

## COMPLETING THE PUZZLE

### Defining Manipulation Under REMIT

By Dan Harris and Shaun Ledgerwood

*On 20 December 2011, the Agency for the Cooperation of Energy Regulators (ACER) issued its Guidance on the application of the definitions of the Regulation on Wholesale Energy Market Integrity and Transparency (REMIT).<sup>i</sup> In this paper, we provide a brief overview of ACER's definitions with respect to market manipulation, identify some potential weaknesses and offer an approach for achieving greater clarity that would benefit both regulators and market participants.*

#### **Introduction**

On 28 December 2011, REMIT went into effect,<sup>ii</sup> establishing insider trading rules similar to those that apply in financial markets and prohibiting market manipulation, among other things. Inside information could certainly be used to manipulate a market, but what is and is not inside information is purely a legal question. Economists, however, can provide valuable insights as to the types of behaviour that should or should not be considered manipulative, and it is on this aspect of REMIT that we focus our discussion.

#### ***The Many Faces of Manipulation Under REMIT***

Article 2(2) of REMIT distinguishes four categories of market manipulation:

- (1) Market manipulation through false and/or misleading transactions*
- (2) Price positioning*
- (3) Transactions involving fictitious devices/deception*
- (4) Dissemination of false and misleading information*

Many in the energy industry have been concerned that these definitions were too broad to be easily understood and applied. For example, what are 'false or misleading signals,' and when does the price no longer reflect the 'fundamentals of supply and demand'? While the vast majority of market participants have no intention of engaging in manipulation, many are concerned that they could be unwittingly accused of such behaviour if the definitions are open to differing interpretations. Market participants would like a clearly delineated 'safe harbour' where they can be confident that their actions are legitimate.

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It is in response to these concerns that ACER published its REMIT Guidelines. ACER has tried to provide greater clarity in regard to what market manipulation actually means in the context of REMIT by citing a number of concrete examples of market manipulation that have occurred in the past, and by describing specific behaviours that National Regulatory Authorities (NRAs) should take into account in determining whether or not certain acts constitute market manipulation. While ACER's efforts to better define market manipulation are welcome, we see two potential shortfalls with this approach.

First, while the Guidelines offer examples of what is likely to be manipulation, there is still room for significant doubt about circumstances not covered by the examples. Because each specific example provides only narrow insight into what behaviour is prohibited, knitting the various examples together is much like trying to discern the picture of a puzzle when many of the pieces are missing.

Second, the examples themselves seem to raise more questions than they answer. The examples given could occur as a symptom of manipulation, but could equally arise during legitimate trading activity. For example, the Guidelines note that the NRAs should take into account:

'... the extent to which orders to trade given or transactions undertaken represent a significant proportion of the daily volume of transactions in the relevant wholesale energy product on the trading venue concerned, in particular when these activities lead to a significant change in the price of the wholesale energy product.'<sup>iii</sup>

While it is true that some market manipulation could involve large trades, any large order is likely to change the price of the commodity, particularly when the market is illiquid. Indeed, sometimes it can be perfectly legitimate to make a large trade; for example, to replace production from an outage. No doubt any subsequent investigation would establish this. However, the risk is that firms may respond to the Guidelines by carrying smaller trades than would otherwise be efficient, so as to avoid setting off 'alarm bells' and an investigation procedure. Similarly, NRAs may feel obliged to investigate legitimate behaviour that exhibits one or more of the features in the Guidelines.

ACER gives the example of 'Circular Trading' in one of its case studies and defines it as '[t]he process of executing a sell order with the knowledge that an offsetting buy order is being placed at the exact same time.' But one real-world example where this happened legitimately is the APX-ENDEX market in the Netherlands. Before the introduction of the current market coupling arrangements, the market rules dictated that power imported using day-ahead cross-border capacity must be sold on the APX's exchange. An importer who had already made a deal to sell the power offered the volume on the exchange at €0/MWh, while their counterparty bid to buy at the exchange's price ceiling. Both the offer and bid cleared at the market price, and the parties may also have arranged a Contract for Differences around this price. The practice involved 'executing a sell order with the knowledge that an offsetting buy order is being placed at the exact same time.' But was this really market manipulation since the practice did not affect the market clearing price?

Other behaviours listed in the Guidelines could be symptoms of market manipulation, many of which — with the exception of outright fraud — could be equally legitimate under certain circumstances. For example:

- ◆ Trades placed by different traders within the same entities can, and indeed sometimes do, take the opposite sides of the same transactions for legitimate hedging and/or speculative reasons. Such trades could be inappropriately perceived as matching transactions.

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- ◆ The act of legitimately hedging market positions with directionally opposite physical or financial trades can be misinterpreted as cross-market manipulation, especially if severe adverse price movements caused by the hedge-holder triggers a large profit via the hedge. This, of course, is the purpose of a legitimate hedge: to offset losses in one market with gains in another.
- ◆ Acts involving the legitimate withdrawal of production or transmission capacity from the market could be misconstrued as attempts to create an artificial price. Likewise, transactions following legitimate price signals created by regulatory gaps or seams issues could wrongfully be viewed as manipulative.<sup>iv</sup>

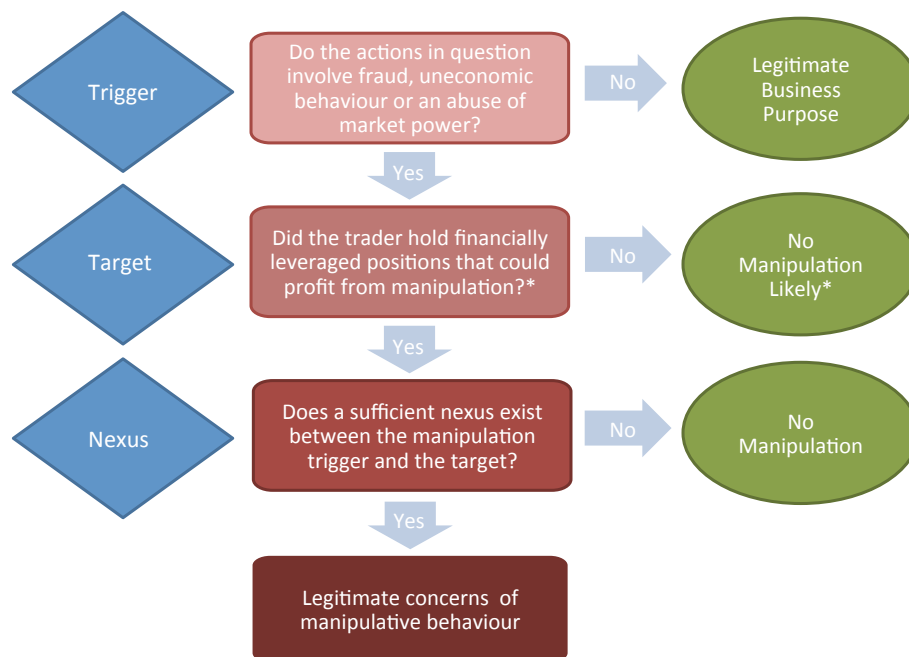
**An Alternative View**

As we have discussed in previous papers,<sup>v</sup> it is possible to think of a market manipulation as having three components:

- (1) **Trigger:** An intentional act performed to produce a directional price movement
- (2) **Target:** One or more positions that stand to benefit from the price movement
- (3) **Nexus:** The causal linkage between the trigger and target

By separating manipulation into these components, a general conceptual framework for thinking about market manipulation emerges. For example, consider the placement of large trades that have a directional influence on prices. These trades could be the manipulation’s trigger, if they were designed to intentionally cause a directional price movement. The price affected would then be the manipulation’s nexus, providing a causal linkage between the large trades and the positions that could benefit therefrom (i.e., the target). A similar logic would attach to any of the other examples of alleged manipulative behaviour discussed above.

**Figure 1 Conceptual Framework of a Market Manipulation Analysis**



\* Not all financial positions may be observable

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The primary benefit of this framework is that it paints a clearer picture of behaviour that is not manipulative. For example, consider Figure 1, which shows a hypothetical analysis of allegedly manipulative behaviour. The first question one might ask in analysing the triggering trades would be whether the transactions lacked a legitimate business purpose on a stand-alone basis. If the trades were legitimate, the trader should be able to assert a 'safe harbour' from anti-manipulation enforcement actions. If not, the next issue would be whether the trader held targeted positions that were sufficiently leveraged to benefit from the price movement and more than offset any losses incurred by the triggering trades (i.e., positions that extend beyond those needed to serve as a legitimate hedge). If so, the final question requires the proof of the nexus between the trigger and target (often made evident through linkage to the same price).

By thinking about manipulation in a more all-encompassing manner than the case study examples included in ACER's guidelines, market participants would benefit from greater certainty with respect to the type of behaviour that should or should not be considered manipulative. Compliance with the new anti-manipulation standard provided by REMIT will improve as a result, benefitting traders, their companies and regulators alike. Most importantly, greater certainty about what is and is not market manipulation would maximise the liquidity provided by legitimate trading, with all its attendant benefits.

## **Conclusion**

### ***The Need for Greater Clarity***

ACER's Guidelines are an important step toward turning REMIT into a workable piece of legislation. However, the Guidelines are not the whole answer. It is clear that a more cohesive set of principles that define market manipulation, while minimising the risk of false positives and investigations, is still needed. The principles adopted should be sufficiently flexible to define market manipulation in a manner that provides consistency across cases, drawing a clearer picture of acts that constitute manipulative behaviour. More importantly, these principles should establish 'safe harbours' such that market participants can trade with the certainty that their actions will not later be misconstrued.

## **Endnotes**

<sup>i</sup> ACER, 'Guidance on the application of the definitions set out in Article 2 of Regulation (EU) No 1227/2011 of the European Parliament and of the Council of 25 October 2011 on wholesale energy market integrity and transparency,' 1st Edition 20 December 2011.

<sup>ii</sup> 'Regulation (EU) No 1227/2011 of the European Parliament and of the Council of 25 October 2011 on wholesale market integrity and transparency (REMIT),' *Official Journal of the European Union*, 8 December 2011.

<sup>iii</sup> ACER, 'Guidance,' page 21, Section 4.4.2(a).

<sup>iv</sup> For example, several wholesale electricity providers in the US were investigated for scheduling power flows around the Great Lakes, causing 'loop flow' as a result. Allegations of manipulation were disproven as the trades in question were found to have legitimately pursued profits left by a regulatory seam between two regions. See <http://www.ferc.gov/enforcement/market-manipulation/nyiso-loop-flow-report.pdf>. Similar opportunities may arise amongst the NRAs as the EU's wholesale energy markets evolve.

<sup>v</sup> See Shaun Ledgerwood, Dan Harris, Bin Zhou and Pinar Bagci, 'Defining Market Manipulation in a Post-REMIT World,' June 2011. Available at: [http://www.brattle.com/\\_documents/UploadLibrary/Upload960.pdf](http://www.brattle.com/_documents/UploadLibrary/Upload960.pdf). See also Shaun Ledgerwood and Dan Harris, 'A Comparison of Anti-Manipulation Rules in US and EU Electricity and Natural Gas Markets: A Proposal for a Common Standard,' forthcoming in *The Energy Law Journal*, March 2012.

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