

changes, which are grouped into several categories. As discussed below, the Commission is revising the definition of Energy Affiliate as follows:

- (1) Engages in or is involved in transmission transactions in U.S. energy or transmission markets; or
- (2) Manages or controls transmission capacity of a Transmission Provider in U.S. energy or transmission markets; or
- (3) Buys, sells, trades or administers natural gas or electric energy in U.S. energy or transmission markets; or
- (4) Engages in financial transactions relating to the sale or transmission of natural gas or electric energy in U.S. energy or transmission markets.
- (5) An energy affiliate does not include:
 - (i) A foreign affiliate that does not participate in U.S. energy markets;
 - (ii) An affiliated Transmission Provider; or
 - (iii) A holding, parent or service company that does not engage in energy or natural gas commodity transactions or is not involved in transmission transactions in U.S. energy markets; or
 - (iv) An affiliate that purchases natural gas or energy solely for its own consumption and does not use an affiliated Transmission Provider for transmission of natural gas or energy; or
 - (v) A state-regulated local distribution company that does not make any off-system sales.

1. LDCs

41. As proposed by the NOPR, Transmission Providers would be required to apply the standards of conduct to their relationships with their affiliated LDCs by eliminating the exemption of Order No. 497, which permitted natural gas pipelines to share employees and information between their transmission businesses and their affiliated LDCs that do not make off-system sales.²⁵

42. Fourteen entities, including producers and unaffiliated gas marketers, NASUCA, AIA, the Industrials and the FTC supported the proposed definition of energy affiliate, focusing on LDCs. They asserted that: (1) Conditions have changed since Order No. 497 was promulgated, and LDCs compete more vigorously for access to transmission service; (2) the current exemption is a loophole that permits LDCs to get preferential access to information, which harms competition; and (3) the LDC exemption permits pipelines to circumvent the standards of conduct by using the LDC as a conduit for sharing information. The Connecticut Commission argued that giving LDCs an unfair competitive advantage can only hurt the long-term competitiveness of the market.

43. However, thirty-four commenters, primarily interstate natural gas

pipelines and affiliated marketers, INGAA and AGA opposed applying the standards of conduct to a Transmission Provider's relationship with its affiliated LDCs. These commenters recommended that the Commission retain the current exception in Order No. 497 for LDCs that do not engage in off-system sales. They argued that: (1) Section 1 of the NGA makes distribution subject to regulation by the states and not FERC; (2) there is no evidence or market analysis to support eliminating the exemption granted under Order No. 497; (3) to require such separation would cause unnecessary duplication of employees and gas control facilities, resulting in additional costs to customers;²⁶ and (4) limits on communications with LDCs would impair reliability, and the "emergency" exception in the proposed rule is insufficient.

44. The Commission has decided to retain the existing exemption for LDCs that do not make off-system sales. Specifically, the definition of Energy Affiliates will exclude those LDCs that are regulated by the state, provide solely retail service and engage in no off-system sales. However, the Commission notes that an affiliated LDC that engages in any off-system sale is an Energy Affiliate, and subject to the standards of conduct. An off-system sale would include a situation in which the affiliated LDC had contractually committed for more gas than it needed to serve its on-system customers and sold that gas off its system, *e.g.*, at a hub or on the spot market. Moreover, affiliated LDCs are prohibited from being conduits for improperly sharing information covered by the Final Rule. We also remind Transmission Providers that they are required to comply with the undue discrimination and undue preferences provisions of the NGA vis-à-vis their behavior with their affiliated LDCs and will be subject to greater scrutiny prospectively.

2. Affiliates Not Engaged or Involved in Transmission Transactions, *e.g.*, Trading and Financial Affiliates

45. Thirteen entities, including Ad Hoc Marketers, INGAA and interstate natural gas pipelines, opposed the proposed definition of Energy Affiliates because it does not require the Energy Affiliate to be engaged or involved in transmission transactions on the Transmission Provider's system. These commenters urged the Commission to narrow the definition of Energy

Affiliates to apply only to affiliates that are involved in transportation on affiliated Transmission Providers' systems. Similarly, several commenters, including Ad Hoc Marketers, INGAA, Gulf South, and four public utility Transmission Providers requested that the Commission exclude from the definition of Energy Affiliates entities that trade power or are engaged in financial transactions. Gulf South argued that gas futures contracts are traded only for delivery in the future and are unrelated to the current spot market price of gas.

46. The Commission disagrees with the commenters. Although an affiliate may not be directly involved in transmission transactions, the transmission markets and energy-related financial markets are so interconnected that a Transmission Provider does have the ability to operate its transmission system in a manner that gives a trading affiliate an undue preference or provides the trading affiliate with unduly preferential information. For example, a transmission constraint directly impacts the value of the commodity being transported. Preferential access to information about such a constraint could provide a significant benefit to an affiliate engaged in speculative trading of the commodity and cause the price of the commodity to rise to the detriment of the market, even if the trader is not using the affiliated Transmission Provider.

47. Entities involved in the trading of power or gas or in financial transactions related to the sale, purchase or transmission of power or gas are an integral part of the financial and transmission markets. The monthly volume of futures contracts on the NYMEX has grown from approximately 170,000 per month in January 1982 to 7,000,000 per month in January 2000.²⁷ As seen in the chart below, the financial natural gas (futures) markets and the physical (or spot) markets are closely linked. For example, NYMEX futures prices strongly correlate with transactions to buy and sell natural gas at Henry Hub, the physical delivery point specified in the NYMEX futures contracts.²⁸

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²⁷ "Derivatives and Risk Management in the Petroleum, Natural Gas and Electricity Industries," www.eia.doe.gov/oiaf/seserviceerpt/derivative/index (Oct. 24, 2003).

²⁸ See, *e.g.*, Fact-Finding Investigation of Potential Manipulation of Electric and Natural Gas Prices, Docket No. PA02-2-000, Final Report on Price Manipulation in Western Market, March 2003 (Chapter IX at pp. IX-2 to IX-9).

²⁵ 18 CFR 161.2(c) (2003).

²⁶ A discussion of the commenters' concerns regarding additional costs is included in the Independent Functioning discussion, below.