Discussion on Commission Use of Natural Gas Price Indices

Over the past year, Staff has gathered information that raises serious doubts about the accuracy of information reported in many wholesale natural gas price indices. Current industry practice is for the trade press to gather price information by polling traders. We have seen ample evidence to raise serious questions regarding the functioning of this current industry practice.

The natural gas industry cannot function without accurate, dependable and trustworthy wholesale price information. Consequently, some action must be taken by the industry to address the problem.

We also propose action by the Commission to assure that the orders and tariffs it approves reflect accurate price information.

We would like to review our concerns today by:

1. Explaining the Commission's interest in price index formation;
2. Reviewing the public evidence that raises questions about price index formation;
3. Defining – at a high level – the criteria important to developing trustworthy price information in the future; and
4. Proposing some next steps.

The Commission's Interest in Accurate Price Index Formation

The Commission's interest in natural gas price indices relates both to the overall functioning of the wholesale market and to specific orders it has approved that reference these indices.

In the 1980s, the natural gas industry developed an approach to developing and disseminating wholesale price information using indices created and published by the trade press. This practice followed the more established practice in oil markets. Soon thereafter, certain orders and tariffs proposed by natural gas companies and approved by the Commission contained references to these price indices.

Natural gas price indices developed by the trade press remain central to the functioning of wholesale natural gas markets. Customers depend on these published price indices to make purchasing decisions. Numerous physical contracts refer to these price indices explicitly. Financial contracts that value the difference in prices between locations across the natural gas delivery system – known as basis – refer to these price indices. Companies interested in investing in exploration and production, transportation and storage rely on these prices to estimate the value of assets.

The Commission's current vision is of dependable, affordable energy through sustained competitive markets. This vision cannot be achieved without the development and dissemination of fair and trustworthy price information.

More specifically, the Commission approves pipeline tariffs that refer to market price data. There are three areas where these references tend to happen:

Cash-out provisions. On most major pipelines, when deliveries and receipts of natural gas are not in balance, the differences may be valued and sold to the shipper or purchased by the pipeline using market price information. These cash-out provisions allow the industry to quickly and efficiently account for and eliminate imbalances.

Penalties. In the determination of pipeline penalties, the Commission sometimes allows pipelines to use market prices to deter shipper conduct that could threaten system operations.

Basis Differentials. Many negotiated rate transportation contracts establish transportation rates using the basis differentials between two or more price index trading points.

The Commission does not approve natural gas price indices for other market-based rates that are largely the result of contract negotiations between parties. However, failure of confidence in these bilaterally negotiated prices could raise concern.

Public Concerns Related to Current Price Index Formation

<u>Staff Investigation</u>. On August 13, 2002, Commission Staff made publicly available its Initial Report of its investigation in Docket No. PA02-2-000. Staff inquired into the characteristics of publicly-reported price indices, including natural gas spot prices at California delivery points used in the California refund proceeding. Staff found significant problems with published price indices. These problems included:

1. The inability to independently verify published price indices – the sources of price information have not been disclosed due to publishers' concerns about revealing source data;
2. Undetected errors that may exist because trade publications reporting spot and forward prices do not employ statistically valid sampling procedures or a systematic, formal verification procedure;
3. Significant incentives of market participants to manipulate spot market prices reported to trade publications because natural gas is the fuel input for the electricity generators that set the market price in California.
4. Wash trades may have an adverse effect on reported price data; and
5. Enron OnLine, Enron's former electronic trading platform, was a significant source of price discovery and formation, and was potentially susceptible to manipulation by market participants which could affect the published price indices.

Since the issuance of the Staff Initial Report, five companies have admitted that some of their employees provided false data to the trade press that publish energy price indices:

<u>Dynegy</u>. On September 25, 2002, Dynegy announced that they had discovered that 15 Dynegy employees had engaged in reporting false data to trade publications that publish price indices. On December 18, 2002, the Commodity Futures Trading Commission announced that it had reached a $5 million settlement with Dynegy and West Coast Power, LLC. The settlement stated that

Dynegy had "knowingly submitted false information to the reporting firms in an attempt to skew those indexes to Dynegy Marketing & Trades' financial benefit."

El Paso. On November 8, 2002, the El Paso Corp. announced that it had discovered evidence that one of its employees had misreported trade data to the Trade Press. On December 4, 2002, the United States Department of Justice indicted Todd Geiger, a former vice president of El Paso Energy, on charges of false reporting and wire fraud. On January 13, 2003, federal prosecutors in court for a pretrial conference in the Geiger case told U.S. District Judge Nancy Atlas that there was a conspiracy among El Paso traders to provide bogus price information dating back at least two years. Also on January 13, 2003, El Paso issued a statement saying it had found more instances of its traders providing inaccurate information to *Inside FERC*.

AEP. On October 9, 2002, AEP announced that it had "dismissed five employees involved in natural gas trading and marketing after the company determined that they provided inaccurate price information for use indexes compiled and published by the trade publications".

Williams. On October 25, 2002 Williams announced it has learned that natural gas traders had provided inaccurate information regarding natural gas trades to an energy industry publication that compiles and reports index prices. Williams stated that the inaccuracies came to light during Williams' independent, internal review of its trading activities.

CMS. On November 4, 2002, CMS announced that it was conducting an internal review of the natural gas trade information provided to the trade press by two subsidiaries; CMS Marketing Services and Trading and CMS Field Services. CMS stated that a preliminary analysis indicated that employees had provided inaccurate data. CMS further stated that it would take appropriate disciplinary action and that it would stop providing information to the Trade Press.

Commission Use of Price Indices Going Forward

In the future, Staff proposes that the Commission require that certain minimum standards be met before natural gas pipelines are permitted to use natural gas price indices in new tariffs, or for other new regulatory purposes.

Evidence for these new filings would need to be presented and reviewed to assure that any price index referred to meet minimum index formation standards. In particular, the index would need to represent an accurate reflection of market. To be approved, a new tariff containing a reference to an index would need to be shown as demonstrating:

1. Confidence in the accuracy of price reporting – that is, the ability to verify that reporting is for deals actually done, not simply aggregate opinions.
2. Adequacy of coverage – that is, the ability to assure the collection of adequate information to represent prices across the relevant marketplace well.
3. Information about market liquidity – or some insight into how much trading is going on at a particular point in order to generate warnings when markets are thin, and confidence when they are liquid.
4. Verifiability – or the ability to assure integrity of the process through independent review by a trustworthy third party.

Staff suggests that only after assuring the Commission that these characteristics have been met should a natural gas price index be approved for use in a new pipeline tariff.

Summary

Recent reports raise serious doubts about the accuracy of information reported in many wholesale natural gas price indices. The market cannot function without accurate, dependable and trustworthy wholesale price information.

The industry must take the lead in solving this problem, and Staff is tracking several efforts to develop new approaches to solve it.

Additionally, Staff proposes that the Commission require any new pipeline tariff reference to natural gas price indices be shown to meet the standards of accuracy, adequacy of coverage, information about market liquidity, and verifiability outlined above.