There are signs that price reporting will remain voluntary, despite the drop-off in reporting levels, but proposals are still being made on all sides. *Eric Fishhaut* looks at the progress being made to achieve greater price transparency

Faith in the figures

★ With extensive trading scandals in the North American natural gas business in recent years, the credibility of price reporting has suffered immensely. Regional gas pricing indexes, the standard used nationwide in the US in gas trades worth billions of dollars each year, have been called into question after several firms admitted employees lied about gas trading activity and tried to manipulate prices.

Producers often sign contracts to sell their natural gas to a buyer for the price of a specific nearby index. Sometimes, the contract combines different publications or locations, by adding or subtracting a penny, nickel, dime or fraction thereof to arrive at a price. Buyers do the same, with the result that, on long-term contracts lasting months, the actual price paid for the commodity floats up and down in relation to the regional index movement.

The industry as a whole had for a long time been relying on this index pricing. Suddenly it was obvious that the underlying information was suspect.

It came to light that traders from a wave of energy companies had engaged in so-called 'round-trip' trades, where the same amount of gas was bought and sold at the same price with a single party. Admissions of incorrect and false price reports were also uncovered. Companies that admitted the wrongdoing said the trades were designed to boost volume and bragging rights, not to make money. While some in the industry feel the false trades may not have had much of an effect on the all-important price indexes, how much or how long the false reporting had been going on is not clear.

In response to reports of manipulation, the gas industry questioned how publications arrived at the published prices. Key publishers include Platts, Argus, Natural Gas Intelligence and Dow Jones. Platts – the largest – offers information on oil, natural gas, electricity, nuclear power, coal, petrochemical and metals markets, and says that every day, more than $10 billion in trades and contracts are made based on its price assessments.

Index creation

Trading organisations rely on price transparency. Toward that end, publishers attempt to aggregate input from as many net buyers and sellers as possible to detect any obvious anomalies. If a price is outside the statistical range and it cannot be independently verified, it should be thrown out. If a source provides bad information, that person should be excluded from subsequent surveys. All publications promise anonymity and confidentiality.

Industry practice had been for the trade press to gather price information by polling traders. In the past, publishers surveyed gas traders via telephone, email or fax about the price and volume of natural gas at specific locations to create their reports. The voluntary survey information is compiled into regional indexes, although publishers stress that index editors always evaluate the survey information and sometimes reject trade information if it seems inconsistent with the rest of the market.

As issues regarding the credibility of reporting arose, publishers wanted the price and volume information to come from an audited back office with senior executive sign-off. They wanted more details – not just on volume and price, but about who was the counterparty to the deal, which company was the buyer, which the seller and when the deal was made.

To cover its bases, Platts' *Inside Ferc* monthly *Gas Market Report* for gas delivered to 48 pipeline locations started showing disclaimers. The report said the indexes with asterisks meant the company didn't have enough survey information to calculate an accurate price at those pipeline locations, but that editors thought prices listed this way were pretty accurate based on other information. At one point late in 2002, 33 of the 48 indexes carried disclaimers.

Regulators step in

The Federal Energy Regulatory Commission (Ferc) began looking into how pricing data was supplied to publishing houses during its investigation of Enron, and said the system was susceptible to "unscrupulous traders". Gas producers, meanwhile, have long complained that traders at the biggest companies routinely misreported pricing data in an effort to make millions in additional profits.

The US Commodity Futures Trading Commission (CFTC) has settled with 14 energy trading companies for a total of $180 million since launching a comprehensive investigation into price reporting. At one point, six energy trading organisations paid fines totalling $50 million to settle allegations that they schemed to massage markets by spreading bad information to natural gas pricing indexes, but did not have to admit wrongdoing. Specifically, the commission found these entities knowingly delivered false trade information to reporting firms in an effort to skew the indexes to benefit their trading positions. The information either contained non-existent trades or actual trades in which the price and/or volume was altered.

In one case, the CFTC filed a lawsuit against AEP last September seeking up to $336 million in penalties for alleged attempts to manipulate the value of gas price indexes. AEP uncovered and reported instances of false trading, fired five traders for participating in the activity and said it didn't believe any current employees engaged in the practice.

The subpoenas cast a chill over the marketplace. Transaction reporting dropped off rapidly

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Eric Fishhaut, GlobalView

as companies concluded that it was safer from a legal standpoint not to report, thereby avoiding the possibility of false reports. Many firms even ceased trading activities. Even companies that were not demonstrated to have participated in improper behaviour were forced to exit the market. The ramification of those events has damaged liquidity and hurt remaining players, which currently suffer from poor credit quality and sagging stock prices.

Improvements

Ferc held a conference in April 2003 to discuss the issues of collection and publication of natural gas price information. According to Ferc, there had been ample evidence to raise serious questions regarding the functioning of this practice. While there was no consensus on a specific course of action reached, most participants expressed a preference for a private, industry-driven solution, but were willing to consider some form of third-party involvement.

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One concept that attracted strong interest was the idea of creating or commissioning a 'self-regulating organisation' (SRO) to collect, process and publish price information. Some proponents of the SRO idea, such as the US-based Committee of Chief Risk Officers, recommended that at the very least, price reporting must consist of transaction-level detail, come from back-office (not traders) and include counterparty information. But the requirement for counterparty data led to confidentiality concerns. It eventually scuttled any momentum in organising a price reporting entity.

Ferc has been pressing energy companies for months to disclose more data, threatening to step in if the industry doesn't solve its own problems. As a benchmark, each of the financial markets for fixed-income securities, equities, municipal bonds and corporate bonds rely on a central hub to collect and disseminate price information. And each of these financial market data hubs is a not-for-profit 'utility' that provides data at reasonable cost on an open-access basis.

In follow-up, Ferc suggested last summer that private publishers who gather information about natural gas transactions establish a code of conduct and create a system that verifies the authenticity of the data they receive. At the same time, reporting companies must discipline violators and cooperate fully with regulators. The guidelines do not require traders to name their counterparties but do allow Ferc "reasonable access" to the information. The aim is to restore confidence in the indexes.

Industry input

A broad coalition of producers and end users, including the Natural Gas Supply Association (NGSA), the Independent Petroleum Association of America (IPAA), and the Process Gas Consumers Group (PGC), have sent comments to Ferc stating that they believe an industry-led solution remains the most effective way to provide the natural gas industry with price transparency and bolster confidence in natural gas price indexes. The coalition feels it is inappropriate for the federal government to establish its own price index, and that the proper government role is to monitor markets and step in to penalise those who intentionally abuse it, thereby encouraging and promoting market transparency.

The NGSA, IPAA and PGC believe any revised data collection process should be constructed so that companies include all reportable cash transactions – those that allow the index developer to correctly represent the natural gas physical spot market – concerning volume, price, location, transaction date, term and buy/sell indicator. Companies should report each transaction separately and through an employee with no direct, personal interest in the price reported and should perform periodic internal or external audits to provide sufficient assurance on their control process.

However, the coalition objects to any proposal that mandates the reporting of counterparty information for transactions. While companies within the natural gas industry share common natural gas policy goals, it is a competitive marketplace and there is strong concern that divulging the details of their gas sales and/or purchase arrangements to third parties that could lead to anti-competitive behaviour.

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Ferc staff said in early May that industry confidence in the accuracy of published gas and electricity price indexes has increased dramatically since late 2002. Indicating that there's still room for improvement, it said that faith "could be stronger". This statement was based on the result of its latest confidential industry survey, where respondents put their level of confidence in price indexes at seven on a scale of one to 10.

Current standing

The survey respondents told Ferc they are, on average, reporting between 49% and 59% of their day-ahead gas prices and 35% to 44% of their bidweek gas prices. These results were much lower than estimates given to Ferc in April by the Market Price Reporting Action Committee (MPRAC), a collection of energy companies, trade groups and index publishers. MPRAC estimated companies were reporting 69% to 71% of day-ahead gas prices and 72% to 74% of bidweek gas prices. MPRAC has since responded to Ferc with a detailed explanation of its calculation methodology, which speculates that the discrepancy is likely to arise in great part from the need to differentiate between counting one or both sides of a trade being reported.

Staff offered Ferc four options to improve price transparency for further consideration: withdrawing completely from further involvement in price reporting; monitoring market activity and compliance with its policy statement; mandating price reporting; and encouraging a greater reliance on electronic trading platforms.

There is also new life in the proposal for an independent data hub that was evident at a meeting of industry leaders in Houston on May 21. What would make the hub attractive to the industry? For some, the independent pricing means less painful – and potentially less costly – compliance with the Sarbanes-Oxley Act. For others, higher credibility in the pricing, which can benefit the market as a whole. And for regulators, access to the data for audit purposes. Progress is being made, but slowly, and the direction price reporting will take is still anybody's guess. ER

Above: Pricing scandals have led to chaos in the natural gas trading industry: can recent moves prevent repeats?

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