erie Loop Flow, or Blumenthal

FERC rejected Respondents' argument that (1) they lacked fair notice that the Loss Trades would be considered fraudulent; (2) FERC's Black Oak orders could be read to authorize those trades because the Commission previously addressed the relevant conduct (including the MLSA as part of a profit seeking calculus) and failed to proscribe it; and (3) the PJM market monitor tacitly agreed that City Power was "not doing anything wrong." The Commission stated that because its Black Oak orders focused on the merits of the MLSA distribution mechanisms and did not explicitly contemplate or condone trading UTCs for the purpose of capturing MLSA revenues, the Respondents cannot now claim to have reasonably concluded that their trades would not be subject to Commission scrutiny. Regarding the comments of the PJM market monitor after the Loss Trades were executed, FERC stated that Respondents did not rely on those comments. According to FERC, "compliance with a tariff is not determinative as to whether fraud has occurred."

FERC also rejected the Respondents' comparison of their conduct with the Lake Erie Loop Flow[7] and Blumenthal[8] cases. In those cases, market participants were pursuing transactions to lower costs in order to profit from price signals or honoring capacity supply obligations, not entering into uneconomic, risk-free, round-trip UTC trades designed not for arbitrage or profit, but solely to earn MLSA payments. The Commission also rejected Respondents' claim that the Loss Trades actually were "optionality" trades placed with the intent to profit from one leg of the spread failing to clear as an after-the-fact rationale, lacking any credible support and contrary to the evidence. Indeed, according to OE Staff, the Respondents had no chance to profit from an optionality strategy.

Duty of Candor

With respect to its violation of section 35.41(b) of the Commission's regulations, FERC found that in the course of OE Staff's investigation, Mr. Tsingas, on behalf of City Power, made a series of misrepresentations, false statements, and material omissions about the existence of relevant IMs in an effort to hide them from OE Staff. The Commission determined these violations caused OE Staff to waste valuable time and resources during their investigative process, and indeed, FERC considered this an aggravating factor in its penalty determination.[9] Respondents did not assert a defense of due diligence and, therefore, FERC did not address it. In addition, the Commission determined that Mr. Tsingas attempted to "cover up" the company's Loss Trades scheme, after PJM's IMM left a message for Mr. Tsingas to discuss City Power's UTC trading.

The Commission repeated that market participants are on notice of their obligation to be candid, and that it takes false or misleading statements seriously, particularly when they occur in the context of a Staff investigation into potentially improper conduct. The Commission rejected City Power's defense that it provided the "literal truth" to the OE Staff and concluded that City Power's intentional misrepresentations were "very serious, warranting a significant penalty."

Sufficient Means to Pay the Penalty

The Commission applied here a "case-by-case" rather than a formulaic approach to penalty assessment against the Respondents because there were multiple violations including fraud, intentional misrepresentations, and false statements, and a natural person, Mr. Tsingas, also committed these violations. Aggravating factors included the seriousness of the violation, senior management involvement, willfully concealing documents, and making false statements. The Commission was not persuaded by Respondents' argument that its financial condition and corresponding inability to pay should reduce the penalty and disgorgement to well below $1 million.

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[7] *New York Independent System Operator, Inc.*, 128 FERC ¶ 61,049, at P 61,256 (2009) (*"Lake Erie Loop Flow"*) ("the existence of a pricing incentive is suggestive of the lack of a fraudulent device, scheme or artifice, and is indicative instead of market participants responding to existing prices, rather than artificially affecting them.").

[8] *Blumenthal v. Indep. Sys. Operator of New England*, 132 FERC ¶ 63,017, at P 111 (2010) (*"Blumenthal"*) (Commission held that the "alleged 'scheme, artifice, or device' was not a fraudulent scheme at all, but an intentional plan by the energy companies to satisfy their tariff requirements while earning capacity payments and minimizing economic risks – a 'pattern of rational economic behavior.'").

[9] 152 FERC ¶ 61,012 at P 241.

Even assuming City Power's assets have dwindled to less than $850,000, as City Power claimed, the Commission found Mr. Tsingas has assets totaling at least $10 million. Moreover, the Commission stated it "question[ed] the candor of City Power's plea and claims of dwindling assets, given statements from Mr. Tsingas' website, which boasts that the company 'continues to thrive and flourish everyday.'" FERC noted the company website states further that "Mr. Tsingas has 'ensured that the company was prosperous from day one, ultimately making more than $40 million almost single handedly.'" Thus, the Commission concluded that from Mr. Tsingas' own representations that both City Power and Mr. Tsingas have ample ability to pay the $14 million civil penalty.

FERC rejected City Power's argument that it was entitled to compliance credit. The Commission stated that, even assuming arguendo that City Power had a compliance program in place at the time of the violations, compliance credit was not warranted because City Power's founder and majority owner designed and directed the fraudulent trading conduct and then engaged in a cover-up to block OE Staff's efforts to discover IMs relevant to that conduct.

The Commission also directed PJM to establish and provide to the Commission a method to resettle and distribute the resettled MLSA payments (to be disgorged by City Power and Mr. Tsingas) in a manner which identifies: (i) the market participants that would have received higher MLSA payments in the absence of Respondents' activity during the manipulation period; and (ii) the amounts of those higher payments.

Next Stop, District Court?

As detailed in our June alert, May 2015 Brings a Crop of FERC 'Loophole' Manipulation Civil Penalty Assessments, this investigation (although different in several material respects) is similar to Powhatan and Maxim Power to the extent it represents an important expansion of OE's interests to include not only "relational trading" but also so-called tariff "loopholes" enforcement matters.

Rather than have an administrative hearing before an administrative law judge, Respondents have elected under section 31(d)(3)(A) of the FPA for the following procedure: (i) prompt assessment of a penalty by Commission order; (ii) if the penalty is unpaid within 60 days, the Commission will institute a proceeding in the appropriate district court seeking an order affirming the assessment of a civil penalty and that court will have the authority to review de novo the law and facts involved; and (iii) the district court will have the jurisdiction to enforce, modify, or set aside, in whole or in part, such penalty assessment. Following this process, a person can appeal to a United States Court of Appeals for review of the district court order. Respondents also could explore other litigation tactics as well.

Assuming that the penalty will not be paid by City Power or Mr. Tsingas and the matter does not settle at this time, the Respondents will find themselves in court.

City Power and Mr. Tsingas may or may not argue that FERC lacks jurisdiction over UTCs as financial transactions and over individuals. As discussed in our June alert, however, this may be no easy task, given the U.S. District Court for the Eastern District of California's May 2015 ruling denying a motion to dismiss and upholding FERC's determination that it had jurisdiction over (1) a global financial institution and four of its energy traders; and (2) FERC's allegations of market manipulation through arguably purely financial trading in the West. That court concluded that section 222 of the FPA prohibits market manipulation by "any entity," which applies to natural persons as well as organizations.

Another threshold issue in district court will be a determination of the scope of review regarding the assessment of the civil penalty de novo, as mandated by section 31(d)(3)(A) of the FPA. Is the scope a simple review of the existing FERC investigative materials or de novo trial, including discovery and cross-examination rights? This issue is being litigated in the Eastern District of California proceeding mentioned above and in FERC v. Silkman et al., No. 1:13-cv-13054 and FERC v. Lincoln Paper & Tissue, LLC, No. 1:13-cv-13056 in the District of Massachusetts. FERC has taken the view in various forums that courts should apply a deferential standard; no trial is required. FERC asserts that under de novo review, the court can affirm the penalty assessment based on FERC's order assessing civil penalties and the existing investigatory record – no discovery or cross-examination is warranted.

FERC's authority and decisions will be tested in various enforcement matters pending in or making their way to district court.

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