UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

97 FERC ¶ 63,004

Public Utilities Commission of the
State of California

v. **Docket No. RP00-241-000**

El Paso Natural Gas Company,
EL Paso Merchant Energy-Gas, L.P.
and EL Paso Merchant Energy Company

INITIAL DECISION

(Issued October 9, 2001)

APPEARANCES

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Sandra E. Rizzo, Esq., and *Donald Kaplan, Esq.* on behalf of PPL Energy Plua, LLC

Lisa M. Ochsenhirt, Esq., and *John P. Gregg, Esq.* on behalf of El Paso Municipal Customer Group

Barbara S. Jost, Esq. on behalf of Phelps Dodge Corporation and Apache Nitrogen Products, Inc.

Katherine B. Edwards, Esq. on behalf of Indicated Shippers, Amoco Production Company, BP Energy Company, Burlington Resources Oil and Gas Company, Conoco, Inc., Aera Energy, LLC, Marathon Oil Company

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WAGNER, CHIEF ADMINISTRATIVE LAW JUDGE:

I. STATEMENT OF THE CASE

A. Introduction

On April 4, 2000, the Public Utilities Commission of the State of California (CPUC) filed a complaint under section 5 of the Natural Gas Act (NGA)[1] against El Paso Natural Gas Company (El Paso Pipeline), El Paso Merchant Energy-Gas, L.P., and El Paso Merchant Energy Company[2] (jointly, El Paso Merchant). The complaint asserts, inter alia, that three transportation contracts between El Paso Pipeline and El Paso Merchant for approximately 1,220 MMcf/day of firm capacity to California (El Paso Contracts)[3] raise issues of possible affiliate abuse, of anti-competitive impact on the delivered price of gas and the wholesale electric market in California, and of the effectiveness of the Block II recall rights established in El Paso Pipeline's 1996 settlement with its transportation customers (El Paso Settlement).

In the complaint, CPUC asks the Commission to terminate the El Paso Contracts or to require El Paso Merchant to release on a short-term basis any unused firm transportation rights under those contracts to replacement shippers offering a higher rate than El Paso Merchant is obligated to pay El Paso Pipeline. CPUC further requests that the Commission order El Paso Pipeline to remove certain restrictions in the Block II contract.

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[1]15 U.S.C. § 717d (1994).

[2]Effective January 1, 2001, El Paso Merchant Energy Company changed its name to El Paso Merchant Energy, L.P.

[3]The El Paso Contracts are attached as Exhibit N to CPUC's complaint.

On June 28, 2000, the Commission issued an Order on Complaint Requiring Response to Data Requests (June 28, 2000 order).[4] In that order, the Commission granted in part CPUC's discovery requests and also required El Paso Pipeline and El Paso Merchant to provide additional information requested by the Commission. On July 28, 2000, El Paso Merchant filed a request for rehearing of the June 28, 2000 order.

On August 31, 2000, CPUC filed a motion for summary disposition urging the Commission to abrogate the El Paso Contracts. CPUC also asked the Commission to prohibit El Paso Pipeline from tying together Block I, Block II, and Block III capacity in a "total package" arrangement in subsequent open seasons or prearranged agreements, and to prohibit El Paso Merchant or any other El Paso Pipeline affiliate from bidding for or subscribing to the Block I, Block II, or Block III capacity.

On August 31, 2000, CPUC also filed a motion for a protective order, asserting that other parties should be given access to the information provided to CPUC and this Commission in compliance with the June 28, 2000 order. On September 15, 2000, the Commission issued the requested protective order (September 15, 2000 Protective Order).[5] On September 22, 2000, El Paso filed a request for rehearing of the September 15, 2000 Protective Order.

On December 7, 2000, Southern California Edison Company (Edison) filed a motion for expedited consideration and for immediate relief. Edison asked the Commission to grant immediately CPUC's motion for summary disposition or, in the alternative, to require El Paso Merchant to comply with the September 15, 2000 Protective Order.

In an order issued January 10, 2001, the Commission denied the requests for rehearing of the June 28, 2000 order and the September 15, 2000 Protective Order and required El Paso Merchant to provide Protected Materials to parties that executed the Protective Order and appropriate Non-Disclosure Certificates (January 10, 2001 order).[6] The January 10, 2001 order also permitted parties receiving the Protected Materials to

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[4]Public Utilities Commission of the State of California v. El Paso Natural Gas Co., 91 FERC ¶ 61,312 (2000).

[5]Public Utilities Commission of the State of California v. El Paso Natural Gas Co., 92 FERC ¶ 61,225 (2000).

[6]Public Utilities Commission of the State of California v. El Paso Natural Gas Co., 94 FERC ¶ 61,021 (2001).

file additional comments based on their examination of the Protected Materials. Both El Paso Pipeline and El Paso Merchant filed answers to the parties' comments.

The three blocks of capacity subject to the El Paso Contracts were established in a settlement approved by the Commission in 1997 after California local distribution companies (LDCs) permanently turned back capacity to El Paso Pipeline at a time when there was a great deal of excess pipeline capacity into California. CPUC supported this settlement. Subsequently, the three blocks of capacity were acquired as a unit by two successive marketers under negotiated rate contracts on terms approved by the Commission. The current El Paso Contracts were awarded following an open season that was conducted in accordance with Commission rules and policies.

Edison submitted a study (Brattle Study) in support of its allegations and those of CPUC[7] that El Paso Merchant exercised market power. However, the Brattle Study covered only the period from March 2000 through July 2000, does not address other factors that have impacted natural gas prices in California, and acknowledges that "it is difficult to sort out the market power from market conditions....[8] El Paso Pipeline submitted a study (Lukens Study) and El Paso Merchant submitted another study (Morris Study),[9] both of which challenge the findings of the Brattle Study.

On March 28, 2001, the Commission issued an Order Denying Motion for Summary Disposition, Dismissing Complaint in Part, and Setting it for Hearing in Part (March 28, 2001 order).[10] In that order the Commission ruled that the fact that El Paso Merchant controls a large volume of capacity does not, in an of itself, render the El Paso Contracts unjust, unreasonable, or unduly discriminatory. The March 28, 2001, order also found that El Paso Pipeline and El Paso Merchant did not violate the Commission's Standards of Conduct for Interstate Pipelines with Marketing Affiliates (Affiliate

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[7]CPUC did not present a market power study in support of its allegations, and although other parties did file such studies, there was much disagreement on essential issues.

[8]Brattle Study at 2.

[9]Response and Opposition of El Paso Merchant Energy Company to the Motions of the Public Utilities Commission of the State of California and Southern California Edison Company, September 29, 2000, Ex. No. 1.

[10]Public Utilities Commission of the State of California v. El Paso Natural Gas Co., 94 FERC ¶ 61,338 (2001).

Standards)[11] in negotiating and entering into the El Paso Contracts. The Commission further found that the record in this proceeding was incomplete with respect to the question of whether El Paso Pipeline and/or El Paso Merchant had market power, and if so, exercised it so as to drive up the price of natural gas at the California border and directed the Administrative Law Judge to supplement the record on this issue.

On March 29, 2001, the Chief Judge designated himself to hear the issues set for hearing by the Commission herein. On May 31, 2001, the Chief Judge issued a Report to the Commission seeking guidance from the Commission with respect to the scope of the hearing on the market power issue. The Chief Judge asked the Commission to clarify whether its finding in the March 28, 2001, order of no violation of the Commission's Affiliate Standards was based solely on the record before the Commission at the time of the March 28, 2001, order and whether the Commission intended that he compile a more complete record on the question of possible violations of the Affiliate Standards and make findings as to whether any such violation, if it existed, contributed to the alleged exercise of market power by El Paso Pipeline and El Paso Merchant. On June 5, 2001, El Paso Pipeline filed comments on the May 31, 2001 report by the Chief Judge, asserting that (1) the Commission already had already reviewed thoroughly the issues relating to the Affiliate Standards; (2) no evidence had emerged at the hearing that is inconsistent with the Commission's findings concerning affiliate issues in the March 28, 2001 order; (3) the affiliate rulings were subject to rehearing at the Commission level and need not be interjected into the hearing; and (4) if the scope of the hearing was to be expanded to include compliance with the Affiliate Standards, the parties must then be afforded the opportunity to file new testimony regarding all allegations of affiliate abuse.

On June 11, 2001, the Commission issued its Order on Rehearing (June 11, 2001 order)[12] granting in part and denying in part the requests for rehearing of the March 28, 2001, order filed by CPUC, PG&E, and Edison and setting for hearing the allegations of affiliate abuse and violations of the Affiliate Standards raised by complainants. The June 11, 2001, order also denied the requests for rehearing of the March 28, 2001, order filed by El Paso Pipeline and El Paso Merchant. The Commission determined to set for hearing the issues raised by the CPUC's complaint concerning allegations of affiliate abuse and violation of the Affiliate Standards, pointing out that the Commission now believes that these allegations raise factual issues that are best resolved in an evidentiary hearing.

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[11] 18 C.F.R. Part 161 (2000).

[12] Public Utilities Commission of the State of California v. El Paso Natural Gas Co., 95 FERC ¶ 61,368 (2001).

1. El Paso Settlement[13]

As excess capacity to the California markets increased in the early 1990s, LDCs, including Southern California Gas Company (SoCalGas) and Pacific Gas & Electric Company (PG&E), permanently turned back capacity on El Paso Pipeline's system. On June 30, 1995, El Paso Pipeline filed a section 4 rate proceeding, which in part sought to impose an exit fee on customers that reduced or terminated their contract quantities. Although the Commission specifically rejected the exit fee, the remainder of the proceeding was resolved by a settlement that was supported by CPUC and accepted by the Commission. The El Paso Settlement contained, inter alia, a mechanism for sharing the risk of unsubscribed capacity. The El Paso Settlement further provided for crediting firm customers 35 percent of El Paso Pipeline's revenues from firm and interruptible transportation, above a stipulated threshold that would increase from approximately $35 million to approximately $38 million.

The El Paso Settlement also divided the turned-back capacity into three blocks:

> Block I, which consists of 500 MMcf/day of capacity with alternate receipt point access to all system receipt points unless the capacity is sold for maximum tariff rates, in which case there are primary receipt point access rights to the Permian and Anadarko Basins, but not to the San Juan Basin;
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> Block II, which consists of 614 MMcf/day of capacity designated for primary point deliveries to Topock, Arizona, for PG&E or shipper(s) serving a market in PG&E's service territory (collectively "Block II Shippers") and having primary access to all system receipt points, including the San Juan Basin. If El Paso Pipeline markets Block II capacity to shippers that are not serving Northern California, the Block II Shippers have recall rights; and
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> Block III, which consists of 500 MMcf/day of capacity having primary access rights to all system receipt points.

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[13] The history of the El Paso Settlement is fully described in orders relating to that proceeding. El Paso Natural Gas Co., 79 FERC ¶ 61,028, order on reh'g, 80 FERC ¶ 61,084 (1997), remanded, Southern California Edison Co. v. FERC, 162 F.3d 116 (D.C. Cir. 1998), order on remand, 89 FERC ¶ 61,164 (1999), order on reh'g, 90 FERC ¶ 61,354 (2000).

2. El Paso Pipeline's Contracts With Dynegy Marketing and Trade (Dynegy)

Effective January 1, 1998, El Paso Pipeline entered into three two-year negotiated rate contracts with Dynegy's predecessor covering the Block I, Block II, and Block III capacity (Dynegy Contracts). Various parties challenged the transaction, raising issues relating to the posting of the capacity, the possible anti-competitive or unduly discriminatory effects of the Dynegy Contracts, and whether the Dynegy Contracts were consistent with the El Paso Settlement. The Commission concluded that the Dynegy Contracts generally were consistent with Commission policies and regulations, but required the parties to modify the contracts to make them consistent with the provisions of the El Paso Settlement relating to the Block II capacity.[14]

The Dynegy Contracts contained a Reservation Reduction Mechanism (RRM) which protestors contended was intended to restrain competition and that Dynegy's control of such a large amount of capacity would give it excessive market power in the California market. The Commission found that while the RRM reduced Dynegy's minimum pay obligation and reduced El Paso Pipeline's incentive to discount IT, it did not result in undue discrimination in the gas transportation market to California. The Commission also observed that the amount of capacity controlled by Dynegy would not permit it to exercise market power in the California market in light of the unutilized capacity during the term of the Dynegy Contracts, and the fact that capacity release rates remained below the maximum ceiling price.

At the time the Dynegy Contracts were posted for competitive bidding, El Paso Pipeline stated that they were considered a single transaction, and bidders were not permitted to bid for less than the entire capacity or for any of the three contracts individually. Because no party met the terms, the Dynegy Contracts became final.

3. El Paso Pipeline's Contracts With Enron North America Corp. (Enron)

Following expiration of the Dynegy Contacts, El Paso Pipeline posted the capacity and entered into three one-year term negotiated rate contracts with Enron for essentially

[14]The history of the Dynegy Contracts is discussed in El Paso Natural Gas Co., 83 FERC ¶ 61,286 (1998), order on reh'g, 88 FERC ¶ 61,139, order on reh'g, 89 FERC ¶ 61,073 (1999), petitions for review dismissed as moot, Public Utilities Commission of the State of California v. FERC, 236 F.3d 708 (D.C. Cir. 2001).

the same capacity that was subject to the Dynegy Contracts (Enron Contracts). The Enron Contracts contained a revenue sharing provision, although it differed from the RRM that was included in the Dynegy Contracts.

The Commission found that the Enron Contracts were not inconsistent with the public interest, emphasizing that size alone has not been grounds for rejecting a pipeline transportation agreement, nor has the affiliation between a producer and a pipeline. The Commission found no credible allegations of discrimination and rejected as speculative the allegation that Enron, acting through its affiliate, might withhold capacity from the market. The Commission found that the revenue sharing mechanism was less likely to inhibit competition than the RRM. Because the scope of the Enron Contracts was essentially the same as that of the Dynegy Contracts, the Commission found that the impact should be the same unless conditions changed dramatically.

With respect to the Block II provisions, the Commission required the parties to amend the Enron Contracts, consistent with the El Paso Settlement, to clarify that Block II capacity has primary delivery rights only at PG&E Topock and has alternative delivery points at the other Topock delivery points. The parties terminated the Enron Contracts, which again made the three blocks of capacity available.

4. The El Paso Contracts

CPUC states that, in February 2000, El Paso Pipeline conducted an open season for the capacity and received 25 bids, 24 of which were for only portions of the capacity. However, CPUC asserts that marketers seeking portions of the capacity were unsuccessful because El Paso Merchant significantly outbid the other parties, offering $38.5 million for all of the capacity.

The principal allegations of the complaint and the motion for summary disposition are that El Paso Pipeline and its affiliates took improper advantage of their affiliate relationships and that the El Paso Contracts are anti-competitive and unduly discriminatory, allowing El Paso Merchant to exercise market power and artificially drive up the price of natural gas transported into California.

B. The Hearing Record

The hearing in this proceeding commenced on April 3, 2001, and concluded on August 6, 2001. The record consisted of 32 volumes of transcript comprised of 5,573 pages. A total of 515 exhibits were admitted into evidence. Initial briefs were filed on August 24, 2001, by the CPUC, El Paso Pipeline, El Paso Merchant, PG&E, Edison, the

City of Los Angeles, California, the County of Los Angeles, SoCalGas, and the Commission Trial Staff (Commission Staff). Reply briefs were filed on September 14, 2001, by the CPUC, El Paso Pipeline, El Paso Merchant, PG&E, Edison, SoCalGas, and the Commission Staff. The briefs measured approximately one linear foot.

II. WHETHER EL PASO MERCHANT AND/OR EL PASO PIPELINE HAD THE ABILITY TO EXERCISE MARKET POWER

A. The Relevant Legal Standard

The Commission has adopted the antitrust principles and analytical framework of the Department of Justice and Federal Trade Commission 1992 Horizontal Merger Guidelines (Merger Guidelines) to evaluate market power issues in the forward-looking context of proposed electric utility mergers and proposed market-based rates by natural gas pipelines.[15] El Paso Merchant argues for the first time in its reply brief that the Commission has not specifically adopted the Merger Guidelines to evaluate after the fact the type of single-firm conduct that is alleged in this proceeding (El Paso Merchant Reply Brief, p. 20). El Paso Merchant asserts that the Commission should follow the antitrust principles and analytical approach developed under Section 2 of the Sherman Act.[16] Section 2 of the Sherman Act sets forth two necessary elements: (1) the possession of monopoly power by a single firm, and (2) the willful acquisition or maintenance of that power.[17] A key distinction between the Merger Guidelines and the Sherman Act is the threshold of market share that must be reached before a more thorough investigation is conducted. The Merger Guidelines suggest a market share of 35 percent as an indicator that the seller is likely to exercise market power acting alone, while Section 2 of the Sherman Act, as construed and applied by the courts, generally requires market share in excess of 50 percent as evidence of monopolization. At no time during cross-examination of any witness in this proceeding did El Paso Merchant challenge the applicability of the Merger Guidelines. El Paso Merchant's Witness, Dr. John R. Morris, Vice President at Economists, Inc., testified that 35 percent market share is large enough to warrant additional investigation to determine whether a firm has market power pursuant to the Merger Guidelines (Exh. EPM-1 at 45).

[15]U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines, 4 Trade Reg. Rep (CCH) ¶ 13,104 (1997).

[16]15 U.S.C.A § 2 (1994).

[17]*United States v. Grinnell Corp.*, 384 U.S. 563, 570-71 (1966).

Contrary to El Paso Merchant's argument that the Commission adopted the Merger Guidelines to evaluate market power issues in the forward-looking proposed electric utility mergers[18] and proposed market-based rates by natural gas pipelines[19] and not to evaluate after the fact the type of single firm conduct that is alleged in this case, the market power issues examined in this proceeding are not the type of after the fact, single-firm conduct that should be reviewed under Section 2 of the Sherman Act standard. When the complaint in this proceeding was filed on April 4, 2000, it addressed the future or prospective antitrust competitive impart of the El Paso Contracts on the delivered price of gas and the wholesale electric market in California. The fact that this case was not set for hearing until the involved contracts were about to expire and that the parties are writing briefs after the fact should not alter the standard for review that was appropriate when the complaint was filed. In addition, the Commission's use of the Merger Guidelines as the basis for its analytical approach to market power are not limited to electric mergers. The Commission relies on the Merger Guidelines to evaluate applications for market-based rates by oil pipelines and natural gas pipelines.[20]

B. The Bidding during the Open Season

El Paso Merchant was the only bidder for the entire capacity in question, and its bid exceeded the aggregate of all bids for portions of the capacity. As a result, it obtained firm capacity totaling 1,220 MMcf/day or approximately 1.2 Bcf/d. As indicated before herein, the three contracts for the three blocks of capacity commenced on March 1, 2000, and expired on May 31, 2001. As a matter of interest, since the contract expiration, and beginning on June 1, 2001, the 1,220 MMcf/d is held by 30 shippers with varying terms from 17 months to 15 years.

The Chief Judge notes that **not** a single party that actually submitted a bid during the open season involved in this case has complained about the way in which the open season was structured, nor about the impact of the Mojave IT discount on their respective

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[18]*See* Inquiry Concerning the Commission's Merger Policy Under the Federal Power Act: Policy Statement, Order No. 592, 61 Fed. Reg. 68,595 (1996), FERC Stats. & Regs. ¶ 31,044 (1996), *order on reconsideration*, Order No. 592-A, 62 Fed. Reg. 33,341 (1997), 79 FERC ¶ 61,321 (1997).

[19]*See* Statement of Policy and Request for Comments, 74 FERC ¶ 61,076 (1996); *order denying requests for rehearing and clarification*, 75 FERC ¶ 61,024 (1996).

[20]*See Buckeye Pipe Line Co.*, 53 FERC ¶ 61,473 (1990); *Koch Gateway Pipeline Co.*, 85 FERC ¶ 61,013 (1998).

open season bids. In other words, there has been no complaint from any bidder whatsoever.

C. The Relevant Product and Geographic Markets

There is no dispute in this case that the relevant product is delivered natural gas. The disagreement concerns the relevant product and geographic markets. This presents two questions: (1) Is the geographic market the entire state of California as contended by El Paso Pipeline and El Paso Merchant, or is it limited to Southern California as contended by CPUC, Edison, and PG&E? and (2)Are all three blocks of capacity in the relevant product market or should only Block III be considered in the relevant product market as alleged by El Paso Merchant and El Paso Pipeline? The Commission Staff contends that the geographic market is the entire state of California, except for two months when there were constraints in Southern California.

1. The Relevant Product Market

No party disputes that Block III gas is in the relevant product market, but there is disagreement as to whether Block I and Block II should be included. If Block II capacity is used to serve Southern California, it can be recalled by a shipper when it is nominated to a SoCalGas receipt point. However, the facts show Block II capacity was only recalled on two occasions during the period of the contract–the last time being in early July 2000. The question is whether this is sufficient to remove Block II gas for the rest of the period involved in this case. Block II capacity was used during March, April and June 2000 to serve Mojave and SoCalGas at Ehrenberg in addition to the PG&E delivery point. At least for most of the period of the contract, Block II gas is in the relevant product market. It is doubtful that the two recalls are sufficient enough factors to remove Block II from the market for the entire period. Looking at Block I capacity, it is sufficient to note that El Paso Merchant upgraded the entirety of this capacity on November 22, 2000, by paying El Paso Pipeline the maximum tariff rate. This is clear evidence that there is not a distinction between Block I and Block III capacity quality. El Paso Merchant could have exercised its right to upgrade Block I capacity at any time during the period of the contract. The Chief Judge finds that all three blocks or contracts should be included in the relevant product market.

2. The Relevant Geographic Market

The Chief Judge finds that the relevant geographic market is Southern California. The geographic market is the region where the relevant product, as found above, is available. In order to show that another pipeline provides a good alternative and is in the relevant geographic market, it must be shown that customers could purchase the relevant product from an alternative pipeline. This would require that capacity be available on the other pipeline and that customers could obtain their needed services by using these facilities. The alternative pipelines, *i.e.*, again those other than serving the Southern California border, must be able to reach the involved relevant market physically and economically. Under these circumstances, any transmission constraints would limit the market significantly. The evidence in this case is fairly clear that alternative supplies to Southern California are not available. As Dr. Paul R. Carpenter, Principal of the *Brattle Group*, a witness for Edison, pointed out there are three potential alternative supplies, (1) gas transported from Canada on PG&EGT to Malin, Oregon, (2) gas transported from the Rocky Mountains on Kern River, and (3) gas transported from the Southwest on Transwestern Pipeline. As Dr. Carpenter further pointed out all three of these pipelines are baseloads with combined average monthly load factors for the period March 2000 - March 2001 of 98 percent. (Exhs. SCE-13, 164, 165; tr. pp. 4423-4424) Consequently, with this extraordinarily high load factor, they did not and could not respond with additional supplies. Another reason that Southern California is a separate market from the Northern California market is the price differential. PG&E's Witness Mr. James F. Wilson, Principal, LECG, LLC, pointed out at the hearing that the prices in Northern California were substantially lower than the prices in Southern California. The disconnect between Southern and Northern California prices in and of itself establishes that the entire state of California is not the relevant market for the period of the contract (Exh. SCE-166; tr. p. 3890-3891). Dr. Jonathan D. Ogur, a witness for the Commission Staff, testified that: " . . . [W]hen prices differ significantly, particularly by more than the cost of transportation between these regions, that is evidence that the two regions are in separate markets." (tr. p. 2730) In addition, the Chief Judge observes that logic would have it that if Southern California and Northern California were the same geographic market, then the three pipelines would have sold their output at the substantially higher prices prevailing in the Southern California market. As indicated before herein, the three alternate pipelines did not have the capacity and the supply available to serve Southern California in competition with El Paso Pipeline.

D. Price Correlations

Dr.Morris argues that the behavior of gas prices in Northern and Southern California is highly correlated and is consistent with California being one market (Exh. EPM-1) He computes a price correlation for the period March 1, 2000 through March 31, 2001 of .91 between the prices at the Southern California/Arizona border and at the Northern California/Oregon border and concludes that the prices move together and, therefore, both locations are in the same market (EPM-1; tr. 1546-1547) This argument fails to withstand scrutiny. While Dr. Morris claims that his analysis is consistent with the Merger Guidelines (tr. 3084), he admits that the Merger Guidelines do not mention correlation as a geographic market test method (tr. 3085-3086). Dr. Morris also admits that correlations of prices demonstrate only the direction of price movement and that correlations of prices do not consider the absolute increases and decreases of prices. Prices may increase by substantially different amounts, and still be "perfectly correlated." Finally, the fact that common factors influence Northern and Southern California markets renders correlation analysis unhelpful (Tr. 4421, 3902-03).

E. El Paso Merchant's Market Share

One method for determining market concentration and market share that is used by the courts and by this Commission is the Herfindahl-Hirschman Index (HHI), which is a calculation based on the market shares of each participant in the market. This Commission has deemed an HHI below 1,800 to be a workable competitive situation that does not require close scrutiny. On the other hand, the Commission generally holds that an HHI higher or greater than 1,800 is an indication that additional analysis is needed because of concern that sellers acting alone or jointly may possess market power. An HHI can be calculated using delivery data and/or capacity data. Each market participant's market share is calculated as the maximum daily quantity (MDQ) representing the reservation or contracted demand of gas transported for that market participant, divided by the total MDQ of gas transported for all market participants (Exh. S-8, p.5). If the market share of the seller is greater than 35 percent, additional analysis is required because of the concern that a seller might exercise market power along (Exh. S-1, p. 13 and Exh. S-3, Section 2.2). Commission Staff Witness Dr. Ogur and El Paso Merchant Witness Dr. Morris applied the same general framework set forth in the Merger Guidelines but reached different results because of the way each treated the relevant product market and the relevant geographic market. Dr. Ogur would find, for at least the two months where he finds a separate geographic market to be Southern California, that the HHI–based on Blocks I, II, and III–would be 2,262 and El Paso Merchant's market share rises to 45 percent, which exceeds the 1,800 threshold and the 35 percent market share respectively (Exh. S-1, p. 19). Dr. Morris, on the other hand, calculated an HHI based upon primary pipeline capacity for the entire California delivered gas market as 1,043. However, the Chief Judge has found before herein that the relevant geographic market is Southern California and the relevant product market consists of all three blocks of capacity. Dr. Carpenter found El Paso Merchant's share to be 35 percent with an HHI of 2,155. El Paso Merchant argues that Dr. Carpenter's geographic market is based on an alleged faulty method of picking specific points where El Paso Pipeline and Transwestern Pipeline deliver gas to SoCalGas and PG&E. Dr. Morris, assuming arguendo that Southern California was the relevant geographic market and assuming that SoCalGas' core capacity should be excluded, but including Pacific Gas Transmission and

Kern River, found a market share of 23 percent and an HHI of 906 by excluding Block II capacity (tr. 3007-3009).

In view of the Chief Judge's finding that Southern California is the relevant geographic market, that all three contracts–Blocks I, II, and III–are the relevant product market, the HHI would exceed 1,800 by a significant amount and the market share would top the 35 percent guideline. In view of the fact that the three contracts gave El Paso Merchant an additional capacity of 1,220 MMbtu/d and the further fact that El Paso Pipeline is one of the largest pipeline companies in the United States, ranking eighth in operating revenue, seventh in peak rate send out, fourth in miles of transmission pipe, and fourth in number of compression stations in the nation; the Chief Judge finds that El Paso Pipeline and El Paso Merchant had the ability to exercise market power. The Chief Judge recognizes that size along is not sufficient to find market power. However, the Chief Judge finds, as will be pointed out more fully hereinafter, that while El Paso Pipeline and El Paso Merchant had the ability to exercise market power, it is not at all clear from the record in this proceeding that El Paso Merchant and El Paso Pipeline exercised market power.

III. WHETHER EL PASO MERCHANT AND/OR EL PASO PIPELINE EXERCISED MARKET POWER

A. El Paso Merchant's Utilization Nomination Strategy

El Paso Merchant's utilization of its capacity to California was significantly less than that of other El Paso Pipeline shippers during the period March 2000 - October 2000. For example, during that period, the average utilization of Burlington was 87 percent; of Williams, 84 percent; and of SoCalGas, 86 percent; in contrast to El Paso Merchant's average utilization of 44 percent (Exh. SCE-107). Edison claims that on days when the basis differential–the difference between the price of purchasing gas in the Southwest producing basins and the price the gas can be sold for at the California border–exceeded the variable cost of shipping gas and El Paso Merchant's capacity was not utilized, then El Paso Merchant was withholding capacity from the market (Exh. SCE-4). The Brattle Study shows that during most days during the period June 1, 2000 - November 30, 2000, El Paso Merchant withheld 500 - 700 MMcf/d (Exh. SCE-4). Dr. Carpenter points out that from November 2000 to the end of March 2001, when the other three major shippers utilized capacity at 80 percent plus levels, El Paso Merchant simultaneously increased its capacity utilization to approximately 80 percent (tr. 4126, 4145). Dr. Carpenter argues that this demonstrates that El Paso Merchant could have used considerably more capacity prior to November 2000 instead of idling 56 percent of its capacity.

On the other hand, El Paso Pipeline Witness John Somerhalder, executive vice president for the company's regulated business, including El Paso Pipeline Group, testified that Dr. Carpenter had erroneously concluded that El Paso Pipeline had a much larger capacity during the relevant period than was actually available. Mr. Somerhalder pointed out that Dr. Carpenter had failed to include the loss of pipeline capacity resulting from the Carlsbad Pipeline rupture and from necessary periodic maintenance on the El Paso Pipeline system (tr. p. 2775, p. 2790). Mr. Somerhalder further testified that from June 21, 2000 - March 31, 2001, no El Paso Pipeline's capacity was withheld from the marketplace. EPNG Exhs. 24, 25, and 29 illustrate that shippers used 95% of the El Paso Pipeline available capacity during this period of time (tr. p. 2766). In fact, EPNG Exhs. 24, 25, and 27 show that on many days El Paso Pipeline's shippers used 100 percent of the pipeline's available capacity (tr. p. 2774). Further, EPNG Exhs. 26, 27, and 29 show that 95 percent of the pipeline's capacity into Southern California was utilized during this crucial period. EPNG Exh. 34 shows that El Paso Pipeline's system was full or virtually full during the entire period that the price of natural gas at the California border increased.

The evidence herein shows that during March 2000 - May 2000 when El Paso Merchant was not nominating all of its capacity, other shippers were also not nominating all of their capacity. This included SoCalGas which during the spring of 2000 held 1.2 Bcf/d of capacity, almost half that of other shippers, and was utilizing its capacity to fill storage (Exh. EPM-78, EPM-209). California demand was slack during this period and basis differentials were hovering around the variable cost of shipping. Evidently, if there had been more "in the money" transactions available to be taken advantage of, other shippers would have taken advantage of them because they had the capacity to do so.

During the June 2000 - November 2000 period El Paso Merchant nominated essentially 100 percent of its Block III capacity, its SoCalGas released capacity and its capacity on Transwestern. El Paso Merchant also nominated very high percentages of its Block II capacity (Exh. EPM-79). At the same time, El Paso Merchant experienced significant curtailments in scheduled deliveries, including Block I curtailments that began early in the summer of 2000 and Block II curtailments that arose consistently from the late summer 2000 onward (Exh. EPM-163). However, even on those occasions during this period when El Paso Merchant did not nominate 100 percent of its capacity, the relevant question is whether other shippers had sufficient capacity to take up the slack. The evidence shows that if El Paso Merchant had attempted to exercise market power by restricting its nominations and flows of gas to California during the summer of 2000 and thereafter, other firm shippers who were experiencing cuts in their own nominations could have flowed, and would have had every incentive to flow, more gas.

All parties agree that from November 2000 - March 2001 El Paso Pipeline was full. During that period El Paso nominated essentially all of its available capacity and it, as well as other shippers experienced consistent capacity-related cuts in their nominations. Consequently, there could be no artificial withholding of gas to Southern California during this period since California was receiving all of the gas that was physically possible.

B. Whether El Paso Merchant Withheld Capacity

El Paso Merchant witness, Dr. Joseph P. Kalt, Professor of International Political Economy at the John F. Kennedy School of Government, Harvard University, set forth three basic conditions that would have to be met in order to prove that Merchant exercised market power (tr. pp. 3131-3132). Professor Kalt explained that the three conditions would have to hold at the same time. The three conditions are:

1. The system for getting gas to California customers must not be full;
2. El Paso Merchant must have unutilized, but usable delivery rights, and
3. Other shippers must have fully utilized their delivery rights.

On the first point, Professor Kalt explained that it is critical that the system must not be full because once capacity becomes constrained, neither El Paso Merchant nor any other shipper could exercise market power. Dr. Ogur agreed with Professor Kalt's view that exercising market power requires a restriction of supply, and if pipelines are full, then supply is at its maximum (tr. p. 2701). Dr. Carpenter also acknowledged that when the pipeline system was full El Paso Merchant could not exercise market power (tr. p. 996). During the spring of 2000, El Paso Merchant and other shippers had unutilized capacity because there was insufficient demand at the California border. During this period basis differentials between the producing basins and the California border were close to the variable cost of shipping. When prices exceeded the variable cost of shipping gas flowed. Conversely, El Paso Merchant argues that if prices were below the variable cost of shipping, it would not have been prudent to ship gas. During mid-2000, conditions quickly changed. Within a relatively short period of time the pipeline systems bringing gas to and into California became fully constrained as the average daily demand ran at almost 20 percent higher than any of the previous four years. It was during this period that El Paso Merchant began to experience consistent cuts in its nominations. Also, starting in June 2000, potential interruptible transportation (IT) shippers' nominations increased sharply, but since firm shippers were already using most of the capacity very little IT actually flowed even though such sales would have been economic.

As for the second point, Professor Kalt points out that the term "usable" means both "economically viable" and "physically available." Professor Kalt stated that the second condition was not met because El Paso Merchant did not have unutilized, but usable delivery rights. In the spring of 2000, El Paso Merchant had unutilized delivery rights, but they were not usable because it was not economic to ship gas due to low demand and prices at the California border. Neither El Paso Merchant nor other shippers on El Paso Pipeline fully nominated or utilized their capacity during this period. By late June, while is was economically viable for El Paso Merchant to ship gas, the pipeline systems were full and El Paso Merchant's nominations were consistently cut in the El Paso Pipeline scheduling process. During this period El Paso Merchant fully nominated its contracted Block III capacity from June 2000 to November 2000, but experienced consistent capacity cuts on its nominations of Block III deliveries throughout the period March 2000 through March 2001. El Paso Merchant nominated the vast majority of its Block I capacity on El Paso Pipeline to SoCal-Ehrenberg delivery point and suffered consistent capacity cuts throughout the period beginning late June/early July 2000 and extending through March 2001. Even after El Paso Merchant upgraded its Block I capacity to primary receipt point to primary delivery point quality on November 22, 2000, its nominations to El Paso Pipeline delivery point at SoCal-Ehrenberg were consistently cut due to capacity constraints on the physical transportation system to and into California from November 22, 2000 through March 2001. The record herein shows that throughout the term of the El Paso Merchant contracts, numerous shippers other than El Paso Merchant collectively had just 100 MMcf/d of unused capacity almost every day between March 1, 2000 and March 31, 2001. Even Dr. Carpenter and Dr. Ogur conceded at the hearing that El Paso Merchant could not exercise market power during the November 2000 to March 2001 time period because the pipeline system was full.

Regarding third point, Professor Kalt argued that Merchant could not have exercised market power if other shippers had unused, but usable, delivery rights since such delivery rights constituted supply available to the market that could offset any withholding of supply by El Paso Merchant. Professor Kalt argued that for the entire period of the El Paso Merchant contracts, other shippers had unutilized firm capacity of their own as a result of weak demand during the spring 2000 and later as a result of cuts in nominations due to capacity constraints as growing demand. Moreover, starting in the summer 2000, when the basis differentials began to exceed the cost of interruptible transportation, the capacity that was allegedly withheld by El Paso Merchant would have been available as interruptible service.

C. El Paso Merchant's Financial Hedging

In acquiring the three blocks of capacity on El Paso Pipeline, El Paso Merchant agreed to pay a fixed demand charge of $38.5 million, payable monthly over the 15-month term. El Paso Merchant felt that this demand charge represented a risk to El Paso Merchant, since it might not be able to flow enough volumes at sufficient price over the term of the contracts to offset the fixed demand charges (tr. 1836 - 1837; Exh. EPM-64, p. 79). Particularly since the prior holder of essentially the same El Paso Pipeline capacity, Dynegy, lost $17 million during 1998-1999 (tr. 1836 - 1837, 1847). Consequently, as soon as El Paso Merchant contracted for the capacity from El Paso Pipeline, it began entering into financial transactions to minimize the risk that basis differentials between the producing basins and the California border would decline during the term of the El Paso Merchant Contracts (tr. 2122 - 2123; Exh. EPM-63). This risk management technique is generally known as "hedging." The Commission described hedging in Order No. 637 as follows:[21]

> Hedging occurs when a seller uses a financial instrument to fix the price at which it will buy or sell a commodity at some future date. By locking in a known price in the future, a buyer in the natural gas market, for example, can protect itself against future increases in the spot market price. Two financial instruments commonly used for hedging are a forward contract and a futures contract.

As the Commission recognized in Order No. 637, a very active financial market has developed in the gas business. Unlike physical gas transaction, which require delivery of actual volumes of gas to specified locations, financial transactions are based on future prices of gas, without corresponding need to flow or deliver gas physically. The financial marketplace has developed a variety of options and futures contracts used by consumers, producers, and marketing companies to hedge against potential price fluctuations associated with their contracts in the physical gas market (*See* Order No. 637, at 61,253).

El Paso Merchant hedged its future price risk under its contracts with El Paso Pipeline primarily by making forward financial sales – sales today for some date in the future at a specified price, volume, and term – at the California border. The volumes of the forward financial sales were based on expected throughputs, which were El Paso Merchant's expected load factors based on historical El paso Pipeline flow levels. El Paso Merchant's strategy was to lock-in a basis spread between the production basins and the border that equaled its reservation charge plus variable cost on a per-unit basis (Exh. EPM-63; tr. 1839).

[21]FERC Stats. & Regs. [Regulation Preambles] ¶ 31,091 at 31,253 (2000).

El Paso Merchant argues that if it possessed the market power asserted by the CPUC, PG&E, and Edison, it would not have needed to hedge against downside price risks because it could guarantee prices and basis differentials above "competitive levels" (Tr. 1843, 2121 - 2122, 2192, 2432; Exh. EPM-1, Exh. EPM-64).

Edison argues that while El Paso Merchant held approximately 14,000 MMcf/d of capacity between its three capacity blocks and its SoCalGas release, only 700 MMcf/d, approximately 50 percent were held (Edison In. Brief, p. 39). Thus, there was significant capacity left to provide an incentive to El Paso Merchant to increase the price.

The Chief Judge finds that there is merit in El Paso Merchant's arguments. However, at the same time, despite of the hedging, El Paso Merchant made tremendous profits, $184 million, on the 50 percent of the capacity that was not hedged (tr. 2058 - 2061, 4182 - 4183; Exh. SCE-167).

D. Increases in Demand and Price Increases

The Commission in its *Order Removing Obstacles to Increase Electric Generation and Natural Gas Supply in the Western United States and Requesting Comments on Further Actions to Increase Energy Supply and Decrease Energy Consumption*, 94 FERC ¶ 61,272 (2001), found that unusually warm weather, low hydroelectric production, the cumulative effect of annual demand growth, lack of new generation facilities, a seriously flawed electric market, and other factors all contributed to higher electric power prices. The Chief Judge finds that the higher prices being obtained for electric power made gas-fired generation much more economic than in prior years, which resulted in a substantial increase in demand for gas, which increased the price. PG&E's witness, Mr. Wilson, testified that even without El Paso Merchant exercising market power, gas prices would have been higher in 2000 due to scarcity and high pipeline utilization (tr. 640-641). Natural gas consumption in California beginning in May 2000 was 1.3 Bcf/d higher than average levels for the same months during the years 1996 - 1999 (Exh. EPM-1; tr. p. 108-109). The result was an inevitable sudden and dramatic increase in the price of natural gas under the law of supply and demand.

In Order 637, at 31,273, the Commission said, " . . . during peak periods, the value of transportation will rise because the transportation quantity demanded begins to exceed the quantity of capacity supplied. As a result, a higher price is needed to effectively allocate transportation to those who need to obtain it and are willing to pay the highest price for the bundled commodity. Such prices would occur in any competitive market when supply becomes constrained relative to demand."[22] The Commission also stated in Order No. 637-A, "[H]igh prices during peak periods are a legitimate reaction to supply and demand forces."[23] In this proceeding the evidence shows that El Paso Pipeline's capacity was used at an extremely high load factor for nine consecutive months (EPNG Exh. 26, 27, 29, and 34). No party disputes the fact that the other three interstate pipelines serving California also ran at high load factors during this period. This was a dramatic shift from a market characterized by a substantial amount of excess capacity to one characterized by a prolonged multi-month period with demand being at the limit of available supply. This was a legitimate reaction to supply and demand forces.

Be that as it may, the Commission, in Order No. 637, found that price increases are not necessarily indicative of market power:

> The fact that the value of transportation in the short-term bundled sales market exceeds the daily or monthly maximum rate now permitted in pipeline tariffs is not surprising, nor is it evidence that market power is being exercised. The daily or monthly rates (derived by simple division of the annual rate) were never intended to replicate prices that demand conditions would produce. Particularly during peak periods, the value of transportation will rise because the transportation quantity demanded begins to exceed the quantity of capacity supplied. As a result, a higher price is needed to efficiently allocate transportation of those who most need to obtain it and are willing to pay the highest price for the bundled commodity. Such price increases would occur in any competitive market when supply becomes constrained relative to demand.[24]

In Order 637-A, the Commission further emphasized:

> Because no capacity can be withheld from the market above the regulated maximum rate and buyers can always obtain capacity from the pipeline on a non-discriminatory basis, market power cannot be exercised when rates exceed the cost-of-service price ceiling, and consequently the resulting price is the

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[22]Order No. 637, FERC Stats & Regs. [Regulation Preambles] ¶ 31,091 at 31,275 (2000).

[23]Order No. 637-A, at 31,567.

[24]Order No. 637, FERC Stats & Regs. [Regulation Preambles] ¶ 31,091 at 31,275 (2000).

competitive price needed to equate supply and demand and allocate the available capacity.[25]

El Paso Pipeline, by motion filed on October 4, 2001, requested the Chief Judge to take official notice of a press release issued on September 27, 2001, by PG&E and of a press release by the California Energy Commission attaching a report adopted on October 3, 2001, entitled: "Natural Gas Infrastructure Issues." A joint answer opposing El Paso Pipeline's motion was filed by PG&E, Edison, and the CPUC on the ground that it is not a proper subject for official notice and that it is not material beyond reasonable controversy.

The Chief Judge finds the material to be relevant to this case and the PG&E press release to be a statement by one of the major parties concerning the reasons for the high gas prices in Southern California during the period involved in this case. These documents will be made a part of the official record for the Commission's use.

Among other statements concerning PG&E's expectations that gas prices would decrease, the press release of PG&E states:

> Gas prices began increasing across the country last year because of tight supplies and high demand. Prices charged by gas suppliers last winter were especially high because of increased demand by natural gas-fired power plants. Additionally, cold weather -- which results in higher demand -- in other parts of the country tends to drive up prices here because the pipelines and supply basins in Canada and the Southwest U.S. that serve California are also connected to other regions.

E. FERC Regulations Prevent Withholding of Capacity

When a pipeline complies with the Commission's regulations set forth in Order Nos. 637 and 637-A, the exercise of market power by the withholding of capacity by an affiliate or any other shipper on a pipeline is prevented. The evidence in this case shows that El Paso Pipeline did in fact comply with Order Nos. 637 and 637-A. Order No. 637-A, at 31,564 states:

> While market analysis looks principally at market structure and barriers to entry in an attempt to discern whether firms will have incentives to reduce output to raise price, the Commission's regulations protect against the exercise of market power by directly limiting the withholding of available transportation capacity through

[25]Order No. 637-A, at 31,564 (2000).

> the requirement that pipelines sell all available capacity at a regulated rate. There is only a fixed amount of capacity in the short-term capacity market. Any capacity not sold or used by a firm shipper is, by definition, available from the pipeline as interruptible or short-term firm capacity. In these circumstances, if firm shippers attempt to exercise market power by raising price above the regulated rate, buyers can acquire the capacity from the pipeline at the regulated rate. Because no capacity can be withheld from the market above the regulated maximum rate and buyers can always obtain capacity from the pipeline on a non-discriminatory basis, market power cannot be exercised when rates exceed the cost-of-service price ceiling, and consequently the resulting price is the competitive price needed to equate supply and demand and allocate the available capacity. The requirement that a pipeline sell its capacity at the regulated maximum rate prevents tacit collusion between the pipeline and the shipper to withhold capacity to raise price above the ceiling rate, and effectively limits the releasing shipper's ability to exercise market power at prices above the ceiling rate.[26]

Order 637-A goes on to state:

> The rate ceiling on pipeline capacity also will continue to protect against the exercise of market power in the event capacity is held by a pipeline affiliate. The pipeline affiliate, like any other firm shipper, will be unable to withhold capacity and exercise market power because, if the affiliate refuses to sell released capacity, buyers can obtain that capacity as interruptible transportation at a just and reasonable rate from the pipeline.[27]

El Paso Pipeline 's president, Ms. Patricia A. Shelton, testified that El Paso Pipeline posted on its electronic bulletin board all of its capacity available at each of its four California delivery points. In addition, El Paso Pipeline posted all of its available capacity at its receipt points and at points elsewhere on its system where capacity constraints are most frequent. Ms. Shelton further testified that any capacity not used by El Paso Pipeline's firm shippers was made available to any interruptible shipper willing to pay the El Paso Pipeline approved tariff rates. It is undisputed in this case that El Paso Pipeline posted all capacity not scheduled by its firm shippers. Interruptible service is considered by this Commission to be an effective protection against withholding of capacity by firm shippers. That fact does not necessarily mean that a substantial amount of interruptible capacity will flow on El Paso Pipeline's system. Further, there is no

[26]Order No. 637-A, at 31,564 (2000)

[27]*Id.*, at 31,564.

requirement that a pipeline discount its interruptible service (Order No. 637-A, at 31,567). The El Paso Pipeline's procedures described by Ms. Shelton would tend provide substantial control on the exercise of market power by the withholding capacity.

IV. THE AFFILIATE STANDARDS ISSUE

The Commission in its March 28, 2001 order[28] in this proceeding stated (page 3 of slip):

> ". . . The Commission finds no merit in the allegations that the bidding process for the three blocks of capacity was skewed to favor El Paso Merchant and that El Paso Merchant possessed certain information concerning a discount that was not available to other bidders. Further, the Commission has examined the evidence and does not find a violation of the Standards of Conduct for Interstate Pipelines with Marketing Affiliates (Affiliate Standards)."

Then the Commission went on to state:

> "As stated above, the Commission does not prohibit marketing companies from arranging transportation and related discounts with their pipeline affiliates. The Commission's examination of the record before it, including Protected Materials, reveals no violation of the Affiliate Standards. <u>Nevertheless, while the evidence in the existing record does not show that El Paso Pipeline and El Paso Merchant violated the Commission's Affiliate Standards, the CPUC and the intervenors have cited internal El Paso Pipeline communications that they claim show evidence that El Pas Pipeline and El Paso Merchant intended to manipulate the market</u>. These documents and the three studies presented by Edison, El Paso Pipeline, and El Paso Merchant raise doubt about whether El Paso Merchant had market power and, if so, exercised it so as to increase natural gas prices at the California border. The Commission is concerned about

[28] Public Utilities Commission of the State of California v. El Paso Natural Gas Co., 94 FERC ¶ 61,338 (2001), at 62,246.

> these allegations, and directs the ALJ to compile a record on this issue." (Emphasis supplied)[29]

But in its June 11, 2001 order[30] on Rehearing herein the Commission said:

> In their requests for rehearing, CPUC, PG&E, and Edison claim that El Paso Merchant had secret and material information that was unavailable to other potential bidders, thereby tainting the process. CPUC asserts that it is undisputed that, during the open season, <u>EL Paso Merchant negotiated lower rates for large volume</u> utilizing Mojave's IT rates to Wheeler Ridge, and that no other party knew of this discount until after the close of the open season. They further contend that the open season was skewed to favor a bid by El Paso Merchant in a variety of ways. CPUC, PG&E, and <u>Edison generally argue that the Commission misinterpreted the evidence relating to the open season and the discount on which it relied in the March 28, 2001</u> order and failed to provide an adequate explanation of the basis for its decision not to address the issue of affiliate abuse at a hearing.
>
> In consideration of the Chief Judge's request for guidance with respect to the affiliate issues <u>and the request for rehearing filed by CPUC, PG&E, and</u> Edison, the Commission has determined to set for hearing <u>the issues raised by CPUC's complaint concerning allegations of affiliate abuse and violation of the Affiliate Standards. The Commission now believes these allegations raise factual issues that are best resolved in an evidentiary hearing.</u>" (Emphasis supplied)

In other words the Commission decided that the evidence relied upon in its March 28, 2001 order herein needed a second look. The Commission in the June 11, 2001 order stated, as pointed out above, that in view of the issues raised by CPUC, PG&E and

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[29]*Id.*, at 62,254

[30]Public Utilities Commission of the State of California v. El Paso Natural Gas Co., 95 FERC ¶ 61,368 (2001), at 62,391.

Edison in their petitions for rehearing the Commission now believes factual issues needed a more in depth review.

Standard of Conduct F[31] requires that a pipeline that provides to its marketing affiliate information relating to the transportation of natural gas must contemporaneously provide that information to all other potential shippers. It provides that a pipeline and its affiliates operating personnel must function independently and that communications should be limited to specific information regarding the affiliate's transportation request or service.

Standard of Conduct G[32] provides that to the maximum extent practicable the pipeline must require its operating personnel and the operating personnel of its marketing affiliate to function independently of each other.

Here CPUC placed into evidence transcripts of two telephone conversations between Mr. Robin Cox, a vice president of El Paso Merchant, and Mr. Harvey Rodman of another El Paso affiliate, Mojave Pipeline Company, who markets transportation for both Mojave and El Paso Pipeline, in which it is clear to the Chief Judge that a deal was reached during the open season for a term discount that other potential shippers were not aware of. In fact, there was agreement to hold the discount until the contract was awarded. These telephone transcripts demonstrate blatant collusion on the part of El Paso Merchant and Mojave/El Paso Pipeline to keep secret a discount for service on the downstream Mojave system until the open season ended, giving El Paso Merchant an advantage in making its bid for the total 1,220 MMcf/day offered. In order that there can be no doubt concerning these facts, the Chief Judge is setting out below the transcripts of the two telephone conversations:

COX-RODMAN - TELEPHONE CALL
2/7/00 1:20pm

Telephone dialing and ringing

RODMAN: Hello?

COX: Harvey, how are you doing?

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[31] 18 C.F.R. § 161.3(f) (2000).

[32] 18 C.F.R. § 161.3(g) (2000).

RODMAN: Pretty good.

COX: Hey, uh, two or three questions I need to ask you.

RODMAN: Ok.

COX: Uh, one, when do you expect the fuel issue to be resolved?

RODMAN: I have no earthly idea.

COX: Ok.

RODMAN: When the Commission addresses it. That's . . . that's our federal dollars at work for us.

COX: OK, um, from a - with a perspective of bidding on this capacity?

RODMAN: Yup.

COX: What do you suggest we do from um, from a fuel standpoint . . . calculating our value?

RODMAN: Uh, well, El Paso -

COX: It'll give you more value if we calculate based on your um, new fuel.

RODMAN: . . . El Paso's position is, is that we uh, believe that the fuel if anything should be phased in and not done automatically over a three year period. So, uh..

COX: I'm sorry say that again.

RODMAN: Uh, if . . .if they are . . . they are, in fact going to uphold their decisions at Blanco and Chaco, we, we would ask that it be phased in over a three year period. So I, I would say the fuel would come out, uh, for the period that this offering is for - I would say that you use the 4.85 percent fuel . . .

COX: Ok.

RODMAN: . . . I mean, that's what I'd do.

COX: Right, ok.

RODMAN: But an order could come out tomorrow saying no.

COX: Ok, then its, then its just gravy for us.

RODMAN: Yup.

COX: Ok, um, second question.

RODMAN: Ok.

COX: Um, is . . . who,who owns Mojave - what are, who are the partners?

RODMAN: El Paso Natural Gas Company.

COX: And that's it?

RODMAN: That's it.

COX: Ok.

RODMAN: They used to be jointly owned between El Paso and Transwestern and we bought them out a long time ago.

COX: Ok, I was wondering why it said partners.

RODMAN: Ah, ok.

COX: Um, third question. Um, in order to bid on this capacity, we're going to need some rate certainty on, um, Mojave - to go to, uh. Wheeler Ridge, even if its - even if, you know, we can't even schedule it, we still need to know what a rate certainty could be.

RODMAN: A rate certainty?

COX: In other words, we, would like to, negotiate a term discount, and perhaps some kind of minimum volume guarantee, um, over a certain term. But we would like to at least know what our - um, its critical that we know what our, uh, uh, discount is going to be, for this, for this specific term.

RODMAN: Ok. Let me, let me call you back on that one.

COX: Ok, and we can, we can do some, you know, substantial volume guarantees so uh . . .

RODMAN: Yup . . .

COX: Um . . .

RODMAN: How much - what kind of capacity are, are you looking at bidding on?

COX: All of it.

RODMAN: All of it. Ok.

COX: And, but specifically for Block II we need some, some type of, uh . . .

ROMAN: Yup . . .

COX: . . . guarantees on Mojave.

RODMAN: Yup, uh, let me see what I can do.

COX: Ok.

RODMAN: Ok.

COX: Appreciate it.

COX: Bye

COX-RODMAN - TELEPHONE CALL
2/9/00 2:14pm

RODMAN answers phone: Hello.

COX: Hey

RODMAN: Hey, why don't you stay at your desk?

COX: What's that?

RODMAN: Why don't you stay at your desk?

COX: Why don't you answer your phone?

RODMAN: I do.

COX: I feel like you're putting FERC over me.

RODMAN: Somedays that happens.

COX: Ok. Well, uh, hey, I got a couple of questions for you.

RODMAN: Ok.

COX: What about that, uh, long term discount on, uh . . . on . . . uh . . . Mojave?

RODMAN: Well, what was your - yeah, I wanted to get back - what was your . . . desired rate on that?

COX: Well, we could do, like, uh . . . anything above a hundred, uh, two cents, anything below a hundred, say, something like three?

RODMAN: Oh, I'll probably do something like a tiered rate over a period of time two, three and four.

COX: Two, three and four - hundred thousand?

RODMAN: 100,000, maybe the two cents, uh, 50 to a 100,000, uh, three, and less than 50,000 two, uh . . . at four.

COX: Ok.

RODMAN: I'll probably do something like that and just post it out there.

COX: Ok. Can you post it later though? Like, can you post it like, uh, next Tuesday or Wednesday?

RODMAN: Uh, . . . as soon as I can get to it I'll get it posted.

COX: Ok, so it'd be like four cents below 50,000 . . .three cents -

RODMAN: 50 to 100, 2 cents for anything over a hundred thousand averaged over the month.

COX: Ok. I appreciate it.

RODMAN: You know what my accountants have to deal with to do this?

COX: What? . . . Well, we'll let you know what our volume is . . .

RODMAN: Yeah . . .

COX: . . . that'll be the easy way . . . hey, if I'm -

RODMAN: It's just that they have to check everybody else because they got to put it out as a published discount.

COX: Ok, . . .

RODMAN: They'll hate me.

COX: We're not, we're not wanting to do that, you know, we'll we officially request this like next Wednesday.

RODMAN: Oh, ok.

Mr. Cox, immediately after the telephone conversation on February 9, 2000, at 2:26 p.m., sent an E-mail to several of his co-workers in El Paso Merchant's various Risk Management Operations. In that E-mail, Mr. Cox informed them, "Mojave is willing to offer something along this offer" and he then specified the volumes and corresponding rates of the tiered discount. Mr. Cox went on the state that he would officially request the discount that next Wednesday "assuming that Merchant won the capacity." (Exh. PUC-19) It is clear from this E-mail that El Paso Merchant planned to take advantage of the new Mojave discount if it prevailed in wining the El Paso Pipeline open season capacity. The discount actually received by El Paso Merchant was identical to that requested in the telephone conversation. It is immaterial that after being awarded the contract El Paso Merchant asked for an even better discount but was refused.

Neither Mr. Cox nor Mr. Rodman were produced as witnesses to explain their intent in these conversations even though the Chief Judge urged their appearance as witnesses. Rather, El Paso Pipeline and El Paso Merchant relied upon the testimony of the President of El Paso Pipeline and Mr. Cox' boss. Neither of which were participants in the calls. The transcript of that colloquy between the Chief Judge, El Paso Pipeline President Ms. Shelton and El Paso Pipeline and El Paso Merchant's counsel on this subject is important and shows the strong urging of the Chief Judge to produce Mr. Rodman and Mr. Cox as witnesses. That portion of the transcript, pages 5213 beginning at line 13 thru 5219, line 11, is produced here:

> PRESIDING JUDGE: And you know, it's pretty clear here, and I think we need a better explanation than we've got, that the merchants, marketer, purchaser, whatever Cox's title is, has called up El Paso and he has agreed to what -- El Paso has agreed with Merchant's man, what the rate will be, what the discount rate will be, and then he also agrees to hold it up until after the contract is let. So it is a secret. You know, I'll take official notice of that. This is not what is open and above board and the reason that I'm dubbing it is so we don't spend all morning talking about this one item and it's still not clear.
>
> I think it is very clear here and if there's an explanation as to why these people did this, it's up to Merchant and El Paso to put it on the record. Also, I would be interested to know if this goes on every day between Merchant and El Paso, and I'm sure the Commission would like to know.

I think these two telephone conversation tapes are devastating to the affiliate relationships, and I'm not prejudging the case. I'm just telling you what you've got to do to overcome this. This looks very, very bad, and it is a telephone conversation between these two people, and I got an agreement yesterday that it was authentic and accurate from Merchant and El Paso.

So, you know, if you have a real explanation for this, Ms. Shelton, I'll let you get it. If you don't know why they did it, you just say you don't know why they did it.

THE WITNESS: Well, I don't want to get in trouble with Your Honor but I don't see it as an agreement. And if you followed the rest of the records, you'll find that the actual transportation discount that Merchant requested was not this one. They asked for something far better than this one.

PRESIDING JUDGE: I'm concerned with the fact, not with the actual discount, but I'm concerned with the fact the method that was followed. Hey, hold this up for a week. And that is what really concerns me.

THE WITNESS: Well, I don't think it's hold it up for a week so we can keep it secret. They didn't even know if they were going to win the open season, so why go through all of this if you don't know if you're going to even win the open season. There is no way Merchant knew they were going to win the open season, your Honor.

PRESIDING JUDGE: Of course without dragging Cox and Rodman in here which, you know, we may have to do, it looks to me like they do know, you know. Rodman's saying, hey my accountants are going to shoot me if we do this because we're supposed to publish this to everybody, and Cox says, you don't have to, we'll make it next week, we'll say we're making it next week officially.

And you know, if that's not hanky panky, there's no such thing as hanky panky.

(Laughter.)

THE WITNESS: Your Honor, may I take exception to one thing you said?

PRESIDING JUDGE: Yes.

THE WITNESS: The accountants aren't trying to hold it up. The accountant comment was directed to --

PRESIDING JUDGE: No, no, that isn't what I said. He's saying that my accountants will kill me, they'll have to publish it.

THE WITNESS: No.

PRESIDING JUDGE: Well, that's what it says, Ms. Shelton. Look at it. Cox says, okay, I appreciate it. He tells him, you know, what he wants to hear. And Rodman says, you know what my accountants have to deal with to do this. Cox, What? What .... well, we'll let you know what our volume is yeah. Cox, that'll be the easiest way. Hey, if I'm -- Rodman butts in. It's just that they have to check everybody else because they've got to put it out as a published discount. Cox. Okay. Rodman. They'll hate me. Cox. We're not willing to do that, you know. Well, we'll officially request this like next Wednesday. Rodman. Oh, okay.

You know, it's very clear what they're doing, and if you want to bring Rodman and Cox in here this afternoon or Monday morning, I'll leave that up to your counsel. But I think this is, you know, hanky panky if I ever saw it, and I'm telling you that you need to get somebody in here to explain it.

THE WITNESS: May I say --

MR. COLLINS: Hold on, hold on for a second.
Excuse me, Your Honor. We respectfully and vigorously disagree.

PRESIDING JUDGE: You may disagree but I'm telling you to get Rodman and Cox in here this afternoon or Monday, and under oath, let them, subject to perjury, let them testify that this wasn't what they were doing. You have the option to do that. If you want to rely on the record as it is, you may rely on the record as it is. I told you my perception of what's here, and I'm sure it's everybody's perception. It's going to be the Commission's perception, it's going to be the court's perception. You know, this is the kind of stuff we pass affiliate standards to prevent, and you're openly doing it.

Why you kept a transcript of a telephone conference like this is beyond my imagination but you did do it, and now it's out in the open and now you've got to live with it.

So do you want to bring Cox and Rodman in here. This lady, as smart as she is, and she's their boss, doesn't know what was in their mind. She doesn't know what they're pulling. She'll probably go back and give them some kind of disciplinary action.

MR. COLLINS: Your Honor, if I might, I have no desire at all to, in any way, upset you.

PRESIDING JUDGE: Well, you're not upsetting me. I'm just telling you what you need if you want to win this case.

MR. COLLINS: And I hear Your Honor, loud and clear, and we'll do it.

PRESIDING JUDGE: I thought I made it clear to you yesterday I thought this was bad stuff and needs to be explained.

MR. COLLINS: And that's what I rose to talk about, Your Honor. And I know we went through this somewhat yesterday with regard to the Commission's regulations and with regard to what flexibility a marketing affiliate has to seek discounts from its related pipelines.

> PRESIDING JUDGE: Yes, Mr. Collins. But what the thing doesn't do is to say, you seek a discount from the pipeline, the affiliate seeks a discount from the pipeline and then they say, let's keep it secret till after the bid period closes, then we'll officially say we'll push it.
>
> What he did here is clear. What he has done, Cox, is to have gotten that he will get at least this much discount so he can go do his bid, nobody will know about it until next Wednesday. That's what it says. We'll do this next Wednesday. That's what he's saying.
>
> And Rodman has a little bit of conscience pinch because he said, my accountants will kill me. And he said, you know, we'll take care of that, we'll wait till next Wednesday.
>
> MR. COLLINS: Another perfectly plausible explanation for that, Your Honor, can be given by saying until you know whether you're going to get the bid.
>
> PRESIDING JUDGE: That wasn't what he said. You know that --
>
> MR. COLLINS: I said, Your Honor, what I said was a perfectly plausible interpretation of that is, until I get the bid, I'm not going to request a discount.
>
> PRESIDING JUDGE: That's right, but that is not the explanation that I get from reading this. And I have to make a finding on it. And, you know, if you want to bring these people in and let them tell me what they meant, or what they were really doing, under oath, I'm glad to let you do it.

In spite of El Paso Pipeline counsel's promise (Tr. P. 5217 lines 24 and 25) neither Mr. Cox nor Mr. Rodman was produced as a witness. The cases are clear that when a party has relevant evidence within its control which it fails to produce that failure gives rise to an inference that the evidence is unfavorable to it.[33] Be that as it may El Paso Pipeline and El Paso Merchant failed to go forward and rebut the evidence which the Chief Judge ruled along with PUC Exhibits 36 and 37 made a prima facie case on the affiliate abuse question (tr. p. 5567).

On February 14, 2000, a presentation was made to Bill Wise, the CEO of El Paso Corporation the parent company for both El Paso Merchant and El Paso Pipeline, apparently to solicit his endorsement of El Paso Merchants' proposal to bid for the 1,220 MMcf/day capacity involved in the open season. El Paso Merchant during the hearing and at page 50 of its initial brief contends that Bill Wise played no role in El Paso Merchants' bid package. El Paso Merchant witness Ralph Eads, an Executive Vice President of the El Paso Corporation and President of El Paso Merchant Energy Group of which El Paso Merchant is a part, testified at page 1836 in reference to questions concerning Bill Wise's involvement in El Paso Merchant and its proposed bid for the 1,220 MMcf/day in question:

> "THE WITNESS: He certainly doesn't micromanage it as a general matter, but when it comes to things like this he doesn't get involved." (Emphasis added.)

However, Ralph Eads after extensive questioning by the Chief Judge admitted that Bill Wise approved the bid. Getting this important evidence from Ralph Eads was a rather difficult job as the following excerpt from the transcript demonstrates (tr. p. 2037 line 2 through 2039 line 20 and 2041 line 15 2042 line 8):

> BY MR. LINDH:
> Q Let me ask you the question, then. At the February 14th meeting or at about the time of the February 14th meeting, is it not true that you went to Mr. Wise and received permission for Merchant Energy to take over this capacity on the El Paso Pipeline?
>
> A Instead of answering that question specifically, describe–
>
> PRESIDING JUDGE: Answer him yes or no.

[33] *International Union (UAW) v. NLRB*, 459 F.2d 1329, 1336 (D.C. Cir. 1972), *York v. AT&T*, 95 F.3d 948, 955 (10th Cir. 1996), and *Brice v. Nkaru,* 220 F.3d 233, 240 n.9 (4th Cir. 2000).

THE WITNESS: Could you repeat the question?

PRESIDING JUDGE: The reporter will read the question.

(The reporter read the record as requested.)

THE WITNESS: No, that's not my understanding.

PRESIDING JUDGE: You did not ask Mr. Wise in any way whether you should do this?

THE WITNESS: That's just the point, your Honor. We live with these rules. They're important rules to us, and I'm careful not to ask him.

PRESIDING JUDGE: Mr. Eads, just answer my question. You did not ask him in any way whether to endorse this purchase?

THE WITNESS: That's correct, your Honor, I didn't say Bill, can we go do this? I didn't ask him this.

PRESIDING JUDGE: Why did you do this presentation to solicit his endorsement, that's under oath by Mr. Mitchell?

THE WITNESS: I believe Mr. Mitchell was referring to this whole process that we go through. Your Honor, let me put it this way. It's clearly true that Mr. Wise, if he had said don't do this, we wouldn't have done it. That's clearly true, absolutely right.

PRESIDING JUDGE: Maybe I'm asking it the wrong way, and maybe I have to ask you exactly the quote. I can go through 2899 different ways to do it. Did you say "Bill, do you think this is a pretty good idea?"

THE WITNESS: I understand --

PRESIDING JUDGE: Did you say that? "Bill, do you think this is a pretty good idea?"

THE WITNESS: Let me provide this. This may help give some context. I am certain, in this process, we had discussions about this, and I talked to Mr. Wise separate from this meeting about this, too. I am certain that along the way he said if you guys want to bid on the capacity, that's okay with me. I'm certain he said that. But the question, did we go into the meeting with this notion of his approval --

PRESIDING JUDGE: Did you get approval from Mr. Wise, whether you got it after the meeting, whether you got it the day before, whether you got it in the head while you were both relieving yourselves?

The "head," for nonboating people, is restroom.

THE WITNESS: Let me put it this way. I certainly knew Mr. Wise found it acceptable for us to bid. I certainly knew that, but -- maybe this is form over substance. I'll accept that criticism, that maybe I'm emphasized form over substance here. But I am careful -- I mean, one thing I'll tell you, he didn't know what we were going to bid exactly. We didn't disclose that to him. He certainly knew we were going to bid. I certainly knew it was okay with him that we bid. As a specific matter, I didn't go say Bill, can we do that. If I had done that, I would have put in the presentation recommend approval of the bid. All I'm saying is I knew it was okay with him, and certainly he approved of the bid. That is absolutely accurate. Yes, he approved of the bid.

. . .

PRESIDING JUDGE: What I want is, when you bring Mitchell on, to have him explain in detail what he means by paragraph 21, because the answer we got here I don't feel is what Mr. Mitchell meant, and I feel you're trying to pull something over my eyes, which I don't appreciate. If I'm not satisfied there, I'm going to subpoena Wise and have him under oath say he didn't have anything to do with this bid.

> THE WITNESS: Your Honor, I'm sorry if I didn't answer your question properly. Mr. Wise did know what we were doing.
>
> PRESIDING JUDGE: He did approve it?
>
> THE WITNESS: Yes, sir, I think that's fair.
>
> PRESIDING JUDGE: That's the answer I want. Why didn't you tell me that this morning and we would have all been home by now? It was Mr. Wise's approval. You have to get my blood pressure up to get the truth out of you. Have you finished your cross-examination?

The next day at the Chief Judge's request Mr. Bill Wise appeared and was examined by the Chief Judge. He testified that he ". . . in essence, approved them going forward with the bid" and ". . . I definitely, in the process of that meeting, approved going forward with it." (tr. p. 2204)

Mr. Wise further testified that both Ralph Eads executive vice president for the Marketing Group and John Somerhalder, executive vice president for the company's regulated business, including El Paso Pipeline Group, report directly to him. He stated that Ralph Eads and John Somerhalder along with the other members of the senior staff met together with him every three weeks to once a month to discuss general policy matters, but that specific business plans were not discussed because of the regulated and non-regulated people in that policy committee. Mr. Eads had testified earlier that he would step out of the room when pipeline matters were discussed and Mr. Somerhalder would step out when non-regulated matters were discussed. At the time of the open season both Ralph Eads and John Somerhalder's offices were on the same floor as Bill Wise.

On April 14, 2000, Greg Jenkins, then president of El Paso Merchant (who by the way was never offered as a witness even though requested by the Chief Judge) addressed a memorandum to Bill Wise the subject being "EPEM Update - Board of Directors Meeting April 27, 2000 - Newport Beach, CA." One paragraph of that document was placed in evidence in this proceeding as PUC Exhibit 37. The first sentence of that document was made public by counsel for El Paso Merchant. That sentence said: "El Paso Capacity – We will make money two ways: 1) increase the load factor, 2) widen the basis spread." The Chief Judge reviewed the entire document *in camera*. He found that other than the paragraph set forth in PUC 37, it contained nothing relating to the 1,220

MMcf/day capacity obtained by El Paso Merchant in the open season. He did find that the document covered a wide area of El Paso Merchant's business including financial information, the development of El Paso Merchant projects, risk management, El Paso Merchant's trading operations, human resources programs including hiring and firing, etc. The really interesting thing about the document was the fact that a copy was sent to John Somerhalder, the executive vice president for the pipeline group, (Judge's Ex. 1). The sharing of this document which discusses nearly every aspect of El Paso Merchant's business including what was necessary to make a profit and what must happen if it is to make money indicates clearly that there was no firewall between El Paso Pipeline and El Paso Merchant.

Several parties contend that certain members of the El Paso Merchant Risk Management Committee were also employees of the affiliated pipelines, El Paso Pipeline and Mojave. However, it appears that the officials who were officers of both regulated and non-regulated affiliates and who were receiving nonpublic information from El Paso Merchant did not participate in the day-to-day operating decisions of either the pipeline or the marketing affiliate and therefore were not in violation of the Standards of Conduct.

The Chief Judge finds that El Paso Corporation and its affiliates El Paso Pipeline, Mojave, and El Paso Merchant were in clear violation of Standards of Conduct F and G since the affiliates were not operating independently, at least during the period involved in this proceeding, and by exchanging information off the record resulting in agreed upon deals between El Paso Merchant and Mojave that were not communicated to other potential bidders. In addition, there was little separation of regulated and non-regulated businesses by El Paso Corporation with a sharing of information and close supervision by the corporate head.

It is noted by the Chief Judge that while there are clear violations of the current Standards of Conduct in this case, those rules were promulgated many years ago and the gas industry has undergone tremendous changes since then with merger after merger creating large holding companies, such as the El Paso Corporation, and very different methods of doing business than in bygone years. At least at the holding company level there may very well be a need to exercise more control over affiliates and widen the avenues of communication. In the opinion of the Chief Judge, the officers of parent companies would be derelict in their duties if they did not exercise some degree of supervision and approval over important decisions, particularly in matters with a magnitude as large as that involved in this proceeding. At the same time, it must be kept in mind that here there was a dialog between the pipeline affiliates and the marketing affiliate that gave an unfair advantage to the bidding in the open season. In addition, as pointed out above in the discussion of Judge's Exh. 1, there appears to be a general sharing of El Paso Merchant's entire business activities with the pipeline.

V. CONCLUSION

While the Chief Judge finds that El Paso Pipeline and El Paso Merchant had the ability to exercise market power, the record in this case is not at all clear that they in fact exercised market power. Therefore, the issue in the complaint concerning whether El Paso Pipeline and/or El Paso Merchant may have had market power and, if so, exercised it to drive up natural gas prices at the California border should be dismissed. The Chief Judge further finds that for the reasons stated before herein, El Paso Corporation, El Paso Pipeline, and El Paso Merchant are guilty of affiliate abuse and have violated Commission's Standards of Conduct F and G.

Curtis L. Wagner, Jr.
Chief Administrative Law Judge