FERC addresses natural gas index liquidity and transparency issues

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Price reporting agencies (PRAs) like S&P Global Platts, Natural Gas Intelligence and Intercontinental Exchange produce the natural gas price indices that play a vital role in establishing price transparency in natural gas markets. These indices provide a foundation for establishing the price of natural gas in index-based transactions, which have become more prevalent than fixed-price transactions. These indices are also used by regional transmission organizations when mitigating market power in wholesale electric markets. However, price transparency is limited by the PRAs' reliance on voluntary reporting of fixed-price transactions by market participants, which has decreased significantly over the past decade.

This decrease in reporting has caused the Federal Energy Regulatory Commission to question market liquidity at trading locations included in these indices, which FERC refers to as "index liquidity." On June 29, 2017, FERC held a technical conference to explore these issues. The record developed in this technical conference may help FERC develop a solution that encourages, or even mandates, market participant reporting to the PRAs. Future mandatory reporting to PRAs could apply to IDEA members who purchase natural gas for their district energy operations.

NATURAL GAS PRICE INDICES BACKGROUND

FERC first addressed price indices and market liquidity in its 2003 Policy Statement on Natural Gas and Electric Price Indices, where it established guidelines for market participants to follow when reporting to PRAs.[1] FERC believed that these guidelines would encourage market participants to report their natural gas transactions to PRAs by providing regulatory certainty. The 2003 Policy Statement clarified the PRA reporting standards and required market participants who report their transactions to

1. adopt a code of conduct for employees who engage in transactions and reporting;
2. have an independent internal organization to report to PRAs;
3. report "each bilateral, arm's-length transaction between non-affiliated companies in the physical (cash) markets at all trading locations and report errors as soon as practicable";
4. cooperate with PRAs to resolve errors; and
5. retain reported data for at least three years and have an independent auditor annually review the company's data gathering and submission procedures.

FERC also established a "safe harbor," stating that it did not intend to prosecute or penalize market participants for inadvertent mistakes made in their PRA reports. If a market participant follows FERC's guidelines when reporting its transactions, then FERC will presume that the data is accurate and timely and submitted in good faith.

While reporting gas transaction data to PRAs is voluntary, reporting certain gas transaction data to FERC is mandatory. In 2008, FERC issued Order No. 704,[2] requiring natural gas buyers and sellers to report their transactions to FERC annually on Form 552. Once filed, these reports are available to the public on the FERC website. FERC Form 552 requires submittal of data for many physical natural gas transactions, whether fixed or index-priced (certain thresholds and criteria apply). This provides FERC and the public with a more robust picture of the natural gas market over what the indices provide. FERC believed this would increase price transparency by allowing it to understand the magnitude of the total natural gas market and the size of the fixed-price trading market used to create the indices.

Through the 2003 Policy Statement and Order No. 704, FERC established policies to encourage reporting to PRAs that are intended to promote price transparency. FERC has never mandated that market participants report their transactions to the PRAs. However, with the recent developments in the natural gas market discussed below, FERC's approach may change.

WITH RECENT NATURAL GAS MARKET DEVELOPMENTS, FERC'S APPROACH TO REPORTING OF NATURAL GAS SALES TRANSACTIONS MAY CHANGE.

CHANGES IN THE NATURAL GAS MARKET

Since FERC issued the 2003 Policy Statement and Order No. 704, natural gas markets have changed considerably. The shale revolution has resulted in abundant supply in the Mid-Atlantic. Nationally, natural gas production has steadily increased by 3.6 percent per year between 2010 and 2015.[3] Since 2005, over 17,000 miles of pipeline were added to the interstate gas transportation system, allowing new supplies to reach new markets.[4] Since 2012, natural gas storage capacity has increased by 205 Bcf.[5] These increases in supply and storage and transportation capacity have led to a significant decrease in natural gas prices. For example, at Henry Hub, the spot market price has decreased from $13.42 per MMBtu at its peak in October 2005 to $2.98 per MMBtu in June 2017.[6]

In response to lower natural gas prices, market demand has increased. Since 2005, for example, industrial demand for natural gas has risen 17 percent, and in 2016, for the first time ever, natural gas became the primary fuel source for electric generators.[7]

These market changes affected the PRAs. New pipelines have created new locations where natural gas is traded, which means new locations for the PRAs to include in their indices. Since 2007, Natural Gas Intelligence has added 11 new price points to its northeast region indices and added a new Appalachia region as well.[8] But while the number of price points has increased, the number of transactions reported has decreased, leading FERC staff to question if the indices accurately reflect market prices.

REDUCED PRA REPORTING

Natural gas producers and traders are relying more on index-based contracts, rather than fixed-price contracts. In 2009, index-priced deals outnumbered fixed-price deals by a 2-1 margin. That ratio has since grown to almost 8-to-1, with index-priced transactions currently representing 78 percent of the total natural gas market. At the same time, the number of transactions reported to the PRAs has decreased. In 2015, only 49.3 percent of all fixed-price transactions were reported to the PRAs, down from 62.1 percent in 2008.[9] When there has been insufficient reporting at a particular location, PRAs estimate the prices at those locations. This decrease in reporting could have widespread impacts on nearly all participants in the natural gas markets. Thirteen out of the 125 price points referenced in natural gas tariffs were illiquid at some point between April 2016 and May 2017.[10] Natural gas pipeline tariffs reference price points listed in the S&P Global Platts, Natural Gas Intelligence and other index publications to calculate settlement of imbalances and certain penalties.

Industry panelists at the June 29 FERC technical conference, including PRAs, producers and marketers, identified three major reasons for the decrease in reporting.

First, post-recession regulations caused many banks to leave the natural gas markets. Banks historically engaged in more speculation than end-user market participants. Their exit has led to more price stability, which, along with lower gas prices, has made index-priced transactions more attractive to market participants.

Second, to quote Dexter Steis, executive publisher of Natural Gas Intelligence, indices are "victims of [their] own success." Market participants use indices because they value the reliability and transparency that the indices provide. As indices become more valuable to market participants, they in turn enter into more indexed trades. And as the number of indexed transactions increases, the number of fixed-price transactions decreases, reducing the number of transactions that are eligible for PRA reporting.

FERC'S ATTEMPT AT CREATING REGULATORY CERTAINTY IN THE 2003 POLICY STATEMENT HAS RESULTED IN UNCERTAINTY IN THE EYES OF MANY MARKET PARTICIPANTS.

Finally, panelists conceded that market participants do not want to bear the burden associated with PRA reporting. The 2003 Policy Statement imposes costs associated with establishing internal organizations to report and collect data, respond to PRA inquiries, implement data retention procedures and conduct an annual audit of these procedures. Further, there are (at least perceived, if not actual) risks of costly investigations by FERC if the data is misreported. Although there is a safe harbor provision in the 2003 Policy Statement, market participants at the technical conferenced argued that the provision is, at best, unclear as to the types of behavior that will be deemed to fall within the scope of the guidelines in order to be protected by the safe harbor provision. If a market participant reports to one PRA, must it report to all PRAs? Should the guidelines be read in light of the technology used in 2003, which required several hours of preparation in order to submit to just one PRA? Or, should they be read in light of 2017 technologies, which enable market participants to report their transactions to multiple PRAs through a single email? Many were concerned that even with the safe harbor, something as simple as a typo could cause a FERC investigation. Thus, FERC's attempt at creating regulatory certainty in the 2003 Policy Statement has resulted in uncertainty in the eyes of many market participants.

The panelists did not see cause for concern with the decline in reporting. Each panelist agreed that, despite this decline, the indices were still robust. Using somewhat circular logic, several panelists noted that their continued reliance on indices is proof of their continuing confidence. In post-conference comments, however, the American Public Gas Association remarked on the dissonance between the panelists' admission that the decrease in price reporting has led to less accurate indices and their continued reliance on those indices. The Environmental Defense Fund argued in its comments that the decline in reporting creates uncertainty for electric generators that make midday gas purchases. Currently, indices do not reflect midday gas prices, which forces generators to rely on stale indices to predict next-day electric prices, a problem that is exacerbated when these indices do not accurately reflect the natural gas markets.

PROPOSED SOLUTIONS

Because market participants appeared to have confidence in price indices, the panelists advised FERC against a complete overhaul of the 2003 Policy Statement. The panelists agreed that the flexibility of the 2003 Policy Statement allows the guidelines to continue to be relevant and beneficial to market participants. Indeed, in their post-conference comments, several parties urged FERC to incorporate the 2003 Policy Statement guidelines into its regulations, albeit with some modifications, such as allowing only monthly or only daily reporting, limiting the scope of audits and clearly stating that FERC will not impose penalties for inadvertent errors.

The panelists almost universally agreed that FERC needs to expand the safe harbor provision in the 2003 Policy Statement, though no consensus was reached on specific measures. The PRA panelists asked FERC to revise the safe harbor provision to require reporting to all applicable PRAs. Natural gas producers, like BP, asked FERC to expand the minimum market liquidity threshold PRAs use when establishing their indices. They also encouraged FERC to mandate reporting by marketers that buy for resale purposes only. In contrast to the producers, marketers and analysts warned that the industry would not meet a reporting mandate with open arms. They maintain that a mandate would increase costs for market participants, while also subjecting them to the risk of investigation, especially if such a mandate is not coupled with clarifications to the safe harbor provision.

FERC adopted the currently effective PRA reporting guidelines nearly 15 years ago. Since then, the natural gas market has changed significantly, as have the reporting methods for market participants. Following review of the technical conference transcript and post-conference comments filed by interested participants, FERC may decide that revisions to the 2003 Policy Statement are necessary to promote greater transparency. Whatever the regulatory result, IDEA members who purchase natural gas should monitor this docket closely to determine whether any additional reporting or other regulatory burdens are ultimately imposed.

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End notes

[1] *Price Discovery in Natural Gas and Electric Markets*, 104 FERC ¶ 61,121 (2003).

[2] *Transparency Provisions of Section 23 of the Natural Gas Act*, Order No. 704, *FERC Stats. and Regs.*, ¶ 31,260 (2007).

[3] FERC *State of the Markets Report 2015*.

[4] U.S. Energy Information Administration natural gas pipeline data (www.eia.gov/naturalgas/data.php#pipelines).

[5] U.S. Energy Information Administration, "U.S. Natural Gas Storage Capacity Increased Slightly in 2016," April 4, 2017 (www.eia.gov/todayinenergy/detail.php?id=30632).

[6] Henry Hub Natural Gas Spot Price, July 26, 2017 (www.eia.gov/dnav/ng/hist/rngwhhdm.htm).

[7] FERC *State of the Markets Report 2015.*

[8] *NGI's Price Index Methodology Point-By-Point Index Descriptions and Code of Conduct Statement*, April 25, 2017 (www.naturalgasintel.com/ext/resources/Daily-GPI/NGIMethodology.pdf).

[9] Cornerstone Research, *Characteristics of U.S. Natural Gas Transactions*, page 11, May 16, 2016 (www.cornerstone.com/Publications/Reports/Characteristics-of-US-Natural-Gas-Transactions-2016).

[10] FERC June 29, 2017 technical conference transcript, 19:5-8.