



ENERGY TRANSFER

Energy Transfer Partners Responds to FERC Summary Excerpt

On October 9, 2007, Energy Transfer Partners, L.P. (NYSE:ETP) filed its response to the Order to Show Cause issued by the Federal Energy Regulatory Commission (FERC) on July 26, 2007. A copy of the response will be available in the eLibrary of the FERC's website (www.ferc.gov) under docket number IN06-3-002 following the posting of our response by FERC. See Below for the summary excerpt of this response.

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Energy Transfer Partners, L.P., *et al.*

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Docket No. IN06-3-002

*ANSWER OF ENERGY TRANSFER PARTNERS, L.P. IN OPPOSITION TO
ORDER TO SHOW CAUSE AND NOTICE OF PROPOSED PENALTIES*

The Commission’s theory of the case against Energy Transfer Partners, L.P. and its affiliates (collectively, “ETP”) is economically incoherent, internally inconsistent, riddled with factual errors and contrary to sound public policy. In federal court—the proper forum for adjudicating remedies here, as we demonstrated on rehearing—the Commission’s analysis would never survive an independent *de novo* review or a *Daubert* challenge. Nor can it support further proceedings before the Commission.

ETP did not engage in market manipulation. Its trades were profitable and economically rational, reflecting real-world supply and demand conditions. These transactions therefore had a legitimate business purpose—a complete and total affirmative defense under Rule 2 of the Commission’s Market Behavior Rules. The Show Cause Order, *Energy Transfer Partners, L.P.*, 120 FERC ¶ 61,086 (2007), does not and cannot prove otherwise. The Commission therefore should immediately and summarily dismiss its charges against ETP.

The Commission’s preeminent error—among many—is its zealous insistence that it can tell what the price “should have been” in the physical natural gas markets—with amazing accuracy (greater than 99 percent) and in the wake of severe market dislocations caused by Hurricanes Katrina and Rita—all without doing any meaningful analysis of real-world physical trades or fundamental market conditions. And where, one might ask, has the Commission found such an extraordinarily precise, backward-looking analytical tool, purportedly eliminating any need to examine actual supply and demand forces but allegedly suitable, nevertheless, to justify

over \$100 million in penalties and disgorgement? In the most surprising of places: the derivatives markets.

In many quarters now, from Warren Buffett to the halls of Congress, the derivatives markets are suspiciously viewed as opaque and allegedly subject to manipulation. Those who hold this skepticism surely would be surprised to learn that the Commission has embraced the derivatives markets as a paragon of accurate pricing.

We may put this dispute aside for our purposes here, however, because to our knowledge *no one has ever proposed to use price outcomes in the derivatives markets in the absolute and extraordinarily flawed way the Commission proposes here.* The Commission's approach here is completely novel and completely mistaken.

According to the Commission, price outcomes in the derivatives markets are so perfectly precise and reliable that even a single natural gas financial basis swap can tell us the "right" price for roughly contemporaneous physical sales of gas. We need not inquire into what motivated the counterparties in the derivatives transaction. We need not determine whether they both are fully informed about market fundamentals. We cannot admit the possibility that one or both may have misjudged expected price outcomes or developed a different point of view as conditions changed. We cannot recognize that a basis swap transaction rests on a view about the *relationship between* two price points, *not* an absolute view about the specific "right" price at either point. And we cannot suggest that the price in this single transaction might simply embody the inherent variance we see constantly in all markets such as these, where prices, formed through bilateral transactions, oscillate in imprecise fashion around ever-moving equilibria.

Instead, according to the Commission, we must take derivatives transactions as gospel, using them to second-guess actual physical trades of gas between sophisticated buyers and

sellers of natural gas, where an actual commodity changes hands as it moves from wellhead to burner-tip. If the physical price varies by the smallest amount—even *less than one percent*—from the price “implied” in the derivatives market, the result must, in the Commission’s view, be due to market manipulation. And not manipulation in the derivatives market, as one might first think, but in the actual physical market.

In short, the Commission claims to have found an analytical tool as perfectly precise as an atomic clock. In reality, as we explain in detail below, the Commission’s “implied price” methodology is fatally flawed. If adopted here it will wreak havoc on competitive markets for years to come.

We do not suggest that basis swaps are irrelevant. As Professor Craig Pirrong—who pioneered the use of statistical techniques to detect the presence or absence of commodity market manipulation, and whose work is cited in the Show Cause Order—explains in his attached affidavit (“Pirrong Aff.”), an analysis of historical price relationships, including basis swaps, can be an appropriate first step in the analysis. Where sufficient data are available, it is useful as an initial screen. Here, however, the relevant data are far too sparse, in Prof. Pirrong’s expert opinion, to support conclusions about market manipulation. Pirrong Aff. ¶ 34.

Furthermore, even putting data issues aside, examining price relationships is the beginning, not the end, of the analysis. Where the initial screens are “hit,” one must then engage in a scientifically valid analysis of the actual trading conduct and market fundamentals. The Commission erroneously ignores these essential steps in the analysis—effectively stopping halfway to first base yet claiming to have scored an inside-the-park home run.

We have filled the gaping void in the Commission’s analysis not only with Prof. Pirrong’s affidavit, but also with the joint affidavit of Professor Joseph Kalt and Dr. John Morris

(“Kalt/Morris Aff.”), both renowned economists with deep expertise in the natural gas markets and in manipulation claims. Kalt/Morris Aff. ¶¶ 7-10; Exhs. 1, 2. Prof. Kalt and Dr. Morris provide a detailed analysis of the Commission’s market manipulation allegations. They have uncovered myriad errors that eviscerate the Commission’s unsupported findings. Most significant here, however, is their analysis of ETP’s physical gas sales activity.

As they explain, while ETP is accused of creating an artificially low price by “flooding the market” for monthly physical gas sales at the Houston Ship Channel (“HSC”), *ETP made money on the physical sales in question*. While ETP had financial positions that profited if the spread between Henry Hub and HSC widened, even if we put those positions aside, ETP’s physical trades had a legitimate business purpose. *First*, they were intrinsically profitable transactions with economic substance. *Second*, there is no valid indication here that ETP engaged in any “off-market” transactions—for example, by systematically and intentionally rejecting opportunities to sell gas for \$10, choosing instead to sell at \$9. The Show Cause Order never directly makes any such allegations, nor could it. ETP repeatedly sought to sell at the highest prices it could, but when potential counterparties were not transacting at higher prices, ETP ultimately made sales at lower, but still profitable, levels, consistent with other ongoing trading activity and competitive pressures in the market.

This is not, then, a case where a marketer takes a loss in the physical market but makes up his losses, and more, in the financial market. ETP’s physical transactions were legitimate, profit-making endeavors, and the resulting profits and bidding behavior all support this conclusion. The resulting physical market prices therefore were not artificial.

The Commission nevertheless condemns these transactions because the resulting prices were lower than the artificial reference point it retroactively derives from the derivatives markets.

The Commission does not and cannot point to real buyers and sellers actually transacting at the Commission's chosen "right" prices in the physical markets during the time periods at issue. In reality, those prices were simply not available. As Prof. Kalt and Dr. Morris demonstrate, the implied price theory is itself disconnected from the reality of the relevant trades and actual market conditions, and reflects expected spreads, not expected absolute price levels. Legitimate supply and demand forces were driving physical prices down to the competitive levels reflected in ETP's physical transactions.

What then is a marketer to do? According to the logic of the Show Cause Order, ETP should have refused to sell gas, even though the sales would have been profitable. But the effect of this would have been to physically withhold gas from the market. If, as the Commission claims, ETP had market power, this would have driven the price up, eventually hitting the Commission's imaginary target price. Undoubtedly, however, ETP then would stand accused of a manipulative withholding strategy that *raised* prices in the wake of two massive hurricanes. And its defense—that regardless of fundamentals in the real world, the message from the derivatives market was to withhold—almost certainly would not be accepted by the Commission.

The proper approach is to examine prices and price relationships as a threshold matter, and then, where warranted, examine the underlying transactions to determine if they are legitimate. The Commission instead demands that a marketer reach its retroactively determined price with knife's-edge precision. This illusory precision is the inescapable consequence of the Commission insisting on the supremacy of its abstract "implied price," uninformed by any probative analysis of market fundamentals or dynamics. It ignores reality, where real prices continually move towards and around ever-changing equilibria, in favor of an artificial standard that exists nowhere in the real world of physical transactions.

By thoroughly analyzing the market fundamentals, Prof. Kalt and Dr. Morris not only demonstrate that ETP's underlying trading conduct was legitimate and profitable, but also show that the physical prices the Commission views as artificial were consistent with real supply and demand conditions—critical factors the Show Cause Order *never meaningfully addresses*. As they also explain, the Commission's contrary methodology is utterly incapable of distinguishing illegitimate conduct from legitimate conduct (driven by supply and demand conditions). It generates an extraordinarily high level of false positives, a tell-tale sign of invalid analytical methods that would be “thrown out” as unreliable if offered as testimony in federal district court.

In addition, Prof. Kalt and Dr. Morris identify numerous analytical and factual mistakes and mischaracterizations. For example, they expose numerous flaws in the Commission's claims that HSC prices artificially diverged from prices at other Texas points. Viewed accurately, price outcomes are relatively consistent between HSC and other Texas trading points. Prof. Pirrong makes similar observations. While there is some divergence in the wake of Katrina and Rita, that is hardly surprising and reflects both the “shock to the system” the storms delivered and the fact, openly acknowledged by the Commission, that pipeline constraints were pervasive. Even then HSC prices moved in correlation with trading points across South Texas. Kalt/Morris Aff. ¶¶ 139-49, 200-18; *see also id.* ¶ 197; Pirrong Aff. ¶¶ 46-47.

Prof. Kalt and Dr. Morris also address, from an economic perspective, the statements made by Mr. McCrea in the September 26, 2005 telephone call the Commission relies on so heavily (for its so-called “intent” evidence). Kalt/Morris Aff. ¶¶ 176-83, Exh. 49. As they explain, this discussion is not connected to any actual trades by actual marketers, and is consistent with accurate observations about market fundamentals occurring during the days immediately following the landfall of Hurricane Rita. At various points Mr. McCrea expresses

an interest in higher prices and increased demand. Lamenting the softening demand for natural gas caused by the hurricane, Mr. McCrea notes the need to “come out hard” to attract demand, allowing ETP to sell gas that otherwise would bottleneck the system. As Prof. Kalt and Dr. Morris find, these statements are consistent with competitive market behavior and thus do not support the foundational weight the Commission requires them to bear. *Id.* ¶¶ 179-82.

Finally, regarding the manipulation claims, Prof. Pirrong explains that several obvious factors contradict the Commission’s conclusions here. Pirrong Aff. ¶¶ 37-54. Most importantly, when market manipulation is used to reduce prices in the real world, once the manipulative activities cease, prices will rise to their natural levels, determined by fundamentals. Here the Commission’s most significant allegation of market manipulation concerns October 2005 physical natural gas prices at HSC. The Commission makes no allegations of market manipulation for the next month, November 2005. Yet in *that* month, prices did *not* return to pre-October levels. Pirrong Aff. ¶¶ 48-49. Instead they remained relatively flat. This sharply contradicts the Commission’s market manipulation claims.

In sum, the Commission’s allegations regarding alleged market manipulation are fundamentally and fatally flawed and do not justify the extreme remedies the Commission implies. To capture several highlights:

- ETP did *not* intentionally drive down physical prices of natural gas to artificial levels to make more money on its financial transactions.
- ETP’s physical sales had a *legitimate business purpose*. Specifically, ETP *made money* on its monthly physical sales, entirely apart from its financial transactions. And there is no indication whatsoever of “off-market” pricing.
- *Market fundamentals*, which the Commission essentially ignores, support ETP’s real-world prices, not the abstract price the Commission “implies” from the derivatives market.
- The Commission bases its contrary position on the *novel theory* that ETP should have sold gas at a higher implied price derived from derivatives transactions, even

though actual buyers and sellers—including some of the largest, most sophisticated businesses in the world—did not actually transact at the Commission’s “implied price” but instead bought and sold at lower prices.

- For ETP to have achieved the Commission’s abstract “implied price” in the real world, it would have had to *physically withhold supply*—arguably exercising market power to raise prices by refusing to make profitable sales.
- The Commission illogically claims that its “implied price” methodology can distinguish legitimate market behavior from market manipulation *within pennies*—an alleged error of *less than 1 percent*. No one has ever developed an analytical tool that can so perfectly determine the “right” price for a commodity, particularly a volatile one like natural gas, and particularly using an indirect measure such as basis spreads.
- The Commission’s methodology *has an incredibly high level of false positive results*. If we apply that methodology to prices at Waha, it indicates manipulation *two-thirds of the time*. Applying it to prices at other trading points, predominately in the western United States, indicates manipulation *50 to 70 percent of the time*. This obviously is not the case. The Commission’s “implied price” methodology simply cannot distinguish between legitimate market behavior and manipulation.
- For these and other reasons, well-regarded economic experts have concluded that the Commission’s “implied price” theory is *unreliable and devoid of any valid basis*.
- While the Commission seeks disgorgement of approximately *\$67 million* in profits, it cannot support that number without access to data from Platts—*data it does not have* (but data we are seeking in a separate motion for a third-party subpoena filed today). Depending on what those data show, alleged profits could be as low as *\$1.3 million* (accepting for argument’s sake the Commission’s groundless theory in this case). The Commission thus has simply assumed the most severe outcome with no valid basis.
- The Commission ignores economic fundamentals and reality. It fails to meaningfully consider the *chaos and destruction that two catastrophic hurricanes inflicted on the Gulf Coast* and the natural gas industry located there. Rita, in particular, obviously affected supply and demand fundamentals, and therefore natural gas prices, driving a physical wedge between the two sides of the Commission’s implied price theory—Texas and Louisiana.
- After Katrina, President Bush threatened to bring the full weight of the law down on any attempts at price gouging. How can the government condemn ETP for selling gas *at too low a price* in the wake of two catastrophic hurricanes when ETP actually was *selling at a profit*?

We explain these points, and others, in detail below.

The Commission's Show Cause Order also addresses a completely separate subject area involving operations of the Oasis Pipeline, an intrastate pipeline system that is owned by ETP. Oasis provides firm and interruptible service on an *intrastate* basis that is *not* FERC-jurisdictional. In addition, Oasis provides *interruptible-only* interstate service, which is FERC-jurisdictional under Natural Gas Policy Act of 1978 ("NGPA") section 311(a)(2), 15 U.S.C. § 3371. Oasis' firm service will always have a priority over interruptible service (both intrastate and interstate), and Oasis thus does not and cannot reserve space for interruptible service. Oasis' operational planning instead necessarily must be based on the assumption that its firm shippers will fully utilize their contracted-for capacity. Shippers always are free to nominate interruptible service, and Oasis' experience is that the system generally is able to accommodate interruptible nominations (when available).

The Show Cause Order complains that Oasis unduly favored its affiliate, ETC Marketing, when providing interstate interruptible service. The Order argues that ETC Marketing's interruptible interstate shipments on Oasis exceeded interruptible interstate shipments by non-affiliates. But the Commission has never ruled that the mere percentage of capacity holding itself constitutes discrimination. In any event, the Commission's analysis of capacity holdings is independently flawed.

The Commission further alleges that Oasis overcharged non-affiliates. But these alleged overcharges were for *intrastate* transportation contracts that are exempt from the Commission's rate cap. While the Commission claims that the gas actually was interstate, the gas was certified by Oasis shippers as intrastate. Because Oasis is a downstream transporter, it does not have independent knowledge as to the source of the gas that it transports and must rely upon the

representations of its shippers as to the character of the gas being transported. As the Commission has recognized, this has been standard industry practice for years.

Finally, the Commission's remaining Oasis allegations are not well founded.