

gas market appear to stem, at least in part, from efforts to manipulate price indices compiled by trade publications. The Final Report stated that reporting of false data and wash trading are examples of efforts to manipulate published price indices.

8. While the Final Report contained numerous recommendations which will not be discussed here, the Staff did recommend that §§284.284 and 284.402 of the Commission's regulations be amended to provide explicit guidelines or prohibitions for trading natural gas under Commission blanket certificates. The specific recommendations include: (1) Conditioning natural gas companies' blanket certificates on providing accurate and honest information to entities that publish price indices; (2) conditioning blanket certificates on retaining all relevant data for three years for reconstruction of price indices; (3) establishing rules banning any form of prearranged wash trading; and (4) prohibiting the reporting of trades between affiliates to industry indices.

IV. The Commission's Proposal

A. Introduction

9. Over the past decade, the combination of wellhead decontrol mandated by Congress, open access transportation and the unbundling of pipeline gas sales from transportation increased efficiency and competition both in the gas commodity market and the transportation market. The Commission's open access and unbundling initiatives were supplemented by the actions of state regulators who also saw the need to begin to open local distribution company (LDC) systems by allowing large industrial and commercial customers to purchase their own gas and transport that gas both on the interstate pipeline and on the LDC's facilities. As a result of the Commission and state open access and unbundling efforts, more efficient and competitive markets developed that would reduce overall gas prices to customers.

10. The Commission's NGA jurisdiction to regulate the prices charged by sellers of natural gas has been substantially narrowed by the Natural Gas Policy Act of 1978 (NGPA) and Congress' subsequent enactment of the Natural Gas Wellhead Decontrol Act of 1989. The end result of these statutory provisions is that the only sales of natural gas that the Commission currently has jurisdiction to regulate are sales for resale of domestic gas by pipelines, local distribution companies (LDCs), or their affiliates so long as they

do not produce the gas that they sell.⁶ The Commission believes that reliance on competition for gas sales within its jurisdiction has been successful. It has been shown that the wellhead deregulation and reliance on competition in the natural gas industry has provided substantial economic benefits, including among other things, "[l]ower national energy costs to consumers by over \$600 billion as compared to continuation of tight regulations."⁷ However, the Commission believes that, in light of Staff's determinations in the Final Report, it is the Commission's responsibility to ensure the integrity of the gas sales market that remains within the Commission's jurisdiction. Accordingly, pursuant to the Commission's authority under section 7 of the Natural Gas Act, the Commission proposes to revise §284.288 of its regulations, which is currently reserved, to require that pipelines providing unbundled sales service adhere to a code of conduct when making gas sales. The Commission also proposes to add a new §284.403 to part 284, subpart L to require persons holding blanket marketing certificates under §284.402 to adhere to a code of conduct when making gas sales.⁸

B. Proposed Code of Conduct

11. As a general matter, the Commission will prohibit pipelines making unbundled gas sales and persons making sales for resale in interstate commerce from engaging in actions or transactions without a legitimate business purpose that manipulate or attempt to manipulate market prices, market conditions, or market rules for natural gas or that result in prices that do not reflect the legitimate forces of supply and demand. The prohibited actions or transactions include but are not limited to prearranged offsetting trades of the same product among the same parties, which involve no economic risk, and no net change in beneficial ownership (sometimes called "wash trades") and collusion with another party for the purpose of creating market prices at

levels differing from those set by market forces. The Commission considers a legitimate business purpose to be an action consistent with appropriate behavior in a competitive market which is taken to further a firm's business objectives without engaging in manipulative, illegal, or otherwise anti-competitive acts. Engaging in manipulation, for example, in order to maximize profits is not a legitimate business purpose.

12. The Final Report found that wash trading adversely affected the California energy markets. A wash trade is a prearranged pair of trades of the same product between the same parties or an affiliate of a party, involving no economic risk and no net change in beneficial ownership between the parties or any affiliate. Such transactions do not appear to serve any legitimate business purpose. The Staff found that wash trading damages the integrity of the market because it can, among other things, create false liquidity, send false price signals, increase trading revenue figures, and adversely affect index prices reported for a market.

13. The Commission will require that blanket sales certificate holders provide complete, accurate and factual information when reporting transactions to publishers of gas price indices. The blanket sales certificate holder must notify the Commission of whether it engages in such reporting. The basis for this condition is the Final Report's finding that the process for reporting natural gas prices indices was fundamentally flawed. Staff found that gas traders had the ability and incentive to manipulate published prices because natural gas was the fuel input for generators that set the price for electricity in California. Further, the Commission could not independently verify price indices and there did not appear to be a systematic, reliable verification process employed by publishers of natural gas price indices. The Commission finds that accurate price indices are necessary in order to have a properly functioning competitive gas market.

14. In addition, the Commission is considering various options for addressing concerns regarding the validity of price indices. On April 24, 2002, we convened a public conference in Docket No. AD03-7-000, together with the Commodity Futures Trading Commission (CFTC), to consider natural gas price formation issues, including the development of alternative index formation models. At that conference and from comments submitted thereafter, we have received valuable

⁶ See, Reporting of Natural Gas Sales to the California Market, 96 FERC ¶ 61,119 at 61,463, *reh'g*, 97 FERC ¶ 61,029 (2001), and San Diego Gas and Electric Company, *et al.*, 101 FERC ¶ 61,161 at P 10 (2002).

⁷ Center for the Advancement of Energy Markets, California Here We Come: The Lessons Learned from Natural Gas Deregulation by Dr. Rodney Lemon (August 2001).

⁸ Section 284.5 of the Commission's regulations also states that "[t]he Commission may prospectively, by rule or order, impose such further terms and conditions as it deems appropriate on transactions authorized by this part."