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Ban JPMorgan from California's electricity trading business

Players as cunning as JPMorgan will always be able to outsmart federal watchdogs and manipulate the complex market. The U.S. should outlaw the banks' trading and reconsider the auction-based approach.

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So much for the new, "tougher" Federal Energy Regulatory Commission.

FERC, as the agency is known, is in the process of negotiating a settlement with JPMorgan Chase & Co., the huge New York bank that has been accused of serial frauds against California electricity customers and the state's electric distribution system.

The reported size of the settlement price could be as high as $500 million, which would be a record penalty in a FERC proceeding.

That certainly sounds like a big number. But here's the number that measures the deterrent effect the settlement likely would have on JPMorgan's inclination and ability to stage similar schemes again and again: zero.

That's true for two reasons. First, it's unlikely that the settlement would cost any high-ranked Morgan executive any money, much less his or her job. (The most often-mentioned individual is Blythe Masters, who essentially created Morgan's commodity business.) Second, there's no sign that FERC is inclined to bar Morgan permanently from the electricity trading business. That's a costly sentence that could really make the bank reconsider its past misbehavior.

No matter the size of the fine the regulators impose, these players will always find a way to outsmart the watchdogs. "The more complicated the market, the more opaque it is," Robert McCullough, an energy consultant who follows the trading markets from Portland, Ore., told me. "We're going to learn what yesterday's manipulation is, but we're never going to get ahead of it."

In fact, there's evidence that Morgan actually evaded a stiff penalty FERC imposed for its earlier shenanigans by concocting yet another shady scheme. More on that in a moment.

Morgan's behavior may not be menacing Californians' pocketbooks at the moment; in May it sold to Southern California Edison its rights to control and trade the output of 12 California power generating units, removing a headache its presence in the market had caused for state regulators. But its past trading has already roiled state power sales. And nothing says Morgan couldn't reenter the California market any time it wishes. Morgan wouldn't comment on any aspects of its adventures in the California electric power market.

In any case, the settlement negotiations dodge the most important question about the business model of Morgan and other banks: Why are they allowed in the commodity markets in the first place?

That question was the subject of a hearing Tuesday before the Senate Banking Committee, which delved into the drawbacks of allowing big commercial banks into the electricity, metals and oil trading businesses. The upshot, observed Sen. Sherrod Brown (D-Ohio), has been "a host of anticompetitive activities."

The banks contend that they perform a service for clients and the economy as a whole by making the trading markets more liquid, reducing costs for the commodities' buyers and sellers alike.

But Saule T. Omarova, a regulatory expert at the University of North Carolina law school, pointed out that the potential for conflicts of interest, market manipulation and bank profiteering might outweigh those benefits.

"There's no particular benefit to the economy in having JPMorgan play the role that Enron played," Omarova told me.

Indeed, a spokeswoman for the California Independent System Operator, a quasi-state agency that oversees much of California's electrical distribution grid and filed the initial complaints about Morgan's scheme, essentially told me that the ISO regards electricity-trading banks as pests.

"The banks have introduced a new culture in the market, not consistent with the kind of trading we've seen with energy companies," says the spokeswoman, Stephanie McCorkle.

Let's not overlook that the activities Morgan was accused of are crimes: market manipulation, fraud and lying to government officials. If JPMorgan were just an average mook on the street, by now it would have been consigned for life to San Quentin under the state's three-strikes law. But its color is green and its collar is white, and as a result it continues to skate. No criminal charges against the bank, its traders or its executives are on the table, and that's improper.

The $500-million penalty wouldn't rank as a big hit in terms of the bank's wealth. It comes to about 2.35% of Morgan's $21.3-billion profit last year. If the sum were to come directly out of its shareholders' hides, it would cut their annual $1.20 dividend per share less than three cents.

A Morgan settlement with FERC would come on the heels of several other eye-catching actions by the agency, which has been playing itself up as a serious sheriff over the electricity markets. Earlier this month, the agency slapped a $470-million penalty on Barclays Bank for market manipulation in California. Barclays says it will fight the case in court.

What's worst about enforcement by cashier's check is that it allows FERC to evade the real lesson taught by these endlessly repeated shenanigans in the energy markets — the markets are too complex, and the potential profits from wrongdoing are too high, for government regulators to supervise properly.

With banks, the task of oversight becomes even harder because of the numerous regulatory gaps they can exploit. For example, Barclays is accused of having played the physical electricity markets against the financial markets in energy futures from 2006 to 2008 (its trades in the electricity markets were allegedly designed to pump up the value of its financial contracts).

The former is regulated by FERC and the latter by the Commodity Futures Trading Commission; one reason it took the regulators until 2013 to lower the boom on a 7-year-old scheme is that it fell through the cracks between them. And that's not even counting that the banks' overall soundness is overseen by a third regulator, the Federal Reserve.

The biggest problem in California, McCullough says, is that power bidding in the state is done in secret — unlike other states where bids and offers are made in public. That allows for more manipulation and may help explain why wholesale power prices in California tend to be higher than in surrounding states. But FERC also needs to examine whether electricity is too important a commodity to be traded by auction at all.

Morgan's behavior provides a perfect example of the costs of this system. As I've chronicled in the past, the California ISO accused Morgan of having made bogus bids in its electricity auctions so it could pocket undeserved and inflated trading profits.

The ISO estimated its direct losses from Morgan's trading at $83 million, costs shouldered one way or another by California ratepayers. But that could be only the tip of the iceberg, thanks to the price discrepancies Morgan's trading may have introduced into the statewide power market.

Once the ISO brought its complaint about Morgan to FERC, the bank stiff-armed FERC's enforcement staff, withholding financial information and other records the agency sought. A fed-up FERC dropped a nuclear bomb: It suspended Morgan's authority to participate in California's auction-based electricity market for six months, starting April 1.

That's the sort of step that could really hurt Morgan's bottom line, but there's evidence that the bank found a way to evade the penalty. According to documents the ISO filed with FERC in May, a Morgan subsidiary reached agreements with two independent trading firms temporarily ceding to them the California power the bank controlled. Suspiciously, those agreements involved precisely the power rights that the FERC suspension affected, and ran from April 1 to Sept. 30, precisely the period of the suspension.

Morgan, the ISO said, "may be evading the commission's order" by using these contracts to conceal its financial interest and "to obtain profits during the suspension period beyond those contemplated in the commission's suspension order."

McCorkle says Morgan's sale of its trading rights to Edison made that accusation moot, "though we'll be keeping a close eye on bidding behavior."

That's not enough. The incessant accusations of manipulation in California and around the country show that the power markets are rotten and their participants aren't feeling enough heat from regulators. Two steps are necessary: Outlaw the banks' trading and reconsider the move to market trading for this crucial service.

"Turning electricity into another casino commodity has hurt consumers," says Tyson Slocum, an electrical regulation expert at the consumer advocacy group Public Citizen. He's right, and giving cheats free access to the casino floor has only made things worse.

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