



I remain confused.



Kevin J. Gates

VP of Managing Member
Powhatan Energy Fund LLC



WCEE

Electricity Markets: Growing Pains or Mid-life Crisis?
July 16, 2014



Powhatan is being investigated for market manipulation.

- In 2010, through a trader named Alan Chen, Powhatan invested in the PJM market.
- Alan realized that, under some circumstances, PJM paid rebates to traders. Alan contacted PJM to verify this.
- Alan considered these rebates when implementing his trading strategy and he made money.
- PJM changed the rules and eliminated the rebates.
- FERC's Office of Enforcement has accused Powhatan of market manipulation because of Alan's rebate-influenced trades.
- Powhatan has spent millions of dollars defending itself from the FERC Office of Enforcement and has built a website at www.ferclitigation.com.

I've been having conversations with lawyers.

■ Q: Have you ever gone by any other names, or nicknames?

A: Kevin, Kev, The Kevster

A: I've enjoyed [our discussion], but it's not what I otherwise would have chosen to do today

- Kevin J. Gates, deposition under oath, September 23, 2010

■ Tell more jokes! You need them to like you. Don't act like you are from Wall Street.

- My first attorney's comments in advance of second deposition

■ Kevin's a businessman, isn't he? He knows that it's cheaper to settle than it is to fight this investigation.

- FERC attorney after my second deposition, September 7, 2011

■ Your problem is that you're an outsider to the industry and you made a lot of money* in a short period of time. You're not sympathetic.

- My first attorney's comments later that week

* Google "Moxy Vote" to see what I did with some of that money.



Here's my background.

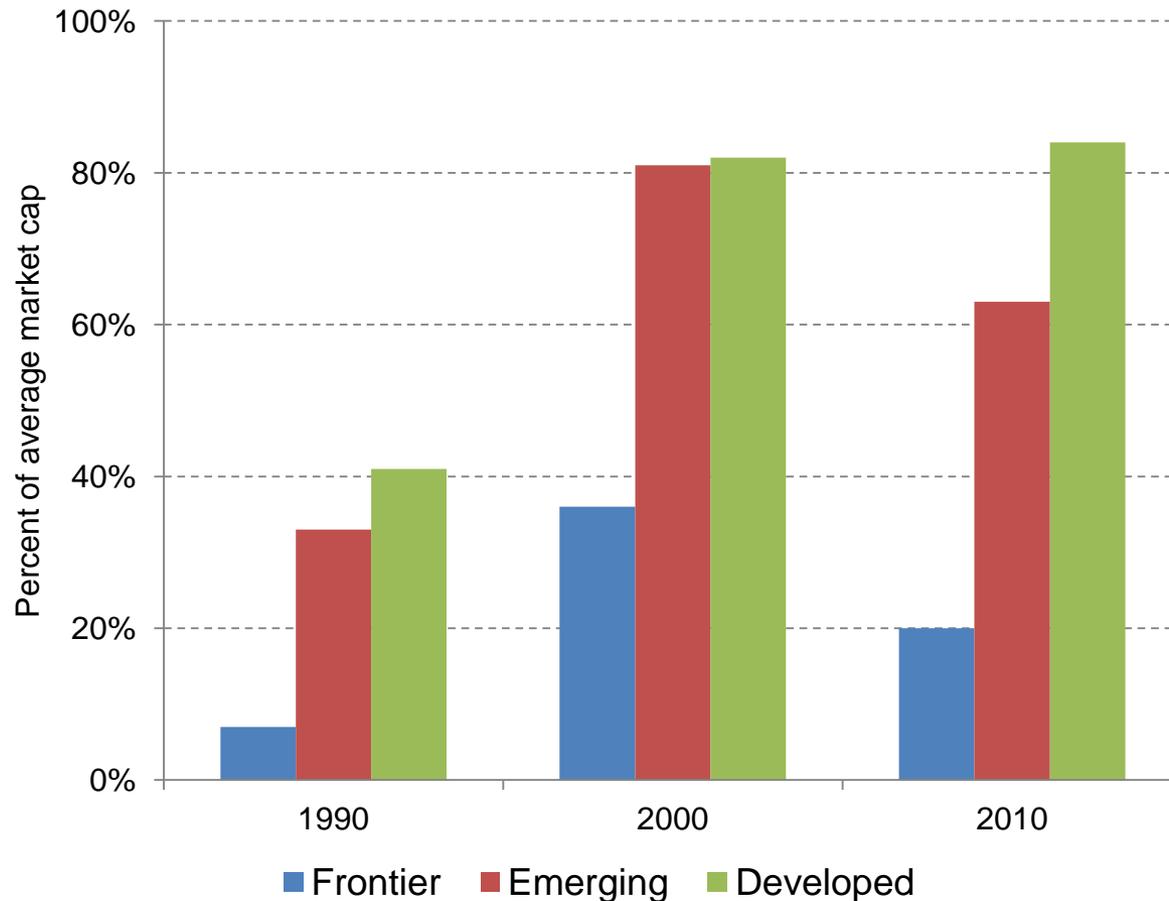
- My brother and I started TFS Capital* 17 years ago using money borrowed from credit cards.
- TFS Capital is now an asset manager with over \$1 billion under management, including 3 SEC-registered mutual funds.
- TFS Capital is an SEC-registered investment advisor and a commodity pool operator registered with the CFTC.

* TFS Capital is unaffiliated with and unrelated to Powhatan Energy Fund LLC.



Open markets beget liquidity in equities.

Turnover ratio for equities as a percentage of average market cap



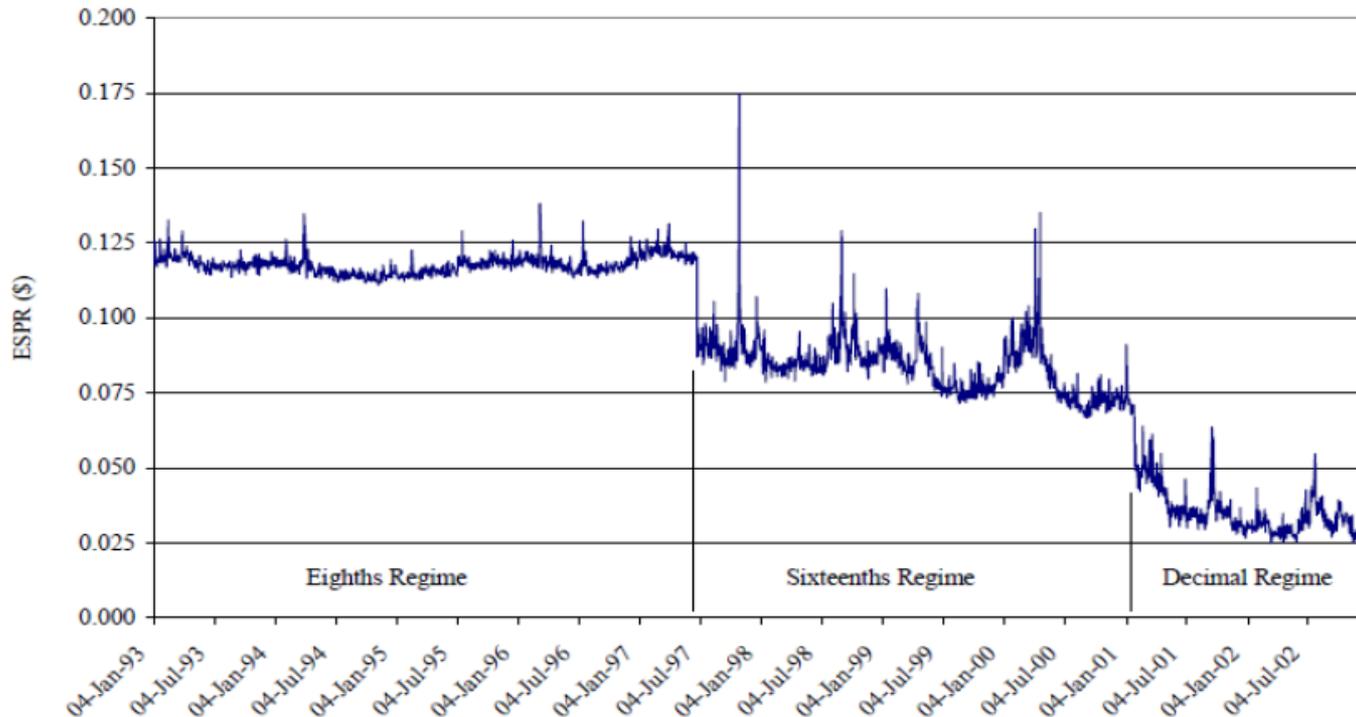
“[F]rontier... markets are less developed and are generally riskier in terms of liquidity, market structure, and political climates... relative to developed markets (and also, one could argue, to emerging markets).”

Source: Vanguard, *Exploring the next frontier: A review of frontier equity markets, January 2013*



US equity markets have been improving.

Value Weighted Daily Average Effective Spread, NYSE, 1993-2002



“... the good part of high-frequency trading is that the intense competition between high-frequency traders had driven the costs of trading very close to zero. They’ve never been cheaper, so maybe sometime I’m going to have to rethink the idea that trading costs reduce the returns of investors.”

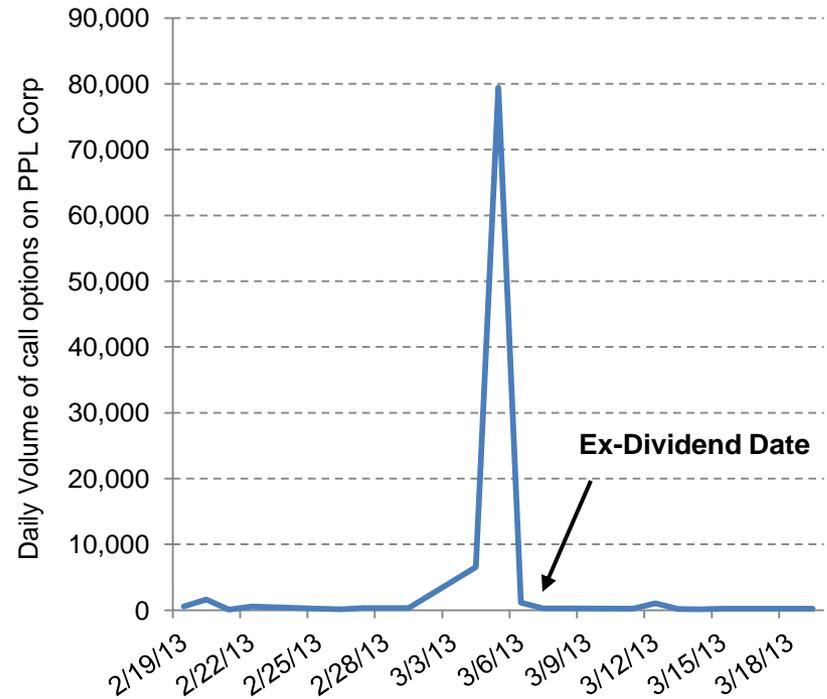
- Jack Bogle, July 2014

Source: Equity Trading in the 21st Century - Angel, Harris and Spatt (2010)



I know about the equity markets.

- Spread trades are where a trader takes offsetting positions in two closely related contracts, attempting to obtain a benefit while taking on limited market risk. *e.g.* Long BRK.A, short BRK.B.
- Wash trades aren't *per se* manipulation – only if done with the objective of introducing false information into the markets. Peter Kellogg could have had ulterior motives for his wash trades – didn't matter.
- Ex-dividend arbitrage makes graphs like this because of wash trades.



Source: Bloomberg Professional

The law should matter. Due process is important.

- In every other market, spread trades are ubiquitous.
- Why should anyone ignore an unexpected payment of \$900,000? How could they?
- Black Oak Energy: FERC debated, predicted and encouraged this behavior. PJM changed its tariff.
- Alan contacted PJM in 2009 expressing an interest in the rebates.
- I'm guessing all UTC traders were making money. Many are under investigation.
- PJM changed its tariff again.
- Powhatan was accused by another market participant of killing the goose that laid the golden egg.

The Fourteenth Amendment to the United States Constitution requires, in part, that laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited. It incorporates notions of fair notice or warning and requires legislatures to set reasonably clear guidelines for law enforcement officials and triers of fact in order to prevent arbitrary and discriminatory enforcement.

Why aren't we talking about the law?

- Instead of the law, we are talking about other things. Why?
- Today, for instance, we are talking about “social value”, a term not found in a tariff, the governing law, or FERC’s charges against Powhatan.
 - What does it even mean?
 - Highly subjective and causes arbitrary enforcement and prosecutorial abuse.
- But, if we must have the discussion, Alan’s trades did add social value in many ways. To address convergence, Alan’s trades would have done just that at the very time that the market needed it the most.

January 23, 2014

	DA	RT
COMED	\$328.77	\$160.96
MISO	<u>\$264.18</u>	<u>\$155.12</u>
Spread	\$64.59	\$5.84

- If a market participant can't rely on the law, then how is she supposed to make business decisions?

FERC is endangering the functioning of the power markets by extending its definition of market manipulation in ways that are “extremely dangerous” and “could unravel the entire power market.” - **Professor William Hogan, Harvard University, October 2013**

It's too easy to disagree about whether things “add value”.

- Abortion providers
- Breweries
- Bureaucrats
- Casinos
- Credit cards
- Factory farming
- Fashion models
- Fast food
- Fracking
- Genetic research
- Nutritional supplements
- Fossil fuels
- Fox News
- Hollywood
- Lawyers
- Lobbyists
- MSNBC
- Paper mills
- Psychiatrists
- Salesmen
- Telemarketers
- Tobacco
- Video games

“ It is in this realm—in which the prosecutor picks some person whom he dislikes or desires to embarrass, or selects some group of unpopular persons and then looks for an offense, that the greatest danger of abuse of prosecuting power lies. It is here that law enforcement becomes personal, and the real crime becomes that of being unpopular with the predominant or governing group, being attached to the wrong political views, or being personally obnoxious to or in the way of the prosecutor himself.”

Robert H. Jackson, Attorney General of the United States
April 1, 1940
(More text of this speech in at the end of this presentation.)

FERC's Office of Enforcement creates a no-win situation.

- Oceanside Power LLC settled.
 - disgorgement, fine, kicked out of market for year, compliance classes and scarlet letter.
- Powhatan will never settle. Have spent millions so far. Could last another 10 years.

“Even when there is no infraction, it can be financially ruinous to mount a legal defense against powerful agencies that seem bent on coercing a plea deal or settlement.”

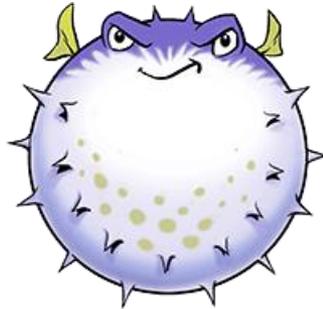
- Tim Lynch, CATO Institute, May 2014



Dr. Alan Chen and family

Here's what I'm doing now.

- Powhatan is still “under investigation”, as it has been for the last four years. The next step could be a “Notice of Alleged Violation”.
- **The Pufferfish Foundation** (www.pufferfish.org) –I've founded a non-profit named after a fish that's poisonous and shouldn't be eaten. It's a fun-loving animal, but when it's attacked or threatened, it blows-up.



- I expect to produce a documentary about this experience.

1940 Speech by Robert H. Jackson – The Federal Prosecutor

There is a most important reason why the prosecutor should have, as nearly as possible, a detached and impartial view of all groups in his community. Law enforcement is not automatic. It isn't blind. One of the greatest difficulties of the position of prosecutor is that he must pick his cases, because no prosecutor can even investigate all of the cases in which he receives complaints....What every prosecutor is practically required to do is to select the cases for prosecution and to select those in which the offense is the most flagrant, the public harm the greatest, and the proof the most certain.

If the prosecutor is obliged to choose his cases, it follows that he can choose his defendants. Therein is the most dangerous power of the prosecutor: that he will pick people that he thinks he should get, rather than pick cases that need to be prosecuted. With the law books filled with a great assortment of crimes, a prosecutor stands a fair chance of finding at least a technical violation of some act on the part of almost anyone. In such a case, it is not a question of discovering the commission of a crime and then looking for the man who has committed it, it is a question of picking the man and then searching the law books, or putting investigators to work, to pin some offense on him. It is in this realm—in which the prosecutor picks some person whom he dislikes or desires to embarrass, or selects some group of unpopular persons and then looks for an offense, that the greatest danger of abuse of prosecuting power lies. It is here that law enforcement becomes personal, and the real crime becomes that of being unpopular with the predominant or governing group, being attached to the wrong political views, or being personally obnoxious to or in the way of the prosecutor himself.

Full speech available here: <http://www.roberthjackson.org/the-man/speeches-articles/speeches/speeches-by-robert-h-jackson/the-federal-prosecutor/>

