BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

GENERIC CONTESTED CASE TO	)	
ANALYZE AND EVALUATE THE	)	
COST BENEFITS AND FUNDING	)	**DOCKET NO. 08-00064**
MECHANISMS FOR ENERGY	)	

INITIAL BRIEF OF THE CONSUMER ADVOCATE REGARDING THE STATUTORY AUTHORITY TO IMPLEMENT GTI'S PROPOSED SURCHARGE ON TENNESSEE CONSUMERS

Robert E. Cooper, Jr., B.P.R. No. 10934
Attorney General
State of Tennessee

Ryan L. McGehee, B.P.R. No.025559
Assistant Attorney General
Office of the Attorney General
Consumer Advocate and Protection Division
P.O. Box 20207
Nashville, Tennessee 37202-0207
(615) 741-3549

Executive Summary

In this docket, Gas Technology Institute ("GTI") has proposed a mandatory surcharge on approximately 300,000 Tennessee natural gas consumers. The proceeds from the surcharge would be applied to GTI's research and development programs for producing equipment related to natural gas in order to support the engineers, scientists and labs in the natural gas research and development field. The resulting products and equipment, if successfully developed, would then be patented and marketed to manufacturers and retailers. Thus, products and equipment funded by Tennessee consumers would then be sold to the public at market price. In effect, Tennessee consumers would be subsidizing manufacturers and retailers of such products and equipment. There is no justification in a free market for requiring captive rate-payers to fund GTI's activities absent a legislative directive to do so.

The Consumer Advocate is concerned GTI's proposal calls upon the Tennessee Regulatory Authority ("TRA") to act beyond its statutory authority. No party to this docket has offered a legal theory anchored in statutory law supporting the legal basis to implement mandatory consumer funding of GTI's activities. The absence of an argument supported by statutory authority has required the Consumer Advocate to address this issue in a lengthy and broad manner. The Consumer Advocate has reviewed the substantive powers of the TRA arguably related to the implementing GTI's proposal. There is no direct statutory authority to require consumers to fund GTI's proposal. Nor does such authority arise from carrying out the provisions of the enabling statutes of the agency.

The TRA's "plenary" authority is restricted to governing and controlling public utilities. GTI's activities are not a utility service furnished by the local natural gas distribution companies. Just and reasonable rates are set in fairness to the consumer and the utility. In exchange for the delivery of natural gas to the homes and workplaces of consumers, a natural gas utility is authorized to recover the cost of service to deliver natural gas and a fair return on the value of the used and useful investment the utility makes in providing the service. GTI's proposal for mandatory consumer funding goes well beyond just and reasonable rates and intrudes upon the principles of the regulatory compact.

Under GTI's proposal, consumers would not be compensating the Industry for an investment in used and useful property employed to serve consumers. Consumers would not be compensating the Industry for the cost of service for delivering natural gas to the homes and businesses of consumers. Rather, the proposal in this docket calls for the consumers to directly fund GTI for the research and development of products. The resulting products, if they are successfully developed, would be sold in the public marketplace years from now.

The benefits GTI professes that it will be able to provide Tennessee consumers are based on abstract calculations and self-serving assumptions which ignore market forces. There is no guarantee that any of GTI's projects will be successful. Furthermore, the benefits of research and development would not be confined to Tennessee consumers. Natural gas utilities, pipelines, manufacturers, and retailers stand to benefit from GTI's activities, yet in this docket it has been proposed that only Tennessee consumers provide the funding.

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INTRODUCTION

This docket was convened by order of all four serving directors of the Tennessee Regulatory Authority ("TRA", "Authority", "agency") on March 19, 2008 for purposes of analyzing and evaluating the cost benefits and funding mechanisms for energy conservation research.[1] The three largest local natural gas companies, Chattanooga Gas Company, Atmos Energy Corporation ("Atmos") and Piedmont Natural Gas Company, Inc. have intervened (collectively "Industry"). To date, one research entity, Gas Technology Institute ("GTI"), is participating in this docket. On October 7, 2008, GTI filed a proposal of sample projects for the parties to study in this docket. Under GTI's proposal, any project(s) selected for the TRA's energy conservation research program would be funded by a surcharge on Tennessee natural gas consumers. In return, GTI argues that Tennessee consumers will benefit from the research and development they will be required to fund.

GTI is a non-profit organization based in Illinois that specializes in the research and development of energy and natural gas related technology. The organization's board of directors is composed of corporate officers of natural gas pipeline and local distribution companies, including the respective chairmen and CEOs of Atmos and AGL Resources Inc.[2] GTI is a successful company financially. According to the company's 2006 annual report, GTI had unrestricted net assets totaling $91.5 million. GTI's 2007 annual report shows unrestricted

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[1] Docket 06-00309; *Order Initiating Generic Contested Case and Rule-making Concerning Energy Conservation* (March 19, 2008); The Authority further ordered that a rule-making docket be convened and held in abeyance pending completion of the contested generic docket for purposes of establishing guidelines, selection of research companies and methods for funding conservation research.

[2] Chattanooga Gas Company is a subsidiary of AGL Resources, Inc.

net assets of $97.5 million, an increase of $6 million in a year. In this docket, GTI proposes a mandatory surcharge on Tennessee consumers to fund research and development activities.

Prior to 2004, GTI's activities were funded through a federal pipeline surcharge on natural gas.[3] The surcharge was passed on to consumers across the country as a gas cost on bills. However, in 1998, the Federal Energy Regulatory Commission ("FERC") accepted a natural gas industry wide settlement to gradually phase out the mandated surcharge providing GTI's funding after 2004. In 2004, GTI applied to FERC to renew the federal surcharge funding. FERC declined to approve GTI's application for a renewed surcharge. In doing so, FERC conclude mandatory funding for research and development is not necessary, noting the substantial research and development activities of entities both within and outside the natural gas industries. *Order on Application for Advance Approval of a Research and Development Program and Jurisdictional Rate Provisions to Fund Program*, 109 FERC P 61164, *61792-61793 (November 18, 2004) at Attachment A. Since even before FERC's 2004 decision, GTI has sought or lobbied within several TRA dockets to institute a surcharge on Tennessee consumers to fund the organization's research and development programs.[4]

GTI's proposal in this docket calls for a surcharge on Tennessee's consumers to fund various research and development of natural gas related equipment. The diverse range of sample projects runs from the development of a more efficient commercial fryer, apparently for commercial food use, to the development of better coating techniques for underground utility vaults. Some of the projects are intended to be more efficient in the use of natural gas while

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[3] Formerly, the Gas Research Institute ("GRI") received funding from the FERC mandated surcharge since 1977. GTI merged with GRI in 2000 and stepped into the funding provided by federally administered surcharge.

[4] Docket 07-00105, Docket 06-00309, Docket 05-00046, Docket 04-00034, Docket 03-00313.

others are intended to allow public utilities to be more efficient in operating as a public utility. According to GTI, the sample projects in this docket may take anywhere from three to six years or perhaps more to develop, commercialize and market.

As the Consumer Advocate understands GTI's proposal, approximately 300,000 Tennessee consumers will be required to pay a surcharge based on the volume of natural gas they consume to fund GTI's activities. The proceeds from the surcharge would be collected by the Industry and passed to GTI. GTI would then apply these funds to the research and development of products associated with natural gas. The resulting products, if successful, would be patented and marketed to manufacturers. The manufacturer(s) would then produce and sell for retail/market price the resulting products. Once on the open market, customers and natural gas companies alike, both within and beyond Tennessee, could then purchase the products Tennessee consumers funded the develop of if the resulting products are desirable and affordable.

The Consumer Advocate has concerns regarding a proposal that requires mandatory consumer funding. The end result of GTI's proposal would have a select group of Tennessee households subsidizing the research and development of products that will be manufactured and sold by private companies. In effect, they will be subsidizing manufacturers and those that sell such equipment for retail in the public market. This has been recognized in other jurisdictions. In rejecting GTI's proposal for mandatory consumer funding, the Massachusetts Department of Telecommunications and Energy noted that gas utilities, natural gas producers, interstate pipelines, manufacturers and retailers will benefit from GTI's research, yet GTI's proposal requires that only natural gas consumers provide funding. *Re: Boston Gas Company*, 2003 WL

22964772, * 197-200, D.T.E. 03-40 (October 31, 2003) at Attachment B (excerpt only due to volume). Thus, if approved, Tennessee consumers would be required to invest in the development of products for which they may have no interest in purchasing or even have the means to afford while entities beyond Tennessee's borders will benefit.

In a free market, there is no justification for Tennessee's captive natural gas rate-payers to subsidize manufacturers for the development of new products that will benefit gas utilities, natural gas producers, interstate pipelines, manufacturers and retailers. Similarly, the Kansas State Corporation Commission came to the same conclusion. In denying GTI's proposed mandatory surcharge, the commission found that consumers should not be saddled with paying for research and development, but rather funding for GTI's activities is best allocated through the competitive market. *Re: Gas Technology Institute Costs*, Docket 04-GIMG-814-GIG (October 11, 2005) 2005 WL 3091872 at Attachment C. The Consumer Advocate agrees with this position.

Consumers are required to pay just and reasonable rates for the delivery of natural gas to their homes. However, GTI's proposal calls upon Tennessee consumers to fund research and development activities for which they will receive no measurable benefit. Because the fruits of GTI's work are so far removed from the actual service that the local gas Industry provides to consumers and because any resulting benefits cannot be measured and accumulated by Tennessee consumers, the Consumer Advocate has concerns that the TRA lacks the authority to require consumers to fund it. As described herein, the Consumer Advocate submits that GTI's proposal for mandatory consumer funding calls for the TRA to act beyond its statutory mandate. There is no statutory directive that authorizes the TRA to require consumers to fund a public policy which has such a tenuous and remote connection to the regulated service the Industry provides to consumers, namely the delivery of natural gas to their homes and businesses. When consumers have been required to fund or subsidize public policy or activities that has an extraneous or remote connection to the utility service they receive, it is the General Assembly that has made this decision and granted a mandate.

I. THE ACTIONS OF THE TRA MUST BE AUTHORIZED BY STATUTORY AUTHORITY

The initial matter in this docket is not about questioning the expertise and intentions of GTI. GTI's management of resources and expertise covers a broad spectrum, from assisting private manufacturers in the development of particle drills for energy exploration to the testing of natural gas powered vehicles. The initial threshold issue in this docket is whether statutory authority exists that requires Tennessee consumers to fund GTI's research and development activities. To date, no party participating in this docket has offered a legal theory anchored in statutory law justifying a mandate to compel consumer funding for GTI's research and development activities. GTI has submitted that authority is found in TRA Rule 1220-4-1-.11(1)(c), the apparent decision of the former Tennessee Public Service Commission to require Southern Bell Telephone consumers to fund research and development, and other entities such as the Tennessee Valley Authority that have apparently required funding for the Electric Power Research Institute. The TRA has indicated to some extent that the agency presumes it has statutory authority in regards to funding via the "plenary" authority bestowed by the General Assembly.[5]

[5] Docket 08-00064, Transcript of Proceedings (June 12, 2008), p. 23.

Without doubt, the TRA convened this docket in an effort to foster more energy conservation.[6]

> One of the actions that I believe we can take immediately is to determine the best method of funding contributions to research and development of natural gas equipment that will promote conservation. While my priority is implementing a low-income energy conservation pilot program, I also appreciate the importance of research and development of energy conservation equipment. I believe that we must support the scientists and engineers on energy R&D in our nation's labs.

Transcript of Authority Conference (February 11, 2008), p. 5-6. The Authority recognized the funding of such programs was an issue and that Tennessee consumers were a potential source to fund energy conservation research and development. *Id.* p. 6-10. Given the nature of the comments and objectives of the Directors, this is an issue of public policy. Thus, the issue of whether 300,000 Tennessee rate-payers should fund GTI's research and development activities is a matter of public policy. However, it is also a question of law. GTI's proposal may entail the raising or appropriation of funds from Tennessee consumers and mandate how those will be applied in a TRA program not authorized by statute. In execution such actions may require the legislative powers of taxation and appropriation. *Process Gas Consumers Group v. Pennsylvania Public Utility Commission*, 511 A. 2d 1315, 1321 (Penn.1986). Taxation is an attribute of sovereignty, and by constitution this attribute of sovereignty belongs solely to the General Assembly. *Jenkins v. Ewin*, 55 Tenn. 456 (1872); *State v. Sneed*, 68 Tenn. 472 (1876).

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[6] Docket 06-00309, *Order Initiating Generic Contested Case and Rulemaking Concerning Energy Conservation Research*, (March 19, 2008), p 2.; *Order Establishing Energy Conservation Pilot Program*, (January 17, 2008), p.1; Docket 08-00064, Transcript of Proceeding (June 12, 2008), p. 6. In large part, the comments and opinions exchanged during the sessions of the Tennessee Home Energy Conservation Task Force convened in Docket 06-00309. Many constructive ideas and recommendations were exchanged during these sessions which the Industry, GTI and the Consumer Advocate participated in. However, the great stumbling block on many such issues has centered on how to fund these public policy initiatives.

The powers of the TRA must be found in statutory law. *Tennessee-Carolina Transportation, Inc. v. Pentecost*, 334 S.W. 2d 950, 953 (Tenn.1960). If the power or authority is not there, then it is non-existent. *Id.* The TRA is an administrative agency established by the legislature and governed by statute. Administrative agencies are creatures born of elected legislatures which define their authority and powers from which statutory confines there is no escape. *Sanfill of Tenn., Inc. v. Tennessee Solid Waste Disposal Control Bd.*, 907 S.W. 2d 807, 810 (Tenn.1995). They have no inherent or common law power of their own. *General Portland, Inc. v. Chattanooga Hamilton County Air Pollution Control Bd.*, 560 S.W. 2d 810, 914 (Tenn.Ct.App.1976). Simply put, an administrative agency has no inherent power other than that granted to it by the General Assembly. *State v. Medicine Bird*, 63 S.W. 3d 734, 768-769 (Tenn.Ct.App.2001) (cert.denied). Actions taken by a governmental agency without the required authorities are nullities. *Id.* citing *Johnson v. Alcoholic Beverage Comm'n*, 844 S.W. 2d 182, 186 (Tenn.Ct.App.1992).

An unlawful action or regulation is not validated simply because it is deemed beneficial. *Blazt Brewing Company v. Collins*, 88 Cal. App. 2d 438, 199 P. 2d 34, 42 (1st Dist.1948). In the American system, legal authority for an administrative agency to act should be derived expressly or implied by positive law. Sutherland Statutory Construction, Vol. 3 § 65:1, p. 373 (2006, 6th Ed.). Such legal authority should spring from either a direct statutory directive or by the authority that is apparent by implication within the realm of the statutory powers that have been granted to the TRA by the General Assembly. *Tennessee Public Service Commission v. Southern Railway Co.* 554 S.W. 2d 612, 613 (Tenn.1977). To date, the General Assembly has not granted an express statutory directive or mandate authorizing the TRA to require mandatory funding from consumers to fund the research and development projects such as those proposed by GTI. For the agency to exercise such authority to mandate consumer funding, statutory authority must be apparent by implication. Thus, this is a matter of statutory construction.

II. GENERAL PRINCIPLES OF STATUTORY CONSTRUCTION

An analysis of whether the TRA has the authority to implement a surcharge begins with the statutes that create and define the agency itself. When statutory construction and interpretation are in issue, Tennessee courts follow the well established principle that the primary purpose of construing statutes is to ascertain and give effect to the intention and purpose of the General Assembly. *Lipscomb v. Doe*, 32 S.W. 3d 840, 844 (Tenn.2003). When statutory authority is clear and unambiguous, the courts have applied the plain language in its normal and accepted use. *Boarman v. Jaynes*, 109 S.W. 3d 286, 291 (Tenn.2003).

Legislative intent is ascertained from the natural and ordinary meaning of the statutory language read "within the context of the entire statute, without any forced or subtle construction which would extend or limit its meanings." *State v. Butler*, 980 S.W. 2d 359, 363 (Tenn.1997). Thus, if the language is clear and unambiguous, the particular language in dispute is read within the context of the entire statute in a manner that would not produce an unreasonable or unnatural interpretation while expressing the full intent of the General Assembly.

III. A LIBERAL CONSTRUCTION OF THE AGENCY'S SUBSTANTIVE POWERS IS SUBJECT TO LIMITATIONS

Generally, Tennessee courts have applied a liberal rather than a narrow interpretation of the existence of an administrative agency's power. *Tennessee Cable Television Association v. Tennessee Public Service Commission*, 844 S.W. 2d 151, 159 (citing *Patterson v. City of Chattanooga*, 192 Tenn. 267, 277-278). In fact, the General Assembly has provided statutory directives that require a liberal construction which generally concludes that any doubt raised as to the existence or extent of a power conferred to the TRA shall be resolved in favor of the existence of the power. However, one must note that the enabling statutes of the agency contain two separate and distinct liberal interpretation instructions which apply to different powers and duties of the Authority. One provision covers the procedural powers of the agency while another applies to the bulk of the agency's substantive powers.

Tenn. Code Ann.§ 65-2-121 contains a very broad general liberal construction that specifically applies to chapter 2 of Title 65.

> This chapter shall not be construed as in derogation of the common law, but shall be given a liberal construction, and any doubt as to the existence or the extent of a power conferred shall be resolved in favor of the existence of the power.

Tenn. Code Ann.§ 65-2-121. Chapter 2 of Title 65 covers primarily the procedural nature and aspects of how the Authority conducts business such as declaratory judgments, show cause orders and rules of evidence.

A second liberal construction provision, Tenn.Code Ann.§ 65-4-106, applies to the remaining chapters of Title 65 relating to the agency, including the bulk of the TRA's substantive powers such as the power to fix rates, price cap regulation and the Do Not Call program. Implementing a mandatory consumer surcharge would without exception be an exercise of substantive power. Although Tenn.Code Ann.§ 65-4-106 contains nearly identical language to that in Tenn. Code Ann. § 65-2-121, this provision includes additional language to limit the liberal interpretation.

> This chapter shall not be construed as in derogation of the common law, but shall be given a liberal construction, and any doubt as to the existence or the extent of a power conferred by this chapter, or chapters 1, 3 and 5 of this title shall be resolved in favor of

the existence of the power, to the end that the authority may effectively govern and control the public utilities placed under its jurisdiction by this chapter. (emphasis added).

Tenn.Code Ann.§ 65-4-106. In requiring a liberal construction of the substantive powers of the TRA, the General Assembly specifically drew limits by adding the phrase "to the end that the authority may effectively govern and control public utilities" the agency regulates. A liberal construction of the substantive powers of the Authority must be tempered with an inquiry into whether the existence or extent of a disputed power is in fact necessary to effectively govern and control public utilities. Thus, even when viewed through the prism of a liberal interpretation, one must inquire whether a public policy of research and development of natural gas products funded by consumers on a mandatory basis is necessary or required to govern and control the local distribution company.

Even without the specific boundary required by Tenn.Code Ann. 65-4-106, a "liberal" interpretation of the authority of an agency such as the TRA has limitations. *BellSouth v. Greer*, 972 S.W. 2d 663, 680 (Tenn.Ct.App.1997) (cert.denied). There are legal and practical boundaries of reason and law that check the unilateral exercise of power that exceeds the authority granted by statute. *Id.* citing *Pharr v. Nashville*, C& St. L. Ry. 186 Tenn. 154, 161. The discretion of the TRA does not extend beyond the boundaries established by statutes and constitutional provisions that govern the agency. *Consumer Advocate v. Tennessee Regulatory*, 2007 WL 2316458*3 (Tenn.Ct.App.2007) at Attachment D. Any authority exercised by the TRA must be the result of an express grant of authority by statute or arise by necessary implication from an express grant of authority. Thus, any regulatory action or policy the TRA authors and implements must specifically be authorized by or reasonably arise from a statute. *Id.*

IV. THE NEGATIVE IMPLICATION APPARENT WITHIN THE ACTIONS OF THE GENERAL ASSEMBLY

Statutory construction in Tennessee law requires that a statute be construed within the context of the entire statute, without any forced or subtle construction which would extend or limit its meanings. *State v. Butler*, 980 S.W. 2d 359, 363 (Tenn.1997). In reading all of the statutory text concerning the TRA, it is apparent that where the legislature has intended a public policy to be funded by utility consumers, it has specifically and expressly granted that authority. This has been true since the agency was founded. This gives rise to a readily apparent implication that the agency lacks the authority, apparent or implied, to mandate consumer funding for a public policy issue.

A. The Funding of Public Policy Programs Within the TRA's Jurisdiction Have Arisen by Express Directives by the General Assembly

Throughout the history of the TRA and its predecessors, only through specific grants of authority or through specific statutory directives has the General Assembly required rate-payers to fund initiatives designed to benefit the public and society. This has been true since the beginning. The TRA can trace its ancestry to the creation of the Tennessee Railroad Commission in 1897. In setting rates, the commission was allowed at one time by law to set free or discounted rates for "religious, charitable or benevolent purposes." 1897 Public Acts, Ch. 10 § 24. This provision did not survive the test of time.

More contemporary mandates for the funding of public policy initiatives include the creation of the Telecommunication Devices Access Program ("TDAP"). Tenn.Code Ann. § 65-21-115. TDAP is a program that provides modified telephone equipment designed to accommodate consumers with disabilities in order that they may have access to telephone service. By statute, funding is derived from contributions provided by several telecommunications companies in the state which meet a financial threshold, including rate of return incumbents. In another example, the General Assembly has initiated a program by statute in an effort to help foster diversity in ownership and to encourage minority owned businesses. Tenn.Code Ann.§ 65-5-113 (2002). Prior to 2004, the funding was mandatorily provided by telecommunications companies in which the TRA determined the annual contribution made by each company to fund the program. Public Acts of 1995, Ch. 408 § 17; Public Acts of 1998, Ch. 702, § 1.

The Universal Service program is an example of a public policy funded by utility consumers through a surcharge on telephone bills. The federally authorized program is intended to help insure that telephone service is provided in rural areas where the cost of maintaining service may be higher. The program also includes providing Life-line and Link-up initiatives which subsidize phone service for low-income households throughout the state. While this program was not created by the General Assembly, the authority to implement Universal Service was granted by federal mandate.

The General Assembly has determined through a specific statutory directive that in the event the federal mandate is ever foreclosed, the TRA will have the authority to establish a state universal service program if it is in the public interest. Tenn.Code Ann.§ 65-5-107. This implies the legislature recognized that the creation of a universal service program, funded by consumers, was not already within the realm of the TRA's statutory authority. Rather than clarify an existing power, a new one was created with an express statutory grant of power with specific instructions.[7]

B. The General Assembly Has Made No Policy Declarations or Statements Regarding Consumer Funded Research and Development

The General Assembly has the prerogative, within constitutional limits, to fashion this state's public policy. *BellSouth v. Greer*, 972 S.W. 2d 663, 683 (Tenn.Ct.App.1998) (cert.denied) citing *Cary v. Cary*, 937 S.W. 2d 777, 781 (Tenn.1996). The legislature has codified public policy statements that guide the policy actions and decisions of the TRA. Tenn.Code Ann.§§ 65-4-123, 65-5-107. In determining whether a policy decision of the TRA exceeded its statutory authority, Tennessee courts have reviewed policy declarations made by the legislature. *United Telephone-Southeast v. Tennessee Regulatory*, 2001 WL 266051, *3-4 (Tenn.Ct.App.2001) at Attachment E. No such policy statements concerning mandatory consumer funding for conservation research and development applicable to the TRA have been codified.

Furthermore, not only have Tennessee courts looked to codified policy statements in disputes involving the authority of the TRA but also at the preambles of legislative acts pertaining to the agency. *BellSouth BSE, Inc. v. Tennessee Regulatory Authority*, 2003 WL 354466*11 (Tenn.Ct.App.2003) at Attachment F. In the preambles of the public acts pertaining to the enabling statutes of the TRA, the General Assembly has not commented on mandatory consumer funding for conservation research and development.

[7] Tenn.Code Ann. 65-5-107 contains several statutory instructions, some of which are intimately detailed requirements. One should note that the General Assembly took great interest in how a state program would function.

C. Recently Enacted Legislation Shows the General Assembly is Still Contemplating A State-wide Energy Conservation Program

It is evident the General Assembly is still contemplating and considering the means and design of a comprehensive policy or policies intended to foster energy conservation. 2007 Public Acts, Ch. 33. A recent legislative enactment requests the Governor to utilize various state entities, including the TRA, to develop a comprehensive energy conservation plan which must be presented, reviewed and approved by the General Assembly prior to its implementation. *Id.*

D. The Authority, Powers and Duties of the Tennessee Energy Authority Were Not Transferred to the TRA.

At one time, the General Assembly empowered the Tennessee Energy Authority to formulate, implement and administer energy policy for the state. This included several energy conservation initiatives.[8] The agency was dissolved in 1983. The preamble to another recent enactment, 2007 Public Acts, Ch. 401, notes that when the Tennessee Energy Authority was dissolved in 1983, responsibilities for energy conservation were delegated to the Department of Economic and Community Development and other states offices. Neither the TRA nor the former Public Service Commission has ever been delegated mandates or responsibilities formerly held by the Tennessee Energy Authority. 1983 Public Acts, Ch. 429.

V. THE NATURE OF THE TRA'S "PLENARY AUTHORITY" DOES NOT ENCOMPASS REQUIRING CONSUMERS TO FUND A PUBLIC POLICY ABSENT A LEGISLATIVE DIRECTIVE

The General Assembly has granted the TRA jurisdiction, control, general supervisory and regulatory power over public utilities and their property. Tenn.Code Ann. § 65-4-104.

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[8] Tennessee Bluebook: 1981-1982, p. 111-112.

Read in tandem with the liberal construction requirement of Tenn.Code Ann. § 65-4-106, the Authority has been granted a broad mandate to rein over the public utilities within its jurisdiction. Tennessee courts have referred to this statutory provision as granting the agency "practically plenary authority" over public utilities. *Tennessee Cable Television Ass'n v. Tennessee Public Service Commission*, 844 S.W. 2d 151, 159 (Tenn.Ct.App.1992). However, inferring in essence absolute or unlimited power from this statutory provision ignores limitations inherent within the statute itself. The General Assembly placed language limiting such power within the statute.

> The authority has general supervisory and regulatory power, jurisdiction, and control over all public utilities, and also over their property, property rights, facilities, and franchises, so far as may be necessary for the purpose of carrying out the provisions of this chapter. However, such general supervisory and regulatory power and jurisdiction and control shall not apply to street railway companies. (emphasis added).

Tenn.Code Ann. § 65-4-104. In construing the statute, one must consider two specific points readily apparent within the statutory language. First, the supervisory and regulatory power and control pertains to public utilities and their property rights. If approved, the GTI proposal would not touch upon the property rights of the industry but rather encroaches directly into the pocket books of consumers. GTI's proposal is based solely on funding from consumers rather than from utilities. The utility would simply function as the tax or toll collector, passing the funds obtained from consumers onto GTI. Neither this statute nor any other portion of the agency's enabling statutes give the TRA the authority or power over consumers to require them to pay for something other than a utility service except where the General Assembly has specifically authorized.

Second, the General Assembly limited the "plenary" authority of the TRA in that such power extends "as far as may be necessary for the purpose of carrying out the provisions of this chapter." *Id.* The provisions of Chapter 4 of Title 65 of the Tennessee Code do not in of themselves authorize the TRA to mandate consumer funding of a public policy. No other statutory provision relating to the TRA authorizes mandatory consumer funding for activities such as GTI's proposed research and development programs.

When considering Tenn.Code Ann. § 65-4-104 as the statutory authority from which a surcharge can be levied upon consumers for purposes of funding GTI's research and development activities, one must adhere to the principles of statutory construction and answer two questions. As there is no express statutory authority, one must consider whether authority is apparent by implication within the realm of the statutory powers that have been granted to the TRA by the General Assembly. *Tennessee Public Service Commission v. Southern Railway Co.* 554 S.W. 2d 612, 613 (Tenn.1977). Furthermore, one must consider the explicit limitation within the liberal construction that applies to the substantive powers of the TRA such as those contained in Chapter 4 of Title 65: is the power in dispute necessary to the end of effectively governing and controlling public utilities?

The Consumer Advocate would submit that the authority to mandate consumer funding for GTI's proposal is not apparent or implied within the enabling statutes of the TRA. However, what is readily apparent is the actions of the General Assembly in issuing direct and express statutory authority to require consumers or utilities to fund public policy when it has chosen to do so. Furthermore, mandating consumer funding of GTI's proposal has no reasonable connection to the ability of the TRA to better or more effectively control and govern public utilities. The function of the local natural gas Industry is to deliver natural gas to the homes and workplaces of consumers. The Industry does not itself conduct research and development.

In effect, mandating consumer funding of GTI's proposal, absent a statutory directive, places consumers in the unenviable position of potentially funding any public policy proposed by the Industry or any other party no matter how tenuous the connection is to providing consumers with utility service. If anything, GTI's proposal calls for the TRA to exercise sovereignty over Tennessee rate-payers rather than the public utilities that serve them. This is a concern of the Consumer Advocate in terms of establishing a precedent in that future public policy initiatives funded by consumers on a mandatory basis could be approved by the TRA without a legislative directive.

VI. THE AUTHORITY TO SET RATES DOES NOT ENTAIL MANDATORY CONSUMER FUNDING FOR A PUBLIC POLICY

The general rate-making authority of public utility regulators is not a proper tool from which to require consumers to fund a public policy for which there is no statutory authority. *Arkansas Gas Consumers v. Arkansas Public Service Commission*, 118 S.W. 3d 109 (2003); *Mountain States Tel. & Tel. Co. v. Public Service Commission*, 754 P. 2d 928 (Utah.1988); *Process Gas Consumers Group v. Pennsylvania Public Utility Commission*, 511 A. 2d 928; *Mountain States Legal Fund v. New Mexico State Corp. Commission*, 687 P. 2d 92, (1984); *Colorado Municipal League v. Public Service Commission*, 591 P. 2d 577 (Colo.1979). If the General Assembly intended for consumers to fund a public policy, it would have done so in a statutory directive as it has in the past. Similarly, a majority of the states that have approved mandatory consumer funding of GTI's activities have had the statutory authority to consider conservation and energy efficiency in setting just and reasonable rates.[9]

The General Assembly has delegated the role of fixing just and reasonable rates to the TRA. This power is found in an explicit statutory directive.

> The Tennessee regulatory authority has the power after hearing upon notice, by order in writing, to fix just and reasonable individual rates, joint rates, tolls, fares, charges or schedules thereof, as well as commutation, mileage, and other special rates which shall be imposed, observed, and followed thereafter by any public utility as defined in §65-4-101, whenever the authority shall determine any existing individual rate, joint rate, toll, fare, charge, or schedule thereof or commutation, mileage, or other special rates to be unjust, unreasonable, excessive, insufficient, or unjustly discriminatory or preferential, howsoever the same may have heretofore been fixed or established. In fixing such rates, joint rates, tolls, fares, charges or schedules, or commutation, mileage or other special rates, the authority shall take into account the safety, adequacy and efficiency or lack thereof of the service or services furnished by the public utility.

Tenn.Code Ann. 65-5-101(a). In liberally interpreting this statutory provision the TRA must consider whether mandatory consumer funding for GTI's proposal is necessary to the end of effectively governing and controlling the local natural gas Industry. Tenn.Code Ann. § 65-4-106. Further, the TRA must consider whether mandatory consumer funding for GTI is necessary for carrying out the provisions of the agency's enabling statutes. Tenn.Code Ann. § 65-4-104. Finally, the language of the provision must be construed within the context of the entire statute, without any forced or subtle construction which would extend or limit its meanings. *State v. Butler*, 980 S.W. 2d 359, 363 (Tenn.1997).

The actual wording of the delegation of rate-making authority to the TRA has changed very little since the 1930s. Williams Tennessee Code § 5450 (c) (1934). The statute still contains terms of statutory antiquity such as tolls, fares, and mileage that hark back to the days

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[9] See pages 33-35 of this brief.

the former Public Service Commission regulated the railroad and trucking industry in the state. Of some significance, in 1974 the legislature added the phrase "the commission shall take into account the safety, adequacy and efficiency or lack thereof of the service or services furnished by the public utility." Public Acts 1974, Ch. 470. Legislative history indicates that this provision was added because the Public Service Commission had expressed doubts that it had authority to consider poor service quality during the course of a rate case.[10]

The Consumer Advocate would submit that the relevant language within Tenn.Code Ann. 65-5-101(a) for consideration in this matter is the term "just and reasonable" rates and the phrase "service or services furnished by the public utility."

A. *Just & Reasonable Rates Does Not Include the Funding of GTI's Activities*

The term "just and reasonable" rates has been defined as a rate which allows a public utility to earn a return on the value of property which it employs for serving consumers to that generally being made as other businesses with similar risk and sufficiently reasonable to assure the financial soundness of the utility. *Bluefield Water Works vs. Public Service Commission of West Virginia*, 262 U.S. 679 (1923); *Federal Power Commission vs. Hope Natural Gas Co.*, 320 U.S. 591 (1944). In describing the traditional objectives of rate-making, Tennessee courts have opined that just and reasonable rates should be fixed in fairness to both the utility and the consumer, that the rate should insure a fair return on the investment of the utility, and that the rates should not be so low as to affect the quality of service. *Southern Bell Telephone v.*

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[10] See Legislative History for Public Acts 1974, Ch. 470 at Attachment G; Specifically, the 1974 amendment came about due to fact the former Public Service Commission had expressed by letter that it could not take into account the adequacy of service despite community concerns in Knox and Anderson counties over the poor quality of telephone service they received from Tennessee Telephone Company.

Tennessee Public Service Commission, 304 S.W. 2d 640, 642-263 (Tenn.1957) citing *Smyth v. Ames*, 169 U.S. 466.

In essence, the objective of rate-making is to provide fair compensation for a public utility in exchange for the utility service provided to consumers. *Id.*, *CF Industries v. T.P.S.C.*, 599 S.W. 2d 536, 543 (Tenn.1980); *Powell Telephone v. T.P.S.C.*, 660 S.W. 2d 44 (Tenn.1983); *AARP v. T.P.S.C.*, 896 S.W. 2d 127, 133 (Tenn.Ct.App.1994). However, GTI's proposal has little connection to compensating a public utility for the cost of service and return on investments made by the Industry in delivering natural gas to consumers.

GTI's proposal would have consumers funding the development of property that the public utility does not currently own or employ in the service of delivering natural gas to the homes and workplaces of consumers. Rather than compensate the utility for the investment made in property in order to deliver natural gas, consumers are required to directly fund GTI. The return for the consumer's investment is the promise of speculative benefits which consumers alone bear the risk and the burden. Absent a statutory directive to the contrary, funding GTI's projects is simply outside the scope of the rates consumers pay for service. Under ratemaking authority, GTI's proposal does not fall in the category of a just and reasonable rate. Thus, the proposal is not just and reasonable.

Just and reasonable rates need not be construed as including GTI's surcharge as such an interpretation is not necessary to the end of controlling and governing a public utility. Tenn.Code Ann. § 65-4-106. Such an interpretation is not needed to carry out the provisions of the enabling statutes of the TRA. Tenn.Code Ann. § 65-4-104. Furthermore, requiring Tennessee consumers to fund a public policy through just and reasonable rates, absent a statutory directive, ignores other specific statutory provisions the General Assembly has provided in which consumers were required to fund a specific public policy.

B. GTI's Activities Are Not A Utility Service Furnished by the Regulated Industry in This State

The statutory language requiring the TRA to "take into account the safety, adequacy and efficiency or lack thereof of the service or services furnished by the public utility" in essence entails the safety, adequacy and efficiency of the *utility service* provided by the utility to consumers. In the context of Tennessee's natural gas consumers, the phrase "utility service" encompasses the safe, adequate and efficient delivery of natural gas by a public utility to the homes and workplaces of Tennessee consumers.

An example that illustrates how the TRA enforces this provision occurs when a natural gas public utility is required to replace the bare-steel pipes which carry natural gas to consumers. Bare steel pipes are far more likely to have corrosion issues, implicating safety and efficiency issues. Thus, the TRA has required that they be replaced. In context of the application of rate-making authority, the company must invest in new pipes. The new pipes will assist the public utility in the delivery of natural gas to the consumers in a safe and efficient manner. The new pipes are used and useful and presumably a prudent investment by the company. The rates the TRA fixes as just and reasonable will include a fair return for this investment and also a depreciation rate for the new pipes.

Assuming arguendo that GTI's activities are considered a utility service furnished by a public utility under Tenn.Code Ann. 65-5-101(a), the actual research and development of a product is not "used and useful" as the term is applied in the public utility regulatory sense.

Take for example, the Commercial Grade Acoustic Locator ("CGAC") for steel and plastic pipes which GTI has provided as a sample project for potential consumer funding, presumably to produce more efficiency in the operations of the Industry.[11] The CGAC, which could have applications for any number of commercial enterprises and businesses that use steel and plastic pipes, does not at this time exist as a product on the market that a public utility could invest in as an expense or as rate base. Assuming consumers are required to fund the development of the CGAC, it may take three to six years for the product to become available, if it is in fact a successful endeavor. Thus, consumers would be required to invest in property which for three to six years will not be used and useful, assuming the project is successful. Just as plant-held-for-future-use is excluded from rate base because it is not used and useful, costs or surcharges for research and development of speculative projects which may never yield a measureable or useful benefit for Tennessee rate-payers should not be included in rates.[12]

If and when the CGAC is developed under GTI's proposal, the Industry may determine that the product is needed for its service and purchase it. Tennessee consumers, who will have helped fund the development of CGAC, would then have to bear the costs through rates for the Industry to obtain the CGAC and any other maintenance expenses the equipment requires. Thus, not only will consumers be required to nurse new equipment onto the market, they will pay for it again when or if the Industry purchases a CGAC. At the same time, any number of commercial enterprises and private businesses that deal with plastic and steel pipes could

[11] GTI Natural Gas Research and Development Proposals (October 7, 2008), Ex. A, p. 3.

[12] The TRA adheres to the "used & useful" doctrine as first articulated in *Smyth v. Ames*, as most recently noted in Docket 06-00187 (November 27, 2007), p. 16.

benefit from the purchase the CGAC that Tennessee consumers have helped fund. Thus, GTI's activities have little resemblance to a utility service furnished by a public utility.

The Consumer Advocate would submit that GTI's activities are not related to the provision of a utility service. If the meaning of "utility service" is so broadly construed as to include the costs of GTI's proposal, then consumers will find themselves funding much more than what it takes to deliver natural gas to their homes. Construing "utility service" so far beyond the costs of service and fair return required for delivering natural gas to the homes of consumers has the effect of warping the regulatory compact.

The regulatory compact is the theoretical contract between regulated public utilities and the consumers they serve. *United States Gypsum, Inc. v. Indiana Gas Co., Inc* 735 N.E. 2d 790, 797-798 (Ind.2000). In exchange for a monopoly, it is the duty of the local gas Industry to provide the delivery of natural gas to willing consumers within their service area. In exchange for the delivery of natural gas, consumers pay rates that allow the Industry recovery of the cost of service and the opportunity to earn a reasonable return on the capital the Industry invests in delivering natural gas to consumers. However, GTI's proposal turns the regulatory compact on its head. Consumers are required to make the investment in the development of property that may never be successful and that neither the consumer nor the Industry will use or benefit from. In return, consumers are promised speculative benefits that are intended to be reaped in the years to come.

A utility service in the context of Tenn.Code Ann.§ 65-5-101(a) need not be construed as including GTI's surcharge as such an interpretation is not necessary to the end of controlling and governing a public utility. Tenn.Code Ann. § 65-4-106. Such an interpretation is not needed to carry out the provisions of the enabling statutes of the TRA. Tenn.Code Ann. § 65-4-104. Furthermore, defining a "utility service" furnished by a public utility as including a surcharge for GTI's activities goes well beyond the ordinary meaning of the statutory language. Finally, requiring Tennessee consumers to fund a public policy as if it were a "utility service", absent a statutory directive, ignores other specific statutory provisions the General Assembly has enacted in which consumers were required to fund a specific public policy.

C. Rate-payers Will Not Reap A Tangible Benefit From Being Required to Fund GTI's Activities

GTI believes that Tennessee consumers can enjoy the benefits of increased energy efficiency, lower gas and energy bills, lower gas demand, and reduced emissions if Tennessee's conservation research and development is focused on energy efficiency. In support of its sample proposal, GTI has provided a cost benefit analysis. GTI calculates a saving of over $4 million dollars a year for Tennessee's natural gas consumers, assuming hypothetically all of the sample projects submitted were funded and successful. GTI states that Tennessee consumers can benefit from GTI's research and development activities by a 14.8 to 1 ratio. This is nearly double the 8 to 1 benefit-cost ratio GTI purportedly was able to provide to consumers during the 27 years GTI/GRI received funding via the FERC mandated surcharge.[13]

The calculations of GTI's cost-benefit analysis are based on a series of assumptions. These include assumptions as to the number of users in Tennessee that will purchase the new product, uses the price of natural gas for 2006 to project the amount of natural gas conserved, the projected savings over the projected life-span of the product and various other factors to

[13] Docket 03-00313, Rebuttal Testimony of Ronald B. Edelstein (September 2, 2003), p. 2.

arrive at the savings Tennessee consumers will purportedly enjoy as a result being required to invest in GTI. This abstract analysis is composed of self-serving calculations and projections, assumes all of GTI's sample projects will be successful, assumes a specific number of Tennesseans will be able to purchase these products and ignores the forces of the market.

In part, the logic of GTI's position is that the end-user products it intends to develop will use less natural gas, thus lowering demand and natural gas prices. However, the national market for natural gas does not exist in a vacuum. Tennessee consumers are already conserving natural gas through their own efforts as attested by members of the Industry.[14] Yet there has been little relief from higher market prices. Demand for natural gas continues to grow.[15] This is due to a variety of sources at play in the market. Prices have been in flux since the 1990s when electric deregulation began, fostering private entities that use natural gas to produce electricity to sell on the power market. Furthermore, rampant, unregulated and non-traditional speculation in the commodities market, including that for natural gas, has been cited by researchers as a decisive factor for the increase in market prices.[16] These are just some of the market forces that dictate the price of natural gas Tennessee consumers must pay. GTI's cost/benefit analysis takes none of this into consideration.

Ironically, GTI is actually contributing to a new sector of research and development that will further increase market demand for natural gas through the organization's work and

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[14] Docket 08-00197, *Atmos Energy Corporation Petition for Adjustment of Rates* (October 15, 2008), p. 3-4.

[15] Docket 06-00309, Comments of Piedmont (August 8, 2007), p. 2.

[16] *The Accidential Hunt Brothers; How Institutional Investors are Driving Up Food and Energy Prices*, Michael W. Masters & Adam K. White (July 31, 2008) at Attachment H.

research on natural gas powered vehicles.[17] Sponsoring testing of a whole new avenue for use of natural gas in cars will likely lead to more demand for natural gas, off-setting savings from future new products that Tennessee consumers would be required to subsidize. Demand from natural gas powered electric generation and allegedly, rampant speculation in commodities such as natural gas, are just some of the forces in the market that are causing higher natural gas prices.

Tennessee consumers are not causing these costs. Tennessee consumers are already working to reduce demand through their own efforts. Yet under GTI's proposal they would be required to invest in activities that would not bear fruit for years to come for the promise of speculative and abstract benefits. However, even then consumers are at risk for any future return on their investment. GTI's research projects are not guaranteed to be successful.[18] There is no way to predict in advance what project may be successful and what project may fail.[19] Thus, the costs benefit analysis supporting the proposal is by its very nature speculative, more closely resembling a Potemkin village rather than an investment with a guaranteed and tangible benefit in return.

Tennessee rate-payers are expected to not only fund projects in exchange for speculative benefits, but to shoulder the risks of failed projects. Costs or surcharges for research and development of speculative projects which may never yield a measureable or useful benefit for

[17] LNG Interchangability/Gas Quality: Results of the National Energy Technology Laboratory's Research for the FERC on Natural Gas Quality and Interchangeability; DOE/NETL-2007/1290 (June 2007), p. 4-40.

[18] Pre-filed Direct Testimony of Ronald Edelstein on behalf of Atmos Energy before the Georgia Public Service Commission in Docket No. 20298 (October 24, 2005), p. 2.

[19] *Id.*

Tennessee rate-payers should not be included in rates. This is not an investment in used and useful property. If Tennessee rate-payers are required to fund research and development of projects, Tennessee rate-payers will shoulder 100% of the risks for the speculative investment they are mandated to provide. Once more, if any measurable benefit is ever obtained, such benefits will not be reaped solely by Tennesseans despite being a captive source of funding.

Assuming that funding GTI's activities would result in benefits, if the projects funded were successful the benefits would not flow to consumers for years to come. It is not sound policy to require one generation of ratepayers to subsidize future ratepayers. In addition, as noted by the Massachusetts Department of Telecommunications and Energy, gas utilities, natural gas producers, interstate pipelines, manufacturers and retailers will benefit from GTI's research, yet GTI's proposal requires that only natural gas consumers provide funding. *Re: Boston Gas Company*, 2003 WL 22964772, * 197-200, D.T.E. 03-40 (October 31, 2003) at Attachment B (excerpt only due to volume). What cannot be ignored is the fact that the local natural gas companies participating in this docket have a vested and long term interest in supporting conservation efforts. In order to attract and retain consumers in a region dominated by the Tennessee Valley Authority, the stockholders of the Industry have a long term interest in keeping natural gas prices affordable and in being more efficient. All three gas companies participating in this docket stand to benefit from research and development if GTI could deliver the benefits promised.

D. Most States That Have Approved Mandatory Consumer Funding of GTI Have Express Statutory Authority to Consider and Implement Such Programs in General or When Setting Utility Rates

At least a majority of utility regulatory agencies that have adopted consumer funded proposals to support GTI's research and development activities were permitted either through statutory grants related to energy conservation.

Since 1973 California, by statute, has allowed the commission the discretion to include expenses for research and development when setting the rates of every electric, natural gas, heating and telephone utility within its jurisdiction. Cal.Pub.Util.Code § 740. A subsequent legislative enactment in 2001 granted the specific authority to the commission to implement surcharges on consumers to recovery these costs rather than through rates. Cal.Pub.Util.Code § 890(a).

In Florida, the commission is authorized to give consideration to energy conservation programs when setting rates. Fla. Stat. Ann. § 366.041.

Minnesota's Public Utilities Commission has an energy conservation mandate that allows public utilities to recover costs associated with energy conservation plans. Minn.Stat. Ann. § 216B.16(6).

The legislature in Mississippi has made clear by statute that the setting of just and reasonable rates should include long term management and conservation of energy resource practices. Miss. Code Ann. § 77-3-2.

North Carolina's Utilities Commission has been vested with a statutory directive that "reliable utility service" includes aspects of conservation and energy efficiency programs and that such programs be considered in setting rates. N.C. Gen. Stat.§ 62-2, *et seq*.

New Mexico's commission has been vested with authority to consider energy efficiency and conservation programs. N.M.S.A. § 62-17-5.

New York's legislature has required the public service commission to encourage public utilities to formulate conservation programs. McKinney's Public Service Law § 5(2).

Oklahoma's legislature has vested the Corporation Commission with the exclusive jurisdiction, power and authority to make rules and issue orders to govern and regulate the conservation of natural gas within the state. 27A Okl.St.Ann. § 1-3-101(E).

Oregon's legislature has granted the Public Utility Commission the discretion to adopt policies designed to encourage the acquisition of effective conservation resources. O.R.S. § 757.262.

Pennsylvania's legislation specifically created a Bureau of Conservation, Economics and Energy Planning within the state public service commission to research into energy and conservation issues in order to advise the commission and develop an energy conservation program. 66 Pa.C.S.A. § 308 (c).

Utah's legislature has defined by "just and reasonable rates" by statute as including methods and means of encouraging conservation of resources and energy. U.C.A. 1953 § 54-3-1.

Vermont's legislature has required that the setting of rates for gas and electric utilities include energy efficiency proposals. Vt. Stat. Ann. 30 § 218.

Virginia's legislature provides the state commission with supervisory power over rates and practices intended to promote effective conservation and use of energy. Va. Code Ann.§ 56-235.1.

The state of Washington has provided the state commission with a statutory directive encouraging and considering energy efficiency programs when setting rates. R.C.W.A.§ 80.28.025.

VII. RULE-MAKING & TRA RULE & REGULATION 1220-4-1-.11(1)(C)

GTI's sample proposal suggests that pursuant to a TRA rule adopting the Uniform System of Accounts, that includes an accounting category for research and development, is sufficient authority from which to approve a mandatory surcharge levied on consumers for the benefit of GTI.[20] The General Assembly has invested rule-making authority within the enabling statutes of the agency. The TRA is authorized to make rules and regulations that in effect create the policies that carry out the intent of the agency's enabling statutes. Tenn.Code Ann. § 65-2-102(2). However, such authority cannot be employed to expand its power and jurisdiction or to deviate from those laws empowering the TRA. *Id.* Thus, the power to mandate consumer funding of a public policy by an administrative rule absent statutory authority would be void. Rulemaking power is not in of itself authorizing power, but rather a regulatory tool from which the TRA carries out the statutory directives the General Assembly has dictated. A policy promulgated by rule must have a basis in statutory authority.

[20] GTI's Natural Gas Research and Development Proposals (October 7, 2008), p. 9-10.

VIII. CONCLUSION

For the reason herein, the Consumer Advocate would submit that GTI's proposal calls for the TRA to act beyond the agency's statutory authority.

Respectfully submitted,

Ryan L. McGehee, B.P.R. No.025559
Assistant Attorney General
Office of the Attorney General
Consumer Advocate and Protection Division

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing Brief was served on the party below via facsimile, U.S. Mail, hand delivery, commercial delivery, or e-mail, on the 21 day of November, 2008.

J. W. Luna, Esq.
Jennifer L. Brundige, Esq.
Farmer & Luna, PLLC
333 Union Street, Suite 300
Nashville, TN 37201
Telephone: (615) 254-9146
jwluna@farmerluna.com
jbrundige@farmerluna.com

Archie Hickerson
AGL Resources
150 W. Main Street, Suite 1510
Norfolk, VA 23510
Telephone: (757) 616-7510

Elizabeth Wade
AGL Resources
Ten Peachtree Place, N.W. 15th Floor
Atlanta, GA 30309
Telephone: (404) 584-4000
ewade@aglresources.com

R. Dale Grimes
Bass, Berry & Sims, PLC
AmSouth Center
315 Deaderick Street, Ste.2700
Nashville, Tennessee 37238-3001
Telephone: (615) 742-6244
dgrimes@bassberry.com

William T. Ramsey
A. Scott Ross
Neal & Harwell PLC
One Nashville Place, Suite 2000
150 Fourth Avenue North
Nashville, Tennessee 37219
Telephone: (615) 244-1713
ramseywt@nealharwell.com
sross@nealharwell.com

Mr. James H. Jeffries IV
Moore & Van Allen PLLC
100 North Tryon Street, Suite 4700
Charlotte, NC 28202-4003
Telephone: (704) 331-1079
jeffriesj@mvalaw.com

Gary Hotvedt, Esq.
Office of Legal Counsel
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243-0505
Telephone: (615) 741-2904
Gary.Hotvedt@state.tn.us

Jane Lewis-Raymond
Vice President and General Counsel
Piedmont Natural Gas Company, Inc.
P.O. Box 33068
Charlotte, North Carolina 28233
Jane.Lewis-Raymond@piedmontng.com

Ryan L. McGehee
Assistant Attorney General

Attachment A

H
109 FERC P 61164, 2004 WL 2619913 (F.E.R.C.)

FEDERAL ENERGY REGULATORY COMMISSION

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1
Commission Opinions, Orders and Notices

Before Commissioners: Pat Wood, III, Chairman; Nora Mead Brownell, Joseph T. Kelliher, and Suedeen G. Kelly.

Gas Technology Institute

Docket No. RP04-378-000

ORDER ON APPLICATION FOR ADVANCE APPROVAL OF A RESEARCH AND DEVELOPMENT PROGRAM AND JURISDICTIONAL RATE PROVISIONS TO FUND THE PROGRAM

(Issued November 18, 2004)

***61784** 1. On July 1, 2004, the Gas Technology Institute (GTI) filed an application for the advance approval of a 2005-2009 research, development and demonstration (RD&D) program and for approval of jurisdictional natural gas pipeline rate provisions to fund the 2005 RD&D program (Application). For the reasons appearing below, the Application is rejected. This order is in the public interest because it fulfills the 1998 settlement entered into by the Gas Research Institute (GRI), the predecessor to GTI, natural gas pipelines, local distribution companies (LDCs) and customer and public interest groups, as approved by the Commission. [FN1]

Background

2. In order to properly set the Application of GTI in perspective, it is first necessary to discuss GTI's predecessor organization, GRI, and the settlement GRI reached with its customers in 1998. The history of GRI's activities and the basis for funding of GRI's activities through a mandatory surcharge on volumes of gas transported by pipeline began with the recognition by the Commission and the gas industry that more efforts were needed in RD&D geared to the natural gas industry for the benefit of industry participants at all levels and ultimately for the benefit of consumers. [FN2] RD&D activities, the mechanisms for funding RD&D through GRI, and the process for approving that funding all evolved over a period of some 20 years, culminating in the 1998 settlement.

3. The approved mechanism for GRI funding prior to the 1998 settlement arose from an earlier contested settlement that in 1993 prescribed funding for GRI's 1994 and

1995 RD&D programs. This funding mechanism was extended through 1997, and GRI was required to file by March 1, 1997 a proposal for a long-term funding mechanism. GRI made such a filing in December 1996 in Docket No. RP97-149-000. The Commission convened a public conference in March 1997 to discuss the future funding of RD&D in the natural gas industry, and as a result of statements made at the conference by a representative cross-section of the industry, on April 30, 1997, the Commission issued a Notice of Proposed Rulemaking in Docket No. RM97-3-000. [FN3] The Commission proposed to amend its regulations to guarantee long-term funding for GRI. The Commission proposed a two-part mechanism that would fund GRI "core" RD&D programs that provide widely dispersed benefits through a non-discountable, non-by-passable, volumetric surcharge on all jurisdictional pipeline throughput. All other, or non-core, programs would be funded on a voluntary basis. Also on April 30, 1997, the Commission issued an order extending the funding mechanism which had been approved for GRI for 1996 and 1997 through the year 1998, [FN4] in order that the Commission and the parties would have ample time to complete the rulemaking in Docket No. RM97-3-000.

**2 4. On June 10, 1997, GRI filed its annual application in Docket No. RP97-391-000 for advance approval of its 1998 RD&D program and its 1998-2002 five-year plan. Subsequent to the issuance of Staff's report on GRI's plan, GRI filed a petition requesting Commission approval of a comprehensive settlement proposed by the Interstate Natural Gas Association of America (INGAA), designed to address the funding for GRI, and adopted by GRI's Board of Directors. At the heart of this plan was a proposal to convert to voluntary funding all core and non-core projects beginning in 2003. The proposed settlement was supported by many interstate pipelines and GRI. The Commission, in its order approving the five-year plan for GRI, [FN5] noted that the settlement had not been negotiated by all segments of the natural gas industry, and referred the matter to a settlement judge for further proceedings. [FN6]

5. In the spring of 1998, the parties in Docket Nos. RP97-149-000 and RM97-3-000 representing a broad cross-section of the natural gas industry, including industrial customers, consumer advocates, producers, pipelines, LDCs, municipal distribution companies, and other industry participants, reached a settlement regarding the funding of GRI's RD&D program through mandatory surcharges on pipeline throughput. The settlement essentially provided for a commodity-based surcharge to be applied to discountable volumes of gas transported by interstate pipelines, and the monies so collected to be transferred to GRI to fund its RD&D program. Of utmost concern to the parties was the settlement's creation of an orderly seven-year transition to a system of completely voluntary funding no later than December 31, 2004. [FN7] The surcharge would steadily decline over the seven-year period, and no later than December 31, 2004, it would be eliminated altogether. Thereafter, all funding of any RD&D sponsored by GRI would be at GRI's risk - ratepayers*61785 would not be required to fund the RD&D program should GRI desire to continue any of its program beyond the expiration of the setlement. On April 29, 1998, the Com-

mission approved the 1998 settlement, including the provision for the transition to completely voluntary funding. In so doing, the Commission stated: "All funding of GRI will be on a voluntary basis after December 31, 2004. Therefore, the Commission's objective of ensuring a broad based, voluntary long-term funding mechanism for GRI is achieved by the Settlement." [FN8]

Description of GTI's Application

6. GTI states that it is a non-profit organization providing a full range of technology solutions to energy industry stakeholders: natural gas producers, natural gas pipelines, LDCs, end-use equipment manufacturers, industrials, consumers and government agencies. It asserts that its programs span the complete technology development spectrum. [FN9] It contends that it is a registered assumed corporate name for the Institute of Gas Technology (IGT), and that it has remained separate and apart from GRI. GTI states that IGT was incorporated in 1941, and it exists today as an assumed corporate name for IGT. GTI acknowledges that it has assumed many of GRI's duties pursuant to the 1998 settlement, having combined with GRI on April 24, 2000, but that it is an "impermissible stretch" to conclude that GTI "stands in the shoes" for all purposes so far as the 1998 settlement is concerned. GTI contends that it cannot be considered a signatory to the 1998 settlement. [FN10] GTI states that "gas industry RD&D funding initiatives outside the Commission's advance approval context have been ongoing under GRI's auspices, *and more recently under GTI's auspices* [emphasis added], since 1998." [FN11] GTI contends that there are other RD&D efforts that will continue to depend on an industry collaborative program. [FN12]

****3** 7. GTI seeks, through the instant application, advance approval of its proposed Collaborative Research, Development and Demonstration Program. GTI proposes an annual budget of $48 million per year for five years (2005-2009) funded by a commodity surcharge of 0.56 cents per dth, effective January 1, 2005, applied to interstate transportation and storage services rendered by the jurisdictional pipelines that support this application.

8. GTI proposes to use the $48 million per year in five different program areas. [FN13] GTI allocates the $48 million as follows: Supply, 14.6 percent; Transmission, 22.9 percent; Distribution, 39.6 percent; Utilization, 14.6 percent; and 8.3 percent, Administrative costs.

9. First, GTI allocates $7 million to its Gas Supply Program Area that would allegedly provide U.S. gas producers with technology solutions that would reduce costs, increase U.S. natural gas resources, and explore options for alternative supplies.

10. Second, GTI allocates $11 million to its Gas Transmission Program Area to develop and disseminate technologies, products and procedures that would purportedly allow transmission companies to improve system delivery performance, safety, environmental performance and reliability in a cost-effective manner, thereby redu-

cing the cost of service to customers.

11. Third, GTI allocates $19 million to its Gas Distribution Program Area to develop and disseminate technologies, products and procedures that GTI contends would reduce the cost of safely and reliably operating gas distribution systems and, thereby, reduce the cost of service to gas customers.

12. Fourth, GTI allocates $7 million to its Gas Utilization Program Area to develop and disseminate gas end-use equipment and systems which, according to GTI, would provide consumers with increased efficiency and effectiveness, while reducing cost, maintaining operational safety and complying with environmental regulations.

13. Finally, GTI allocates $4 million to its Program Management and Administration to manage the program.

14. GTI seeks Commission approval of a mandatory, fixed, but discountable, surcharge of 0.56 cents/dth, effective January 1, 2005. For each participating pipeline's customers, the surcharge would be mandatory unless discounted by the pipeline. For discounted transactions, pipelines would discount the GTI surcharge first and collect and remit to GTI only the surcharge amount that exceeds the discounted rate. [FN14]

15. GTI predicts the surcharge would raise $48 million annually, based on an anticipated yearly pipeline throughput of 8.3 Tcf. GTI assumes that during the initial five-year period, its annual revenues would remain constant, and that any increases in throughput would be offset by increased discounting. GTI states that it would review these assumptions after the first two years of experience. Finally, GTI states that if actual cash inflows exceed cash outlays, the excess funds would be retained in an interest-bearing account and all earned interest would be reported and remain part of the available program funds. GTI reserves the right to modify the surcharge in the future. [FN15]

****4 *61786** 16. The following services would be subject to the GTI surcharge: [FN16] deliveries of gas transported to LDCs for sale or use by such utilities, whether or not such LDCs are themselves members of GTI; deliveries of gas to other interstate pipeline companies that are not members of GTI; deliveries of transported gas to consumers for ultimate use, including gas transported by interstate pipelines for LDCs for redelivery to such end users; and deliveries of gas to intrastate pipeline companies, whether or not they are members of GTI. LDCs shipping gas on "participant" pipelines with discounted service would have the option to include the GTI surcharge in their pipeline invoices. This provision is referred to as "check the box" in pipeline tariffs. [FN17] Producers whose gas is shipped only on non-participating pipelines would have the opportunity to qualify as producer participants by using the "check the box" provision on gas that they ship on such pipelines. [FN18]

17. For storage the following rules would apply: (1) where storage is provided pursuant to an overall, one-time charge for service that includes such functions as transportation to the storage site, injection, inventory control, withdrawal, and transportation out of storage to customer delivery points, the volumetric surcharge would be included in billing for such overall service, unless discounted, in which case the pipeline would collect and remit only the amount by which the surcharge exceeded the discount; and (2) where there are separate charges and no change of ownership of the gas for various storage-related functions (*i.e.*, where there are separate charges for transportation to and/or from the storage site, and a separate charge for storage-related services), the volumetric surcharge would be included in billing only for the transportation transaction; where there are separate transactions for both transportation to storage and transportation from storage, the volumetric surcharge would be included in billing only for the first leg (*i.e.*, transportation to the storage site) and would not be included in the billing for the storage service; if service is rendered on a discounted basis, the pipeline would collect and remit only the amount by which the pertinent surcharge exceeded the discount. [FN19]

18. For transportation transactions involving more than one pipeline, the surcharge would be collected on the last transaction in the pipeline chain. GTI states that this is intended to ensure that natural gas transported in interstate commerce is subject only to one surcharge from the wellhead to the market. [FN20]

Procedural Matters, Interventions and Protests

19. On July 8, 2004, the Commission issued a notice of GTI's application, specifying that motions to intervene or protests should be filed by August 9, 2004. Thereafter, in response to a request filed by Bruce B. Ellsworth, the Commission extended the time for filing comments on the filing to August 23, 2004. Numerous timely motions to intervene were filed by interested parties. [FN21] Pursuant to Rule 214 (18 C.F.R. § 385.214 (2004)), any timely filed motion to intervene is granted unless an answer in opposition is filed within 15 days of the date such motion is filed. No answers in opposition to motions to intervene were filed.

****5** 20. Motions to intervene out of time were filed by certain parties. Pursuant to 18 C.F.R. § 214(d) (2004), the Commission finds that granting intervention at this stage of the proceeding will not disrupt this proceeding or place additional burdens on existing parties. Consequently the motions for late intervention are hereby granted.

Comments and Answers

21. Comments were filed by numerous parties, some in support of GTI's application and some opposed. In addition, many of those parties who oppose the application also filed motions to reject the application, essentially arguing that the application is barred by the terms of the 1998 settlement and the Commission's April 29 Order. These parties argue that the GTI, as predecessor to GRI, is bound by the terms of the 1998 settlement and its provision to eliminate mandatory surcharges

on pipeline throughput on and after December 31, 2004.

22. On August 24, 2004, GTI filed an answer to the motions for summary disposition filed by Process Gas Consumers Group, filing on behalf of the American Chemistry Council, American Forest & Paper Association, American Iron and Steel Institute, Georgia Industrial Group, Industrial Gas Users of Florida, New Jersey Large Energy Users Coalition, and California Manufacturers & Technology Association (collectively referred to as PGC) and the Independent Petroleum Association of America (IPAA), and sought leave to answer the protests filed in this proceeding. GTI contends that it is a wholly separate entity from GRI, that it is free to make the instant proposal and that it is not bound by the terms of the 1998 settlement. In ***61787** its Application, GTI claimed wide support for its proposal. However in light of the vigorous opposition to the proposal, as discussed more fully below, GTI has recognized in its answer that it does not enjoy the wide support it thought it had. [FN22] The Fertilizer Institute filed a motion to reject GTI's answers to protests.

Discussion

GTI and the 1998 GRI Settlement

23. GTI states that it is distinct from the GRI, and that it (GTI) is not a signatory party to the 1998 settlement. [FN23] Several supporting parties [FN24] argue that the 1998 settlement applies only to GRI, and thus, GTI is not precluded from filing, or the Commission from approving, GTI's collaborative RD&D funding mechanism subsequent to December 31, 2004. [FN25]

24. In general, all of the opposing parties listed in Appendix C, object to GTI's assertions that it is a separate entity from GRI, and that it is not bound to the GRI Settlement. The Fertilizer Institute, IPAA, Indicated Shippers, the Missouri Public Service Commission (Missouri Commission), the National Association of State Utility Consumer Advocates (State Consumer Advocates), the Natural Gas Supply Association (NGSA), and PGC filed legal arguments based on the fundamental principles of corporate and contract law and Commission policy and precedent, arguing that GTI is bound by the terms of the 1998 settlement. Essentially, those parties state that GTI is the result of a "*de facto* merger" [FN26] between GRI and IGT, and as such, GTI is a successor-in-interest to GRI and bound by the terms of the 1998 settlement.

****6** 25. Under corporate-successor law, PGC argues that in the case of a *de facto* merger "all contractual obligations transfer to the successor as if the parties engaged in a traditional merger." [FN27] According to PGC and Indicated Shippers, under this law, the courts consider "several factors to determine whether a transaction is a *de facto* merger, including whether there is continuity of ownership, management, and business operations and whether any other equitable reasons exist to treat the transaction as a merger." [FN28]

Noting that GRI and GTI share the same President and CEO and the same General

Counsel, and that senior executives are paid by both GTI and GRI, PGC claims that "continuity of ownership [a critical element for a *de facto* merger] exists between GTI and GRI." [FN29]

26. The Natural Gas Supply Association (NGSA) [FN30] and Statoil Natural Gas LLC (Statoil) [FN31] also refute GTI's contention that GRI did not "technically" merge with GTI, based on the principles of contract law. [FN32] Whatever the "ultimate corporate form of the transaction between GRI and IGT," NGSA asserts that "the reality of their 'combining' is that GTI assumed the rights and duties of GRI, and most importantly, received the surcharge amounts." [FN33] Statoil also argues that the fundamental principles of contract law "make it quite clear that IGT and GRI merged and GTI 'stepped into the shoes' of the original two organizations." As such, Statoil states that GTI is obligated to the Settlement, including the benefit of using the funds collected by the interstate pipelines under the expiring mandatory surcharge to administer the RD&D programs. Moreoever, Statoil affirms that contract law refutes GTI's asserted right to "arbitrarily choose" which elements of the Settlement to effectuate. IPAA concurs stating that "just as Microsoft [Corporation] cannot 'combine' with another organization, streamline its operations, and then repudiate its settlement with the Department of Justice, GTI ***61788** cannot validly claim that there is no reason that it should 'stand in GRI's shoes'." [FN34]

27. PGC asserts that, even when an agreement has not been expressly assigned, courts have held that a party's, "silence and acceptance of the revenue," may be implied to have assumed the agreement. [FN35] PGC concludes that, in the first instance, GTI is legally obligated to comply with all the terms of the Settlement because of its *de facto* merger. In the alternative, even if GTI should not be held to stand in GRI's shoes due to a *de facto* merger, GTI's behavior consistently indicated acceptance of the Settlement terms and the Settlement revenues.

28. PGC and Indicated Shippers state that GTI both "implicitly and explicitly stood in GRI's shoes" and accepted the terms of the Settlement. The GTI website repeatedly references, in annual reports to shareholders and in questions and answers, that GTI manages the RD&D program funded by mandatory surcharges on interstate natural gas pipeline throughput. GTI lists the mandatory surcharges as sources of its (not GRI's) funding. GTI even makes the statement that "FERC itself reviews the program...proposed by GTI each year."

****7** 29. Several parties contend that the GTI/GRI merger is substantiated by GTI in its 2003 Annual Report stating that GTI manages the "Commission-approved" R&D program, [FN36] and GRI's website (http://www.gri.org) which redirects the user to GTI's website citing all of GTI's R&D endeavors. [FN37] The Fertilizer Institute points to a specific statement on GTI's website:

> A substantial part of the GTI program is supported by funds made available through a surcharge on interstate gas sales that is authorized by the [FERC]....An agreement reached in 1998 by the FERC and Gas Research Institute -

one of GTI's predecessor organizations - defined the terms for planning and conducting this program. GRI carries out the FERC-authorized program through contracts with GTI and other parties.

30. The Fertilizer Institute also points to the Application [FN38] and its references to GRI and its expressed duties under the Settlement (*e.g.*, GTI is an "assumed business name"; GTI "represents the joining" of IGT and GRI"; GTI refers to itself as "combination of the two [GRI and GTI] organizations"; GTI "has assumed many of GRI's duties" under the Settlement). Further, The Fertilizer Institute notes that GRI no longer maintains its own offices, its own staff or its own telephone number. All of these were transferred to GTI. [FN39]

31. Other parties cite to specific documentation also substantiating the GTI/GRI merger. PGC cites to an *Oil and Gas Journal* interview with John Riordan, the president and chief executive of GTI, who describes "the challenges of bringing IGT and GRI together into a single entity," and that "all of our staff need to get comfortable describing GTI as one company." [FN40] SCANA notes that GRI's former counsel signed GTI's instant proposal, wherein it states that GTI claims it is a "new entity beyond the scope of the 1998 Settlement", and that it "relies on GRI's experience in research to demonstrate GTI's capability and experience to perform the planned RD&D."

32. Missouri Commission cites to a footnote in the GTI/GRI combined Year 2000 financial statements in GRI's 2002 Application in Docket No. RP01-434-000, stating: [FN41]

> On April 24, 2000 the management and memberships of Gas Research Institute ("GRI") and Institute of Gas Technology ("IGT"), (collectively the "Companies"), formed Gas Technology Institute ("GTI") to migrate towards a combination of the two organizations in order to serve a wider range of customers in meeting their technology needs associated with finding, delivering and using natural gas. As part of this effort, the two organizations elected a set of common officers and designated separate, but identical memberships and Boards of Directors.

33. Citing to the Financial Statements attached to the Application at Exhibit 4, CenterPoint Energy Minnegasco (Minnegasco) contends that GTI is "essentially a new incarnation of GRI," as ***61789** reflected in the Financial Statements showing that GTI and GRI are the same organization.

****8** 34. Calpine Corporation contends that releasing GTI from its obligations under the Settlement potentially results in "gamesmanship..., allowing parties to renege on past deals, merely by changing business forms and titles." [FN42]

35. Indicated Shippers contend that, even if GTI is somehow considered not bound by the 1998 settlement, it is established law that parties to a settlement are bound by it; thus, the other signatory parties are bound. [FN43] Indicated Ship-

pers state that these parties include all of the major interstate pipelines listed in Appendix B to the Settlement, INGAA, the American Gas Association (AGA), the PGC, and numerous individual producers, pipelines, LDCs and industrial users. [FN44] Indicated Shippers aver that "[i]f the Commission were to permit parties to avoid the effects of a settlement simply by changing their names, as requested herein, it would completely undermine the Commission's regulatory regime and the ability to rely upon Commission-approved settlements." [FN45]

36. GTI, in both its application and in its answer to the pleadings of others, argues that, while it "assumed many of GRI's duties pursuant to the 1998 GRI S&A," it is "an impermissible stretch to conclude that GTI 'stands in GRI's shoes' for all purposes so far as the 1998 GRI S&A is concerned." [FN46] GTI argues that, in any event, its obligations in the Settlement expire concurrently with the surcharges on December 31, 2004. [FN47]

37. The opposing parties disagree. PGC states that, when GTI accepted the funds from the pipelines and allocated them to R&D programs, it exercised "dominion" over the mandated surcharge and acquiesced to the terms of the Settlement. [FN48] PGC avers that GTI's cherry picking of the stipulations under the Settlement is contrary to basic contract law. [FN49] Citing to *American Legacy Foundation v. Lorillard Tobacco Co.*, PGC notes that courts uniformly reject non-signatories' efforts to circumvent contracts that the non-signatories previously endorsed even where the non-signatory did not enter into a legal/formal relationship with the signatory. [FN50] PGC refutes GTI's arguments on this issue stating that GTI assumed GRI's obligations under the 1998 Settlement when for the past four years it "reaped the benefits" of the surcharges under the settlement, managed the R&D programs, [FN51] determined which projects to fund, and "induced the natural gas industry into believing that it would comply with the Settlement" and that the mandatory surcharges would end no later than December 31, 2004. [FN52] NGSA concurs with PGC that because GTI accepted the benefits negotiated by its predecessor GRI, GTI is obligated to fulfill the remaining stipulations under the Settlement, including the complete transition to a voluntary funding mechanism. [FN53] PGC, IPAA, and Statoil argue that the Commission should not allow GTI to "renege" on the Settlement after admitting its assumed responsibility for implementing the primary purpose of the Settlement. [FN54]

****9** 38. The Fertilizer Institute also concurs with PGC stating that the GRI Settlement "provided a stream of guaranteed payments to GRI over seven years through mandatory surcharges in exchange for GRI's promise to ask for nothing more after seven years." The Fertilizer Institute notes that such agreements are not unusual, in that the Commission previously used this type of agreement to settle take-or-pay contracts or stranded costs (*i.e.*, the ratepayers agree to pay a specified surcharge for a period of years, and the utility agrees to no further surcharges after the end of the period). Several parties concur that "[GRI's] agreement in 'perpetuity' does not make it any less enforceable."

39. The Indicated Shippers state that "canons of contract construction require a contract (and settlement agreement) to be interpreted in a manner which gives meaning to the provisions of the contract." [FN55] In other words, Indicated Shippers states "[w]hen interpreting the language of a contract, a court must give reasonable meaning to all parts of the contract and not render portions of the contract meaningless." [FN56] Southern Company Services, Inc. (Southern Company) [FN57] agrees with the Indicated Shippers and views GTI as the successor to GRI, bound with all parties by the Settlement and barred from proposing or supporting any continuation of a Commission-approved uniform R&D surcharge to fund GRI and its successor GTI beyond 2004. PGC and NGSA echo these sentiments.

40. Missouri Commission states Article VI of the 1998 settlement specifically prohibits GTI, which now stands in GRI's shoes, from filing to re-institute an RD&D surcharge after December 31, 2004. [FN58] Specifically, Article VI of the Settlement states:

- By agreeing to this Offer of Settlement, no party is required to continue membership in GRI beyond December 31, 2004. Subject to Article V, all parties agree that (i) the Commission-approved uniform research and development surcharges shall terminate... December 31, 2004; (ii) funding of GRI will be voluntary thereafter as described herein; and (iii) none of the parties will propose or support any modification of the Offer of Settlement or any continuation of Commission-approved uniform research and development surcharges to fund GRI beyond December 31, 2004.

Commission Decision

41. The issue the Commission must resolve at the outset is whether GTI, as successor to GRI, is bound by the terms of the Commission's April 29 Order and the1998 settlement, which provides that GRI would transition to voluntary funding over a seven-year period ending on December 31, 2004. Based on our review of the filing, the comments and arguments by the parties, we conclude that GTI is bound by the terms of the April 29 Order and the 1998 settlement.

42. GTI contends that it is not bound by the terms of the 1998 settlement, since it is technically not a signatory to the 1998 settlement. Our review of the applicable pleadings leads us to conclude that GTI is the product of a combination of IGT with GRI and is to be treated as a successor-in-interest to GRI. [FN59] As successor-in-interest to GRI, GTI must fulfill GRI's obligations under the 1998 settlement. Though GTI has filed the instant application, it is clear that GTI is nothing more than a reconstituted GRI. According to one part of the application, GTI states that it is really an assumed corporate name for IGT. [FN60] It states further that GTI represents the joining of IGT and GRI. It continues that it (GTI) has assumed many of the GRI's duties pursuant to the 1998 settlement. Moreover, on its own web site, GTI states that a substantial part of the GTI program is supported by funds collected through a surcharge on interstate gas sales authorized by the Commission, and that an agreement reached in 1998 by the Commission and GRI, one of GTI's predecessor organizations, defined the terms for planning and con-

ducting this program. Thus, whether GTI was formed from the joining or combining of IGT and GRI, there can be no doubt that GTI is the successor organization to GRI. GRI agreed to stop collecting the surcharges no later than December 31, 2004. [FN61] GRI's successor in interest cannot escape GRI's obligation to cease mandatory surcharges under the 1998 settlement merely by changing its name.

****10** 43. Continuity of ownership exists between GTI and GRI. All former members of GRI became members of GTI, thus retaining an ownership interest in the combined entity. [FN62] GTI intended that its Board of Directors comply with the terms of ***61790** the 1998 settlement, as evidenced by GRI's filing in Docket No. RP01-434-000, August 31, 2001, at 3: "A consolidated [GTI and GRI] board of directors and management structure, which fully complies with the provisions of the GRI funding settlement, is now in place." In addition, GTI has absorbed GRI in such a manner that it would appear to outsiders that the companies had merged. The RD&D Program is run under GTI's auspices, and as stated by GRI, GTI "carries on all the essential activities of the two original organizations." [FN63] In its 2003 Annual Report, GTI states that it manages the R&D program approved by this Commission, and no mention is made of GRI. [FN64] Moreover, the website for GRI (www.gri.org) automatically redirects the user to GTI's website, and there all of the press releases announce GTI's R&D accomplishments. The natural gas industry appears to view GTI as having absorbed GRI, [FN65] and GTI itself considers itself and GRI to be "one company" as evidenced by the statement of its president. In fact, except for the fact that GRI's name has appeared only on the documents filed with the Commission for budget approval once a year, GRI does not appear to have any role. Based on the foregoing, it is clear that GTI is in fact GRI.

44. Moreover, GTI explicitly on numerous occasions announced that it would continue to abide by the terms of the 1998 settlement. GTI stated that its "consolidated board of directors and management structure fully complies with the provision of the GRI funding settlement." [FN66] In its 2003 application for Commission approval of its RD&D program and funding for 2004, GRI stated that GTI's board of directors set a goal that it "become self-sustaining by 2005, as envisioned in the 1998 funding settlement." [FN67] GTI and GRI have been irretrievably mixed, and even GRI in its earlier applications treated the combined entity as one and the same.

45. GTI is bound by the 1998 settlement because it assumed the contract upon its combination with GRI. GTI accepted the benefits of the 1998 settlement, since it collected the natural gas surcharges which enabled it to fund and manage the RD&D programs since its combination with GRI in 2000. It decided which projects to fund and it took the credit for the technological enhancements achieved by such projects. GTI cannot now, having garnered the benefits of the 1998 settlement, turn its back on the obligations contained within that settlement. The law is replete with examples of where courts have held this to be true. [FN68] The thrust of these cases is that when a third party reaps the benefits of a contract, it cannot later disclaim the obligations that the agreement imposes on it, especially

where, as here, the third party ostensibly acts in replacement of one of the contracting parties.

****11** 46. Finally, the parties to the 1998 settlement detrimentally relied on the assurances provided by GRI/GTI that it would abide by the terms of the 1998 settlement by their forbearance in objecting to the continued funding of RD&D pursuant to the terms of the 1998 settlement, even though GTI would conduct the operations formerly conducted by GRI, reasonably believing that GTI would not seek a continuation of the mandatory surcharge mechanism when the settlement expired at the end of 2004. Since the combination of the two entities in April of 2000, GTI has collected some $200 million from the parties to the 1998 settlement. [FN69] GTI cannot at this point avoid its obligation imposed by the 1998 settlement to discontinue the surcharge mechanism.

47. GTI argues that, even if the Commission concludes that GTI is bound by the 1998 settlement, the Commission should still allow it to seek RD&D funding under the Commission's regulations for the period after 2004. GTI contends that "the parties in entering into the GRI S&A [the 1998 settlement], and the Commission in approving it, had at least two goals in mind: (1) to provide a means of securing a broad-based and stable funding for consumer-oriented GRI programs, and (2) to do so in a way that would ultimately make GRI funding voluntary and no longer subject to FERC oversight." [FN70] However, the achievement of voluntary GRI funding has never been considered by the Commission to be merely a "goal" of the settlement. Rather, GRI made a commitment to fund future RD&D projects on a voluntary basis. It is important to note that it was GRI, GTI's predecessor, that first broached the subject of a transition to an entirely voluntary funding mechanism for both core and non-core projects. [FN71] It did so in the settlement originally filed in Docket Nos. RP97-149-002 and RP97-291-000, on August 22, 1997, which led to ***61791** the Commission's Opinion No. 418. [FN72] Thereafter, the parties agreed to transition to entirely voluntary funding within seven years, rather than the five originally proposed by GRI, [FN73] and this is what the Commission approved in the April 29 Order. In response to the contention of a group of East Coast LDCs that the seven-year period was too long, the Commission stated:

> The seven-year period [for transition to voluntary funding] agreed to by the parties was a compromise which was necessary to achieve a settlement which enjoyed broad support across the natural gas industry. The proposed settlement reflects weeks of negotiations that preceded its filing. No party received all that it desired. Moreover, under the terms of the settlement, seven years appears to be reasonable. The settlement provides for a three-year transition to voluntary funding of Non-Core projects and seven years of funding for Core projects. *By the year 2004, there will be no more GRI surcharges for either Core or Non-Core projects. All GRI funding will be voluntary and no longer subject to FERC oversight.* (April 29 Order, 83 FERC at 61,457 [emphasis added].)

****12** 48. Thus, the Commission approved a settlement among the parties that did not merely state that its *goal* was to achieve voluntary funding, but that *committed*

GRI to entirely voluntary funding after 2004.

49. As to GTI's contention that the 1998 settlement is ambiguous as to what is intended after 2004 in the event that voluntary funding fails, the Commission does not agree that there is any ambiguity in the 1998 settlement. The 1998 settlement clearly provides, in Article VI, that mandatory funding shall cease at the latest at the end of 2004. Such cessation is not contingent upon voluntary funding being successful, nor is cessation conditional on any other condition. In fact, the 1998 settlement precludes the Commission from considering an application from the settling parties for the continued mandatory funding of RD&D projects beyond 2004. Yet, this is precisely what GTI, successor to GRI, would have the Commission do. GTI states in its application: "In order to ensure an orderly *continuation of funding*, GTI hereby requests that the Commission order that all GTI pipeline members may include the proposed funding components in their jurisdictional tariffs effective on January 1, 2005." [FN74] The point here is that GTI seeks a "continuation of funding" - *i.e.*, the continuation of GRI-type funding. This is a clear admission by GTI that it is proposing an extension of the GRI funding mechanism for a similar RD&D program, and this is in direct contravention of the 1998 settlement.

50. GTI contends that, even if it is bound by the 1998 settlement, the Commission clearly intended that the funding of an RD&D program such as that envisioned in the GTI application is not barred. GTI contends that the 1998 settlement must be interpreted to accommodate the public interest in maintaining adequate collaborative RD&D efforts in the gas industry. [FN75] GTI proposes, as an alternate rationale for approval of its application, that the Commission find that neither the Commission nor the industry intended the decision to phase out advanced approval funding for the GRI program as putting an effective end to cooperative RD&D in the gas industry.

51. The Commission agrees with GTI that phasing out funding for GRI should not be viewed as a decision for all time to put an effective end to cooperative RD&D in the gas industry. However, it was the parties to the settlement - including GTI's predecessor - who determined to put a "sunset" date on the mandatory funding that GTI seeks to continue. In fact, it was the Commission's proposal in the concurrent rulemaking to establish a mandatory surcharge on all volumes transported by interstate pipelines, without the possibility of discounting. The parties evidently could not agree with that approach, and now GTI would have the Commission revert to a substantially similar mechanism for funding which the parties agreed to end. Whether this marks the end of cooperative RD&D is unclear at this time. Given the fact that substantial RD&D is conducted by companies in this industry as well as many other industries, the Commission is not convinced that some form of cooperative efforts cannot be accomplished without the necessity of the mandatory funding mechanism, especially as proposed by GTI.

****13** 52. GTI asserts that an adequate collaborative gas industry RD&D effort continues to depend on continued support from interstate pipelines through advance approval pursuant to section 154.401 of the Commission's Regulations. GTI argues that "core circumstances pertaining to the [1998 settlement] have changed fundamentally," arguing that "market conditions are now very different than they were six years ago," [FN76] and that there are significant differences between the proposed GTI and GRI programs, in terms of project size, scope, governance, design, and management structure.

53. We do not agree that continued reliance on mandatory funding for RD&D is necessary. If the industry and consumers demand a form of ***61793** cooperative effort in RD&D, they will be accommodated without the mandatory funding GTI seeks here. Market-based RD&D would better serve the consuming public than the acrimony that has accompanied each and every GRI application since the onset of the program for mandatory funding of cooperative RD&D projects.

54. As to differences between GTI and GRI, we see very little evidence that GTI differs materially from GRI. As discussed above, we find that GTI is in fact the successor to GRI and is bound by the terms of the 1998 settlement, including the proscription on mandatory funding beyond 2004.

55. GTI further states that since 1998, there have been major changes in market and regulatory conditions, and that such changed conditions have led to increased needs for technology innovations associated with transmission and distribution integrity and security, safety and cost containment. GTI states that technology aimed at more general improvements in efficiency or reductions in emissions have not attracted significant new private capital, because benefits are rarely captured by the developer, instead accruing to energy consumers, and that technologies offering broad consumer benefits are not economic if developed and introduced by a single LDC or pipeline; rather, these technologies will not succeed without participation of industry as a whole. GTI further argues that it has been quite diligent in pursuing alternative funding avenues, but these initiatives have not obviated the need for a stable funding base for a gas industry cooperative RD&D effort aimed at technology development and deployment.

56. That there have been major changes in market and regulatory conditions since 1998 is obvious to all. However, nowhere does GTI make the necessary nexus between the effect of those changes and its alleged need for mandatory funding for cooperative voluntary RD&D through GTI. GTI has not demonstrated that there has been inadequate private capital devoted to RD&D efforts in enhancing technological improvements in efficiency or reductions in emissions, or in enhanced safety and security. There have been assertions that efforts by private parties would be insufficient to obtain such funding. However, GTI's application itself shows that it has obtained some $42 million annually for RD&D. [FN77] GTI notes that it has raised some $17 million from LDCs, and has commitments of $2-3 million per year from pipeline-oriented sources. In this connection, we note that individual pipelines may seek recovery in their rates for any reasonable amounts expended for

RD&D purposes whether those RD&D efforts are provided by the pipeline or by a third party, provided they meet the tests of section 4 of the Natural Gas Act (NGA). Understandably, while there is the prospect of mandatory discountable surcharge funding, we have received no NGA section 4 applications which request rate coverage for such expenditures. Pipelines with RD&D expenditures can either file an application for advance approval, pursuant to §154.401 of our regulations, or account for RD&D expenses in Account No.188 of the Commission's Uniform System of Accounts and seek recovery of such costs in a section 4 rate proceeding. Finally, if GTI is correct that RD&D will elicit only inadequate financial support, then forcing the industry and its customers to pay for GTI-managed RD&D has not been justified. The industry and its customers are the supposed beneficiaries of this RD&D, and their consensus in opposition to mandatory funding should not be overridden by our second-guessing.

Effect of the Commission's Order on Rehearing Approving the 1998 Settlement

****14** 57. GTI argues that "On rehearing of the Commission's order approving the 1998 GRI funding S&A, APGA set forth its view as to two situations in which the provisions of the S&A would *not* pertain: (1) *beyond* December 31, 2004; and (2) in the event of termination before December 31, 2004; in its June 26, 1998 rehearing order, the Commission agreed with APGA that the 1998 S&A would no longer be effective under these circumstances, and that the proscription against advocating means of funding GRI, other than as provided in the 1998 S&A, would end." GTI concludes that the Commission should find that this same proscription would not preclude GTI funding after December 31, 2004. [FN78]

58. In its June 26 Order on rehearing, the Commission stated:

> APGA raises an issue regarding Article VI of the settlement, seeking clarification that it will not be bound in perpetuity to not taking a particular position regarding Commission-approved funding for GRI. It claims that it did not agree to be bound not to propose or support any modification of the settlement beyond the end of the settlement term, or December 31, 2004. It points out that there may be events which transpire which would effectively end the settlement before the end of its stated term, and that it should not be foreclosed from arguing for or supporting something other than what is in the existing settlement if such an event should occur. The Commission agrees with APGA on this point. The settlement agreement, in such an event, would no longer be effective and the proscription against advocating or supporting modifications to the settlement would end. Thus, the April 29 order is clarified to this extent. [FN79]

59. GTI claims that, in the June 26 Order, the Commission agreed with APGA's request for clarification***61794** of Article VI under the GRI Settlement and declared Article VI without legal effect. [FN80] KeySpan concurs and states that, in response to APGA's claim when it agreed to the GRI stipulation its intent was not to be bound in perpetuity, the Commission determined that the GRI stipulation's proscription against the continuation of Commission-approved funding for the GRI beyond December 31, 2004 was effective only so long as the GRI settlement was in ef-

fect. KeySpan further contends that neither the Commission nor any other party disputed APGA's claim that the settlement did not bind parties beyond December 31, 2004. KeySpan therefore states that Article VI should not be interpreted as precluding parties from proposing collaborative funding mechanisms to support other organizations engaged in RD&D activities for periods beyond December 31, 2004. GTI argues that its obligations in the Settlement expire concurrently with the surcharges on December 31, 2004. [FN81]

60. Contrary to GTI's claim, several parties [FN82] concur that the Commission's June 26 Order does not remove the legal effect of the 1998 settlement's bar on pre-approved Commission funding after December 31, 2004. Conversely, as the Commission explains "the settlement is a means to decrease and ultimately remove Commission-approved GRI surcharges." [FN83] NGSA insists that the Commission's order supported APGA's position "under limited circumstances." [FN84] NGSA states that it is clear that the Commission's agreement was tied to the situation where events occur that "effectively end the settlement before the end of its stated term"; in other words, the Commission held that in limited circumstances the 1998 settlement would no longer be effective and parties could support measures that were not originally in the agreement.

****15** 61. PGC asserts that the Commission never indicated that any provision of the 1998 settlement did not have the force and effect of law. In fact, PGC notes, the Commission recognized that "there may be events which transpire which would effectively end the settlement before the end of its stated term." PGC avers that the 1998 settlement remains in full effect because "such an event" has not occurred; therefore, the 1998 settlement and Article VI continue to bind the parties and their successors. [FN85]

62. PGC also points to a previous Commission finding that to "accept any other position would quickly make settlements meaningless, since a party to a settlement, finding its terms disadvantageous, could transfer its interests to a third party that could then ignore the restrictions of the settlement." [FN86]

63. Missouri Commission argues that the seven-year phase out period is not the "term" of the Settlement in the sense that a utility might agree to a seven-year moratorium in a rate settlement. [FN87] Missouri Commission contends that the phase-out period constituted a compromise during the negotiation process between those who favored continuation of the GRI funding and those who wanted the GRI funding eliminated.

Commission Decision

64. GTI misconstrues the effect of the Commission's June 26 Order on rehearing. GTI interprets our June 26 Order to give parties freedom to ignore their obligations under the 1998 settlement, one of which is not to propose modification of the funding mechanism approved, and not to seek any extension of mandatory funding beyond December 31, 2004. However, the elimination of the proscription against

modifying the settlement only applies if a party sought to modify the settlement during its term. No one has sought to modify the settlement. In other words, if events had transpired which would have ended the settlement prematurely, then AP-GA, or other signatories, would not have been precluded from proposing some other approach to a GRI-type funding mechanism as a substitute until December 31, 2004, the date after which the Commission would no longer allow a GRI funding mechanism. Nothing in the Commission's clarification should be taken as allowing GRI or its successor, or any other signatory, to propose a new Commission-approved mandatory funding mechanism after the settlement termination date.

65. The 1998 settlement provides for the phasing out of the surcharge so that it ends when GRI has collected the maximum it could, but in no event later than December 31, 2004, after which funding will be on a voluntary basis. The limitation on funding in the 1998 settlement to voluntary funding after December 31, 2004 remains in effect. This was a fundamental undertaking of GTI's predecessor and of all parties to the settlement. The interpretation that GTI would place on this provision would render the settlement meaningless and the parties who had relied on the undertakings of GTI's predecessor to end mandatory funding at the end of 2004 would be irretrievably damaged. Rather than construe away the rights of the parties to the 1998 settlement, the law is quite ***61795** clear that a contract, or in this case a settlement, "should be read to give effect to all its provisions." [FN88] Parties who seek to modify the 1998 settlement in this regard must do so only through a NGA section 5 proceeding.

Conclusion

****16** 66. Because we find that GTI is a successor company to GRI and is bound to the terms of the 1998 settlement agreement, including the provision for voluntary funding after 2004, we will reject GTI's application.

The Commission orders:

The application by GTI is rejected.

By the Commission.

(SEAL)

Linda Mitry
Deputy Secretary

FN1. *Gas Research Institute*, 83 FERC ¶ 61,093 (1998), *order on reh'g*, 83 FERC ¶ 61,331 (1998), collectively referred to herein as the "April 29 Order." The settlement approved by that order is referred to as the "1998 settlement."

FN2. The early efforts of this Commission and its predecessor, the Federal Power Commission, in encouraging RD&D activities are described in *Gas Research Institute*, Docket No. RM77-14, Opinion No. 11, 2 FERC ¶ 61,259 (1978), at

61,616-61,620.

FN3. *Research, Development, and Demonstration Funding*, 62 Fed. Reg. 24,853 (May 7, 1997), FERC Stats. & Regs. ¶ 32,524 (1997).

FN4. *Gas Research Institute*, 79 FERC ¶ 61,110 (1977), *order on clarification*, 79 FERC ¶ 61,396 (1977).

FN5. *Gas Research Institute*, Opinion No. 418, 81 FERC ¶ 61,182 (1997).

FN6. 81 FERC ¶ 61,182 at 61,784-85.

FN7. *See* 1998 settlement at 4, 9, 10, 14, 18, 20, 21. At 4, the 1998 settlement states, "[I]n no event will a Commission-approved discountable (or non-discountable) uniform funding mechanism extend beyond December 31, 2004."

FN8. 83 FERC ¶ 61,093, at 61,456 (1998).

FN9. Application at 10.

FN10. *Id.* at 9-10.

FN11. *Id.* at 12.

FN12. *Id.*

FN13. *Id.* at 21.

FN14. *Id.* at 32. These provisions regarding the mandatory surcharge and its discounting duplicate the provisions of the 1998 settlement.

FN15. *Id.*

FN16. *Id.* These services are identical to those specified in the 1998 settlement.

FN17. *Id.* "Check the box" refers to a collection mechanism whereby LDC and producer shippers may elect to contribute funds to GTI by including the GTI surcharge in their pipeline invoices from pipelines that discount. Producers whose gas is shipped on non-participating pipelines may also qualify as producer participants in funding GTI by using the "check the box" provision on gas they ship on such pipelines.

FN18. *Id.* GTI provided no explanation of the intent of these provisions or the disparate treatment between producers and LDCs.

FN19. *Id.* at 32-33. These provisions are the same as in the 1998 settlement.

FN20. *Id.* at 33.

FN21. The intervening parties are listed in the Appendices to this order. Appendix

A lists all parties who filed motions to intervene; Appendix B is a list of supporting parties; and Appendix C is a list of opposing parties.

FN22. *See* GTI Answer at 3.

FN23. GTI Application at 9.

FN24. *See e.g.*, KeySpan Delivery Companies, NiSource Inc., and the American Public Gas Association.

FN25. The supporting parties virtually adopt the arguments of GTI in making their support known. Thus, our responses to GTI's claims will serve as comment or response to the assertions of the supporting parties.

FN26. IPAA cites to Black's Law Dictionary defining a "*de facto* merger" as a "transaction that has the economic effect of a statutory merger but is cast in the form of an acquisition of assets or an acquisition of voting stock and is treated by a court as if it were a statutory merger.... Occurs where one corporation is absorbed by another, but without compliance with statutory requirements for a merger."

FN27. PGC at 5, *citing Holland v. Williams Mountain Coal Co.*, 256 F.3d 819, 824 (D.C. Cir. 2001).

FN28. PGC at 5, *citing Cargo Partner AG v. Albatrans, Inc.*, 352 F.3d 41, 46 (2d Cir. 2003); *Nettis v. Levitt*, 241 F.3d 186, 193-94 (2d Cir. 2001); *see* specifically, 241 F.3d at 194, quoting *Woodrick v. Jack J. Burke Real Estate, Inc.*, 703 A.2d 306 (N.J. Super. Ct. App. Div. 1977) (internal quotations omitted) (the *de facto* merger test is flexible, and courts disregard questions of form to determine "whether, in substance, it was the intent of the successor to absorb and continue the operation of the predecessor."); *Gray v. Loyola Univ. of Chicago*, 652 N.E.2d 1306, 1310 (Ill. App. Ct. 1995); *see also* IPAA at 10.

FN29. PGC at 5, *citing* Application of Gas Research Institute for Advance Approval of Its 2002-2006 RD&D Plan and 2002 RD&D Program and Jurisdictional Rate Provisions to Fund the 2002 Program, Docket No. RP01-434-000, June 1, 2001, at 3 ("All current members of GRI and IGT are now members of the Gas Technology Institute."); Application of Gas Research Institute for Advance Approval of its 2001-2005 RD&D Plan and 2001 RD&D Program and Jurisdictional Rate Provisions to Fund the 2001 Program, Docket No. RP00-313-000, June 1, 2000, at 2 (hereinafter "GRI 2000 Application") ("The combined organizations will remain non-profit businesses with a membership made up of all existing members of the two organizations."); *see also Gen. Elec. Capital Corp. v. Lease Resolution Corp.*, 128 F.3d 1074, 1084 (7th Cir. 1997).

FN30. NGSA represents industry gas producers and marketers.

FN31. Statoil imports liquefied natural gas at Dominion Cove Point and sells regasified natural gas.

FN32. *Id.* The Fertilizer Institute concurs rhetorically -- "[t]he bottom-line question is whether each entity has run its own race, or whether there has been a relay-style passing of the baton from one to the other." *Citing, 300 Pine Island v. Cohen*, 547 So. 2d 255, 256 (Fla. Dist. Ct. App. 1989).

FN33. NGSA at 2-7.

FN34. IPAA at 9.

FN35. PGC at 9-12, *citing White v. Nat'l Football League*, 92 F. Supp. 2d 918, 924 (D. Minn. 2000) ("When third parties... silently reap the benefits of contractual agreements..., they cannot later disclaim the obligations these agreements impose on them."); *Hillard v. Guidant Corp.*, 37 F. Supp. 2d 379, 381 (M.D. Pa. 1999) ("The doctrine of equitable assignment provides that when one accepts the benefits of a contract he is bound by equity to be held to the terms of the contract."); *Collins v. Int'l Dairy Queen, Inc.*, 2 F. Supp. 2d 1465, 1471 (M.D. Ga. 1998) (holding that a third party "cannot accept the benefits of the contract while at the same time avoiding its limitations").

FN36. *Citing* Gas Technology Institute, 2003 Annual Report at 3 (2004), available at http://www.gastechnology.org/webroot/downloads/en/4ReportsPubs/4% y(1)6D4 AnnualRpt IGTIo3AnnualReport.pdf. *See also* Statoil at 3.

FN37. The Fertilizer Institute at 7.

FN38. *Id. citing* GTI at 10-12.

FN39. *Id.* The Fertilizer Institute notes that, under the Settlement, $688 million was recovered for GRI-sponsored research funds. The Fertilizer Institute asserts that GRI acknowledged in its 2003 application to the Commission in Docket No. RP03-514-000 for approval of its 2004 research program that its funding would end in 2004, and that if GRI/GTI does not want to honor its commitment under the Settlement, it should return "[the] money so that we can litigate the case we thought we settled in 1998," noting that GRI has recovered its projected $688 million in total GRI-sponsored research since the 1998 settlement. The Fertilizer Institute at 2, 4 and 5.

FN40. PGC at 7, *citing* Bob Williams, *Newly Combined GTI Coping with US Natural Gas Industry R&D Challenges of Gas Supply Pipeline Safety*, Oil & Gas J., May 21, 2001 ("the merger, which Riordan prefers to think of more as a 'combination").

FN41. Missouri Commission at 9-10.

FN42. Calpine at 3 note 6.

FN43. Indicated Shippers at 14, *citing Texas Gas Transmission Corp. v. FPC*, 441 F.2d 1392 (6th Cir. 1971); *Tennessee Gas Pipeline Co. v. FPC*, 504 F.2d 199 (D.C. Cir. 1974); and *Texas Eastern Transmission Corp.*, 91 FERC ¶ 61,293 (2000).

FN44. 83 FERC at 61,457 and notes 28-36.

FN45. Indicated Shippers at 15.

FN46. Application at 10, and arguments stated *infra*, P6.

FN47. Application at 7.

FN48. PGC at 11, *citing* Restatement (Second) of Contracts § 69 (1981) (" of dominion, even though not intended as acceptance..., is a sufficient manifestation of assent....).

FN49. *Id.* at 8, *citing* Restatement (Second) of Contracts § 69 (1981). PGC points to the Restatement of Contracts stating "that when an entity silently reaps the benefits of a contract it implicitly agrees to be bound by its limitations. Accordingly, if a nonsignatory accepts the benefits of a contract, it binds itself to the limitations and restrictions in the contract. [Thus,] GTI is estopped from denying the binding effect of the Settlement Agreement because for four years it accepted the benefits of the contract."

FN50. *Id.* at 12, *citing* 831 A.2d 335 (Del. Ch. 2003) (The Delaware Court of Chancery held that the American Legacy Foundation, a nonprofit organization that produced anti-tobacco advertising and accepted funding under the settlement, was bound to the settlement even though it was not a signatory party to the settlement.); *citing also Philip Morris, Inc. v. Pittsburgh Penguins, Inc.*, 589 F. Supp. 912 (W.D. Pa. 1983).

FN51. *Citing* GTI 2003 Annual Report 3 (2004).

FN52. PGC at 10 *citing Philip Morris, Inc. v. Pittsburgh Penguins, Inc.*, 589 F. Supp. 912, 919 (W.D. Pa. 1983). PGC also cites to certain documents where GTI stated that it would abide by various terms of the Settlement; *citing, e.g.*, Reply Comments of Gas Research Institute, Docket No. RP01-434-000, Aug. 31, 2001, at 3; GRI 2000 Application, at 2-3 ("One-third of the new board will represent gas consumers and public interest segments as specified in the April 29, 1998 GRI settlement."); and GTI 2003 Final Application at 6, where GRI stated that GTI's board of directors set a goal to "become self-sustaining by 2005, as envisioned in the 1998 funding settlement."

FN53. NGSA at 5.

FN54. *Citing* Application at 8-9 ("GTI recognizes diligent effort to free collaborative gas industry RD&D funding from the advance approval process to be a responsibility and submits that it has satisfied this responsibility." To that end, it embarked on "a very intensive campaign" and was "quite diligent in pursuing alternative funding avenues.").

FN55. Indicated Shippers at 17; *citing United States v. Insurance Co. of N. Am.*, 83 F.3d 1507, 1511 (D.C. Cir. 1996) (the "cardinal principle of contract construction [is] that a document should be read to give effect to all its provisions") (quoting *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 63, (1995)). *See also YRT Servs. Corp. v. United States*, 28 Fed. Cl. 366, 389 (1993) ("When interpreting the language of a contract, a court must give reasonable meaning to all parts of the contract and not render portions of the contract meaningless.").

FN56. *Id.* at 17 *citing*, *YRT Servs. Corp. v. United States*, 28 Fed. Cl. 366, 389 (1993).

FN57. Southern Company acts as an agent for seven power companies and produces, transmits, distributes and sells electricity at retail in the south, and sells natural gas at retail in Georgia. A substantial portion of its generation is gas-fired.

FN58. Missouri Commission at 4.

FN59. *See* 15 William Meade Fletcher, Fletcher Cyclopedia of the Law of Private Corporations § 7124.20 (2003) ("A *de facto* merger occurs when one corporation is absorbed but without compliance with the statutory requirements for a merger.") *See also Cargo Partner AG v. Albatrans, Inc.*, 352 F.3d 41, 45 (2d Cir. 2003).

FN60. Application, pp. 10-11. On April 24, 2000, GRI entered into a relationship with IGT, which GTI characterizes as a "combination." IGT then registered with the Illinois Secretary of State to assume the name GTI.

FN61. *See* GRI's "Report on Progress as Operations Under the 1998 Funding Settlement Approach an End," filed June 4, 2004 in Docket No. RP97-391-000. In such report, at p. 1, GRI states that funding pursuant to the 1998 settlement "will be complete on or about August 1, 2004."

FN62. Application of GRI for Advanced Approval of its 2002-2006 RD&D Plan, Docket No. RP01-434-000, filed June 1, 2001, at 3 ("All current members of GRI and IGT are now members of the Gas Technology Institute."); *see also* Application of GRI for Advanced Approval of its 2001-2005 RD&D Plan, Docket No. RP00-313-000, filed June 1, 2000 at 2 ("The combined organizations [GTI and GRI] will remain non-profit businesses with a membership made up of all existing members of the two organizations.").

FN63. Application at 12; Reply Comments of GRI, Docket No. RP01-434-000, August 31, 2001, at 3.

FN64. GTI, 2003 Annual Report at 3 (2004), available on the internet through www.gastechnology.org.

FN65. *See* statement of William J. Haener, Executive Vice President of CMS Energy Corporation, at the hearing on H.R. 3609 before the House Transportation and Infrastructure Subcommittee on Highways and Transit, 107th Cong. (2002); Retail Services Reporter for November 16, 2001, *AGA Plans New Research Program to be Funded by Customers to Compliment GTI* ("Gas Technology Institute, the successor to GRI"); *Study Looks at Tight-Gas Restimulation Candidate Wells*, Oil & Gas Journal, October 8, 2001 ("GTI, formerly Gas Research Institute").

FN66. Reply Comments of GRI, Docket No. RP01-434-000, filed August 31, 2001, at 3.

FN67. GRI 2003 Application, Docket No. RP03-514-000, filed June 2, 2003, at 6.

FN68. *See White v. National Football League*, 92 F. Supp. 2d 918 (D. Minn. 2000); *Hillard v. Guidant Corp.*, 37 F. Supp. 2d 379 (M.D. Pa. 1999); *Philip Morris, Inc. v. Pittsburgh Penguins, Inc.*, 589 F. Supp. 912 (W.D. Pa. 1983).

FN69. *See* IPAA Protest and Comments at 8.

FN70. GTI Answer to Motions for Summary Disposition and Related Protests, filed August 24, 2004, at 12. Footnotes omitted.

FN71. April 29 Order, 83 FERC at 61,456.

FN72. *Gas Research Institute*, Opinion No. 418, 81 FERC ¶ 61,181 (1997).

FN73. *See Id.* at 61,780 ("The settlement...would extend GRI's current funding mechanism through 2002, subject to certain limited modifications. *Voluntary funding of core R&D would begin in 2003.* During the year 2000, GRI would...develop a voluntary funding approach to support this core program after 2002." [emphasis added.]).

FN74. Application at 39. GTI's proposal does not give its member pipelines the option of including the surcharge in their jurisdictional tariffs. GTI's proposal requires that each member pipeline must include mandatory surcharges that it may then discount.

FN75. *See Id.* at 13-19.

FN76. *Id.* at 16.

FN77. *Id.* at 8-9.

FN78. *Id.* at 19.

FN79. *Gas Research Institute, supra*, 83 FERC at 62,338.

FN80. GTI at 3-6.

FN81. *Id.* at 6.

FN82. *See e.g.*, The Fertilizer Institute at 2, IPAA at 8, and Missouri Commission at 6. Specifically, Missouri Commission interprets the Commission's order limited to clarifying that, in case "events transpire" that would "effectively end" the settlement prior to its "stated term" (presumably the seven-year phase-out period), parties would not be barred from supporting something other than the programs and funding covered in the Settlement.

FN83. 83 FERC at 62,337.

FN84. *Citing, GRI*, 83 FERC ¶ 61,331 at 62,338.

FN85. *See also* IPAA at 15 *citing Potomac Elec. Power Co. v. FERC*, 210 F.3d 403, 409 (D.C. Cir. 2000).

FN86. PGC at 19.

FN87. Missouri Commission at 8.

FN88. *United States v. Insurance Co. of N. Am.*, 83 F. 3d 1507, 1511 (D.C. Cir. 1996) (quoting *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 63 (1955)); *see also YRT Servs. Corp. v United States*, 28 Fed. Cl. 366, 389 (1993) ("When interpreting the language of a contract, a court must give reasonable meaning to all parts of the contract and not render portions of the contract meaningless.").

APPENDIX A

List of Intervenors

****17** Aera Energy, LLC

Alabama Gas Corporation

Alliance Pipeline L.P.

Alliant Energy Corporate Services, Inc.

American Chemistry Council

American Forest & Paper Association

American Gas Association

American Iron and Steel Institute

American Public Gas Association and the American Public Gas Association Research Foundation

Anadarko Petroleum Corporation

Aquila Networks

Atlanta Gas Light Company, Chattanooga Gas Company, and Virginia Natural Gas, Inc.

Atmos Energy Corporation

Baltimore Gas and Electric Company

BP America Production Company and BP Energy Company

Bruce B. Ellsworth

Burlington Resources Trading Inc.

California Manufacturers and Technology Association

Calpine Corporation

Canadian Association of Petroleum Producers

CenterPoint Energy - Mississippi River Transmission Corporation

CenterPoint Energy Gas Transmission Company

CenterPoint Energy -- Minnegasco

ConocoPhillips Company

Consolidated Edison Company of New York, Inc. and Orange and Rockland Utilities, Inc.

Consumers Energy Company

Duke Energy Gas Transmission Corporation, Algonquin Gas Transmission, LLC,

East Tennessee Natural Gas, LLC and Texas Eastern Transmission, LP

East Ohio Gas Company, d/b/a Dominion East Ohio, The Peoples Natural Gas

Company, d/b/a Dominion Peoples, and Hope Gas, Inc., d/b/a Dominion Hope

El Paso Corporation's Pipeline Group

Electric Power Supply Association

ExxonMobil Gas & Power Marketing Company, a division of ExxonMobil Corp.

The Fertilizer Institute

Florida Power & Light Company

Georgia Industrial Group

Gulf South Pipeline Company, LP

Gulfstream Natural Gas System, L.L.C.

Independent Petroleum Association of America

Independent Petroleum Association of Mountain States

Industrial Gas Users of Florida

International LNG Alliance

Interstate Natural Gas Association of America

Interstate Oil and Gas Compact Commission

John B. Curtis

KeySpan Delivery Companies

Kinder Morgan Interstate Gas Transmission LLC

Laclede Gas Company

Louisville Gas and Electric Company

Marathon Oil Company

Maritimes & Northeast Pipeline, L.L.C.

Michigan Consolidated Gas Company

Midland Cogeneration Venture Limited Partnership

Missouri Public Service Commission

National Association of State Utility Consumer Advocates

***61796** National Fuel Gas Distribution Corporation and National Fuel Gas Supply Corporation

Natural Gas Supply Association

New Jersey Large Energy Users Coalition

New Jersey Natural Gas Company

Nicor Gas

NiSource Inc.

Northeast Gas Association/NYSEARCH

Northern Natural Gas Company

Northwest Industrial Gas Users

Northwest Natural Gas Company

Occidental Energy Marketing, Inc.

Operations Technology Development, NFP

Pacific Gas and Electric Company

PECO Energy Company

**18 Peoples Gas System, a Division of Tampa Electric Company and Tampa Electric Co.

Piedmont Natural Gas Company, Inc.

Pipeline Research Council International, Inc.

The Process Gas Consumers Group

Progress Energy Corporation

PSEG Companies

Public Utilities Commission of Ohio

Questar Pipeline Company and Questar Gas Company

SCANA Energy Marketing, Inc.

SEMCO Energy Gas Company

Southern Company Services, Inc.

Statoil Natural Gas LLC

The Peoples Gas Light and Coke Company and North Shore Gas Company

UGI Utilities, Inc.

Utilization Technology Development, NFP

Vectren Energy Delivery of Ohio, Inc., and Southern Indiana Gas and Electric Company

Washington Gas Light Company

Wisconsin Public Service Corporation

Xcel Energy Services, Inc., *et al.*

APPENDIX B

List of Supporting Parties

Alabama Gas Corporation (Alabama Gas)

Alliant Energy Corporate Services, Inc. (Alliant)

American Gas Association (AGA) [FN89]

American Public Gas Association and the American Public Gas Association Research Foundation (APGA) and (APGA-RF)

Atlanta Gas Light Company, Chattanooga Gas Company, and Virginia Natural Gas, Inc. (Atlanta), (Chattanooga), and (VNG)

Atmos Energy Corporation (Atmos)

Baltimore Gas and Electric Company (BGE)

Bruce B. Ellsworth

California Energy Commission (CEC)

Consolidated Edison Company of New York, Inc. and Orange and Rockland Utilities, Inc. (Con Edison) (O&R) adopts AGA and Northeast Gas Association/NYSEARCH comments

Consumers Energy Company (CECo)

Dr. Henry R. Linden, founding president of GRI

Duke Energy Gas Transmission Corporation, Algonquin Gas Transmission, LLC, East Tennessee Natural Gas, LLC, and Texas Eastern Transmission, LP (Duke Energy Gas Transmission, Algonquin, East Tennessee, Texas Eastern) (Duke Energy Pipelines)

East Ohio Gas Company, d/b/a Dominion East Ohio, The Peoples Natural Gas Company, d/b/a Dominion Peoples, and Hope Gas, Inc., d/b/a Dominion Hope (The Dominion LDCs)

El Paso Pipeline Group (EPPG)

Industrial Heating Equipment Association (IHEA)

Interstate Natural Gas Association of America (INGAA)

Interstate Oil and Gas Compact Commission

John B. Curtis

John H. Gibbons

KeySpan Delivery Companies (KeySpan)

Louisiana Independent Oil and Gas Association

Louisville Gas and Electric Company (Louisville)

Massachusetts Institute of Technology (MIT)

Miller Brewing Company (Miller)

National Association of Regulatory Utility Commissioners (NARUC)

***61797** National Fuel Gas Distribution Corporation and National Fuel Gas Supply Corporation (Distribution and Supply) (National Fuel)

New Jersey Natural Gas Company (NJNG)

New York State Energy Research and Development Authority (NYSERDA)

NiSource Inc. (NiSource)

Northeast Gas Association/NYSEARCH

Northwest Natural Gas Company (NW Natural)

****19** Operations Technology Development, NFP (OTD)

PECO Energy Company (PECO) adopts AGA comments

Piedmont Natural Gas Company, Inc. (Piedmont)

Pipeline Research Council International, Inc. (PRCI)

Public Utilities Commission of Ohio (PUCO)

Questar Pipeline Company and Questar Gas Company (QPC and QGC)

Research and Special Programs Administration (RSPA)

Rob Dunnette (Plant Manager of the Olmsted Waste to Energy Facility (OWEF))

The INGAA Foundation, Inc. Interstate Natural Gas Association of America (adopts INGAA's comments)

The Peoples Gas Light and Coke Company and North Shore Gas Company (Peoples Gas and North Shore)

UGI Utilities, Inc. (UGI)

Utilization Technology Development (UTD)

Washington Gas Light Company (Washington Gas)

Wisconsin Public Service Corporation (Public Service)

APPENDIX C

List of Opposing Parties

Alliance Pipeline L.P.

Calpine Corporation

Canadian Association of Petroleum Producers (Canadian Association)

CenterPoint Energy Minnegasco, A Division of CenterPoint Energy Resources Corp. (Minnegasco)

Electric Power Supply Association (Electric Power) supports protests of The Process Gas Consumers Group, the Independent Petroleum Association of America, and the Natural Gas Supply Association

The Fertilizer Institute

Independent Petroleum Association of America (IPAA)

International LNG Alliance

Midland Cogeneration Venture Limited Partnership

Missouri Public Service Commission (Missouri COMMISSION)

National Association of Public Utility Consumer Advocates (State Consumer Advocates)

Natural Gas Supply Association (NGSA)

Northwest Industrial Gas Users (Northwest Industrial)

The Process Gas Consumers Group filing on behalf of the American Chemistry Council, American Forest & Paper Association, American Iron and Steel Institute, Georgia Industrial Group, Industrial Gas Users of Florida, New Jersey Large Energy Users Coalition, and California Manufacturers & Technology Association (PGC)

PSEG Companies (PSEG)

The South Carolina Pipeline Corporation, Public Service Company of North Carolina, Inc., and SCANA Energy Marketing, Inc. on behalf of its Georgia retail marketer division SCANA Energy (SCANA)

Southern Company Services, Inc. supports the Fertilizer Institute protest

Statoil Natural Gas LLC (Statoil)

The Indicated Shippers

Williston Basin Interstate Pipeline Company (Williston)

Xcel Energy Services, Inc., *et al.* (Excel)

FN89. Companies supporting GTI's application based on AGA's comments are: PECO Energy Company, Atlanta Gas Light Company, Chattanooga Gas Company, and Virginia Natural Gas, Inc., Washington Gas Light Company, Consolidated Edison Company of New York, Inc. and Orange and Rockland Utilities, Inc., New Jersey Natural Gas Company, Wisconsin Public Service Corporation, ATMOS Energy Corporation, Baltimore Gas and Electric Company, Northwest Natural Gas Company, The Peoples Gas Light and Coke Company and North Shore Gas Company, Alabama Gas Corporation, Questar Gas Company, and Consumers Energy Company.

109 FERC P 61164, 2004 WL 2619913 (F.E.R.C.)
END OF DOCUMENT

Attachment B

Mass.Dept.Tel.Energy

Re Boston Gas Company dba KeySpan Energy Delivery New England
D.T.E. 03-40

Massachusetts Department of Telecommunications and Energy
October 31, 2003

APPEARANC ES: Robert J. K eegan, Esq., Robert N. W erlin, Esq., Cheryl M. K imball, Esq., Andrew O. K aplan, Esq., Keegan, Werlin and Pabian, L. L. P. 265 Franklin Street, 6 th Floor. Boston, Massa chusetts 02110-3113. FOR: BOSTON GAS COMPANY d/b/a KEYSP AN ENERGY DELIVERY NEW ENGLAND - and-Richard Visconti, General Counsel. Thomas P. O 'Neill, Esq., Patricia C rowe, Esq., KeySpan En ergy Delivery New England, 52 Second Street, Waltham, Massachusetts 02451. Petitioner. Thomas F. Reilly, Attorney General, BY: Edward G. Bohlen, Wilner Borgel la, Jr., Alexander C ochis, Judith Laster, Colleen Mc Connell, Karlen J. Reed, Assistant Attorneys General, 200 Portland Street, 4th Floor, Boston, Massachusetts 02114. Intervenor. Steven I. Venezia, Esq., Carol R. W asserman, Esq., Commonwealth of Massachusetts, Division of Energy Resources, 70 Franklin Street, 7th Floor, Boston, Massachusetts 02110. Intervenor. Emilio A. F. Petroccione, Esq., Roland, Fogel, Koblenz and Petroccione, L. L. P. One Columbia Place, Albany, New York 12207. FOR: MASSAC HUSETTS OIL HEAT COUNCIL, INC. AND MASSACHUSETTS ALLIANCE FOR FAIR COMPETITION, INC., Intervenors. Kenneth M. Barna, Esq., Karla J. Dou kas, Esq., Rubin and Rudman, L. L. P. 50 Rowes Wharf, Boston, Massachusetts 02110. FOR: MASSACHUSETTS DEVELOPMENT FINANCE AGENCY. Intervenor. Jerrold Oppen heim, Esq., 57 Middle Street, Gloucester, Massachuse tts 01930-5736. -- and- Charles Harak, Esq., National Consumer Law Center, Inc., 77 Summer Street, 10th Floor, Boston, Massachusetts 02110-1006. FOR: MASSACHUSETTS COMMUNITY ACTION PROGRAM DIRECTORS ASSOCIATION. Intervenor. Robert Rudduck, General Counsel, Associated I ndustries of Massachusetts, 222 Berkeley Street, P . O. Box 763, Boston, Massachusetts 02117-0763. Intervenor. Warren H. Pyle, Esq., Alison D. Morantz, Esq., Pyle, Rome and Lichten, P. C., 18 Tremont Street, Suite 500, Boston, Massa chusetts 02108. FOR: UNITED STEELWORKERS OF AMERICA, AFL-CIO-CLC. Intervenor. James M. Avery, Esq., Brown Rudnick Burlack Israels, L. L. P., One Financial Center, Boston, Massa chusetts 02111. FOR: BERKSHIRE GAS COMPANY. Intervenor. Patricia Fr ench, Esq., NiSource Corporate Services Company, 300 Friberg Parkway, Westborough, Massachusetts 01581. FOR: BAY STATE GAS COMPANY. Intervenor. Rebecca L. Fowler, Esq., LeBoef, Lamb, Greene and MacRae, 260 Franklin Street, Boston, Massa chusetts 02110. FOR: FITCHBURG GAS AND ELECTRIC LIGHT COMPANY. Limited Participant. Mary E. Grover, Esq., NStar Gas and Electric Corporation, 800 Boylston Street, P1700, Boston, Massachusetts 02199. Limited Participant. Stephen Klionsky, Esq.. Western Massachusetts Electric Company, 101 Federal Street, 13th Floor, Boston, Massa chusetts 02110.

***197** The proposed WSC is designed to stabilize customers' distribution bills to within two percent of normal weather. This mechanism would tend to reduce, if not eliminate, the role of efficient pricing in the recovery of distribution service costs. More specifically, if the weather is colder than normal, customers may not factor the price of distribution service in their consumption decisions, anticipating that their actual monthly bills will not go beyond two percent of their normal weather bills. On the other hand, if the weather is warmer than normal, customers also may not factor the price of distribution service in their consumption decisions, knowing that their actual monthly bills would be increased even if their actual needs would be less that their normal weather consumption. Thus, the proposed WSC would not be consistent with the Department's rate structure goal of efficiency because it does not provide the correct price signal to encourage efficient use of distribution services.

Because of the change from its previous billing system to CRIS, the actual daily heating degree days to be used for the purpose of the WSC adjustment will be based on the average temperature over nine three-hour intervals, subtracting that average from 65 degrees Fahrenheit (RR-DTE-19 [rev.]; RR-DTE-20; Tr. 24, at 3266-3267). Although the Company indicated that the average temperature is included in the Company's daily weather data supplied by its weather service provider, the Company has not presented a verifiable procedure for reviewing weather data. In turn, want of a verifiable procedure would render virtually impossible the verification of the monthly WSC adjustments on customers bills from tariffed rates. The Department finds that both the inability to provide the proper price signal, and the difficulty in verifying billing cycle weather data with the corresponding WSC adjustments would result in customer confusion, thereby violating the Department's rate design goal of rate simplicity.

For the reasons discussed above, the Department finds that the Company failed to address the concerns expressed in D.P.U. 92-111 and D.P.U. 92-210. Accordingly, the Department denies the Company's proposal for a weather stabilization clause.

VII. CGA AND LDA CLAUSES

A. Gas Industry Research and Development

1. Introduction

Boston Gas proposes to establish a mandatory **surcharge** to support gas research and development ('R&D') efforts. [FN179] The **surcharge** is intended to replace a Federal Energy Regulatory Commission ('FERC') approved interstate pipeline **surcharge** to LDCs, typically passed on to customers, that has been supporting gas industry R&D (Exhs. KEDNE/JFB-1, at 53; KEDNE/RBE-1, at 9; Tr. 9, at 1037). Pursuant to a 1998 agreement between the FERC, the interstate pipelines, and the LDC industry, the pipeline **surcharge** will be phased out before the end of 2004 (Exh. KEDNE/JFB-1, at 53; Tr. 9, at 1041). [FN180]

Boston Gas proposes to collect a **surcharge** of 1.74 cents per 1,000 cubic feet ('Mcf') on pipeline gas only, and to recover this charge through the LDAC (Exh. KEDNE/JFB-1, at 54). [FN181] The Company estimates that, based on test year weather-normalized load, the annual R&D revenues collected by the proposed **surcharge** would be approximately $1.4 million (*id.*). Boston Gas states that it will use its New York affiliates' currently existing R&D unit to supervise the funding and support of various R&D efforts (*id.*). Although the Company does not seek approval for the funding of specific R&D efforts in the instant filing, it states that it will submit such a proposal for Department review by December 1, 2003, if the **surcharge** is approved (*id.* at 55).

2. Positions of the Parties

a. Attorney General

***198** The Attorney General argues that the Department should reject the Company's proposed R&D **surcharge** because it is unnecessary, unfair, and premature (Attorney General Brief at 61). Specifically, the Attorney General asserts that the Company's proposal is: (1) unnecessary, because R&D proposals will proceed whether or not they are partially funded by Boston Gas' customers; (2) unfair, because the proposed charge would force all Boston Gas distribution customers to subsidize R&D that would primarily benefit other competitive businesses that do not pay a charge; and (3) premature, because the FERC charge is not yet phased out, and a new charge would lead to double collection in the rate year (*id.* at 62).

The Attorney General argues that there is no persuasive evidence that Boston Gas' customers will receive direct benefits from the proposed R&D **surcharge** (*id.*). Instead, the Attorney General asserts that a large number of other entities will benefit from the effects of the proposed R&D **surcharge** without contributing to it (*e.g.*, exploration and production companies, pipeline companies, appliance sellers, and the transportation companies, as well as Keyspan's various unregulated subsidiaries) (*id.* at 63). Because Keyspan's shareholders will benefit from any R&D that leads to the lower cost of gas, greater consumption, and greater revenues for the Company, the Attorney General argues that shareholders should fund R&D projects (*id.*). The Attorney General notes that Keyspan, as a whole, did not make any voluntary R&D contributions during the test year (*id.*, *citing* RR-AG-40).

b. AIM

AIM asserts that approval of Boston Gas' R&D **surcharge** proposal is not appropriate at this time (AIM Reply Brief at 2). Although AIM recognizes the value and importance of R&D in the natural gas industry, it argues that R&D benefits should be realized state-wide for all gas and electricity consumers (*id.*). Therefore, AIM supports a state-wide comprehensive plan for gas and electric R&D, funded by a generic distribution charge (*id.*). Finally, because the Company does not offer a formal plan for spending the R&D funds to be collected, AIM recommends that the

Department not approve the Company's proposed **surcharge** (*id.*).

c. Boston Gas

Boston Gas asserts that R&D efforts benefit the utility and, consequently, the customers (Tr. 21, at 2868). The Company did not address the issue of R&D funding in its initial or reply brief.

3. Analysis and Findings

There are several inadequacies in the Company's proposal that weigh against the approval of the proposed R&D **surcharge.** First, the Company claims that the proposed **surcharge** benefits the consumers asked to carry the financial burden for the research, but does not offer proof of this claim. However, these consumers, if they in fact do benefit, are not the only beneficiaries. [FN182] Gas utilities such as Boston Gas, natural gas producers, interstate pipelines, manufacturers, and retailers will also benefit from this research; yet, under the Company's proposal, only natural gas consumers provide the funding. In addition, because the Company is the only LDC to propose a **surcharge** to date, Boston Gas' customers would be paying for R&D programs providing asserted benefits not just for themselves but for other utility customers in Massachusetts and, perhaps, nationwide. Thus, the costs to Boston Gas' customers would be asymmetrical to the purported benefits these customers may receive. Further, the current FERC-approved **surcharge** will be phased out before the end of 2004. Therefore, initiation of the Company's proposed new **surcharge** before the FERC-approved **surcharge** ends would result in double collection from customers.

***199** Moreover, the Company has not yet presented the Department with its plan for spending the R&D funds to be collected. It could have done so as part of its proof, but chose not to. The Department is reluctant to approve the collection and disbursement of R&D funds prior to review of a detailed proposal outlining specific research projects and the associated costs and benefits to the particular customers who are paying the **surcharge.** Without such a review, there is no way for the Department to determine whether and how specific R&D programs would benefit Boston Gas' customers. Moreover, we are unwilling to incorporate such a charge into rates for monopoly distribution customers without a much more persuasive case than the Company has seen fit to mount. Oil dealers, for example, cannot force their customers to shoulder such costs on the claim of some undescribed and unproven benefit; nor should gas customers be forced to do so on such an unconvincing record.

Finally, the role of R&D efforts in the Massachusetts natural gas industry is a matter of concern to numerous affected parties. The merits of R&D funding and a mechanism for recovery should be considered in a broader investigation involving all Massachusetts LDCs. Therefore, because the Company has failed to present a detailed proposal for review, because collection of a new **surcharge** would be premature, and because the present case does not provide an appropriate context for review of a R&D **surcharge**, the Department does not approve the Company's proposed R&D **surcharge**.

B. Non-Firm Margins

1. Introduction

Boston Gas proposes to adjust the current mechanism, established in Interruptible Transportation Capacity Release, D.P.U. 93-141-A (1996), for calculating and sharing of the margins associated with interruptible transportation, interruptible sales, capacity release and off-system sales (Exh. KEDNE/JFB-1, at 48). [FN183] Specifically, the Company proposes to: (1) eliminate the separate categories of transactions; (2) eliminate the threshold structure of the margin-sharing framework; and (3) apply the 25/75 percent margin-sharing formula to total non-firm margins (*id.* at 52).

2. Positions of the Parties

a. Attorney General

The Attorney General states that there have been changes in the natural gas industry and in Massachusetts that could possibly support a change in the Department's policy with respect to the sharing of margins associated with interruptible transportation, interruptible sales, capacity release, and off-system sales (Attorney General Brief at 102-104). However, the Attorney General argues that these changes affect most of the LDCs in the state and are, therefore, better addressed in a generic proceeding in which all interested parties may be heard (*id.* at 104). The Attorney General, therefore, recommends that the Department open a generic investigation into the need for margin sharing, the changes that affect the categories of costs currently subject to margin sharing, and the development of a revised policy to provide appropriate cost mitigation and incentives (*id.*).

b. MOC

***200** The MOC did not address the Company's proposal to adjust the current margin sharing mechanism but argues, instead, that the Department should require the Company's new and existing interruptible customers to have sufficient backup supplies of alternative fuel for periods of interruption (MOC Brief at 38). The MOC requests that the Department require that Boston Gas' interruptible customers have minimum backup fuel for a period that the Department determines to be sufficient (*id.* at 42). In addition, the MOC proposes that new customers applying for interruptible service from the Company be required to have actual on-site storage and inventories prior to the commencement of the heating season, in an amount to be determined by the Department (*id.*).

c. Boston Gas

Attachment C

Ks.S.C.C. 2005

Re Gas Technology Institute Costs
Docket No. 04-GIMG-814-GIG

Kansas State Corporation Commission
October 11, 2005

***547** ORDER determining that a surcharge to fund the Gas Technology Institute (GTI) should not be included in natural gas rates. The commission is convinced of the benefits of research and development undertaken by GTI; however, it does not believe that mandatory funding is appropriate. Rather, the commission is persuaded that funding for GTI is better allocated voluntarily through the competitive marketplace.

P.U.R. Headnote and Classification

1.

EXPENSES
s48

Ks.S.C.C. 2005

[KAN.] Gas Technology Institute -- Mandatory ratepayer funding -- Grounds for denial.

Re Gas Technology Institute Costs

P.U.R. Headnote and Classification

2.

EXPENSES
s119.1

Ks.S.C.C. 2005

[KAN.] Research and development -- Gas Technology Institute -- Mandatory ratepayer funding -- Grounds for denial.

Re Gas Technology Institute Costs

P.U.R. Headnote and Classification

3.

EXPENSES
s125

Ks.S.C.C. 2005

[KAN.] Natural gas utilities -- Research and development -- Gas Technology Institute -- Mandatory ratepayer funding -- Grounds for denial.

Re Gas Technology Institute Costs

Before Moline, chair and Krehbiel and Moffet, commissioners.

BY THE COMMISSION:

**1 *ORDER DENYING FUNDING*

The above captioned matter comes before the State Corporation Commission of the State of Kansas (Commission) for consideration and decision. Having examined its files and records, and being duly advised in the premises, the Commission makes the following findings:

1. On March 16, 2004, the Commission issued its Order Initiating Investigation and Assessing Costs (Initiating Order) for purposes of determining whether a surcharge for the Gas Technology Institute (GTI) should be included in natural gas rates. Initiating Order, 6. On April 14, 2005, Staff filed its Report and Recommendation (Report), recommending that the Commission reject the funding request proposed by GTI. Report, 1. Staff attached to the Report a Memorandum, authored Staff analysts, Kristin Casarona and Leo Haynos (Memorandum).

2. On April 25, 2005, GTI filed its Reply Comments to Report (GTI Reply). On May 18, 2005, Kansas Gas Service, a division of ONEOK, Inc. (KGS), filed its Comments in Support of GTI Reply (KGS Comments). On May 19, 2005, the Citizen's Utility Ratepayer Board (CURB) filed its Reply Comments to Report (CURB Comments). On May 26, 2005, Aquila, Inc., d/b/a Aquila Networks -- KGO (Aquila) filed its Response to Report (Aquila Response). On May 26, 2005, Atmos Energy (Atmos) filed its Response to Report (Atmos Response).

3. On June 7, 2005, the GTI filed its Request for Hearing (Request). On August 30, 2005, the Commission issued its Order Scheduling Oral Arguments (Scheduling Order). In addition to summarizing the comments in reply to the Report, the Commission scheduled oral arguments for the matter to be conducted on September 14, 2005 (Tr.). At the hearing, Robert Fox appeared for GTI, Walker Hendrix appeared for Kansas Gas Service, James Flaherty appeared for Aquila, Inc. and Atmos Energy, Matt Tomc appeared for Staff, and David Springe appeared for CURB.

4. The Scheduling Order contained a summary of the parties written responses to the Report, and that discussion is hereby incorporated ***548** by reference. At the hearing, all parties were given an opportunity to present arguments. The commissioners asked questions of the attorneys who were able, in turn, to consult with any technical experts as needed when formulating responses.

[1-3] 5. After conducting the oral arguments and after reviewing the Report and responsive comments filed in this docket, the Commission concludes that GTI should not be funded through a mandatory surcharge on Kansas natural gas bills. As pointed out by Staff and CURB, (Tr., 56-57, 63), the issue in this docket is not whether research and development (R&D) is a good proposition, but, rather, the issue regards the appropriate source of funding for GTI R&D. The Commission is convinced of the benefits of R&D in the areas proposed by GTI; however, the Commission does not believe mandatory ratepayer funding is appropriate. The Commission finds persuasive arguments presented by CURB, (Tr., 52-53), that funding for GTI is better allocated voluntarily through the competitive market place.

6. The Commission finds persuasive arguments presented by Staff and CURB, (Tr. 50, 64), regarding the refusal of natural gas LDCs to accept Staff's alternative proposal for shareholders to supply a portion of the funding. The Commission agrees with CURB, (Tr., 60), that some of the GTI R&D benefits flow to the utility shareholders, not just the ratepayers.

7. The Commission also makes the decision in this docket regarding mandatory surcharges for natural gas customers in the context of high natural gas prices. *See* CURB Comments, 9-10. Further, as alluded to by Staff, (Tr., 63), given the high costs of natural gas, the Commission is hesitant to increase those costs without sufficient justifications. The Commission finds that sufficient justifications have not been made in this docket, and therefore concludes that Kansas natural gas ratepayers should not be saddled with the extra expense of the GTI funding surcharge.

****2** IT IS, THEREFORE, BY THE COMMISSION ORDERED THAT:

A. A mandatory surcharge for Kansas natural gas ratepayers for GTI funding is disapproved.

B. A party may file a petition for reconsideration of this order within 15 days of the service of this order. If this order is mailed, service is complete upon mailing and 3 days may be added to the above time frame.

C. The Commission retains jurisdiction over the subject matter and parties for the purpose of entering such further orders as it may deem necessary.

BY THE COMMISSION IT IS SO ORDERED.

Dated: Oct. 11, 2005

END OF DOCUMENT

Attachment D

Only the Westlaw citation is currently available.

SEE COURT OF APPEALS RULES 11 AND 12

Court of Appeals of Tennessee.
OFFICE OF The ATTORNEY GENERAL, CONSUMER ADVOCATE AND PROTECTION DIVISION
v.
TENNESSEE REGULATORY AUTHORITY.
No. M2004-01484-COA-R12-CV.

Assigned on Briefs Aug. 18, 2006.
Aug. 13, 2007.

Appeal from the Tennessee Regulatory Authority, No. 03-00625;Deborah Taylor Tate, Chairman.

Robert E. Cooper, Jr., Attorney General and Reporter; Vance L. Broemel, Senior Counsel; and Joe Shirley, Assistant Attorney General, for the appellants, Consumer Advocate and Protection Division of the Office of the Attorney General.
J. Richard Collier, General Counsel; and Jean A. Stone, Deputy Counsel, for the appellees, Tennessee Regulatory Authority.
R. Dale Grimes, Kristin J. Hazelwood, Guy M. Hicks, and Joelle Phillips, Nashville, Tennessee, for the appellee, BellSouth Telecommunications, Inc.

WILLIAM C. KOCH, JR., P.J., M.S., delivered the opinion of the court, in which WILLIAM B. CAIN and FRANK G. CLEMENT, JR., JJ., joined.

OPINION

WILLIAM C. KOCH, JR., P.J., M.S.
*1 This appeal is a continuation of a dispute between the Tennessee Regulatory Authority and the Consumer Advocate and Protection Division of the Office of the Attorney General regarding the procedure used by the Authority to approve certain tariffs filed by BellSouth Telecommunications, Inc. without convening a contested case hearing. While an appeal from the Authority's denial of a contested case hearing with regard to BellSouth's first tariff was pending, BellSouth filed a second, substantially similar tariff. The Authority denied the Division's request to convene a contested case hearing regarding the second tariff based on its earlier refusal to convene a contested case hearing regarding the first tariff. The Division appealed. The Authority suggests that the appeal is moot in light of this court's decision vacating the Authority's approval of the first tariff. We have determined that this appeal should not be dismissed for mootness. We have also determined that the Authority erred by basing its decision to deny the Division's request for a contested case hearing regarding the second tariff on its earlier decision to decline a contested case hearing with regard to the first tariff. Our invalidation of the process the Authority used to approve the first tariff prevents the Authority from using the same process in future cases.

I.

In January 2003, BellSouth Telecommunications, Inc. ("BellSouth") filed a tariff with the Tennessee Regulatory Authority ("Authority") to introduce its "Welcoming Reward Program." The purpose of the program was to encourage certain businesses in urban areas to shift their telephone service to BellSouth. A group of BellSouth's competitors and the Consumer Advocate and Protection Division of the Office of the Attorney General ("CAPD") petitioned the Authority to suspend the "Welcoming Reward Program" and to convene a contested case proceeding regarding the proposed tariff. The parties soon found themselves involved in a protracted series of discussions, conferences, and colloquies which are more fully described in a prior opinion of this court.[FN1] Eventually, the Authority denied the CAPD's request for a contested case hearing and its accompanying petition to suspend the tariff,[FN2] and the CAPD appealed the matter to this court. Meanwhile, the Welcoming Reward Program ran its course.

FN1. *Office of the Att'y Gen. v. Tenn. Regulatory Auth. (Welcoming Reward I)*, No. M2003-01363-COA-R12-CV, 2005 WL 3193684 (Tenn.Ct.App. Nov. 29, 2005) (No Tenn. R.App. P. 11 application filed).

FN2. The Authority was split on the matter. Chairman Sara Kyle and Director Deborah Taylor Tate voted to deny the contested case hearing. Director Ron Jones dissented.

On December 3, 2003, while *Welcoming Reward I* was pending with this court, BellSouth filed a new tariff with the Authority. Essentially, BellSouth sought to re-create its previous Welcoming Reward Program with a new promotion that would run from January 2, 2004 through June 30, 2004.[FN3]Once again, the CAPD filed a motion to intervene and requested that the Authority convene a contested case hearing. BellSouth responded that, because the new Welcoming Reward tariff was, in almost all respects, the same as the first Welcoming Reward tariff and because the Authority had refused to convene a contested case hearing in that matter, the Authority should similarly decline to convene a contested case hearing regarding the new tariff. The Authority agreed with BellSouth, and on May 6, 2004, issued an order allowing the tariff to go into effect.[FN4]The CAPD filed an appeal with this court, and BellSouth timely filed a notice of appearance. The second Welcoming Reward Program also ran its course.

FN3. The tariff, as revised, differed from the tariff in *Welcoming Reward I* in three relatively inconsequential respects: (1) the regions to which the tariff applied, (2) the amount of the rebate, and (3) the fact that customers needed to have only one telephone line to be eligible for the promotion.

FN4. The composition of the Authority's voting panel was slightly different this time, but the Authority's vote was again split. Chairman Deborah Taylor Tate and Director Pat Miller voted to deny the contested case hearing. Director Ron Jones once again dissented, noting that the issues raised regarding the first Welcoming Reward tariff were still pending before this court.

***2** On July 9, 2004, this court heard oral argument in *Welcoming Reward I.* On September 4, 2004, upon the joint request of the Authority and the CAPD, we issued an order staying proceedings in the current case until the disposition of *Welcoming Reward I.* We delivered our opinion in *Welcoming Reward I* on November 29, 2005 in which we determined that (1) even though the Welcoming Reward promotion had already ended, the case was not moot because it presented issues capable of repetition but which would otherwise evade judicial review,[FN5] and (2) the Authority had abused its discretion by refusing to convene a contested case hearing in the matter.[FN6]

FN5. *Welcoming Reward I,* 2005 WL 3193684, at *6.

FN6. *Welcoming Reward I,* 2005 WL 3193684, at *9-12.

On March 13, 2006, the CAPD filed a motion to lift the stay in this matter. BellSouth and the Authority responded by requesting that we enter an order remanding the case to the Authority for proceedings consistent with our opinion in *Welcoming Reward I.* We requested that the CAPD reply to BellSouth's and the Authority's response, and on April 12, 2006, we lifted the stay.

II.

The Authority and BellSouth argue that this case is now moot and should, therefore, be dismissed. The CAPD responds that this case, like *Welcoming Re-*

ward I, fits within an exception to the mootness doctrine. We agree with the CAPD.

At this point, the second Welcoming Reward tariff has expired, and there is no relief that this court can provide to the CAPD with regard to that particular tariff. In *Welcoming Reward I,* we determined that virtually identical facts fit the "capable of repetition yet evading review" exception to the doctrine of mootness. *Welcoming Reward I,* 2005 WL 3193684, at *5-6.Courts invoke this exception only where (1) there is a reasonable expectation that the official act that provoked the litigation will occur again, (2) there is a risk that effective judicial remedies cannot be provided in the event that the official act reoccurs, and (3) the same complaining party will be prejudiced by the official act when it reoccurs. *See Murphy v. Hunt,* 455 U.S. 478, 482, 102 S.Ct. 1181, 1183 (1982); *Alliance for Native Am. Indian Rights in Tenn., Inc. v. Nicely,* 182 S.W.3d 333, 339-340 (Tenn.Ct.App.2005).

The Authority argues that the facts of this case do not fit within the "capable of repetition yet evading review" exception to the mootness doctrine. It asserts that it now has the benefit of this court's decision in *Welcoming Reward I* and, therefore, that there can be no reasonable expectation that it will engage in similar conduct in the future. Certainly we presume that administrative agencies will act in accordance with the law. *See Estrin v. Moss,* 221 Tenn. 657, 677, 430 S.W.2d 345, 354 (1968); *Seawell v. Beeler,* 199 Tenn. 438, 443, 287 S.W.2d 54, 56 (1956). However, the Authority's argument that its decision to deny the CAPD's request for a contested case hearing in this case was appropriate solely because it was consistent with past precedent casts some cloud over the Authority's protestations that it has now abandoned the procedure we invalidated in *Welcoming Reward I.*

*3 In this case, the circumstances in *Welcoming Reward I* have repeated themselves almost exactly, and the three concerns we expressed regarding the initial case remain relevant now. First, the Authority has manifested an intent to follow in the future the procedure that it followed in both *Welcoming Reward I* and this case. Second, the short duration of the tariff at issue and ones like it make it almost impossible for this court to review similar decisions by the Authority until the tariffs have expired. Third, the Authority's procedure for determining whether or not to convene a contested case hearing could prejudice the interests of the CAPD. *See Welcoming Reward I,* 2005 WL 3193684, at *6. Accordingly, we have determined that this case fits within the exception to the mootness doctrine for issues that are capable of repetition but which will effectively evade judicial review.

III.

The CAPD argues that the Authority's refusal to convene a contested case hearing regarding the second Welcoming Reward tariff constituted an abuse of discretion. The Authority asserts that it properly relied upon its past procedure when it declined to open a contested case hearing.[FN7]We think the CAPD has the better argument.

> FN7. BellSouth did not address this issue in its brief before the court.

The Authority's determination regarding whether to open a contested case hearing in a matter is discretionary. Tenn.Code Ann. § 65-5-103 (2004); Tenn. Comp. R. & Regs. 1220-1-2-.02(4) (2003); *Consumer Advocate Div. v. Greer,* 967 S.W.2d 759, 763-64 (Tenn.1998). A party aggrieved by the Authority's refusal to convene a contested case hearing must file its appeal directly with this court. Tenn.Code Ann. § 4-5-322(b)(1)(B)(iii) (2005); *Welcoming Reward I,* 2005 WL 3193684, at *8. We review the Authority's decision to decline to stay or to open a contested case proceeding using the criteria set forth in Tenn.Code Ann. § 4-5-322(h) (2005); *Welcoming Reward I,* 2005 WL 3193684, at *8.[FN8] Therefore, we will reverse the Authority's decision to refuse to open a contested case hearing only if the Authority's action (1) violated constitutional or statutory provisions,[FN9] (2) was in excess of its statutory authority,[FN10] (3) utilized unlawful procedure,[FN11] (4) was arbitrary, capricious, or characterized by an abuse or clearly unwarranted use of discretion,[FN12] or (5) is unsupported by substantial and material evidence.[FN13]

> FN8. We have previously described many of these criteria as specific manifestations of conduct that, in other contexts, falls under the general rubric of an "abuse of discretion." *Welcoming Reward I,* 2005 WL 3193684, at *8, n. 20.
>
> FN9.Tenn.Code Ann. § 4-5-322(h)(1).
>
> FN10.Tenn.Code Ann. § 4-5-322(h)(2).
>
> FN11.Tenn.Code Ann. § 4-5-322(h)(3).
>
> FN12.Tenn.Code Ann. § 4-5-322(h)(4).
>
> FN13.Tenn.Code Ann. § 4-5-322(h)(5).

The Tennessee General Assembly has given the Authority essentially plenary power over the telecommunications services providers within its jurisdiction. *Consumer Advocate Div. v. Greer,* 967 S.W.2d at 762, and no statute or regulation prescribes specific factors the Authority must consider when deciding whether to dismiss a complaint seeking a contested case proceeding regarding a proposed tariff. *Welcoming Reward I,* 2005 WL 3193684, at *9. While the Authority's enabling statutes are to be liberally construed, Tenn.Code Ann. §§ 65-2-121, 65-4-106 (2004), the Authority's discretion cannot extend beyond the boundaries established by the statutes and constitutional provisions that govern its actions. *See BellSouth Telecommunications, Inc. v. Greer,* 972 S.W.2d 663, 680 (Tenn.Ct.App.1997); *Tenn. Cable Television Ass'n v. Tenn. Pub. Serv. Comm'n,* 844 S.W.2d 151, 161-62 (Tenn.Ct.App.1992).

*4 The Authority asserts that it is entitled to rely on its decisions in previous cases when it is deciding whether to convene a contested case hearing. Therefore, it argues that its decision not to convene a contested case hearing in this case cannot be an abuse of discretion because it had already determined in an earlier proceeding involving essentially the same issues that convening a contested case proceeding was not warranted. The Authority relies on *Consumer Advocate Division v. Tennessee Regulatory Authority,* No. M1999-01170-COA-R12-CV, 2001 WL 575570 (Tenn.Ct.App. May 30, 2001) (No Tenn. R.App. P. 11 application filed) to support its argument. Its reliance is misplaced.

In *Consumer Advocate Division v. Tennessee Regulatory Authority,* the CAPD and BellSouth were at odds over BellSouth's desire to charge customers for directory assistance in spite of a prior settlement agreement between the parties regarding the charges. The Authority determined that the CAPD had already litigated the same issues in two previous cases that were then pending on appeal and that the settlement agreement at issue before the Authority was not binding on the parties. *Consumer Advocate Div. v. Tenn. Regulatory Auth.,* 2001 WL 575570, at *1-3.After making its findings, the Authority declined to convene a contested case hearing. We affirmed the Authority's decision. *Consumer Advocate Div. v. Tenn. Regulatory Auth.,* 2001 WL 575570, at *6.

Our decision to uphold the Authority's actions in *Consumer Advocate Division v. Tennessee Regulatory Authority* was not premised merely upon the fact that the Authority had previously heard the issues presented in the case. Rather, we determined that the Authority did not abuse its discretion when it declined to convene a contested case hearing after it determined as a matter of law that the breach of contract claim before it failed to state a claim upon which relief could be granted and then determined that it had previously decided the remaining issues in the matter. *Consumer Advocate Div. v. Tenn. Regulatory Auth.,* 2001 WL 575570, at *6. We restated this reasoning in *Welcoming Reward I* when we noted that in the previous two cases in which the courts had reviewed the Authority's denial of a contested case hearing, [FN14]"the Authority was not required to resolve any disputed factual issues regarding the nature or effect of the challenged tariff, nor was it required to resolve new legal or policy questions. The complaints were subject to dismissal as a matter of law." *Welcoming Reward I*, 2005 WL 31936845, at *9.

FN14. The two cases were *Consumer Advocate Division v. Tennessee Regulatory Authority* and *Consumer Advocate Division v. Greer.*

Welcoming Reward I, however, presented circumstances quite different from *Consumer Advocate Division v. Tennessee Regulatory Authority*.In the litigation surrounding the first Welcoming Reward tariff, we pointed out several missteps by two of the Authority's directors that resulted in the CAPD being prevented from having a full and fair hearing on its petition. We noted that two of the three directors used their ability to convene a contested case hearing as leverage to induce BellSouth to revise its tariff. The two directors also erroneously treated questions of fact as questions of law and, despite a lack of evidence in the record, concluded that BellSouth's tariff did not result in discriminatory prices. The two-director majority also failed to address the CAPD's assertion that certain aspects of the Welcoming Reward tariff were anti-competitive. *Welcoming Reward I*, 2005 WL 3193684, at *10-11.Taking all the circumstances into consideration, we determined that the Authority had abused its discretion by dismissing the petitions to suspend the tariff and by declining to convene a contested case hearing because it acted without proper consideration of the factual issues raised by the intervening complaints. *Welcoming Reward I*, 2005 WL 3193684, at *11.

*5 The Authority's only justification for refusing to convene a contested case hearing in this matter is that it had in the past considered a virtually identical request-the first Welcoming Reward tariff-and rejected it. Our decision in *Welcoming Reward I* pointed out that the Authority's procedure in that matter was riddled with error. Because the Authority's decision in *Welcoming Reward I* was vacated, the reversal of the Authority's order undermines any substantive or procedural reliance that the Authority otherwise might have been entitled to claim with regard to having already heard and decided the issues CAPD is seeking to raise in this proceeding. The Authority received no evidence and conducted no inquiry into the CAPD's claims that the tariff in this matter was discriminatory and anti-competitive. Instead, it adopted its findings in the prior proceedings involving the first Welcoming Reward tariff which were procedurally deficient. While it is true that the Authority did not have the benefit of our decision in *Welcoming Reward I* when it decided this case, the Authority cannot be allowed to transform its past abuse of discretion into binding precedent. We find that the Authority's refusal to convene a contested case hearing constituted an unwarranted use of its discretion.

IV.

As a final matter, the CAPD has asked us to clarify a footnote in our filed opinion in response to the petitions for rehearing in *Welcoming Reward I*, which referred to a new law affecting proceedings before the Authority arising after July 1, 2004.[FN15]Neither *Welcoming Reward I* nor this matter arose after July 1, 2004. Therefore, we decline to speculate as to the future application of a new law to a tariff that has not yet been filed. We tax the costs of this appeal in equal proportions to the Office of the Attorney General and the Tennessee Regulatory Authority.

FN15. This footnote stated that "[t]his result could conceivably have been different had this proceeding taken place after July 1, 2004 because Tenn.Code Ann. § 65-5-101(c)(3)(C)(i) (2006 Supp.) would have required the complaining party to demonstrate a 'substantial likelihood of prevailing on the merits of its complaint....' " Opinion on Petition for Rehearing, *Office of the Atty. Gen. v. Tenn. Regu-*

latory Auth., No. M2003-01363-COA-R12-CV, at n. 2 (Tenn.Ct.App. Dec. 21, 2005).

Tenn.Ct.App.,2007.
Office of Atty. Gen., Consumer Advocate and Protection Div. v. Tennessee Regulatory Authority
Slip Copy, 2007 WL 2316458 (Tenn.Ct.App.)

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Attachment E

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Only the Westlaw citation is currently available.

SEE COURT OF APPEALS RULES 11 AND 12

Court of Appeals of Tennessee.
UNITED TELEPHONE-SOUTHEAST, INC.,
v.
TENNESSEE REGULATORY AUTHORITY.
No. M1999-02801-COA-R12-CV.

March 20, 2001.
Appeal Denied Sept. 10, 2001.

Appealed from the Tennessee Regulatory Authority, No. 97-01438;Melvin Malone, Chairman.

R. Dale Grimes, Nashville, TN, James B. Wright, Wake Forest, NC, for appellant, United Telephone-Southeast.
H. Edward Phillips, III, Nashville, TN, for appellee, Tennessee Regulatory Authority.
Paul G. Summers, State Attorney General, Michael E. Moore, Solicitor General, Vance L. Broemel, Assistant Attorney General, Nashville, TN, for appellee, Consumer Advocate.

COTTRELL, J., delivered the opinion of the court, in which CANTRELL, P.J., M.S., and KOCH, J., joined.

OPINION

COTTRELL.
*1 United Telephone-Southeast, Inc. challenges a decision of the Tennessee Regulatory Authority denying a rate increase for residential integrated services digital network (ISDN) services on the ground that ISDN is a basic service under Tenn.Code Ann. § 65-5-208(a). Because ISDN provides functionality additional to the provision of basic services, we reverse.

United Telephone-Southeast, Inc. ("United") appeals from a final decision of the Tennessee Regulatory Authority ("TRA") entered November 30, 1998, wherein the TRA denied a rate increase for integrated services digital network (ISDN) services on the ground that ISDN is a basic service under Tenn.Code Ann. § 65-5-208(a).

In 1995, the General Assembly enacted sweeping changes in the regulation of the providers of telecommunications services in Tennessee. Among the changes was the creation of a new method of rate setting as an alternative to the existing "rate of return" regulation by the TRA. Under the new legislation, a provider of telecommunications services could elect the new alternative "price regulation plan" methodology. Tenn.Code Ann. § 65-5-209. United made such an election effective October 15, 1995.

After the initial qualification of a price regulation plan, a provider's ability to increase rates for services is subject to limitations established by statute. *See*Tenn.Code Ann. § 65-5-209. Essentially, Tenn.Code Ann. § 65-5-209(e) authorizes a price regulated company to increase rates for services within a maximum annual adjustment tied to inflation. However, the legislature prohibited increases in rates for certain services for a time after implementation of the new rate setting methodology. A provider's "initial basic local exchange telephone service rates ... shall not increase for a period of four (4) years" from the date the provider became subject to a price regulation plan. Tenn.Code Ann. § 65-5-209(f). On the other hand, increases in non-basic services are not so limited. Tenn.Code Ann. § 65-5-209(h).

The designation of a particular service as either basic or non-basic also has effects beyond the first few years. A provider's rate changes are limited by an overall maximum annual adjustment, and a provider "may adjust its rates for basic local exchange telephone services or non-basic services only so long as its aggregate revenues for [such] services generated by such changes do not exceed the aggregate revenues generated by the maximum rates permitted by the price regulation plan."Tenn.Code Ann. § 65-5-209(e). While this approach provides flexibility in the percentage increases or decreases for specific services within the aggregate revenues limitation, that flexibility is limited with regard to basic services by the four-year prohibition on increases. In addition,

[a]t the expiration of the four-year period, an incumbent local exchange telephone company [FN1] is permitted to adjust annually its rates for basic local exchange telephone services in accordance with the method set forth in subsection (e) provided that in no event shall the rate for residential basic local exchange telephone service be increased in any one (1) year by more than the percentage change in inflation for the United States using the gross domestic product-price index (GDP-PI) from the preceding year as the measure of inflation.

FN1. "Incumbent local exchange telephone company" is a term defined in Tenn.Code Ann. § 65-4-101(d) and is distinguished from a "competing telecommunications service provider" by whether the company was providing local services before June 6, 1995, or was certified to provide such services after that date. *See*Tenn.Code Ann. § 65-4-101(e). Because all the parties to this action agree that United is subject to the four-year freeze on basic services in Tenn.Code Ann. § 65-5-209(f), we presume it is an "incumbent local exchange telephone company" for purposes of application of all provisions in Tenn.Code Ann. § 65-5-209(f).

***2** Tenn.Code Ann. § 65-5-209(f).

Thus, a service classified as basic is subject to limitations on increases in rates beyond the first four years, and those limitations are not applicable to services which are non-basic.

United filed a tariff in September of 1997 in which it proposed rate increases for a number of services, including residential ISDN.[FN2]A contested case proceeding was held, with the Consumer Advocate intervening. From the beginning of the proceedings below, the primary issue in dispute was whether ISDN services are basic services, the rates for which could not be increased at that time. In November of 1998, the TRA issued its order classifying ISDN service as basic service under the statutory definition of "basic local exchange telephone services" found in Tenn.Code Ann. § 65-5-208(a)(1). That definition reads:

FN2. Residential ISDN rates would increase from approximately $25 per month to either $65 or $85 per month, depending on the type of contract the consumer chose. There is no dispute that the remainder of the increases and decreases in rates for specific services complied with the overall maximum annual adjustments allowed under Tenn.Code Ann. § 65-5-209(e).

"Basic local exchange telephone services" are telecommunication services which are comprised of an access line, dial tone, touch-tone and usage provided to the premises for the provision of two-way switched voice or data transmission over voice grade facilities of residential customers or business customers within a local calling area, Lifeline, Link-Up Tennessee, 911 Emergency Services and educational discounts existing on June 6, 1995, or other services required by state or federal statute. These services shall, at a minimum, be provided at the same level of quality as is being provided on June 6, 1995. Rates for these services shall include both recurring and nonrecurring charges.
Tenn.Code Ann. § 65-5-208(a)(1).

I.

The standard for reviewing administrative agency decisions in contested case hearings under the Administrative Procedures Act is set out in Tenn.Code Ann. § 4-5-322. Generally, a court may reverse or modify an agency decision if that decision is arbitrary or capricious, characterized by an abuse or a clearly unwarranted exercise of discretion, unsupported by substantial and material evidence, or if the decision exceeds the statutory authority of the agency. Tenn.Code Ann. § 4-5-322(h)(2); *Sanifill of Tennessee Inc. .. v. Tennessee Solid Waste Disposal Control Bd.,* 907 S.W.2d 807, 810 (Tenn.1995), *Tennessee Cable Television Ass'n. v. Tennessee Pub. Serv. Comm'n.,* 844 S.W.2d 151, 163 (Tenn.Ct.App.1992).

This is not a broad, *de novo* review; it is restricted to the record, and courts should not substitute their judgment for that of an agency as to the weight of the evidence on factual issues. *Sanifill of Tennessee Inc.,* 907 S.W.2d at 810. However, it is the role of the courts to interpret statutes.*Id.* The construction of a statute and the application of the law to the facts are questions of law and, thus, properly the province of the judiciary.*Id.*"The search for the meaning of statutory language is a judicial function." *Bellsouth Telecommunications, Inc. v. Greer,* 972 S.W.2d 663, 672 (Tenn.Ct.App.1997).

In reviewing the TRA's interpretation of Tenn.Code Ann. § 65-5-208(a)(1), we are guided by familiar principles of statutory construction.

***3** The role of this Court in construing statutes is to ascertain and give effect to legislative intent. Whenever possible, legislative intent is to be ascertained from the natural and ordinary meaning of the language used, without forced or subtle construction that would limit or extend the meaning of the language. We must avoid strained constructions which would render portions of the statute inoperative or void. Instead, we must apply a reasonable construction in light of the purposes and objectives of the statutory provision. Finally, a state agency's interpretation of a statute that the agency is charged to enforce is entitled to great weight in determining legislative intent.

Consumer Advocate Div. v. Greer, 967 S.W.2d 759, 761 (Tenn.1998) (citations omitted).

II.

We begin with the purpose underlying the legislature's limitations on rate increases for basic services. The legislature has given us a statement of its intent in enacting the broad changes in telecommunications regulation in 1995.

The general assembly declares that the policy of this state is to foster the development of an efficient, technologically advanced, statewide system of telecommunications services by permitting competition in all telecommunications services markets, and by permitting alternative forms of regulation for telecommunications services and telecommunications services providers. To that end, the regulation of telecommunications services and telecommunications services providers shall protect the interests of consumers without unreasonable prejudice or disadvantage to any telecommunications services provider; universal service shall be maintained; and rates charged to residential customers for essential telecommunications services shall remain affordable.

Tenn.Code Ann. § 65-4-123.

The final two provisions establish the guiding principles applicable to our analysis: that universal service be maintained and that residential rates for essential services remain affordable. We interpret the limitations on rate increases for basic services as fulfilling the goal of maintaining affordable rates for residential essential services. Thus, we conclude that the legislature intended that "basic" services have some correlation to "essential" services.

We also interpret the legislature's declaration of state telecommunications policy as reflecting a relationship between universal service and basic services. In addition, the General Assembly has specifically related the two concepts:

Universal service, consisting of residential basic local exchange telephone service at affordable rates and carrier-of-last-resort obligations must be maintained after the local telecommunications markets are opened to competition. In order to ensure the availability of affordable residential basic local exchange telephone service, the authority shall formulate policies, promulgate rules and issue orders which require all telecommunications service providers to contribute to the support of universal service.

***4** Tenn.Code Ann. § 65-5-207(a).[FN3]

> FN3. The remaining provisions of that statute require the TRA to "determine the cost of providing universal service, determine all current sources of support for universal service and their associated amounts, identify and assess alternative universal service support mechanisms, and determine the need and timetable for modifying current universal service support mechanisms and implementing alternative universal service support mechanisms."Tenn.Code Ann. § 65-5-207(b). In considering an alternative universal service support mechanism, the TRA must consider, at a minimum, "[t]he amount by which the embedded cost of providing residential basic local exchange telephone service exceeds the revenue received from the service, including the cost of the carrier-of-last-resort obligation, for both high and low-density service areas."Tenn.Code Ann. § 65-5-207(c)(8)(i).

Universal service refers to the national policy underlying the creation of the Federal Communications Commission, "to make available, so far as possible, to all the people of the United States ... a rapid, efficient, Nation-wide ... wire and radio communication service with adequate facilities and at reasonable charges."47 U.S.C. § 151. The Universal Service Fund [FN4] was designed to further the objective of making communications services available to all Americans at reasonable charges. *Rural Tel. Coalition v. FCC,* 838 F.2d 1307, 1315 (D.C.Cir.1988). The FCC has the responsibility of overseeing use of the Fund and has determined that its use should be restricted to ensuring that "telephone rates are within the means of the average subscriber."*Id.* (quoting *Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board,* 96 F.C.C.2d 781, 795 (1984)).

> FN4. Payments into the fund are distributed to those providers who furnish the services designated for universal service support in order to offset the cost of providing telephone service at reasonable rates in rural and high cost areas. *See*47 U.S.C. § 254.

The FCC has been charged with designating which services should be supported by federal universal service support mechanisms. 47 U.S.C. § 254(c)(1). While the Telecommunications Act of 1996 recognizes that universal service is an evolving level of services, the Act requires the FCC, in identifying those services eligible for support, to consider the extent to which the services: (1) are essential to education, public health, or public safety; (2) have, through the operation of market choices by customers, been subscribed to by a substantial majority of residential customers; (3) are being deployed in public telecommunications networks by telecommunications carriers; and (4) are consistent with the public interest, convenience and necessity. 47 U.S.C. § 254(c)(1).

The FCC has interpreted this directive as requiring that each of the four criteria must be considered, but not necessarily met, before a service may be included within the general definition of universal service. *In Re Federal-State Joint Board on Universal Service,* CC Docket No. 96-45, Report and Order (rel. May 8, 1997) at ¶ 61. In addition, the FCC has determined that defining the eligible services in a functional sense is preferred because it is technology-neutral and provides more flexibility. The "core" or "designated" services that will receive universal service support are:

Single-party service: voice grade access to the public switched network; Dual Tone Multifrequency ("DTMF") signaling or its functional equivalent; access to emergency services including, in some circumstances, access to 911 and Enhanced 911 ("E911"); access to operator services; access to interexchange service; access to directory assistance; and toll limitation services for qualifying low-income consumers, ... In order to receive universal service support, eligible carriers must offer each of the designated services.

Id. at ¶ 56.

In applying the criteria it was directed to consider, the FCC discussed various services under consideration, and part of that discussion has particular relevance to the issues before us:

***5** [W]e conclude that voice grade access includes the ability to place calls, and thus incorporates the ability to signal the network that the caller wishes to place a call. Voice grade access also includes the ability to receive calls, and thus incorporates the ability to signal the called party that an incoming call is coming. We agree that these components are necessary to make voice grade access fully beneficial to the consumer. We ... adopt the ... finding that ... voice grade access to the public switched network is an essential element of telephone service, is subscribed to by a substantial majority of residential customers, and is being deployed in public telecommunications networks by telecommunications carriers. In addition, we find voice grade access to be essential to education, public health, and public safety because it allows consumers to contact essential services such as schools, health care providers and public safety providers. For this reason, it is also consistent with the public interest, convenience, and necessity.

Id. at ¶ 63.

The FCC has also adopted a definition of voice-grade access in terms of frequency ranges.[FN5]In response to arguments that higher bandwidths should be adopted, the FCC concluded that, except with respect to schools, libraries and health care providers elsewhere covered by universal service,

FN5. In a later report and order, the FCC reconsidered its earlier specification of a bandwidth for voice grade access and changed that definition, replacing 500 Hertz to 4000 Hertz with 300 to 3000 Hertz. The FCC explained that its earlier specification was more exacting than industry standards and that it had not intended to impose more onerous standards. Adopting a narrower bandwidth definition for voice grade access was done to avoid disentitling otherwise eligible providers from support. *In re Federal-State Joint Board on Universal Service,* CC Docket No. 96-45, Fourth Order on Reconsideration (rel. Dec. 30, 1997) at ¶ 16.

voice grade access, and not high speed data transmission is the appropriate goal of universal service policies at this time because we are concerned that supporting an overly expansive definition of core services could adversely affect all consumers by increasing the expense of the universal service program and, thus, increasing the basic cost of telecommunications services for all. As discussed above, voice grade access is subscribed to by a substantial majority of residential customers, and is being deployed in public telecommunications networks by telecommunications carriers. In contrast, the record in this proceeding does not demonstrate that the higher bandwidth services and data transmission capabilities advocated are, at this time, necessary for the public health and safety and that a substantial majority of residential customers currently subscribe to these services.
Id. at ¶ 64.

We are of the opinion that the General Assembly's placing of stricter limitations on rate increases for basic services was, like the Universal Service Support Fund, intended to ensure that the average customer could obtain telephone service at reasonable rates. Thus, the FCC's approach to universal service is instructive.

III.

ISDN is a network architecture involving digital communications transmission. It provides residential and business customers with two voice-grade channels and one low speed data channel over a single line. The voice and data channels can be used simultaneously.

In determining that ISDN is a basic service, the TRA considered each of the criteria in the statutory definition. It found that ISDN consists of an access line, dial tone, touch-tone and usage provided to the premises for the provision of two-way switched voice or data transmission over voice-grade facilities. In so finding, the TRA defined voice-grade facilities as meaning "capable of handling voice communications" and found that "ISDN provides voice communication, in fact a higher quality voice communication than non-ISDN lines."Thus, the agency declined to adopt a more restrictive definition, such as the FCC's definition of voice-grade facilities.

***6** The TRA concluded that ISDN service is a technological advancement that is the logical evolution of the public switched telephone network. In essence, the TRA determined that any service which provides the basics (dial tone, two-way communication, etc.) will be considered basic service regardless of the additional features it provides. We do not agree that such was the intent of the legislature.

The parties have made various arguments about the technology involved; however, we think the issue is one of function, not technology. The requirements regarding both universal service and basic services were established to ensure access to telephone communication to average telephone consumers at reasonable costs. While we do not disagree that the developments in technology which improve the delivery or quality of telephone service may and should benefit the average telephone user, we think the legislature was primarily concerned with protecting the delivery of fundamental telephone communication capabilities when it defined basic services. We must presume that the legislature said what it meant, *Worley v.. Weigel's, Inc.*, 919 S.W.2d 589, 593 (Tenn.1996), and must give effect to its choice of the words "basic" and "essential."

ISDN provides more than basic or fundamental telephone communications. It allows simultaneous transmission of voice and data. Nothing in the record before us supports a conclusion that this functionality is critical to the average telephone consumer. To the contrary, at the time of the hearing, only 129 of the more than 170,000 residential customers of United subscribed to ISDN. Those consumers have chosen ISDN for their unique needs at a monthly cost which is already in excess of basic telephone services.[FN6]We see little difference between this situation and the option given to consumers who want call waiting, call forwarding, or other additional functions which are, without dispute, clearly not included in basic services. These options do not implicate the legislature's efforts to guarantee that consumers are able to get basic services at reasonable rates which cannot increase at a greater rate than inflation.

> FN6. The record indicates that ISDN cost approximately $25 per month at the time of the hearing, and basic service cost approximately $12 per month.

We conclude that ISDN is not a basic service within Tenn.Code Ann. § 65-5-208(a)(1) and, consequently, not included in the limitations on rate increases in Tenn.Code Ann. § 65-5-209(f). Accordingly, we reverse the decision of the Tennessee Regulatory Authority and remand this case for appropriate further proceedings which may be necessary. Costs of this appeal are taxed equally to the Tennessee Regulatory Authority and the Consumer Advocate.

Tenn.Ct.App.,2001.
United Telephone-Southeast, Inc. v. Tennessee Regulatory Authority
Not Reported in S.W.3d, 2001 WL 266051 (Tenn.Ct.App.)

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Attachment F

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Only the Westlaw citation is currently available.

SEE COURT OF APPEALS RULES 11 AND 12

Court of Appeals of Tennessee.
BELLSOUTH BSE, INC.,
v.
TENNESSEE REGULATORY AUTHORITY.
No. M2000-00868-COA-R12-CV.

Feb. 18, 2003.

Tennessee Regulatory Authority, No. 98-00879.

Guilford F. Thornton, Jr., Nashville, Tennessee, for the appellant, Bellsouth BSE, Inc.
Henry Walker, Nashville, Tennessee, for the appellees, MCI WorldCom, Southeastern Competitive Carriers Association, Time Warner Communications of the South, L.P., and U.S. LEC of Tennessee, Inc.
J. Richard Collier, Jonathan N. Wike, Nashville, Tennessee, for the appellee, Tennessee Regulatory Authority.

PATRICIA J. COTTRELL, J., delivered the opinion of the court, in which BEN H. CANTRELL, P.J., M.S., and WILLIAM C. KOCH, JR., joined.

OPINION

PATRICIA J. COTTRELL, J.
*1 BellSouth BSE, Inc. appeals from an order of the Tennessee Regulatory Authority denying BSE's application for certification as a competing local exchange company in those areas where BSE's affiliate, BellSouth Telecommunications, is the incumbent provider of local services. Because the TRA denied the petition on the basis that such certification may be inconsistent with the goal of fostering competition and could be potentially adverse to competition, as opposed to establishing conditions or requirements designed to ensure that anti-competitive practices did not occur, we vacate the order as beyond the agency's statutory authority.

Before the state legislature made significant changes in the law governing telecommunications services in 1995, local telephone service was provided to consumers in a locality by one company under a regulated monopoly system. The adoption of the Tennessee Telecommunication Act, 1995 Tenn. Pub. Acts 408 (effective June 6, 1995), abolished monopolistic control of local telephone service and opened that market to competition. It also changed the way in which providers of such services, and the rates they charge, were regulated.

As part of the implementation of local service competition, a company which was providing basic local exchange telephone service, as defined by statute, prior to June 6, 1995, was designated as the "incumbent local exchange telephone company," or ILEC. Tenn.Code Ann. § 65-4-101(d). New entrants into the market after June 6, 1995, were known as "competing telecommunications service providers" or CLECs. Tenn.Code Ann. § 65-4-101(e). To become a CLEC, a provider is required to be certificated pursuant to Tenn.Code Ann. § 65-4-201, which provides in pertinent part:

After notice to the incumbent local exchange telephone company and other interested parties and following a hearing, the authority shall grant a certificate of convenience and necessity to a competing telecommunications service provider if after examining the evidence presented, the authority finds:

(1) The applicant has demonstrated that it will adhere to all applicable authority policies, rules and orders; and

(2) The applicant possesses sufficient managerial, financial and technical abilities to provide the applied for services.

Tenn.Code Ann. § 65-4-201(c).

BellSouth BSE, Inc. applied for a certificate as a CLEC (First Application) to provide local telephone services on a statewide basis. BellSouth BSE, Inc. is a wholly owned subsidiary of BellSouth BSE Corporation which, in turn, is a wholly owned subsidiary of BellSouth Corporation. BellSouth Telecommunications ("BST"), another wholly-owned subsidiary of BellSouth Corporation, is the incumbent local exchange provider for portions of Tennessee. The Tennessee Regulatory Authority ("TRA") granted BellSouth BSE, Inc. ("BSE") authority to provide local services only in those territories where its affiliate, BST, was not the ILEC. The TRA concluded that the potential for anticompetitive harm outweighed the benefits to consumers if BSE were permitted to operate as a CLEC in those areas where its affiliate was providing local service as the ILEC.

*2 BSE, however, was invited to re-open the issue if at any time in the future it believed it could "carry the public interest burden herein raised and alleviate the Agency's concerns with regard to Tenn.Code Ann. § 65-5-208(c)...." BellSouth BSE, Inc. did just that and sought expanded authority to operate as a CLEC (Second Application). Competitors were allowed to intervene, [FN1] and a hearing was held. The TRA denied the petition. It is that denial which is the subject of this appeal.

> FN1. The intervenors who are also appellees in this appeal are MCI WorldCom, Inc., Southeastern Competitive Carriers Association, Time Warner Telecom of the Mid-South, L.P., and U.S. LEC of Tennessee, Inc.

BSE did not propose to offer any services that could not be offered by BST. BSE intended to provide "any and all services that are or may be provided by a local exchange carrier."

I. The TRA's Concerns

In denying BSE's application for a certificate of convenience and necessity to provide expanded intrastate telecommunications services, the TRA recounted that the Second Application proceedings were held to provide BSE the opportunity to alleviate the concerns which led to the TRA's order on the First Application. Those concerns are related to the potential for anticompetitive behavior and the potential for BST to avoid controls imposed upon it because of its status as an ILEC, as well as its status under federal law as a "Bell operating company," through the use of an affiliate. The TRA expressed several specific areas of concern, which can only be examined in the context of the regulatory framework, both state and federal, for telecommunication services providers.

By enactment of the Telecommunications Act of 1996, Congress made fundamental changes in local telephone markets by, among other things, prohibiting states from enforcing laws that impede competition. In order to facilitate the transition from regulated monopolies to true competition, the Act imposes upon the incumbent provider or ILEC, who formerly enjoyed the monopoly, a number of duties intended to facilitate entry into the market by other, formerly excluded, providers. *AT & T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 371-72, 119 S.Ct. 721, 726-27 (1999). As more specifically ex- plained:

Until the passage of the 1996 Act, state utility commissions continued to regulate local telephone service as a natural monopoly. Commissions typically granted a single company, called a local exchange carrier (LEC), an exclusive franchise to provide telephone service in a designated area. Under this protection the LEC built a local network-made up of elements such as loops (wires), switches, and transmission facilities-that connects telephones in the local calling area to each other and to long distance carriers.

The 1996 Act brought sweeping changes. It ended the monopolies that incumbent LECs held over local telephone service by preempting state laws that had protected the LECs from competition. *See*47

U.S.C. § 253. Congress recognized, however, that removing the legal barriers to entry would not be enough, given current technology, to make local telephone markets competitive. In other words, it is economically impractical to duplicate the incumbent LEC's local network infrastructure. To get around this problem, the Act allows potential competitors, called competing local exchange carriers (CLECs), to enter the local telephone market by using the incumbent LEC's network or services in three ways. First, a CLEC may build its own network and "interconnect" with the network of an incumbent. *See id.* § 251(c)(2). Second, a CLEC may lease elements (loops, switches, etc.) of an incumbent LEC's network "on an unbundled basis." *See id.* § 251(c)(3). Third, a CLEC may buy an incumbent LEC's retail services "at wholesale rates" and then resell those services to customers under its (the CLEC's) brand. *See id.* § 251(c)(4).

***3** *GTE South, Inc. v. Morrison*, 199 F.3d 733, 737 (4th Cir.1999).

This access is accomplished through an interconnection agreement between the ILEC and a CLEC. In addition, an ILEC is required to provide access to its network elements and various services and to provide dialing parity to competing providers on a nondiscriminatory basis. 47 U.S.C. §§ 251(c)(3) & 251(b)(3). The FCC has promulgated rules and policies implementing those provisions "to require incumbent LECs to provide competition with access to the incumbent LECs' networks sufficient to create a competitively neutral playing field for new entrants...."*In Re Implementation of the Telecommunications Act of 1996, Third Report and Order* in CC Docket No. 96-115,*Second Order on Reconsideration of the Second Report and Order* in CC Docket No. 96-98, and *Notice of Proposed Rulemaking* in CC Docket No. 99-273, at ¶ 6 (rel. Sept. 9, 1999).

Under state law, all providers are required to provide non-discriminatory interconnection to their public networks under reasonable terms and conditions, and all are to be provided "desired features, functions and services promptly, and on an unbundled and non-discriminatory basis from all other telecommunications providers."Tenn.Code Ann. § 65-4-124(a).

At the state level, incumbent providers are also governed by specific provisions, again designed to facilitate entry into the local telephone service market by competitors. For example, rates to be charged by incumbent providers opting to be under a price regulation plan are subject to a requirement that such rates be just and reasonable, defined as "affordable", as determined by the TRA. Tenn Code Ann. § 65-5-209(a). These rates are subject to limitations, including safeguards to ensure universal service and nondiscrimination among customers. Tenn.Code Ann. § 65-5-209(b).

After the initial qualification of a price regulation plan, an ILEC's ability to increase rates is subject to limitations. Essentially, a price regulated ILEC can adjust rates for specific services subject to an overall maximum annual adjustment to aggregate revenues for such services. Tenn.Code Ann. § 65-5-209(e). However, rates for basic services cannot be increased for four (4) years after implementation of the plan, and annual increases for basic services are thereafter limited to annual rates of inflation. Tenn.Code Ann. § 65-5-209(f).

ILECs not under a price regulation plan are subject to traditional rate regulation. ILECs have unique, carrier-of-last-resort obligations and universal service obligations. Tenn.Code Ann. § 65-5-207(c)(2) & (8). ILECs, upon request, are required to provide interconnection services to CLECs.Tenn.Code Ann. § 65-5-209(d). None of these burdens apply to CLECs.

Another requirement for ILECs which was the subject of argument herein and part of the TRA's reasoning is that found in Tenn.Code Ann. § 65-5-208(c), which provides:

Effective January 1, 1996, an incumbent local exchange telephone company shall adhere to a price floor for its competitive services subject to such determination as the authority shall make pursuant to § 65-5-207.[FN2]The price floor shall equal the incumbent local exchange telephone company's tariffed rates for essential elements utilized by competing telecommunications service providers plus the total long-run incremental cost of the competitive elements of the service. When shown to be in the public interest, the authority shall exempt a service or group of services provided by an incumbent local exchange telephone company from the requirement of the price floor. **The authority shall, as appropriate, also adopt other rules or issue orders to prohibit cross-subsidization, preferences to competitive services or affiliated entities, predatory pricing, price squeezing, price discrimination, tying arrangements or other anticompetitive practices.**

FN2.Tenn.Code Ann. § 65-5-207 authorizes the TRA to establish policies, rules, and orders requiring all telecommunications service providers to contribute to the support of universal service, which consists of residential basic local exchange telephone service at affordable rates and carrier-of-last-resort obligations.

***4** (emphasis added).

It is the highlighted language which provides the primary basis for the TRA's denial of BSE's application for CLEC status in those areas where its affiliate is the incumbent provider. The TRA expressed concerns that the relationship between BSE and BST fostered the potential for the enumerated, or other, anticompetitive activities, as well as the opportunity for BST to avoid the limitations placed on it as an ILEC. The six concerns, or issues for resolution, expressed by the TRA were:

1. Whether there exists the potential for discriminatory treatment of other CLECs or for preferential treatment of BSE by BellSouth when there are no safeguards being offered to monitor affiliate transactions or performance;

2. Whether BellSouth seeks to avoid its ILEC obligations through BSE's ability to select BellSouth's best customers and offer special deals that BellSouth cannot offer due to statutory prohibitions;

3. Whether there exists the potential for the prohibited acts of price squeezing and cross-subsidization;

4. Whether in the solicitation of BellSouth business customers by BSE, those customers will continue to be offered the same services under the same utility's name, with the same personnel over the same local network as employed by BellSouth;

5. Whether BSE presented substantial and material evidence that it would provide services to consumers that could not be offered by BellSouth; and

6. Whether it is in the public interest for a Regional Bell Operating Company ("RBOC") such as BellSouth, to have an affiliated CLEC operating within its territory.

The last issue involves BellSouth's status as a RBOC, and that issue again requires some background explanation. In 1974, the U.S. Department of Justice brought an antitrust action against AT & T for monopolization of telecommunications services and equipment. *United States v. American Tel. and Tel. Co.,* 552 F.Supp. 131 (D.D.C.1982), *aff'd sub nom. Maryland v. United States,* 406 U.S. 1001, 103 S.Ct. 1240 (1983). That long and complex litigation resulted in a settlement reflected in a consent decree. This consent decree required AT & T to divest itself of the twenty or so Bell operating companies ("BOCs") that provided local telephone service as monopolies. Under the court-approved plan, these BOCs were spun off from AT & T and grouped into seven regional holding companies, or RBOCs, who continued to provide local service as regulated monopolies until the 1996 Telecommunications Act and/or similar legislation in various states. *See AT & T Corp. v. Federal Communications Comm'n,* 220 F.3d 607, 611 (D.C.Cir.2000).

Bell South is a RBOC.*Id.; see also*47 U.S.C. § 153(4) (defining "Bell operating company" by listing twenty companies by name, including South Central Bell Telephone Company, the predecessor of BST). Although the Bell operating companies were allowed to retain their state-regulated monopolies on local service, they were prohibited by the consent decree from entering other parts of the telecommunications business, including long distance, equipment sales, and specified other services. *United States v. American Tel. and Tel. Co.,* 552 F.Supp. at 224.

*5 The Telecommunications Act of 1996 rescinded the consent decree. While a number of key provisions apply to all incumbent local exchange carriers, such as the requirement that they offer nondiscriminatory access and interconnection to local competitors, 47 U.S.C. § 251, the Act also includes "Special Provisions Concerning Bell Operating Companies,"47 U.S.C. §§ 271 to -276, which apply only to the BOCs and their affiliates. Some of these provisions allow BOCs to enter into formerly prohibited areas of the telecommunications market, but only under specifically enumerated conditions. Of primary importance, § 271 establishes requirements that a BOC or its affiliate must meet before it can provide long distance, or InterLATA, services. Those requirements relate primarily to interconnection and include a competitive checklist insuring, among other things, nondiscriminatory access to network elements and other facilities and services. 47 U.S.C. § 271(c).[FN3]

> FN3. The Act further provides that the FCC cannot approve a BOC or BOC affiliate application to provide interLATA services unless it finds that the applicant has met the requirements with respect to access and interconnection, has fully implemented the competitive checklist, "the requested authorization will be carried out in accordance with the requirements of section 272," and the approval is consistent with the public interest, convenience and necessity. 47 U.S.C. § 271(d)(3).

BOCs and their affiliates are barred from manufacturing and selling equipment until they have received authorization to provide interLATA services, which, of course, requires demonstrated compliance with the nondiscriminatory access requirements and the competitive checklist. 47 U.S.C. § 273. That section includes additional strictures on such manufacturing activities. Section 276 includes nondiscrimination safeguards for provision of payphone services by a BOC and a requirement that a BOC may not subsidize its payphone services directly or indirectly from its telephone exchange service operations. In addition, BOCs may provide electronic publishing only through a separate affiliate or through a joint venture operated according to specific requirements, including structural separation. 47 U.S.C. § 274.[FN4]

> FN4. This required structural separation, or line-of-business restriction, has been upheld in a bill of attainder and first amendment challenge. *BellSouth Corp. v. F.C.C.,* 144 F.3d 58, 61 (D.C.Cir.1998), *cert. denied,* Apr. 26, 1999.

Most relevant to our analysis of the issues herein, because of the parties' references to and arguments about "Section 272 affiliates" is the requirement of 47 U.S.C. § 272, which the FCC has described as follows:

Section 272(a) provides that a BOC (including any affiliate) that is a LEC subject to the requirements of section 251(c) may provide certain services only through a separate affiliate. Under section 272, BOCs (or BOC affiliates) may engage in the following activities only through one or more affiliates that are separate from the incumbent LEC entity: (A) manufacturing activities; (B) interLATA telecommunications services that originate in-region; and (C) interLATA information services.

In the Matter of Implementation of the Non-Accounting Safeguards of Sections 271 and 272of *the Communications Act of 1934, As Amended,* CC Docket No. 96-149, First Report and Order, at ¶ 50 (rel. Dec. 24, 1996) (footnotes omitted).

The statute establishes "structural and transactional requirements" for § 272 separate affiliates, including independent operation, maintenance of separate books and records, totally separate officers, directors and employees, and no credit arrangement whereby recourse may be had against the assets of the BOC. 47 U.S.C. § 272(b)(1)-(4). In addition, the affiliate is required "to conduct all transactions with the Bell operating company of which it is an affiliate on an arm's length basis with any such transactions reduced to writing and available for public inspection."47 U.S.C. § 272(b)(5). Nondiscrimination safeguards also exist. 47 U.S.C. § 272(c).

***6** It is this structural and operational separation between the BOC and its affiliate which has been determined on the federal level to provide protection against anticompetitive practices. It allows a BOC affiliate to provide some services that the BOC itself would be prohibited from providing. This separation is a critical element in understanding the TRA's position herein.

II. ILEC Affiliation

The TRA has previously granted certificates to over thirty competing local exchange carriers to provide local services on a statewide basis. In addition, the TRA has granted certificates as CLECs to two affiliates of ILECs, namely Citizens Telecommunications Company of Tennessee and United Telephones-Southeast, Inc.[FN5] BSE asserts that these prior approvals establish precedent which the TRA must follow and require that BSE's statewide application be granted because the TRA is required by federal and state law to certificate CLECs on a competitively neutral basis.

> FN5. At BSE's request, at the hearing involved herein the TRA took judicial notice of its grant of these certificates, and the records from those proceedings have been included in the record herein. Those records reflect that the TRA granted to Sprint Communications Company, L.P. a certificate to provide intrastate service based upon an application to provide a full array of telecommunications services normally provided by an incumbent local exchange telephone company throughout the State of Tennessee in all geographic locations permitted under Tenn.Code Ann. § 65-4-201. Similarly, Citizens Telecommunications Company filed an application for certification as a CLEC seeking authority to operate statewide to provide a full array of telecommunications services as would normally be provided by an incumbent local exchange telephone company. The TRA granted the application.

The TRA responds that its prior decisions, involving other companies in other situations, do not bind it in this situation. It also asserts, and found, that BellSouth and its affiliate BST or BellSouth are different from other CLECs and their affiliates and present unique issues. The TRA found:

In Tennessee, Citizens, Sprint, and their affiliated companies are not similarly situated to BellSouth and BSE. Neither Citizens nor Sprint are RBOCs, and neither possesses the historical market dominance so closely associated with RBOCs such as BellSouth. Unlike Citizens and Sprint, BellSouth maintains approximately eighty percent (80%) of the access lines in Tennessee. Therefore, since BSE is the affiliate of the dominant local exchange carrier in Tennessee, the actions which BSE seeks to take must be evaluated by assessing whether such actions will truly foster competition in Tennessee. The authority finds that Citizens and Sprint are not similarly situated to BSE and BellSouth.

(footnotes omitted).

If the TRA had determined that BSE was ineligible to be certified statewide as a CLEC on the basis that an affiliate was disqualified from certification in the same market where its affiliate was the incumbent provider, the two prior approvals would pose serious problems to affirming the TRA's order herein. However, the TRA did not find that such a *per se* disqualification existed, and we can find none in the statute. The prior approvals indicate that the TRA interpreted the Telecommunications Act as authorizing affiliates of ILECs to be certified as CLECs statewide, including in those markets where the affiliate was the incumbent.

The prior approvals also serve to rebut an argument made herein by the intervenors. Those intervenors argue that it is illegal under Tennessee law for BellSouth to operate as both an ILEC and a CLEC in the same service territory. They assert that because the Telecommunications Act defines a CLEC as a carrier providing service before June 6, 1995, and defines an ILEC as a provider of services certified after June 6, 1995, an ILEC cannot be a CLEC. We do not disagree that the statute envisions an ILEC and a CLEC as being different entities.

*7 However, the intervenors argue that because BST cannot be a CLEC, BellSouth should not be allowed to accomplish the same illegal result through use of an affiliate; i.e., BST cannot do indirectly what it is prohibited from doing directly. While much of the intervenors' argument is addressed to BellSouth's market dominance and position, their argument is also based upon the statutory distinctions between ILECs and CLECs. To that extent, the intervenors' assertions that BellSouth cannot operate both an ILEC and a CLEC would apply equally to any other affiliate relationship. Obviously, the TRA has rejected that interpretation of the statute by certifying as CLECs at least two other entities affiliated with ILECs. We find no basis for rejecting the TRA's interpretation. In fact, the legislature apparently foresaw the possibility of an ILEC providing services to an "affiliated entity." *See*Tenn.Code Ann. § 65-5-208(c).

As the TRA's order makes clear, its denial of BSE's request for a certificate for statewide CLEC status was not based upon BSE's status as an affiliate of an ILEC *per se.*Instead, it was related to the unique position enjoyed by BellSouth as the dominant provider of local exchange services and as a Bell operating company.

We agree with the TRA that each application must be considered on its own merits and upon the facts of each individual situation. In the instant situation, the facts raise issues as to the effect of certification on competition which may differ from those raised by other incumbent affiliate applications. However, the TRA cannot apply legal requirements arbitrarily or capriciously and must have a factual basis for its actions. Tenn.Code Ann. § 4-5-322(h).

III. BOC Status

As set out earlier, BellSouth, BST and BSE (as an affiliate of a BOC) are subject to specific provisions of the Telecommunications Act of 1996 not applicable to other CLECs. The question is whether that status justifies a differing approach or standard for BSE's qualification as a CLEC than that applied to affiliates of other ILECs who are not also BOCs.

BSE argues that the FCC has recognized or authorized affiliates of ILECs and BOCs. The TRA has acknowledged and referred to the FCC's rulings on specific arrangements, but has distinguished the situation covered by those rulings from the situation presented by BSE's application herein.

The FCC has considered the question of the provision of local exchange and exchange access by Section 272 BOC affiliates and reached the following conclusion:

Based on our analysis of the record and the applicable statutory provisions, we conclude that section 272 does not prohibit a section 272 affiliate from providing local exchange services **in addition to** interLATA services, nor can such a prohibition be read into this section. Specifically, section 272(a)(1) states that-

A Bell operating company (including any affiliate) which is a local exchange carrier that is subject to the requirements of section 251(c) may not provide any service described in [section 272(a)(2)] unless it provides that service through one or more affiliates that ... are separate from any operating company entity that is subject to the requirements from section 251(c)...

***8** We find that the statutory language is clear on its face-a BOC section 272 affiliate is not precluded under section 272 from providing local exchange service, **provided that the affiliate does not qualify as an incumbent LEC subject to the requirements of section 251(c).**

In the Matter of Implementation of the Non-Accounting Safeguards of Sections 271 and 272of the Communications Act of 1934, As Amended, CC Docket No. 96-149, First Report and Order, at ¶ 312 (rel. Dec. 24, 1996) (emphasis added).

It is clear that the FCC's comments are addressed to those BOC affiliates which are Section 272 affiliates and are operated independently from an ILEC affiliate. They apply where the BOC incumbent has been authorized to provide long distance services. This means that the BOC incumbent has demonstrated to the FCC's satisfaction that it has complied with the various competition requirements set out in 47 U.S.C. § 271.

We agree with the TRA that the FCC rulings relied upon by BSE do not directly apply to an application by an affiliate of a BOC which is not a Section 272 affiliate to provide local service in an area where the BOC is the incumbent. While BSE is not incorrect in asserting that these FCC rulings do not prohibit the grant of its application, they also do not require it. The FCC, based on federal statutory law, has found that BOC affiliates may provide certain kinds of services when circumstances not present in the case before us exist.

BSE is not a Section 272 affiliate, and does not claim to be. Section 272 affiliate status only applies to affiliates of a BOC which have received Section 271 approval. The TRA determined that BSE "remains a type of affiliate not contemplated under § 272."In addition, the TRA explained:

It is appropriate that BSE has not requested in its Application to provide non-incidental services, because BSE cannot satisfy the requirements for a Section 272 affiliate, for those services, until inter-LATA permission is granted pursuant to Section 271. The Authority concludes that BSE cannot, at this time, as a matter of law, provide Section 272(a)(2) non-incidental services, does not intend to provide Section 272(a)(2) incidental services, and is, therefore, not a Section 272 affiliate. Having concluded as such it is difficult to embrace the position that the safeguards established under Section 272 are applicable to BSE. It is equally difficult to accept that an entity such as BSE is of the type contemplated by the FCC's pronouncement that Section 272 does not prohibit a Section 272 affiliate from providing local exchange services in addition to interLATA services.

(footnotes omitted).

The TRA asserts that BSE's lack of Section 272 status is important is considering the competitive goals of both federal and state legislation. The Authority contends that Section 271 approval indicates satisfaction of the requirements for entry into the long distance market, including compliance with the competitive checklist. As of the date of the proceedings herein, BellSouth did not have Section 271 approval, and the TRA states that BellSouth has been denied that approval several times by the FCC and in other states.[FN6] Consequently, the TRA found that BSE had not been required to show that it has adequate operations support systems with performance measurements in place which would "provide assurance that the public welfare is protected by ensuring that competing carriers have a means to compete and are treated in a competitively neutral manner by the ILEC [BST]." The TRA also found that not only does the denial of such approval indicate that the required proof of compliance with competitive safeguards was not provided in those proceedings, the TRA found that BSE did not demonstrate such compliance in the hearing herein.

FN6. For example:

In the Matter of Application of BellSouth Corporation, et al., Pursuant to Section 271 of the Communications Act of 1934, as amended, to Provide In-Region, InterLATA Services in South Carolina, 13 FCC Rcd 539, 547 P 14 (1997) (failure to (1) provide nondiscriminatory access to operations support systems, (2) provide unbundled network elements in a manner that permits competing carriers to combine them through collocation, and (3) offer certain retail services at discounted rates), *aff'd, BellSouth Corp. v. FCC,* 333 U.S.App. D.C. 253, 162 F.3d 678 (D.C.Cir.1998); *In the Matter of Application by BellSouth Corporation, et al., Pursuant to Section 271 of the Communications Act of 1934, as amended, to Provide In-Region, InterLATA Services in Louisiana,* 13 FCC Rcd 6245, 6246-47 P 1 (1998) (failure to provide nondiscriminatory access to operations support system and to make telecommunications services available for resale); *In the Matter of Application of BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc., for Provision of In-Region, InterLATA Services in Louisiana,* 13 FCC Rcd 20599, 20605 P 10 (1998) (failure to provide nondiscriminatory access to operations support system and unbundled network elements).

AT & T Corp.v. FCC, 220 F.3d at 613.

*9 The TRA did not deny the application for statewide CLEC certification because of BSE's status as a BOC or BOC affiliate. It did, however, consider that status as a factor in its consideration of the competitive effect of allowing BSE to compete with its affiliate where the competition protections assured by Section 272 affiliate status are not present. We conclude that neither BSE's status as an ILEC affiliate nor its status as a BOC affiliate was the basis for the TRA's denial. That status did, however, influence the standards applied by the TRA to BSE in its consideration of the competitive effect of granting BSE's application.

IV. The Issues Presented and The Standard of Review

As the list of TRA concerns set out earlier in this opinion demonstrates, the TRA focused its decision on the potential for anticompetitive activities and conduct if an affiliate of the Regional Bell Operating Company and ILEC were certified as a CLEC, especially in the absence of the protections provided by federal law to Section 272 affiliates. In the order now under appeal, the TRA noted that in its previous denial "one critical area of concern was that the affiliate relationship between BST and BSE could be potentially and irreversibly adverse to competition."The TRA found without Section 271 approval of BellSouth, there was still no evidence that BellSouth had the necessary safeguards in place to ensure fair treatment among all CLECs and further stated:

Exacerbating our concern is that no other performance measurements have been established, which arguably help to serve as support to the existence of competitive neutrality in the relationship between BellSouth, BSE and other CLECs. Without these safeguards and measurements the Authority would have difficulty determining whether BellSouth in fact afforded preferential treatment to its affiliate CLEC in Tennessee.

It was on the basis of these concerns that the TRA determined that approval of BSE's application was not in the public interest and "may, in fact" be inconsistent with the goal of competition. The TRA concluded that BSE offered little convincing evidence or testimony to diminish its concerns regarding potentially abusive collusive behavior.

On appeal, our review of the TRA's order is governed by Tenn.Code Ann. § 4-5-322(h), which provides:

The court may affirm the decision of the agency or remand the case for further proceedings. The court may reverse or modify the decision if the rights of the petitioner have been prejudiced because the administrative findings, inferences, conclusions or decisions are:

(1) In violation of constitutional or statutory provisions;

(2) In excess of the statutory authority of the agency;

(3) Made upon unlawful procedure;

(4) Arbitrary or capricious or characterized by abuse of discretion or clearly unwarranted exercise of discretion; or

(5) Unsupported by evidence which is both substantial and material in the light of the entire record.

***10** In determining the substantiality of evidence, the court shall take into account whatever in the record fairly detracts from its weight, but the court shall not substitute its judgment for that of the agency as to the weight of the evidence on questions of fact.

The TRA may exercise only that authority given it expressly by statute or arising by necessary implication from an express grant. *BellSouth Adver. & Publ'g Corp. v. Tennessee Regulatory Auth.*, 79 S.W.3d 506, 512 (Tenn.2002); *Tennessee Pub. Serv. Comm'n v. Southern Ry. Co.*, 554 S.W.2d 612, 613 (Tenn.1977). The General Assembly has given the TRA "practically plenary authority over the utilities within its jurisdiction."*BellSouth Adver. & Publ'g Corp.*, 79 S.W.3d at 312 (quoting *Tennessee Cable Television Ass'n v. Tennessee Pub. Serv. Comm'n.* 844 S.W.2d 151, 159 (Tenn.Ct.App.1992)). The TRA has "general supervisory and regulatory power, jurisdiction, and control over all public utilities."Tenn.Code Ann. § 65-4-104. The General Assembly has given the TRA, in addition to other jurisdiction conferred, the authority to "investigate, hear and enter appropriate orders to resolve all contested issues of fact or law arising as a result of the application of Acts 1995, ch. 408 [the Tennessee Telecommunications Act]."Tenn.Code Ann. § 65-5-210(a).

BSE asserts, however, that the TRA's order was contrary to governing statutory provisions. In reviewing BSE's request, the TRA was required to apply Tenn.Code Ann. § 65-4-201(c), quoted earlier, which establishes the requirements for certification as a competing provider. BSE asserts that it met the two requirements by demonstrating: (1) that it will adhere to all applicable TRA policies, rules and orders; and (2) that it possesses managerial, financial and technical abilities to provide the services. BSE cites the TRA's approval of it as a CLEC in some territories in Tennessee as proof the TRA has found that BSE meets these statutory qualifications. Accordingly, BSE argues, the TRA was required to grant its application for statewide certification because of the mandatory language of the statute.

There is no dispute that BSE met the two requirements of Tenn.Code Ann. § 65-4-201(c). The TRA, however, determined that its other statutorily assigned responsibilities required it to examine the application in light of its effect on competition, including its responsibility under Tenn.Code Ann. § 65-4-201(a) to consider the present and future public interest in determining whether to grant a certificate of convenience and necessity. In the case herein, however, the TRA defined that public interest in terms of the impact of BSE's application on competition. It is clear from the order that the TRA's reason for denying BSE certification as a CLEC in those areas where its affiliate was the ILEC was its determination that such certification could adversely impact the development of competition in the provision of local telephone service.

***11** The TRA maintains that it was required to consider the effect on competition. The TRA relied upon its obligations set out in Tenn.Code Ann. § 65-5-208(c), also quoted above, to prohibit anti-competitive practices in dealings between the incumbent and competitors. The TRA was also mindful of the General Assembly's policy of fostering competition, as set out in the Tennessee Telecommunications Act of 1995:

The general assembly declares that the policy of this state is to foster the development of an efficient, technologically advanced, statewide system of telecommunications services by permitting competition in all telecommunications services markets, and by permitting alternative forms of regulation for telecommunications services and telecommunications services providers. To that end, the regulation of telecommunications services and telecommunications services providers shall protect the interests of consumers without unreasonable prejudice or disadvantage to any telecommunications services provider; universal service shall be maintained; and rates charged to residential customers for essential telecommunications services shall remain affordable.

Tenn.Code Ann. § 65-4-123. In the preamble to the Tennessee Telecommunications Act, the General Assembly stated a policy that "Competition among providers should be made fair by requiring that all regulation be applied impartially and without discrimination to each." 1995 Tenn. Pub. Acts ch. 408.

In addition, federal law places a duty on the TRA to promote or insure competition in the provision of telecommunication services. In particular, the Telecommunications Act of 1996 requires removal of barriers to entry into that business and states:

(a) In general. No State or local statute or regulation, or other State or local legal requirement, may prohibit or have the effect of prohibiting the ability of any entity to provide any interstate or intrastate telecommunications service.

(b) State regulatory authority. Nothing in this section shall affect the ability of a State to impose, on a competitively neutral basis and consistent with Section 254 of this title, requirements necessary to preserve and advance universal service, protect the public safety and welfare, ensure the continued quality of telecommunications services, and safeguard the rights of consumers.

47 U.S.C. § 253.

We agree with the TRA that it has the authority to consider the effect on competition of an application for statewide certification as a CLEC. In addition to its general almost plenary authority to regulate public utilities and the authority granted by the statutes quoted herein, it also has specific authority to adopt rules or issue orders to prohibit anticompetitive practices. Tenn.Code Ann. § 65-5-208(c). Thus, we conclude the TRA did not act in excess or in contravention of relevant statutory authority in considering the effect on competition.

However, the authority to consider the effect on competition does not remove the requirements that the agency base its decisions on substantial and material evidence and that those decisions not be arbitrary or capricious. The determinative issues in this appeal are framed by BSE's arguments that the TRA's decision was arbitrary because it differentiated among ILEC affiliates and that the decision was based upon speculation and not upon the evidence and, therefore, is not supported by substantial and material evidence. In addition, BSE asserts that the TRA's order is actually anticompetitive and prevents BSE's entry into the market as a competing local exchange service provider by establishing more stringent requirements for it than those applied to other ILEC affiliates. The intervenors assert that BST is already dominant in the local services market, making removal of barriers to entry irrelevant. The TRA asserts its order was designed to further the competition envisioned by both federal and state law.

***12** The TRA did, in fact, treat BSE's application differently from applications for statewide CLEC certification other affiliates of ILECs. They based this differing treatment on BSE's relationship to BellSouth, which has undisputed market dominance in the state and which is a BOC. Regional Bell Operating Companies have been subject to strictures and limitations not applicable to other companies since the consent order was entered in *United States v. American Tel. and Tel. Co.* The 1996 Telecommunications Act has special provisions relating to RBOCs. Because RBOCs had gained control of the local services markets through a monopoly, such measures were considered necessary if true competition were to develop as a practical matter.

The FCC has recognized the authority of state regulatory agencies to treat certain BOC related entities differently because of the potential impact on competition.

> State regulation. As mentioned above, several BOCs have already submitted applications to state regulatory commissions seeking authority to provide both local exchange services and interLATA services from the same affiliate. Although we conclude that the 1996 Act permits section 272 affiliates to offer local exchange service in addition to interLATA service, we recognize that individual states may regulate such integrated affiliates differently than other carriers.[FN7]

> FN7. BSE's application does not include a proposal to provide interLATA (long distance) services. As discussed earlier, the FCC's pronouncements have involved Section 272 affiliates who propose to provide both local and long distance services. Thus, in our earlier discussion of BOC status, we have agreed with the TRA that the FCC's recognition of BOC and ILEC affiliates is not dispositive of the question of whether an affiliate which is not a Section 272 affiliate may qualify as a CLEC where its affiliate is the ILEC. However, while the finding that state regulatory agencies may regulate integrated affiliates differently from other entities is not directly applicable to a non-272 affiliate becoming a CLEC, we think the principles involved are similar enough to warrant reliance on the FCC's recognition of state agencies' authority to regulate BOC affiliates differently.

In the Matter of Implementation of the Non-Accounting Safeguards of Sections 271 and 272of the Communications Act of 1934, As Amended, CC Docket No. 96-149, First Report and Order, at ¶ 317 (rel. Dec. 24, 1996) (footnotes omitted).

Although state statues do not make reference to RBOCs, we conclude that the TRA had the authority to consider BellSouth's market dominance in the state and its status as a BOC in analyzing the competitive effects of its affiliate's application. We also conclude that Tenn.Code Ann. § 65-5-208(c) gave the TRA the authority to issue orders which would prohibit the specific anticompetitive practices listed in the statute, as well as others. Because the relationship between BST, BSE, and BellSouth provides a situation where such practices can develop, the TRA was authorized to examine this situation differently from other applications and to adopt rules or to establish by order standards or requirements to fulfill its responsibility to further competition.

However, that is not what the TRA did. Instead of "regulating" a BOC affiliate differently, the TRA denied the certification. BSE describes the TRA's decision as "Rather than engage with BSE in a reasonable framework of regulation for its services in the market, the TRA has chosen to simply deny BSE a place at the table."The question is whether the TRA could deny certification under the facts presented.

V.

The TRA had previously expressed its concerns about the potential for anticompetitive conduct between BSE and its affiliates. The second hearing was held to allow BSE to address those concerns. In the hearing, BSE offered to submit itself to various requirements to alleviate the concerns of the TRA. In specific, BSE offered:

***13** (1) To operate independently from BST;

(2) To maintain its books, records, and accounts separate from the books, records, and accounts maintained by BST;

(3) To have separate officers, directors, and employees from BST;

(4) Not to obtain credit under any arrangement that would permit a creditor, upon default, to have recourse to the assets of BST;

(5) To conduct all transactions with BST on an arms' length basis with any such transactions reduced to writing and available for public inspection; [FN8]

FN8. Items 1-5 replicate the structural separation requirements set out in 47 U.S.C. § 272(b).

(6) Not to engage in cross-subsidization, granting preferences to competitive services or affiliated entities, predatory pricing, price squeezing, price discrimination, tying arrangements, or other anticompetitive practices as prohibited by Tenn.Code Ann. § 65-5-208(c);

(7) To set its price floor equal to the wholesale price it pays to BST;

(8) To file and resell its Contract Service Agreements;

(9) To be bound by the non-discrimination requirements of 47 U.S.C. §§ 251 and 252;

(10) To file tariffs;

(11) To consent to regular audits of its operations by the TRA;

(12) To provide cost allocation data of its operations;

(13) To accept advertising restrictions assuring that any advertising would properly identify "BellSouth BSE";

(14) To submit to any other applicable ILEC Rules in the event BSE undertakes the activities of its ILEC affiliate BST; and

(15) To abide by any and all of the applicable TRA policies, rules and orders.

The TRA found these promises insufficient, primarily for three reasons. It determined that BSE's failure to file a cost allocation manual prevented the Authority from determining whether appropriate safeguards were in place to prevent cross-subsidies between regulated and non-regulated services.[FN9] Similarly, BSE did not file a business plan, and the TRA stated it routinely examined such plans when considering CLEC applications. The TRA found that "The lack of a business plan and cost allocation manual prevents the Authority from determining the extent to which BSE intends to operate, and whether such operation and the provisioning of telecommunications services on an expanded level is compatible with the public interest."

FN9. There is proof in the record that with regard to BSE's operation in the Tampa, Florida area, cost allocations between BSE and BellSouth's cellular phone company were not very strict, even though the companies shared some costs. For example, the cellular provider paid all advertising costs, and BSE did not pay a portion of that.

Although BSE did not file a business plan, an Intervenor introduced into evidence a report prepared for BellSouth by a consultant regarding the benefits to BellSouth of sending a CLEC affiliate into various markets. BSE disavowed the report, stating that it did not serve as BSE's business plan. In its brief, the TRA argues the report is "significant, not as a representation of BSE's current or future business practices, but for its indication of the most obvious opportunities that a CLEC affiliate would provide for BellSouth and for the fact that BellSouth was studying these opportunities in great detail."The brief continues:

The report is replete with statements that BellSouth viewed its "CLEC" as an extension of BellSouth, which would benefit from maximum identification with BellSouth, that the CLEC would be operated as part of a comprehensive business strategy that would pertain to all BellSouth companies, and that the CLEC would offer many ways of circumventing regulatory restraints on BellSouth's incumbent LEC operations.... Elsewhere, the report states that the rationale for establishing a CLEC is that "BellSouth needs alternatives to gain pricing and packaging freedoms."

***14** We do not disagree with the TRA's description of the report. Although BSE denied the report was ever its business plan, the TRA argues that "The existence of this report submitted by the Intervenors and the absence of a business plan from BSE creates a reasonable presumption that BST intended to let loose its affiliate 'CLEC' upon the market not as a truly independent competitor and in order to circumvent regulatory requirements."

The final, and apparently most significant, reason given by the TRA is its interpretation of BSE's offer to be bound by a price floor equal to the resale price it pays to BST for the purchase of its telecommunications services. As discussed above, Tenn.Code Ann. § 65-5-208(c) requires an ILEC to adhere to a price floor for its competitive services which must equal the ILEC's rates for essential services used by CLECs plus the total long-run incremental cost of the competitive elements of the service.

One of the major concerns of the intervenors was the price floor issue. On appeal, they argue that Tennessee has established a "price floor" for certain ILEC services and prohibited the ILEC from charging customers less than that amount for the purpose of preventing ILECs from engaging in predatory pricing, *i.e.,* pricing services below cost. The intervenors' expert testified that the price floor statute prevents an incumbent provider with market power from pricing services at less than cost and thereby discouraging potential competitors from building their own networks. Essentially, the intervenors argue that since an ILEC is restricted by law to a price floor, the same public policy requires that an affiliate of an ILEC be subject to the same restriction because the ILEC should not be allowed to avoid the statutory price floor by operating through an affiliate.[FN10]

FN10. The intervenors' position is explained in their brief as follows:

Based on the testimony at the second hearing, here is how BSE's scheme would work: Under federal law, BellSouth is required to make all services available for resale at a discounted, wholesale rate. In Tennessee, state regulators have determined that BellSouth's wholesale rate should be 16% less than the carrier's retail rate. Thus, if BellSouth's retail rate for local service were $12.15, a CLEC may purchase that service for a discounted price of $10.31.

During cross-examination, [BSE] was asked to assume, for the sake of argument, that BellSouth's $12.15 rate was also the price floor for that service, as calculated in accordance with section 208(c). Under those circumstances he repeatedly maintained that BSE could legally purchase BellSouth's service at the wholesale rate and resell it for $10.31 or $10.81, substantially less than BellSouth's price floor. In an effort to per-

> suade the TRA to approve BSE's proposal, [BSE] said BSE would agree to price its services at no less than $10.31-the wholesale price it paid to BellSouth-but would not agree to abide by BellSouth's price floor of $12.15.

The TRA was also unconvinced that BSE's offer regarding the price floor was sufficient to alleviate its concerns about anticompetitive conduct and found:

In an effort to lessen the anti-competitive effect of its expanded certification, BSE agreed to be bound by a price floor equal to the resale price paid to BellSouth for the purchase of its telecommunications services. However, BSE failed to demonstrate whether the resale price it will pay to BellSouth will or will not include operator service costs, administrative costs, or marketing and advertising costs. Absent an evidentiary demonstration of all costs to be included in the resale price paid to BST, the "price floor" promised by BSE may not be comparable to that set for incumbents under Tenn.Code Ann. § 65-5-208(c). Furthermore, the Authority is of the opinion that if a price floor is to act as a deterrent against price squeezing, the floor must be set in a manner that will ensure that all of the costs of providing the services are included therein. Thus, a meaningful promise to be bound to a price floor will not only include the rate paid to BellSouth by BSE, but will also include additional costs incurred by BSE in providing such services. Under BSE's proposal to set the price floor at the resale rate paid to BellSouth, BSE would still be free to sell a service below the total cost that BSE must incur to provide that service.

***15** On appeal, the TRA contends that the danger of a price squeeze is presented by the possibility that BSE would lower its resale price, "as long as the cost components of that price are undisclosed or are subject to manipulation," to a level that competitors of BSE and BST would be unable to match. The TRA found BSE's promise to set its price floor at the resale rate it pays BST would still allow BSE to resell a service below the overall cost to BSE of providing the service. The TRA contends this situation results in an "obvious opportunity" for a price squeeze. *See Town of Norwood v. New England Power Co.,* 202 F.3d 408, 418 (1st Cir.2000) (explaining the "traditional price squeeze").

The TRA points out that BSE has never agreed to apply the price floor as described by the TRA. BSE argues that its price floor agreement must be considered in conjunction with the other safeguards it promised to comply with, which will "ensure that all of the costs of providing its services are included in its pricing."

The price floor statute only applies to incumbent providers and does not by its terms apply to CLECs. In fact, in situations where an affiliate relationship with the incumbent is not present, the issue would simply not arise. Consequently, the TRA must rely upon its authority to promote competition and prevent anticompetitive practices as authority for its decision. There is no evidence in the record that in the other situations where the TRA has approved an affiliate of the incumbent provider as a CLEC that any such price floor requirement has been imposed.

It is the relationship between BSE and BellSouth and BellSouth's market dominance and status as a RBOC that created the "concerns" that led the TRA to determine that anticompetitive practices might occur. It is actually the potential for BellSouth to use a subsidiary to circumvent restrictions placed on its operation by federal and state law and regulation, to the detriment of competition, which is at the core of the TRA's action. The fact that it is the affiliate relationship that is the problem is exemplified in the TRA's finding that, "Counterbalancing these proposals [BSE's agreement to the listed restrictions] in the record before the TRA are BSE's numerous demonstrations of its close ties to BST. Further, as BSE's witness admitted, BSE and BST will remain affiliates. BSE will be nominally independent of BST, but neither will be truly independent of BellSouth Corporation."[FN11] Although the TRA did not decide that no affiliate of BellSouth or BST could be certified as a CLEC in those areas where BST is the incumbent provider, it did not by rule or order establish minimum requirements to insure the type of independent operation it felt necessary to prevent "possibilities" for anticompetitive conduct.

> FN11. The Intervenors assert that this case is simply about whether BellSouth can be both an ILEC and a CLEC at the same time and in the same service territory. "Since BSE does not propose to offer any services to Tennessee customers that BellSouth itself cannot also offer, the only apparent reason for BSE's creation is to allow BellSouth to do indirectly, through an affiliate, what it cannot do directly, i.e., to engage in otherwise prohibited pricing and marketing strategies."The intervenors assert that the BellSouth companies are attempting to avoid the effect of those statutes which prohibit BellSouth itself from obtaining a CLEC certificate and which regulate BellSouth as the incumbent provider. This argument presupposes, among other things, that there is no structural and operational separation between the affiliates.

The FCC has addressed concerns similar to those raised by the TRA in the context of a Section 272 affiliate (an affiliate of a BOC which meets the structural separation requirements of 47 U.S.C. § 272) in its report entitled *In the Matter of Implementation of the Non-Accounting Safeguards of Sections 271 and 272of the Communications Act of 1934, As Amended,* CC Docket No. 96-149, First Report and Order (rel. Dec. 24, 1996) wherein it made the following findings:

***16** We also conclude as a matter of policy that regulations prohibiting BOC section 272 affiliates from offering local exchange service do not serve the public interest. The goal of the 1996 Act is to encourage competition and innovation in the telecommunications market. We agree with the BOCs that the increased flexibility resulting from the ability to provide both interLATA and local services from the same entity serves the public interest, because such flexibility will encourage section 272 affiliates to provide innovative new services. To the extent that there are concerns that the BOCs will unlawfully subsidize their affiliates or accord them preferential treatment, we reiterate that improper cost allocation and discrimination are prohibited by existing Commission rules and sections 251, 252, and 272 of the 1996 Act, and that predatory pricing is prohibited by the antitrust laws. Our affiliate transaction rules, as modified by our companion Accounting Safeguards Order, address the BOCs' ability to engage in improper cost allocation. The rules in this Order and our rules, in our First Interconnection Order and our Second Interconnection Order ensure that BOCs may not favor their affiliates. In sum, we find no basis in the record for concluding that competition in the local market would be harmed if a section 272 affiliate offers local exchange service to the public that is similar to local exchange service offered by the BOC.

Id. at ¶ 315 (footnotes omitted).

Of course, BSE is not a Section 272 affiliate, and the structural separation requirements established in that provision are not automatically imposed upon BSE. There is no impediment, however, to the TRA imposing the same safeguards as a condition to certification, by virtue of its authority under Tenn.Code Ann. § 65-5-208(c).[FN12] In fact, BSE and BellSouth agreed to be bound by those structural separation requirements. The TRA could have included other requirements directly related to preventing anticompetitive practices between BSE and BellSouth. Again, BSE and BellSouth agreed to additional safeguards, including the filing of various documents, accepting advertising restrictions which ensure the proper identification of the affiliate, providing cost allocation data, and setting its price floor equal to the wholesale price it pays to BST.

> FN12. The Georgia Public Service Commission, in ruling on a similar application by BSE in Georgia, stated that:

> The critical issue that is raised in this proceeding stems from the affiliate relationship the Applicant has with the predominant incumbent local exchange carrier in Georgia, BellSouth Telecommunications, Inc. Testimony presented by the intervenors raises questions as to whether the service expected to be provided by the Applicant will indeed be in competition with BST. Or, will the entry of the Applicant into the local exchange market simply garner for the parent corporation an even larger share of the market in Georgia and thereby thwart the movement toward telecommunications competition in the state.
>
> After finding that there was not sufficient cause to deny the application, the Commission found that certain conditions would be imposed. Those included use of the same operating system support as other CLECs, a prohibition of favoring treatment to BSE by the incumbent, and certain reporting requirements.

The TRA determined these offers were not sufficient. However, it did not, by order or rule, establish the minimum requirements or safeguards it thought necessary. Instead, it determined that BSE did not sufficiently allay concerns that anticompetitive practices might occur. The TRA found that approval of BSE's application "may" be inconsistent with the goal of fostering competition, that potentially abusive, collusive behavior "might" occur, and that the relationship "could be potentially" adverse to competition.

Additionally, the TRA is not bound by the FCC's judgment that competition in local markets would not be harmed, considering the safeguards provided elsewhere, if Section 272 affiliates were to offer local service. The TRA is authorized to make its own determination about the effect of competition in this state. However, the TRA did not make a determination that competition would be adversely affected by certification of BSE statewide. It merely found that certification "may" be contrary to promotion of competition. Apparently, any harm to competition would come only if the affiliated entities acted collusively, in an anticompetitive manner, and in violation of existing prohibitions.

*17 While Tenn.Code Ann. § 65-5-208(c) authorizes the TRA to implement safeguards to prohibit anticompetitive conduct between an ILEC and its affiliated CLEC, we can find nothing in the statute to authorize the TRA to deny certification of a related entity simply because, by its nature, the affiliate relationship may provide the opportunity for anticompetitive practices. The legislature has prohibited anticompetitive conduct, not affiliation relationships. The TRA's responsibility in that situation is to put in place standards or requirements to prohibit and prevent the anticompetitive possibilities from becoming realities and/or to make violations easier to discover so that regulation is effective.

We conclude that the TRA's decision herein must be vacated because it is in excess of the statutory authority of the agency. We remand to the TRA for consideration of BSE's application in light of the principles set out in this opinion. Because the order which is the subject of this appeal does not establish standards, requirements, or conditions, for the certification, we do not rule upon the validity of any such requirement.[FN13] Costs of this appeal are taxed to the Tennessee Regulatory Authority.

> FN13. For example, we decline to address the issue of whether the TRA may impose a miniumum charge or price floor on BSE which insures it recoups all its costs.

Tenn.Ct.App.,2003.
Bellsouth BSE, Inc. v. Tennessee Regulatory Authority
Not Reported in S.W.3d, 2003 WL 354466 (Tenn.Ct.App.)

END OF DOCUMENT

Attachment G

HB 1363 Utilities House H-101Date: 2/18/74

Clerk: House Bill 1363 by Representative Smith.

Speaker: Representative Smith from Knox county.

Smith: Mr. Speaker, members of the house, House Bill 1362 does just exactly what the printout says. This would permit the public service commissioner, Dickson Rays (?) fair charges, etcetera, to take into account the safety, adequacy and efficiency or lack thereof of utility services in determining where the proposed rates, fares, tolls, charges, etcetera are just and reasonable. This came about because of a situation in the Halls community in Knox county and was represented by me up until the present redistricting plan that is now represented by Representative Clark and the Tennessee Telephone Company requested a rate increase last summer and there were hearings held in the community and the people were dissatisfied with the service and we were then told by the Public Service Commission by East Tennessee Commissioner Corlew (?) that the Public Service Commission had no jurisdiction to consider the adequacy of the service. Now there are several code sections that deal with the Public Service Commissioner and their ability to require certain things but there's nothing that says that they can consider the adequacy of the service when they're studying a rate request. Now the … questions, I have a letter from Mr. Cramer I would read the last paragraph of it; "I think the adoption of House Bill 1363 would be in the public interest and would expressly confer upon this Commission the authority to consider service in the determination of a rate case. In the recent case of General Telephone Company vs. Public Service Commission, utilities used to further this argument, the fact that the Commission had no authority to consider the service provided by utilities in a rate case. This case has been argued in the Chancery Court of Davidson County but no decision has yet been rendered. The bill would eliminate this question in future litigation." Mr. Speaker, pending any questions I will move…. For passage of House Bill 1363 on third and final reading.

Speaker: …for the seconding of the adoption of…. We got a second. Been moved and seconded the adoption of House Bill 1363 on third and final reading. Are there amendments Mr. Clerk?

Clerk: No.

Speaker: No amendments. Are you ready for the vote? (inaudible) You ready for the question Representative Smith? Those members in favor of the adoption of House Bill 1363 on third and final reading vote aye when the bell rings. Those opposed vote no. Let every member cast his vote when the bell rings. Has every member voted? Every member voted. Any member desire to change his vote?

Has every member voted? Any member desire to change his vote? Mr. Clerk, you will record the vote.

Clerk: Ayes votes, two (?) no'es nothing.

Speaker: House Bill 1363, by a constitutional majority of the vote, declare it passed.

term is that right?

Senator Neal: As far as I know any one who don't have judicial function are four year term. This provides that if he does not have any judicial duties that it would be a four year term the 8 year term is a constitutional provision.

Senator Gillock; Senator Neal I think the question that Senator Nave asked was you have not answered as to whether a man that was elected now to an 8 year term whether it would cut it or not.

SEnator Neal: Well, all of those come up for re-election this year.

Senator Peeler: Mr. Speaker as I understand this bill it would simply provide that if by private act the judicial functions of a county judge were taken from him and vested in some other judge of some other court that that person could still serve as county judge and be designated as county judge not with standing the fact that he had been divested of his judicial function. I think you would still have to do by private act.

SEnator Motlow: Mr. Speaker, what has happened in Rutherford County the judge has been changed down there and they want to give him some name and this is all this bill is for is to give him for a name for him.

HB 153: aye's 24 no's 1 passed.

* Senate Bill 1260 HB 1363: Senator Baird: Mr. Speaker I would like to make the usual substitute and conform motion. Mr. Speaker and gentlemen of the Senate, this is a small one page bill but it is of deathly and greatly and public interest. It specifically requires the Public SErvice Commission when fixing rates tolls, fairs, charges and so forth, to take into account the safety adequacey and the efficiency of lack of effieiency thereof of those rates before granting rate increases. Pending any question I move that House Bill 1363 be passed on third and final reading.

Sentor Blank: Mr. Speaker I told Senator Baird and I don't want to violate his confidence I told him I was not going to speak against this bill but there are a couple of things that I would like to point out however and that is in connection the way the bill came about It came about as a result of my understanding of a rate increase hearing in the portion of Knox County and possibly Anderson that the commissioners stated that they did not have any authority or that there was stated there was a latter forwarded stating there was no authority to withhold rates on the basis of poor service or conditions of service. And when this bill first came up I pointed out to Senator Baird that there are at least two sections in the code right now that gibe the same authority but he provided me a a letter where it said that this was not true. However, in the recent case of Tennessee Telephone Corporation they withheld by expressed language $100,000 from the rate incraase until the service was brought up to what they considered the proper rate. I really feel that they already have this authority in there however, if they have told constituants of Senator Bairs's they did not have that authority when in fact they do this I guess will be sure that they dkxx know that they have got it and they can't keep using that excuse.

aye's 25 no's 0 2 present not voting. passed

Senate Bill 1415: Senator Shacklett: Mr. Speaker and members of the Senate, this Senate bill 1415 does apply to municiple government it reqquires when in the process of installing new or repairing curbs and gutters that they will simply provide a means of going up on these particular areas by the handicpaper in wheelchairs. So pening any question sir, I mov e passage of SEnate Bill 1415 on third and final reading.

Senator White: Would the sponsor yield for a question? Senator, would this bill require four ramps on each corner at an intersection? four sloping ramps?

No, two ramps at each corner a total of 8 ramps at each a intersection.

SEnator Shacklett: Well, the bill also SEnator White leaves it up to the descresion of the Transportation departtment for the standards and of course I could not answer it as to wbether it would require two on each corner or not.

Senator White: Well, let me ask you this is the purpose of it to permit wheel chairs to go down an incline and cross the street at a light sxy?

Senator Shacklett: The purpose and the intent of the entire bill is simply at your necessary and given indicacted cross walks and what havex you where that a person is pulling up in a car and he is involved with a wheel chair it would give him access to get up on and off the side walks that is what it would do.

aye's 26 no's 0 passed .

Attachment H

THE ACCIDENTAL HUNT BROTHERS

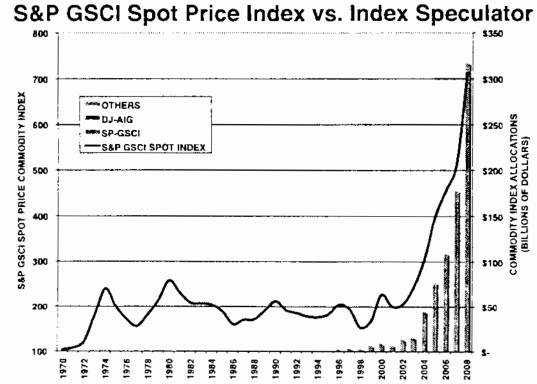
How Institutional Investors Are Driving Up Food And Energy Prices

Michael W. Masters
Portfolio Manager
Masters Capital Management
mike@accidentalhuntbrothers.com

Adam K. White, CFA
Director of Research
White Knight Research & Trading
adam@accidentalhuntbrothers.com

- The Hunt Brothers were famous for trying to corner the silver market. They were successful in driving the futures price of silver from under $10 to over $50 an ounce. When the COMEX stepped in and made them liquidate their position, silver prices dropped back to $10 an ounce within three months.
- Institutional Investors, with nearly $30 trillion in assets under management, have decided en masse to embrace commodities futures as an investable asset class. In the last five years, they have poured hundreds of billions of dollars into the commodities futures markets, a large fraction of which has gone into energy futures.
- While individually these Investors are trying to do the right thing for their portfolios (and stakeholders), they are unaware that collectively they are having a massive impact on the futures markets that makes the Hunt Brothers pale in comparison.
- In the last 4½, years assets allocated to commodity index replication trading strategies have grown from $13 billion in 2003 to $317 billion in July 2008. At the same time, the prices for the 25 commodities that make up these indices have risen by an average of over 200%.

S&P GSCI Spot Price Index vs. Index Speculator Assets



Source: Bloomberg, Goldman Sachs, CFTC Commitments of Traders CIT Supplement, calculations based upon CFTC COT/CIT report (see appendix). 2008 figure is as of 7/1/08.

- Today's commodities futures markets are excessively speculative, and the speculative position limits designed to protect the markets have been raised, or in some cases, eliminated. Congress must act to re-establish hard and fast position limits across all markets.

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Special Report ***July 31, 2008***

ABOUT THIS REPORT

- Chapters One and Two of this report are foundational. They examine the nature of the commodities futures markets and the characteristics of Index Speculators respectively.
- Chapter Three presents the evidence that Index Speculators have been at least partially responsible for the tripling of commodities futures prices over the last five years. *If you read only one chapter in this report this is the one to read.*
- Chapters Four, Five and Six are shorter, conceptual chapters that tackle the topics of the Price Discovery Function, Excessive Speculation and Speculative Position Limits, respectively. They are valuable for understanding the nature of the solutions recommended to combat Excessive Speculation and Index Speculation.
- Chapter Seven presents our recommended legislation solutions.

ABOUT THE AUTHORS

Michael W. Masters is a long/short equity hedge fund portfolio manager and the founder of Masters Capital Management, LLC. Mr. Masters graduated in 1989 from the University of Tennessee with a B.S. in Finance. Mr. Masters was an All-American swimmer at UT. In 1994, Mr. Masters founded Masters Capital Management (MCM). MCM is a global investment management firm that trades and invests in public and private, domestic and international, bonds and equities. In March of 2005, Mr. Masters and Wilbur L. Ross, Jr. formed a partnership to focus on investments in early-, mid- and late-stage companies employing nanotechnology-enabled products and solutions. Mr. Masters was profiled in the book "Stock Market Wizards" by Jack D. Schwager and was the winner of the "Open Your Heart" award in 2004 from the organization Hedge Funds Care. Mr. Masters has started several foundations including St. Croix Mission Outreach and the Atlanta Men's Enterprise Network. Mr. Masters currently serves on the boards of several charitable and private organizations.

Adam K. White, CFA is currently the Director of Research at White Knight Research and Trading an independent research consulting firm. Prior to his current position Mr. White was a successful research analyst with Masters Capital Management. In his 6-year tenure with Masters Capital he had primary research coverage for financial services stocks and was also head of derivatives strategy. Before that he worked for 3 years at The Coca-Cola Company in their treasury department where he was responsible for managing their billion-dollar emerging market currency portfolio. He was also head of the "portfolio project" at Coke treasury and built many of the options pricing systems they use today. Coming out of graduate school, Mr. White worked for Swiss Bank Corporation as a Risk Management Advisor responsible for marketing, pricing and hedging interest rate swaps and options. Mr. White holds a B.S. in Accounting from the Fisher School of Accounting at the University of Florida as well as an M.B.A. in Finance and Economics from the Graduate School of Business at the University of Chicago. Mr. White also holds the Chartered Financial Analyst designation.

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EXECUTIVE SUMMARY

The commodities futures markets are a unique hybrid form of marketplace where two distinctly different categories of market participants transact side by side. Physical Hedgers access the markets to reduce the price risk of their underlying physical commodity businesses, while Speculators trade in the markets to make maximum profits.

When Physical Hedgers dominate the commodities futures marketplace, prices accurately reflect the supply and demand realities that physical consumers and producers are experiencing in their businesses. When Speculators become the dominant force, prices can become un-tethered from supply and demand, reaching irrationally exuberant heights.

In 1936 Congress devised a system to prevent the kind of speculative bubbles we are seeing today. The Commodity Exchange Act placed limits on the size of Speculators' positions, thereby ensuring the dominance of bona fide Physical Hedgers. Congress established position limits with the understanding that the proper functioning of the commodities futures markets was essential to the health of the American economy.

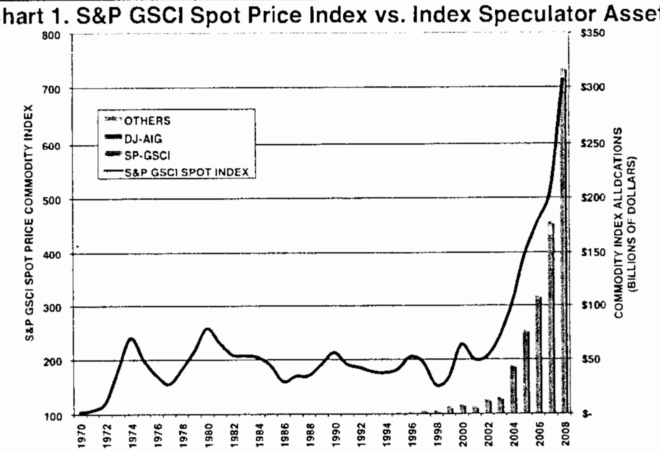
Today the agricultural and energy markets rely on futures prices as their benchmark for the pricing of nearly all their transactions in the real world "spot" markets. For many commodities, when the futures price rises by $1, the spot price rises by $1 as well. This pricing method is preferred by Physical Hedgers because it allows them to use the futures markets to hedge their price risk on a dollar-for-dollar basis.

Unfortunately, this price discovery function of the commodities futures markets is breaking down. With the advent of financial futures, the important distinctions between commodities futures and financial futures were lost to regulators. Excessive speculation gradually became synonymous with manipulation, and speculative position limits were raised or effectively eliminated because they were not deemed necessary to prevent manipulation.

Swaps dealers who trade derivatives in the completely unregulated over-the-counter (OTC) markets have been given the same virtually unlimited access to the futures markets that bona fide Physical Hedgers enjoy. These swaps dealers have convinced Institutional Investors that commodities futures are an asset class that can deliver "equity-like returns" while reducing overall portfolio risk. These investors have been encouraged to make "a broadly diversified, long-only passive investment" in commodities futures indices. As a result, a new and more damaging form of Speculator was born; we call them ***Index Speculators***.

As Chart 1 demonstrates, the result has been a titanic wave of speculative money that has flowed into the commodities futures markets and driven up prices dramatically.

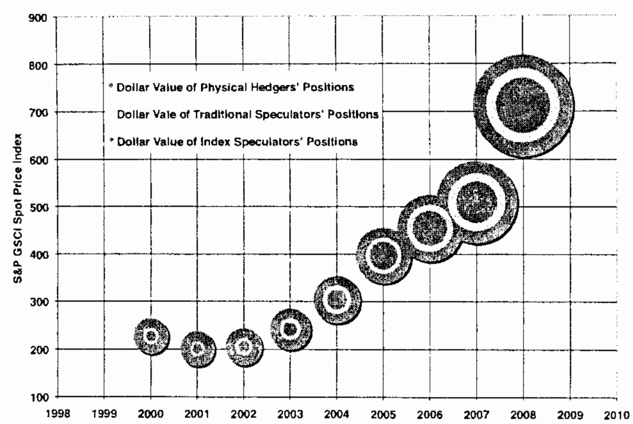
Chart 1. S&P GSCI Spot Price Index vs. Index Speculator Assets



Source: Bloomberg, Goldman Sachs, CFTC Commitments of Traders CIT Supplement, calculations based upon CFTC COT/CIT report (see appendix). 2008 figure is as of 7/1/08.

The total open interest of the 25 largest and most important commodities, upon which the indices are based, was $183 billion in 2004. From the beginning of 2004 to today, Index Speculators have poured $173 billion into these 25 commodities. As Chart 2 shows, this has caused futures prices to rise dramatically as the commodities futures markets were forced to expand in order to absorb this influx of money.

Chart 2. Commodities Futures Market Size (Billions) vs. S&P GSCI Spot Price Index

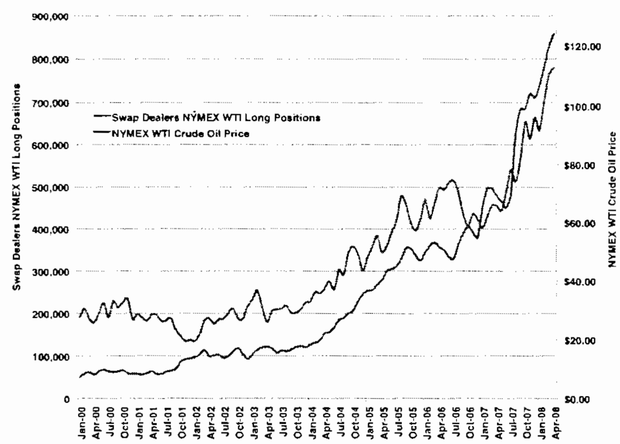


Source: Bloomberg, Goldman Sachs, CFTC Commitments of Traders CIT Supplement, calculations based upon CFTC COT/CIT report (see appendix). Figures represent annual averages and 2008 figure is an average through 7/1/08.

Index Speculators have bought more commodities futures contracts in the last five years than any other group of market participant. They are now the single most dominant force in the commodities futures markets. And most importantly, their buying and trading has nothing to do with the supply and demand fundamentals of any single commodity. They pour money into commodities futures to diversify their portfolios, hedge against inflation or bet against the dollar.

The four largest commodity swaps dealers - Goldman Sachs, Morgan Stanley, J.P. Morgan and Barclays Bank –are reported to control 70% of the commodity index swaps positions. Recently released Commodities Futures Trading Commission (CFTC) data from the House Energy Committee shows that swaps dealers have grown to become the largest holders of NYMEX WTI crude oil futures contracts. Chart 3 shows that, as their positions have grown in size, so has the price of oil.

Chart 3. Swaps Dealers Positions in NYMEX WTI Crude Oil Futures vs. WTI Price



Source: Commodities Futures Trading Commission (CFTC) via the House Energy Committee, Bloomberg

Congress can put an end to excessive speculation by simply re-establishing meaningful speculative position limits that apply on all exchanges trading U.S.-based commodity futures contracts. These speculative position limits also need to be applied to transactions in the over-the-counter swaps market, since that market is now 9 times bigger than the futures exchanges.

In addition to imposing speculative position limits, Congress should take the additional step of prohibiting or severely restricting the practice of commodity index replication. This practice represents a new threat to the markets because it inflates commodities futures prices, consumes liquidity and damages the price discovery function.

Speculative position limits worked well for over 50 years and carry no unintended consequences. If Congress takes these actions, then the speculative money that flowed into these markets will be forced to flow out, and with that the price of commodities futures will come down substantially. Until speculative position limits are restored, investor money will continue to flow unimpeded into the commodities futures markets and the upward pressure on prices will remain.

CHAPTER ONE: FOUNDATIONAL INFORMATION

Commodities Futures Defined

Commodities futures markets have existed in the United States since 1865.[1] A commodities futures contract is a standardized legal agreement to transact in a physical commodity at some designated future time.[2] It is standardized in the sense that it spells out the time and place of delivery as well as the quantity and quality of commodity to be delivered. The only unspecified portion of the contract is the price, which is determined in the commodities futures marketplace.

Since their inception, commodities futures markets have provided two valuable functions for physical commodity market participants (the actual consumers and producers of the physical commodities). In the Commodity Exchange Act of 1936, Congress recognized that the commodities futures markets provide physical market participants with: (1) the means to offset price risk, and (2) a means for price discovery.[3] Since 1974, Congress has entrusted the Commodities Futures Trading Commission (CFTC) with preserving these two vital functions and with protecting them against the threat of fraud, manipulation and excessive speculation.

First Vital Function: Offsetting Price Risk

Commodities futures markets provide a way for physical commodity market participants to hedge against the risk of price fluctuations. As an example, a physical commodity producer, such as an Iowa corn farmer, who is able to sell futures contracts against the amount of the expected harvest can lock in a price for corn and thereby eliminate price risk. A physical commodity consumer, such as a cereal manufacturer, who is able to buy futures contracts for the amount of corn it needs to produce corn flakes can lock in its input costs and eliminate its price risk.

These physical commodity market participants benefit because they are not at risk from price fluctuations and can therefore plan effectively for the future of their businesses. Because food, energy and industrial metals form the basic building blocks of our economy, the financial health of physical commodity market participants is vital to the overall health of the American economy.

Second Vital Function: Price Discovery

Properly functioning commodities futures markets provide a way for physical commodity market participants to determine with the greatest possible accuracy the current price for physical commodities in the overall marketplace. As an example, the farmer in Iowa needs to know the prevailing price for corn before selling to a local consumer. Knowing the futures price allows the farmer to determine if it makes more sense to ship the corn somewhere else in order to get a better price. Likewise, the cereal manufacturer needs to know the prevailing price for corn so that it can negotiate a fair price with its suppliers.

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[1] "Our History," Chicago Board of Trade, http://www.cbot.com/cbot/pub/page/0,3181,942,00.html

[2] "Financial Futures and Options," Todd E. Petzel, Quorum Books, New York, 1989, page 5.

[3] Commodity Exchange Act of 1936: Title 7 Chapter 1 Section 5a http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=browse_usc&docid=Cite:+7USC5

Commodities, by their very nature, are consumed around the globe. Physical commodity markets exist worldwide, but because commodities are bulky and costly to transport, the prices in these markets can vary substantially. For that reason, commodities futures prices have become the benchmark by which prices are set in the physical markets.[4]

In Chapter Four we discuss the price discovery function in depth.

Since prices are the mechanism by which a capitalist economy functions and allocates resources, having this single benchmark for commodity prices is very valuable. Without the price discovery function of the commodities futures markets, the American economy as a whole would function inefficiently.

Two Traditional Types of Market Participants

Historically, the commodities futures markets have had two distinct categories of participants: bona fide Physical Hedgers and Speculators.

Bona fide Physical Hedgers have already been discussed. These are physical commodity market participants that are trying to reduce or eliminate the price risk they face from their commercial activities in the spot markets. These are the producers and consumers - the corn farmers and the cereal companies of the world.

The commodities futures markets were started by physical commodity producers and consumers to improve their businesses and ultimately to strengthen the economy. These markets exist for their benefit.

Speculators are participants in the commodities futures market who do not have an underlying physical commodity position to hedge. They are hoping to profit from changes in futures prices. When commodities futures markets function as they should, Speculators provide an essential function: they accept price risk in exchange for providing liquidity.

As an example, if our corn farmer wants to sell futures contracts but the cereal company is not in the market that day buying, who can the farmer sell them to? The answer is that Speculators are willing to buy from the corn farmer one day and sell to the cereal company another day. For this reason, the commodities futures markets need a certain number of Speculators in order to ensure sufficient liquidity.

When the commodities futures markets are functioning as they should, Speculators are actively buying and selling and adjusting their prices based on what they think the Physical Hedgers are going to do. Speculators have traditionally been students of the supply and demand dynamics in the underlying physical markets, because those dynamics are what determine the behavior of Hedgers.

As an example, if many corn crops were failing, then farmers would not have as many futures contracts to sell. Because of the reduced supply of corn and the consequent reduced supply of corn futures contracts, futures prices would normally

[4] The terms "physical markets," "spot markets" and "underlying markets" all refer to the markets in which tangible commodities are bought and sold by actual producers and consumers. In contrast, the futures markets are where derivative contracts based on commodities are traded.

rise. Historically, Speculators have had to understand and act on these dynamics in order to stay in business.

Four Distinct Types of Markets

Commodities futures markets are not capital markets. It is critical to understand the similarities and differences (presented in Exhibit 1) between the four different markets discussed in this report. A thorough understanding of the current problems and proposed solutions is not possible without recognizing these crucial distinctions.

Capital Markets

The two most common capital markets are the debt markets and equity markets. These markets exist to provide debt and equity financing to corporations and other entities. In the *primary markets* bonds and stocks are issued to investors. In the *secondary markets* investors trade these securities back and forth amongst themselves. In 2004-2005, worldwide bond and stock markets totaled approximately $97.9 trillion in size, with debt markets accounting for $54.3 trillion and equity markets $43.6 trillion.[5]

Financial Futures Markets

Commodities futures exchanges began trading futures contracts based on financial securities beginning in the 1970s. These financial futures became very popular in the 1980s. Financial futures are based on things such as Eurodollar deposits, Treasury Bonds, foreign currencies and the S&P 500 stock index. These are derivative markets, so they allow Investors / Speculators to assume price risk or to hedge price risk depending on their position in the underlying securities relative to the futures.[6]

Just like the capital markets, the financial futures markets are the exclusive domain of one type of market participant – Investors / Speculators. Trading for them is also a two-way street, as they trade back and forth amongst themselves.

Exhibit 1. Four Distinct Markets

COMMODITY MARKETS	CAPITAL MARKETS
Crude Oil, Corn, Copper, etc.	Stocks, Bonds, Real Estate, etc.
$1.6 Trillion (2002)	$97.9+ Trillion (2004-2005)
Physical Commodity Producers and Consumers	Investors / Speculators
COMMODITIES FUTURES	**FINANCIAL FUTURES**
Derive their value from physical commodities	Derive their value from capital markets securities
$0.18 Trillion (2004)	$21 Trillion (2008)
Physical Hedgers **AND** Speculators	Investors / Speculators

[5] CIA World Factbook: Debt figure is for 2004 and equity figure is for 2005. https://www.cia.gov/library/publications/the-world-factbook/geos/xx.html#Econ

[6] Within the capital markets and the financial futures markets there is little difference between the trading behavior of Investors and Speculators. Wikipedia has a good description of the differences between investing and speculating and what is commonly defined as investment. http://en.wikipedia.org/wiki/Investing

Financial futures have far surpassed commodities futures in terms of volume and open interest and represent the lion's share of profits for many of the futures exchanges. Total open interest for financial futures was in the neighborhood of $21 trillion in July of this year.[7]

Physical Commodity Markets

Physical commodity markets are tangible real world markets where producers and consumers meet to buy and sell commodities. Rather than being a two-way street where an existing pool of securities is traded back and forth between participants, it is a one-way street where producers produce and consumers consume. Once producers have sold their production, they do not come back to the commodity markets until they have produced more. Likewise, once consumers have purchased commodities, they do not return to the markets until they have consumed what they purchased.

In 2002, the worldwide annual production of the 25 largest and most important commodities in the world was $1.6 trillion.[8] While this is a large number, it is dwarfed by the size of capital markets and financial futures markets.

Commodities Futures Markets

The commodities futures markets are small markets, especially when compared with the capital markets. As we will see in Chapter Three, the commodities futures markets were only $183 billion in size in 2004.

Commodities futures markets are unique because they involve not one but two distinct categories of market participants. Unlike the other markets we have discussed, physical commodity market participants co-exist alongside Speculators. Trading amongst Speculators is generally a two-way street like in the capital markets. In contrast, Physical Hedgers only have to trade once to establish their hedges and then they either take delivery of the physical commodity or unwind their hedges prior to delivery.

This hybrid combination of two distinctly different categories of market participants with differing goals, behaviors and trading patterns make the commodities futures markets unique.

Bringing Clarity to Blurred Distinctions

When financial futures started to gain popularity in the 1980s, many Wall Street investment banks that previously had no presence in commodities futures began to acquire trading firms with seats on the futures exchanges.[9] During the first hundred years that commodities futures markets existed, Wall Street had little interest in

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[7] Rough calculations based on July 1 Commitments of Traders report published by the CFTC. Eurodollars and Treasury Bills are over $14 trillion and $4 trillion respectively.

[8] This figure was calculated using average 2002 prices from Bloomberg and production figures from the Food and Agriculture Organization of the United Nations, the U.S. Geological Survey – U.S. Department of the Interior, and the Energy Information Association – U.S. Department of Energy. These are the same 25 commodities that compose the major commodity indices.

[9] An example of this phenomenon would be the Goldman Sachs purchase of J. Aron in 1981.

commodities futures. It was only after acquiring these futures trading firms to get access to the financial futures markets that Wall Street got interested in the commodities futures business that they inherited as a result of their acquisitions.

Most Institutional Investors today fail to see the distinction between capital markets and commodities futures markets. They can call up Goldman Sachs and purchase instruments in both markets. They can use Bloomberg to get data on both markets, and when they open the Wall Street Journal they can read about both markets. And yet, as we have seen already (and will explore further), there are crucial distinctions between commodities futures markets and all other markets.

Speculative Price Bubbles

It is worth noting that speculative price bubbles occur in capital markets and not in physical commodity markets. In fact, in just the last 10 years the U.S. capital markets have seen three distinct major bubbles: the tech / internet bubble of 1998-2000 (equities), the housing bubble of 2004-2007 (real estate) and the current credit crisis (CDOs / SIVs / subprime) in the debt markets.

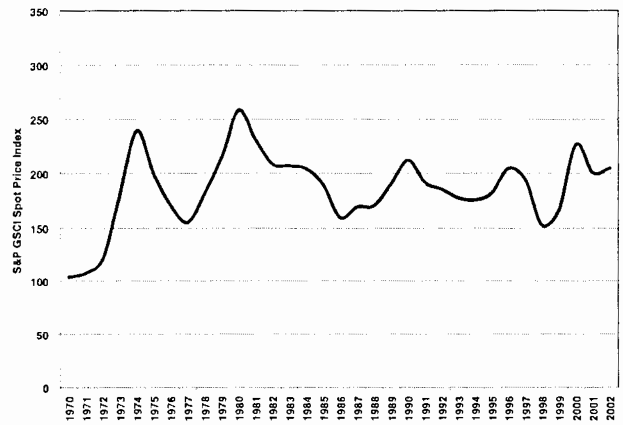
In order for a price bubble to occur, there must be a group of Investors / Speculators, trading back and forth amongst themselves, that are continuously re-valuing upward the profit potential of a class of financial instruments. When consumers purchase physical commodities, they are simply looking to consume those commodities. Consumers don't buy commodities for reasons other than consumption.

Because Speculators participate in commodities futures markets, these markets are capable of experiencing a speculative price bubble. Because Physical Hedgers only want to reduce their price risk, as long as they are the dominant group in the marketplace, speculative bubbles cannot form. But if Speculators somehow become the dominant force, then they can eventually drive the markets to speculative excess. We discuss this in detail in Chapter Five.

Commodities Futures Are Not Investments

Historically, physical commodities themselves have been looked upon as poor "investments" because they have a negative real rate of return. Economists agree that the long-term equilibrium price for a commodity generally equates to its marginal cost of production. Since marginal costs for commodity production have been steady to declining due to the application of modern technology, the prices of commodities have historically not kept up with overall inflation. Chart 4 shows that prior to recent increases, spot commodity prices have traded sideways for three decades.

Chart 4. S&P GSCI Spot Price Index (1970-2002)



Source: Bloomberg

Commodities futures contracts do not pay interest, rents, dividends, or entitle the holder to a share of a company's future cash flow. Therefore, the only return someone can hope to achieve is a favorable change in the price of the contract. This is why buying commodities futures is considered speculation and not investment. For decades, pension plan fiduciaries, as well as other trustees, were prevented from purchasing futures contracts because the Prudent Man rule forbade speculation and therefore prohibited the purchase of futures contracts.[10]

In the early 1990s, the Prudent Investor rule was adopted by most states that allowed trustees to purchase instruments with a view toward the impact it would have on their total portfolio. With the advent of financial futures, futures contracts were no longer expressly prohibited because financial futures could potentially be used to hedge the price risk of financial securities within an investor's portfolio. The Prudent Investor rule did not, however, declare that speculation was acceptable.[11]

[10] "Trust Examination Manual," Federal Deposit Insurance Corporation, Section 3 - Asset Management - Part I(C) Prudent Investments. http://www.fdic.gov/regulations/examinations/trustmanual/section_3/fdic_section_3-asset_management.html#c

[11] ibid.

CHAPTER TWO: RISE OF THE INDEX SPECULATOR

What Is an Index Speculator?

Index Speculators are Institutional Investors engaged in commodities futures trading strategies that seek to replicate one of the major commodities indices by mechanically following that index's methodology. Index Speculators aim to profit from price movements in commodities futures. They are not in the market to hedge an underlying exposure to physical commodities. They are not involved in the production or consumption of actual tangible commodities. Therefore, Index Speculators are not Physical Hedgers; instead, they are a particularly damaging form of Speculator.

Who Are the Index Speculators?

Index Speculators are predominantly Institutional Investors such as corporate and government pension funds, sovereign wealth funds, university endowments, public and private foundations and life insurance companies.[12] Normally, these organizations invest in the debt, equity and real estate markets. According to the most recent estimates, Institutional Investors have approximately $29 trillion dollars allocated to various asset classes.[13]

Why Are They Indexing?

To understand why Institutional Investors would pursue a speculative commodity index replication trading strategy, it is important to understand a little bit of recent history. As was mentioned in the last chapter, prior to the early 1990s, pension funds were banned from trading commodities futures. From the mid 1990s to 2000, pension funds and other investors increased their allocations to stocks. So when the tech bubble burst in 2000, their portfolios suffered. In the subsequent two years, equities performed poorly. Investors were negatively impacted by the 9/11 attacks, the ensuing recession, the Enron and WorldCom accounting scandals and the build-up to the Iraq War.

By 2003, these investors wanted to reduce their holdings of equities and increase their allocation to "alternative assets." Institutional Investors were looking for new asset classes that would provide returns that were uncorrelated with the existing assets in their portfolios. Investments in commodities were being marketed to these pension funds as "providing equity-like returns" while reducing overall portfolio risk.[14] In these pitches, the pension funds were encouraged to make a "broadly-diversified, long-only, passive investment" in commodity indices. The discovery of commodities futures as a new investable asset class was to many of these Investors akin to discovering the Holy Grail.

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[12] Pension funds represent about 65%-75% of institutional assets (source: Standard & Poor's "2008 Money Market Directory"). When we refer to pension funds in this report we are often using them as an example for the overall category of institutional investors.

[13] Tax-exempt assets $26TT: "UK pension fund returns at five-year low," IFAonline, Jennifer Bollen, January 28, 2008. http://www.ifaonline.co.uk/public/showPage.html?page=698204

Sovereign Wealth Funds $3TT: "Sovereign Wealth Funds," Council On Foreign Relations, Lee Hudson Teslik, January 18, 2008. http://www.cfr.org/publication/15251/

[14] "Investing and Trading in the GSCI," Goldman, Sachs & Co., June 1, 2005.

What Are the Indices?

The Standard & Poors - Goldman Sachs Commodity Index[15] and the Dow Jones - AIG Commodity Index[16] are the two most popular commodity indices, with the S&P-GSCI holding approximately 63% market share to the DJ-AIG's 32% market share.[17] Table 1 shows their component weights. The S&P-GSCI has 24 commodities that are weighted according to their worldwide production values. The DJ-AIG has 19 commodities (18 of which it shares with the S&P-GSCI) that are weighted based on worldwide production and liquidity factors.

Table 1. Commodity Index Weights (as of 7/1/08)

		S&P-GSCI	DJ-AIG	Wtd Avg
Agricultural	Cocoa	0.2%	0.0%	0.2%
	Coffee	0.5%	2.7%	2.1%
	Corn	3.6%	6.9%	5.2%
	Cotton	0.7%	2.2%	1.6%
	Soybean Oil	0.0%	2.9%	2.9%
	Soybeans	0.9%	7.4%	5.1%
	Sugar	2.1%	2.8%	2.6%
	Wheat	3.0%	3.4%	3.1%
	Wheat KC	0.7%	0.0%	0.7%
Livestock	Feed Cattle	0.3%	0.0%	0.3%
	Lean Hogs	0.8%	2.5%	1.8%
	Live Cattle	1.6%	4.1%	3.0%
Energy	Brent Crude Oil	14.8%	0.0%	14.8%
	WTI Crude Oil	40.6%	15.0%	36.6%
	Gasoil	5.4%	0.0%	5.4%
	Heating Oil	5.3%	4.5%	5.1%
	Gasoline	4.5%	4.1%	4.4%
	Natural Gas	7.6%	16.0%	11.9%
Base Metals	Aluminum	2.1%	6.9%	5.1%
	Lead	0.2%	0.0%	0.2%
	Nickel	0.5%	1.7%	1.2%
	Zinc	0.4%	1.8%	1.4%
	Copper	2.6%	6.7%	4.9%
Precious Metals	Gold	1.5%	6.1%	4.6%
	Silver	0.2%	2.4%	2.1%

Source: Standard & Poors, Dow Jones and calculations

Because futures prices have become the benchmark for spot prices, both indices are based on commodities futures prices and not on underlying spot prices. The S&P-GSCI and the DJ-AIG are both based predominantly upon the prices of the nearest-to-expiration futures contracts for their respective set of commodities.

Please note that most popular investment indices such as the S&P 500 Stock Index are based upon capital markets securities. The critical distinction between these indices and the commodities market indices is that the commodities indices (the S&P-GSCI and the DJ-AIG) are based not on tangible securities but on derivative instruments – futures contracts.

Because commodities futures expire every one to three months, these indices specify a process of *rolling* the weights of the futures from the expiring month's contract to the next available contract.[18] This rolling of weights takes place on five (5) consecutive business days near the beginning of the month prior to expiration.[19] On each one of these days the

[15] http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_gsci/2,3,4,0,0,0,0,0,0,1,1,0,0,0,0,0.html for the S&P-GSCI

[16] http://www.djindexes.com/mdsidx/?event=showAigHome

[17] Chapter 3 details how much money is benchmarked to each of these indices.

[18] The DJ-AIG says that for commodities with monthly contracts (mostly energy and base metals) they will skip a month and roll to the contract with two months to expiration. The net effect is that the roll occurs 6 times a year instead of 12 times a year.

[19] For the S&P-GSCI the roll period is business days 5-9 and for the DJ-AIG it is business days 6-10.

index transfers 20% of its weight from the expiring contract to the next futures contract.

How Do Pension Funds Allocate Money to These Indices?

In order to replicate these indices a trader must purchase futures contracts and then roll these positions in the exact manner that the indices roll their weight from one contract to the next. Since this roll takes place every month, this strategy requires the trader to be very active in trading futures. For this reason, most Institutional Investors choose to outsource the management of their futures trading to Wall Street Banks.

Reportedly, 85% to 90% of Institutional Investors seeking to allocate money to commodities choose to do so by entering into over-the-counter (OTC) commodity index swaps with Wall Street Banks.[20] Once an institution has entered into the swap agreement, it becomes the Bank's responsibility to trade the futures correctly in order to replicate the index on the investor's behalf

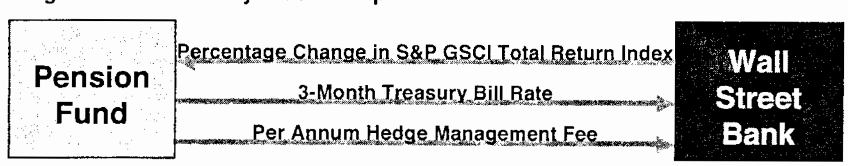
How Does a Swap Work?

In a swap agreement, two counter-parties agree to exchange two different sets of cash flows. The most common swaps are for interest rates, where one party pays a fixed rate and the other party pays a floating rate.

In a typical commodity index swap agreement (depicted below), the pension fund agrees to pay the 3-month Treasury-bill rate plus a management fee to a Wall Street Bank, and the Bank agrees to pay the total return on either the S&P-GSCI or the DJ-AIG index.[21]

Once the swap is entered into, the pension fund will take the notional amount of the swap and invest that amount in 3-month T-bills. This enables the pension fund to make the periodic payments to the Wall Street Bank. Sometimes this strategy is referred to as a collateralized commodities futures strategy because the Index Speculator is effectively posting 100% margin and is therefore fully collateralized.

Diagram 1. Commodity Index Swap



Source: Goldman Sachs

Once entered into, the swap obligates the Wall Street Bank to pay the S&P-GSCI Total Return Index to the pension fund.[22] Therefore, the Bank's swaps trader must hedge the position. In order to perfectly replicate the S&P-GSCI TR index, the trader

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[20] "Commodities: Who's Behind the Boom?" Gene Epstein, Barron's, March 31, 2008. Examination of the CFTC's CIT Supplement to the Commitments of Traders report also makes it clear that 85% to 90% of all index positions are held by swaps dealers.

[21] "Investing and Trading in the GSCI," Goldman, Sachs & Co., June 1, 2005

[22] Because assets benchmarked to the S&P-GSCI are nearly double that of the DJ-AIG, all examples reference the S&P-GSCI.

must exactly follow the commodities futures trading strategy outlined by the S&P-GSCI index methodology.

Diagram 2. Commodity Index Swap Hedging

The Goldman Roll

Whether the Index Speculators are trading futures themselves, or they have outsourced their trading strategy to a swaps dealer, there comes a time when their commodities futures position must be rolled in order to avoid delivery of physical commodities. To do this, a trader will enter into a pre-packaged trade called a "calendar spread." In a calendar spread, a trader simultaneously buys a more distant future and sells their closer-to-expiration future. It is commonplace for traders to roll their positions forward to avoid delivery, so the market facilitates these spread trades, which have their own bid and ask quotations. By packaging the buy and sell together as one trade, the market impact on price is minimized.

Even so, when all Index Speculators roll their positions in unison, it impacts the markets significantly. In Chapter Three, when we detail the size of Index Speculators' futures positions, it will become apparent that because all Index Speculators follow the exact same trading methodology, they have a huge impact on the commodities futures markets. A quick Google search for the term "Goldman Roll" will yield many articles from trading websites about how Speculators plan to position themselves in advance of the regularly recurring Goldman Roll phenomenon.[23]

Index Speculators Invest Ultra-Long-Term

It is important to note that pension funds and other Institutional Investors have extremely long investment time horizons. For example, the average duration of a pension fund's portfolio is designed to match the average employee's years until retirement. This can easily be 20 years or more, depending on the organization. That means that when Index Speculators enter into their commodities futures positions, they intend to maintain that position, via continuous rolling, for a very long time. Therefore, they capture large amounts of available liquidity that they have no intention of releasing in the foreseeable future.

We noted in Chapter One that the reason Traditional Speculators were not completely banned from the commodities futures markets was because they provide beneficial liquidity to the markets. An Index Speculator that consumes liquidity for decades at a time hurts rather than helps the commodities futures markets. Investors would not be allowed to hoard physical commodities, they should not be allowed to hoard commodities futures contracts either.

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[23] http://www.google.com/search?q=goldman+roll

Index Speculators Are Long-Only

Index Speculators are overwhelmingly "long-only;" they do not take short positions. While this type of investment behavior may be considered desirable in the capital markets, it is detrimental to the commodities futures markets.

If Index Speculators took both long and short positions, then they would push prices both up and down. Some might push them up while others might push them down, thereby canceling each other's impact on market prices. This is what Traditional Speculators do. Unfortunately, Index Speculators lean only in one direction - long - and they lean with all their weight. The result is that they push prices in only one direction - up.

Index Speculators Have a Price-Insensitive Dollar Demand

Physical commodity consumers generally have fixed quantities that they must purchase as inputs for their manufacturing process. They are highly motivated to get the lowest average price per unit in order to minimize their total costs.

Index Speculators, however, are insensitive to unit price. They do not need a set number of units, nor are they concerned with what price they pay. Instead, they have a fixed amount of money to allocate. They will buy as many units as they can at whatever price they have to pay until all of their money has been "put to work." The "passive" nature of Index Speculators has been lauded, but is the root cause for their price insensitivity.

We will detail this highly detrimental aspect of Index Speculator demand in the next two chapters.

Index Speculators Damage The Price Discovery Function

Not only do Index Speculators buy without regard to price they also buy without regard to supply and demand fundamentals. By definition, these Institutional Investors invest in a broad basket of commodities and therefore have little, if any, view on the individual commodities. Every contract traded for reasons other than supply and demand is a contract that damages the price discovery function.

We discuss this in-depth in Chapters Four and Five.

CHAPTER THREE: INDEX SPECULATORS HAVE DRIVEN FOOD AND ENERGY PRICES HIGHER

Introduction

In the last five years, futures prices have risen dramatically because of supply and demand ***and demand***. What do we mean by this? Normal supply and demand in the commodity markets have always had an effect on futures prices, but now for the first time there is a huge new source of artificial financial demand that has also contributed greatly to higher prices. Institutional Investors have poured hundreds of billions of dollars into the commodities futures markets as part of a portfolio allocation decision. This titanic wave of money has greatly amplified the current upward trend of commodities futures prices.

Money Flow, Expressed as Buy Orders, Moves Prices

If a homeowner lists a house for sale and five buyers show up that same day with checkbooks in hand, the homeowner will likely get a higher price for the house than if only one buyer shows up after the house has sat on the market for months.[24] Why is this? It is simple, money moves markets; money moves prices.

When money flows into commodities futures markets it results in buy orders. At the most basic level, buy orders are the only thing that cause prices to rise in the futures markets. When a trader sends a buy order to the exchange floor or presses the "buy" key on a trading terminal, if the trader is attempting to buy more contracts than are currently offered for sale at the market price, then the market price will rise.

As a hypothetical example, if there are 50 WTI Crude Oil contracts offered for sale at $135.10 and another 50 WTI Crude Oil contracts offered for sale at $135.15 then a buy order of 100 contracts will result in the price moving up from $135.10 to $135.15.

Please note that *who* initiates a buy order and *why* it is initiated are irrelevant when it comes to explaining an order's impact on market prices. Almost all trading is anonymous. A 100-contract buy order from a bona fide Physical Hedger locking in input costs will have the exact same price impact as a 100-contract buy order from an Institutional Investor trying to allocate into commodity futures. 100 contracts is 100 contracts and demand is demand, regardless of who is initiating the buy orders and why they are initiating them.

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[24] Under both scenarios there is a seller and a buyer but two very different prices.

Institutional Investors Have Driven Prices Higher by Pouring Money into Commodities Futures

Commodities futures market participants fully understand what causes prices to move. As the following quotes from recent research reports show, they know who is largely responsible for the rise in commodities futures prices:

> "A Tidal Wave of Fund Flow - Despite the economic gloom many commodity prices hit new highs in recent weeks, driven largely by investment inflows."[25]
>
> *Citigroup - April 7, 2008*

> "You have a generalized commodity bubble due to commodities having become an asset class that institutions use to an increasing extent."[26]
>
> *George Soros, April 17, 2008*

> "The entry of new financial or speculative investors into global commodities markets is fueling the dramatic run-up in prices"[27]
>
> *Greenwich Associates - May 2008*

> "Without question increased fund flow into commodities has boosted prices."[28]
>
> *Goldman Sachs - May 5, 2008*

> "We have argued recently that some of the price buoyancy during Q1 reflected financial flows and investments in oil and other commodities. . . . Our study indicated that for every $100 million in new inflows, WTI prices increase by 1.6%. . . . Our conclusion for this study is that we are seeing the classic ingredients of an asset bubble."[29]
>
> *Lehman Brothers - May 29, 2008*

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[25] "Great Bulks of Fire IV," Citi Commodities Strategy, Alan Heap and Alex Tonks, April 7, 2008, page 1.

[26] "Soros Says Commodity `Bubble' Still in `Growth Phase' (Update3)," Bloomberg News, Saijel Kishan and John Rega, April 17, 2008. http://www.bloomberg.com/apps/news?pid=20601087&sid=aUN8_k_wjFOM&refer=home

[27] "Financial Investors Fueling Commodities Boom," Greenwich Associates, Andrew Awad, Woody Canaday, et al., May 2008, page 1.

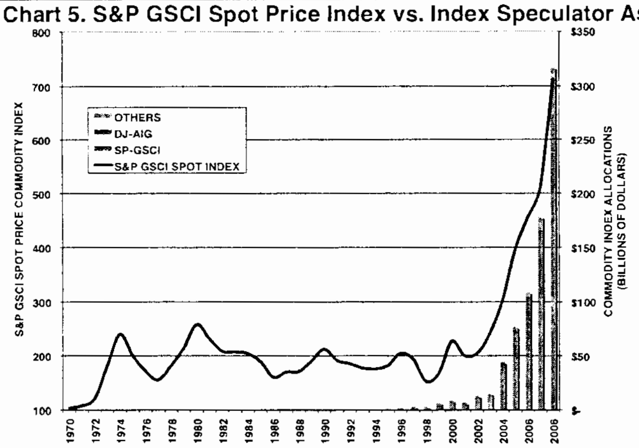
[28] $100 oil reality, part 2: Has the super-spike end game begun?," Goldman Sachs Global Investment Research, Arjun N. Murthi, Brian Singer, et al. May 5, 2008, page 12.

[29] "Oil Dot-com," Lehman Brothers Energy Special Report, Edward Morse, Michael Waldron, et. al., May 29, 2008, page 3.

Index Speculator Demand Has Driven Prices Higher

Chart 5 shows that in the five years from 2003 to July 1, 2008 commodity index investment rose by a factor of 25 times from $13 billion to $317 billion and commodity prices have tripled.

Chart 5. S&P GSCI Spot Price Index vs. Index Speculator Assets



Source: Bloomberg, Goldman Sachs, CFTC Commitments of Traders CIT Supplement, calculations based upon CFTC COT/CIT report (see appendix). 2008 figure is as of July 1, 2008

One of the clearest indications that Index Speculator demand is driving prices higher is the fact that every single one of the 25 commodities which make up the S&P GSCI and the DJ-AIG indices have all risen substantially during the last five years.[30] If purely fundamental economic factors were at work, then one would expect to see some prices going up and some prices going down. Table 2 shows that the prices of these 25 commodities skyrocketed by an average of more than 200% from July 2003 to July 2008

Table 2. Commodity Futures Prices

July 1, 2003 – July 1, 2008

Agricultural	Cocoa	+ 101%
	Coffee	+ 160%
	Corn	+ 214%
	Cotton	+ 18%
	Soybean Oil	+ 196%
	Soybeans	+ 160%
	Sugar	+ 121%
	Wheat	+ 177%
	Wheat KC	+ 190%
Livestock	Feed Cattle	+ 30%
	Lean Hogs	+ 11%
	Live Cattle	+ 48%
Energy	Brent Crude Oil	+ 397%
	WTI Crude Oil	+ 364%
	Gasoil	+ 448%
	Heating Oil	+ 399%
	Unleaded Gas	+ 298%
	Natural Gas	+ 154%
Base Metals	Aluminum	+ 124%
	Lead	+ 265%
	Nickel	+ 157%
	Zinc	+ 141%
	Copper	+ 433%
Precious Metals	Gold	+ 169%
	Silver	+ 298%
	Average	+ 203%

Source: Bloomberg

The Addition of Index Speculator Demand to Existing Demand Has Created a Massive Demand Shock

In the past when commodities prices have spiked, it has typically resulted from a significant supply shortage, also known as a "supply shock." For instance, the Arab Oil Embargo in 1973 dramatically reduced the available supply of oil and caused oil prices to rise.

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[30] These index commodities are also the 25 largest and most important from the standpoint of the world economy. That is why they were chosen to be part of the indices.

Today, commodity prices have risen dramatically but *there are few shortages.* There are no consumers waiting in line for gasoline. OPEC says that there are no supply shortages in the world oil markets.[31] The shelves of grocery stores around the world are stocked. The problem is that people cannot afford to buy the food.[32] It is *prices,* not *supply,* that has led to food riots around the globe.[33]

Currently, the commodities futures markets are experiencing a *demand shock* across all 25 commodities that make up the S&P-GSCI and DJ-AIG. Demand shocks are rare. Events can occur overnight which will wipe out large fractions of supply, but it is rare to see demand for something change dramatically in a short amount of time. A demand shock that would occur simultaneously in the 25 largest and most important commodities is something never before seen in history. But that is exactly what has occurred in the last five years. Even more amazing is the fact that even though commodities futures prices have tripled, demand appears to be growing at an accelerating rate. Pundits have pinned the blame for this demand shock on China but this only goes so far in explaining this phenomenon.

Table 3 on the next page shows how much of each commodity Index Speculators were holding via the futures markets in January 2003 and in July 2008.[34] The middle column represents the net purchases of these Index Speculators in the commodities futures markets during the last 5½ years. It is very important to put these purchases into perspective in order to grasp the magnitude of the impact this additional demand is having upon the markets.

While comparing incremental purchases in the physical commodity markets to incremental purchases in the commodities futures markets is not exactly an apples to apples comparison, it is still instructive for understanding this phenomenon. It gives us a sense of the impact on futures prices that these Index Speculator purchases might have. Since only a fraction of real world consumption is hedged with futures and 100% of Index Speculators purchases occur in the futures market, it is debatable which entity is actually having the greater impact on the futures price.

Crude Oil in Perspective

In the popular press the explanation given most often for rising oil prices is the increased demand for oil from China. Remember, if demand for oil stays the same then prices will stay the same. If supply is constant then demand has to increase for prices to increase. Table 4 on the next page shows that in the last 5½ years China has increased its consumption of petroleum by 992 million barrels. This is far and away the biggest increase of any country. There is little doubt that this increased demand is having some impact on crude oil prices.

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31 "Market supplied with enough oil, OPEC official says," Reuters, April 5, 2008. http://biz.yahoo.com/rb/080405/iran_opec.html

32 "The silent tsunami," The Economist, April 17, 2008. http://www.economist.com/opinion/displaystory.cfm?story_id=11050146

33 "Britain: World Food Crisis a 'Silent Tsunami'," AGENCE FRANCE-PRESSE, April 23, 2008. http://www.nytimes.com/2008/04/23/world/europe/23fbriefs-WORLDFOODCRI_BRF.html?ref=world

34 See "Appendix: How to Calculate Index Speculators' Position Size"

Table 3. Index Speculators' Futures Purchases Last 5½ Years

		Index Speculators' Futures Stockpile as of 1/1/03	Index Speculators' PURCHASES Last 5½ Years	Index Speculators' Futures Stockpile as of 7/1/08
Cocoa	M Tons	18,828	**297,592**	316,420
Coffee	Pounds	195,716,944	**2,192,733,056**	2,388,450,000
Corn	Bushels	242,561,708	**2,070,808,292**	2,313,370,000
Cotton	Pounds	544,934,999	**5,067,015,001**	5,611,950,000
Soybean Oil	Pounds	163,135,678	**4,346,164,322**	4,509,300,000
Soybeans	Bushels	81,028,272	**829,371,728**	910,400,000
Sugar	Pounds	2,291,358,746	**44,990,337,254**	47,281,696,000
Wheat	Bushels	166,738,225	**893,321,775**	1,060,060,000
Wheat KC	Bushels	54,746,014	**89,193,986**	143,940,000
Feed Cattle	Pounds	104,446,612	**475,803,388**	580,250,000
Lean Hogs	Pounds	517,414,747	**4,536,865,253**	5,054,280,000
Live Cattle	Pounds	669,766,732	**6,202,713,268**	6,872,480,000
Brent Crude Oil	Barrels	47,075,357	**161,236,643**	208,312,000
WTI Crude Oil	Barrels	99,880,741	**580,433,259**	680,314,000
Gas Oil	M Tons	1,682,662	**6,700,238**	8,382,900
Heating Oil	Gallons	1,067,859,608	**2,739,650,392**	3,807,510,000
Unleaded Gas	Gallons	1,102,184,401	**2,646,903,599**	3,749,088,000
Natural Gas	MM Btu	330,652,415	**1,975,417,585**	2,306,070,000
Aluminum	M Tons	344,246	**3,252,704**	3,596,950
Lead	M Tons	82,019	**179,731**	261,750
Nickel	M Tons	20,147	**102,715**	122,862
Zinc	M Tons	133,381	**1,175,419**	1,308,800
Copper	M Tons	220,096.25	**1,160,192**	1,380,288
Gold	Ounces	979,863	**8,737,837**	9,717,700
Silver	Ounces	11,126,862	**149,353,138**	160,480,000

Source: CFTC Commitments of Traders CIT Supplement, calculations based upon CFTC COT/CIT report (see Appendix: How to Calculate Index Speculators' Positions)

Looking at Table 3 it shows how much petroleum Index Speculators have purchased via the futures markets. Table 5 converts metric tons and gallons into their barrel equivalents showing that Index Speculators have increased their demand for petroleum by 919 million barrels in the last 5½ years. This means that the increase in Index Speculators' demand is nearly equivalent to the increase in Chinese demand.

Table 4. Increase in Chinese Demand for Petroleum (Last 5½ Years)

Year	Consumption (Barrels Per Year)	Year over Year Change
2002	1,883,660,777	
2003	2,036,010,338	152,349,561
2004	2,349,681,577	313,671,240
2005	2,452,800,000	103,118,423
2006	2.654,750.989	201,950,989
2007	2,803,010,200	148,259,211
2008	2.948,835.000	72,912,400
	Total Change	**992,261,824**

Source: Energy Information Administration, U.S. Department of Energy. Note: 2008 figure is an estimate and change figure is for half a year.

Table 5. Increase in Index Speculator Demand for Petroleum (Last 5½ Years)

Petroleum Product	Barrels
Brent Crude Oil	161,236,643
WTI Crude Oil	580,433,259
Gas Oil	49,045,744
Heating Oil	65,229,771
Unleaded Gas	63,021,514
Total Change	**918,966,932**

Source: CFTC Commitments of Traders CIT Supplement, calculations based upon CFTC COT/CIT report (see Appendix: How to Calculate Index Speculators' Positions)

China is having an impact and it is well-known, but Index Speculators are having a similarly massive impact in the futures markets and the majority of commentators are unaware that it is even taking place. There is little question that traditional economic factors are playing a part in commodity price increases, but Index Speculator demand is also having a very significant impact on commodity futures prices.

Table 3 shows Index Speculators have built a futures stockpile of nearly 1.1 billion barrels of crude oil and crude products. This means Index Speculators have stockpiled more paper barrels of oil than all the physical barrels of oil in all U.S. commercial storage tanks and the Strategic Petroleum Reserve combined.[35]

Copper in Perspective

In 2002, world copper consumption was 15 million metric tons. For 2007, total world demand for copper was 17.7 million metric tons - an increase over 5 years of 2.7 million metric tons. China represented 2 million tons of the increase and the rest of the world was 670,000 tons. Looking at Table 6, it shows that during this same time period, Index Speculators increased their copper futures position by the equivalent of 1.1 million metric tons of copper, better than half of China's increased consumption and greater than the increased consumption of the entire rest of the world.

Table 6. Increase in Index Speculator Demand for Copper

(2002 through 2007)

	Metric Tons
China	2,039,776
Index Speculators	**1,160,192**
Rest of the World	673,310

Source: World Bureau of Metal Statistics, CFTC Commitments of Traders CIT Supplement and calculations (see Appendix)

The United States is the 2nd largest copper producer in the world behind Chile.[36] Index Speculators' current stockpile of copper futures, at 1.4 million tons, is greater than the total annual production of all the mines in the United States.[37] Building construction is the largest use for copper in the United States; Index Speculator's stockpile of copper futures could potentially supply the U.S. building construction industry for almost an entire year.[38]

Wheat in Perspective

In 2007 Americans consumed 2.22 bushels of wheat per person.[39] That means all Americans combined consumed about 665 million bushels of wheat in 2007. At 1.3 billion bushels, the current wheat futures stockpile of Index Speculators is now potentially enough to supply every American with all the bread, pasta and baked goods they can eat for the next two years!

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[35] Energy Information Administration - U.S. Department of Energy, Petroleum Navigator, http://tonto.eia.doe.gov/dnav/pet/pet_stoc_wstk_dcu_nus_w.htm

[36] U.S. Geological Survey, Mineral Commodity Summaries, January 2008, http://minerals.usgs.gov/

[37] U.S. Geological Survey http://minerals.usgs.gov/minerals/pubs/commodity/copper/

[38] Copper Development Association, http://www.copper.org/education/c-facts/homepage.html

[39] Economic Research Service, U.S. Department of Agriculture, http://www.ers.usda.gov/Briefing/Wheat/consumption.htm

Corn in Perspective

With food prices skyrocketing in the last year many economists are casting about for an explanation for the price move. They have focused on the fact that a third of the U.S. corn crop has been diverted away from exports and into ethanol production.[40] What most economists have not considered is the fact that Institutional Investors have purchased over 2 billion bushels of corn futures in the last five years. Right now Index Speculators have stockpiled enough corn futures to potentially fuel the entire United States ethanol industry at full capacity for a year.[41] That means producing 5.3 billion gallons of ethanol, which would make America the world's largest ethanol producer.[42]

Sugar in Perspective

In 2007, Brazil was the world's largest ethanol producer. Brazil produces ethanol from sugarcane. If Index Speculators were to use their current stockpile of refined sugar futures to produce ethanol it would potentially produce more than 2.6 billion gallons of ethanol,[43] which would replace at least six months of U.S. ethanol production.

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[40] "The End Of Cheap Food," The Economist, December 6, 2007. http://www.economist.com/research/articlesBySubject/displaystory.cfm?subjectid=7216688&story_id=10252015

[41] "Ethanol Reshapes the Corn Market," Economic Research Service - U.S. Department Of Agriculture, Allen Baker and Steven Zahniser April 2006. http://www.ers.usda.gov/AmberWaves/April06/Features/Ethanol.htm

[42] "Ethanol Production Could Be Eco-Disaster, Brazil's Critics Say," Kelly Hearn, National Geographic News, February 8, 2007. http://news.nationalgeographic.com/news/2007/02/070208-ethanol.html

[43] "Australian Liquid Biofuels National Production Boundaries," Brian Fleay, January 2006. http://www.aspo-australia.org.au/References/Fleay/Fleay06BiofuelsVsPetrol.pdf

Index Speculators Have Bought More Commodities Futures than All Other Groups Combined

Table 7 compares Index Speculators purchases from Table 3 with purchases by the two other categories – Physical Hedgers and Traditional Speculators. It shows that Index Speculators have bought more commodities futures contracts in the last five years than any other group of market participants. In fact, they have bought more contracts than both Physical Hedgers and Traditional Speculators combined.

Table 7. Futures Contract Purchases by Category (Last 5½ Years: January 1, 2003 to July 1, 2008)

	Physical Hedgers	Traditional Speculators	Index Speculators
Cocoa	-32,461	65,060	29,759
Coffee	-6,570	27,727	58,473
Corn	231,324	216,533	414,162
Cotton	40,618	19,019	101,340
Soybean Oil	715	10,332	72,436
Soybeans	13,305	73,360	165,874
Sugar	133,073	110,068	401,699
Wheat	13,136	34,942	178,664
Wheat KC	-5,967	12,226	17,839
Feed Cattle	3,210	374	9,516
Lean Hogs	12,399	21,955	113,422
Live Cattle	7,435	26,349	155,068
WTI Crude Oil	433,997	527,787	580,433
Heating Oil	-21,534	1,366	65,230
Unleaded Gas	14,957	38,719	63,022
Natural Gas	10,129	118,918	197,542
Gold	-9,936	124,967	87,378
Silver	3,455	7,054	29,871
TOTAL	841,284	1,436,756	2,741,728

Source: CFTC Commitments of Traders CIT Supplement, calculations based upon CFTC COT/CIT report (see appendix). Note that Physical Hedgers in this table are equivalent to the Commercial category. Any Traditional Speculators utilizing the swaps loophole (see Ch. 6) show up here as Physical Hedgers. This table does not include spread trades or non-reported trades. WTI crude oil figures include NYMEX, ICE and NYMEX financial contracts as well as CFTC reclassification. CFTC does not report data for non-U.S. traded commodities.

If Index Speculators have bought more futures contracts than everyone else, is it not reasonable to assume that they have had one of the largest impacts on futures prices?

Index Speculator Demand Is Huge Compared to the Size of Commodities Futures Markets

During the period from January 2003 to July 2008, the amount of money allocated to commodity indices grew from $13 billion to $317 billion. Most of the increase was from investor inflows, but a portion was due to the growth of prior period investments.

There is no publicly available data that shows the total amount of inflows into commodity indexation trading strategies, but some approximations can be made. End-of-year investment figures can be calculated using CFTC data[44], and annual performance is known. Therefore, the amount that the prior year's investment has grown or shrunk can be computed. The remaining difference in the yearly change has to come from net inflows.[45] Table 8 shows estimated annual inflows for the two major commodity indices as well as the total.

Table 8. Estimated Annual Inflows (Billions)

	S&P-GSCI	DJ-AIG	TOTAL
2004	$16.2	$8.9	$25.1
2005	$4.8	$12.4	$17.2
2006	$28.2	$11.3	$39.5
2007	$14.7	$15.4	$30.1
2008	$44.5	$17.0	$61.5
		Total Inflows	**$173.4**

Source: Author calculations

The best way to estimate the size of the commodities futures markets is to look at the average daily dollar value of open interest for each commodity.[46] When Wall Street Banks go out to pitch Institutional Investors on allocating money to OTC commodity index swaps, open interest is the gauge that they use to express the size of the commodities futures markets.[47]

Table 9 (on the next page) calculates the average daily dollar value of open interest by multiplying the average daily open interest in contracts times the average daily price. It shows that the average daily size of the commodities futures markets during 2004 was only $183 billion.[48] Looking back to Table 8, it shows that approximately $25 billion flowed into index replication strategies in 2004. So Index Speculator investment was about 14% of total market size. This amount of inflow had to have a huge impact.

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[44] See "Appendix: How to Calculate Index Speculators' Positions" for more details

[45] When during the year the inflows occurred is not known, so the assumption is made that all net inflows occurred evenly throughout the year. Changing assumptions on net inflow timing only affects the rate of growth for that year's inflow, which never amounts to more than a few billion dollars difference.

[46] Some market participants think that volume is a better measure of market depth, but most of the volume on the exchanges is generated by scalpers or day traders who want to profit from the ebbs and flows of intra-day price moves. For investors that plan to hold their positions for more than a few hours, open interest is the better measure of market depth, since any position held overnight is captured in the open interest figures.

[47] "Investing and Trading in the GSCI," Goldman, Sachs & Co., June 1, 2005.

[48] Table 9 has no data for base metals in 2004. If base metals are assumed to be approximately $33 billion (like 2005), that would make the total commodities futures market size around $183 billion. Since base metals prices rose from 2004 to 2005 this is a conservative assumption. The $183 billion figure appears in Chapter 1.

Table 9. Commodities Futures Markets Size – Dollar Value of Open Interest (Billions)

	2002	2003	2004	2005	2006	2007	2008
Cocoa	$1.8	$1.5	$1.6	$1.9	$2.0	$2.7	$4.1
Coffee	$1.4	$1.7	$2.7	$3.8	$4.2	$6.3	$8.4
Corn	$5.4	$5.1	$8.2	$7.7	$15.1	$23.8	$41.9
Cotton	$1.6	$3.0	$2.6	$2.8	$4.3	$6.8	$11.1
Soybean Oil	$1.4	$2.0	$2.5	$1.9	$3.2	$5.8	$8.7
Soybeans	$4.9	$7.3	$9.5	$8.8	$10.1	$20.9	$34.6
Sugar	$1.5	$1.7	$2.8	$5.1	$8.6	$8.2	$13.9
Wheat	$1.8	$1.9	$2.6	$3.8	$7.4	$11.6	$17.2
Wheat KC	$1.3	$1.1	$1.2	$1.5	$3.1	$4.1	$5.3
Feed Cattle	$0.5	$0.8	$0.8	$1.3	$1.5	$1.4	$1.7
Lean Hogs	$0.6	$0.9	$1.9	$2.3	$3.3	$3.9	$5.2
Live Cattle	$2.7	$3.6	$3.6	$4.9	$6.7	$7.9	$9.7
Brent Crude Oil	$6.6	$8.5	$12.6	$19.4	$31.1	$45.7	$61.8
WTI Crude Oil	$16.1	$20.4	$33.6	$55.3	$96.4	$171.0	$295.7
Gas Oil	$4.0	$3.7	$5.5	$10.2	$14.7	$21.0	$27.7
Heating Oil	$4.4	$5.1	$8.2	$11.8	$13.6	$17.9	$28.3
Unleaded Gas	$3.7	$3.9	$7.3	$10.3	$11.4	$16.1	$29.3
Natural Gas	$23.6	$27.8	$25.9	$42.4	$45.1	$54.1	$87.3
Aluminum	$-	$-	$-	$12.3	$23.7	$27.6	$34.9
Lead	$-	$-	$-	$0.7	$1.0	$2.2	$2.0
Nickel	$-	$-	$-	$2.0	$4.4	$6.7	$6.7
Zinc	$-	$-	$-	$2.7	$6.8	$6.9	$6.3
Copper	$-	$-	$-	$15.4	$31.5	$34.0	$41.8
Gold	$5.6	$9.9	$13.2	$13.9	$18.9	$24.9	$40.1
Silver	$2.0	$2.4	$3.7	$4.3	$6.4	$7.4	$11.8
TOTAL	$91.0	$112.2	$150.1	$246.5	$374.5	$538.7	$835.2

Source: CFTC Commitment of Traders and Bloomberg. For Base Metals, Brent Crude and Gasoil open interest represents futures only. No data for Base Metals in 2002-2004. All other commodities include delta-equivalent options positions but spread positions are omitted. WTI crude oil figures include NYMEX, ICE and NYMEX financial contracts. Figures represent annual averages and 2008 figure is an average through 7/1/08.

To put it in proper perspective, it was mentioned in Chapter One that the worldwide equity markets are $44 trillion in size. What would happen to worldwide stock prices if the stock markets experienced an inflow of 14% or $6.1 trillion? The worldwide oil markets involve production and consumption of 85 million barrels per day.[49] What would happen to oil prices if the world demand for oil jumped by 14% or 11.8 million barrels per day? It is clear that prices would rise dramatically.

Tables 8 & 9 show that while the commodities futures markets were only $183 billion in 2004, Index Speculators poured $173 billion into the markets over the ensuing 4½ years. This caused the market to expand and prices to rise dramatically in order to accommodate this huge growth in demand. Looking at Chart 6 we can see this dynamic at work. Each year as Index Speculators' positions expand, the size of the total market expands and prices are forced to rise in order to absorb these huge inflows of money.

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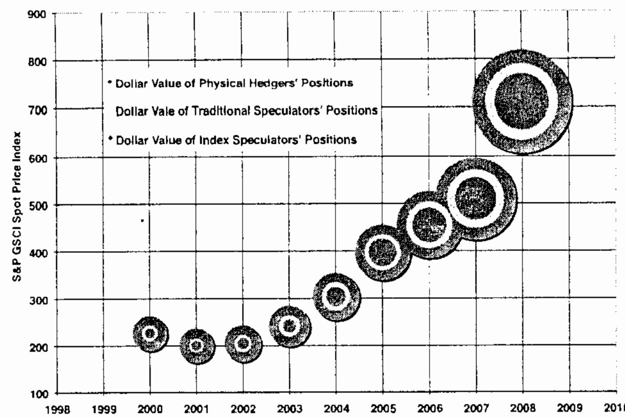
[49] Energy Information Administration - U.S. Department of Energy http://www.eia.doe.gov/emeu/international/oilconsumption.html

Chart 6. Commodities Futures Market Size (Billions) vs. S&P GSCI Spot Price Index



Source: Bloomberg, Goldman Sachs, CFTC Commitments of Traders CIT Supplement, calculations based upon CFTC COT/CIT report (see appendix). Figures represent annual averages and 2008 figure is an average through 7/1/08.

We can also see that the consistent positive price performance of commodities futures has attracted more and more Speculators into the markets. Chart 6 shows that in the first half of 2008, Index Speculators poured money into the markets at the fastest rate yet, causing prices to rise at the fastest pace to date. As Table 8 shows, an estimated $61 billion flowed into these markets in just the first six months of 2008. So while the demand from physical commodity consumers is dropping as prices increase, the demand from Index Speculators is growing even more. This growth in artificial financial demand explains why commodities prices are continuing to rise in 2008 despite physical demand decreases.

Index Speculator Demand Is Insensitive to Price

The price insensitivity of Index Speculators makes them far more damaging to the markets than Traditional Speculators. Traditional Speculators and Physical Hedgers are highly sensitive to the price they pay per unit for any particular commodity; their buy and sell decisions are determined by price per unit.

Index Speculators, in contrast, approach the commodities futures markets with a certain number of dollars, and they will buy however many units they can at whatever price they have to pay until all of their money is "put to work." It would be like a person who goes to an auto dealership with $500,000 and is unconcerned with how many cars can be bought or what the price per car is as long as the entire $500,000 gets spent.

If a pension fund allocates $500 million to the S&P-GSCI, that means it has to purchase $200 million worth of WTI crude oil contracts. The pension fund trader (or swaps dealer) will go out and start buying contracts. If the full $200 million can not be spent buying contracts at the current price then the trader will pay higher and higher prices in order to induce other traders to sell. Remember, there is only one goal: to put the $200 million into crude oil. The pension fund does not care what the per-barrel price is. If they have to drive prices up 30, 40, 50 cents in order to induce someone to sell to them, then they will do it and not think twice. They simply pour money into the markets until all their money is "put to work."

Market Power Is Concentrated in the Hands of Large Swaps Traders

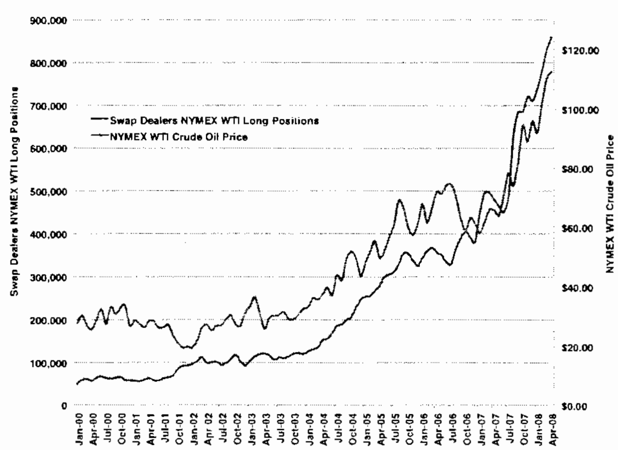
It has been reported that 85% to 90% of all Index Speculators implement their trades through commodity swaps. Further reports indicate that four swaps dealers control 70% of these positions.[50] This means that 60% of all the positions attributed to Index Speculators are controlled by the commodity index swaps traders at four Wall Street Banks. According to Greenwich Associates, the four largest commodity swaps dealers are Goldman Sachs, Morgan Stanley, J.P. Morgan and Barclays Bank.[51]

Index Speculators average about 40% of total long open interest.[52] Therefore, these four swaps traders control an average of 24% of total long open interest for the 25 commodities that make up the indices. That means one out of every four contracts on the commodities futures exchanges is controlled by these four Wall Street Banks. This represents tremendous power over markets and pricing.

Example of Swaps Dealers' Influence over WTI Crude Oil

CFTC data on swaps dealers' positions in NYMEX WTI crude oil futures contracts, recently released by the House Energy Committee, shows that swaps dealers are now the single largest holder of WTI futures contracts on NYMEX. In April of 2008 they held 30% of all outstanding contracts.[53] Chart 7 shows that when one plots the rise of swaps dealers' futures positions with the rise in WTI crude oil prices, there is a very strong correlation.

Chart 7. Swaps Dealers Long Positions in WTI Crude Oil Futures vs. WTI Price



Source: Commodities Futures Trading Commission (CFTC) via the House Energy Committee, Bloomberg

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50 "Commodities: Who's Behind the Boom?," Gene Epstein, Barron's, March 31, 2008.
51 "The Global Commodities Boom," Greenwich Associates, Andrew Awad, Woody Canaday, et al., May 2008, page 1.
52 See Table 10 in Chapter 5.
53 In April 2008 (the most recent available data) swaps dealers in total held 858,877 contracts on the long side of the market. Average April open interest was 2,905,408 contracts, which results in 30% market share. This CFTC data can be accessed at the House Energy Committee website: http://energycommerce.house.gov/Investigations/EnergySpec.shtml

Summary

As hundreds of billions of dollars have poured into the relatively small commodities futures markets, prices have risen dramatically. Index Speculators working through swaps dealers have been the single biggest source of new speculative money. This has driven prices far beyond the levels that supply and demand would indicate, and has done tremendous damage to our economy as a result.

CHAPTER FOUR: PRICE DISCOVERY FUNCTION

Introduction

The price discovery function of commodities futures markets is absolutely critical to the economic health of the United States. If prices in the futures markets are inflated due to reasons other than true supply and demand, then spot prices will also be inflated, causing great damage to our economy.

Commodities futures markets exist for two purposes: price discovery and risk hedging. If prices in the futures markets do not correlate with real world spot prices, then it becomes impossible to hedge effectively. Therefore, commodities futures prices must correlate with spot prices or the markets fail in the fundamental purpose for which they were created.

There are three primary ways in which futures prices impact spot prices. In certain markets, the spot price is the futures price, in most markets there is an arbitrage link between spot and futures prices, and in all markets futures prices are the benchmark for spot market transactions.

Spot Prices Are Equal to Futures Prices in Grain and Energy Markets

Because commodities are bulky and costly to transport, spot markets for commodities are geographically dispersed. Many decades ago, local markets relied almost exclusively on local supply and demand to determine prices, with the result being that there were sometimes great differences between prices in various regional spot markets.

This pricing mechanism began to change in the 1980s when spot market participants in the agricultural and energy markets moved to embrace centralized futures markets as the best indicator of overall supply and demand conditions across all spot markets.[54] These spot market participants agreed to price nearly all spot market transactions at the futures price plus or minus a "local basis" or "differential."

Pricing spot transactions at the futures price plus or minus a spread was beneficial to physical commodity producers and consumers for two reasons. First, they trusted and believed that the futures price was the best indication of overall supply and demand in the marketplace. Therefore, by pricing their transactions off the futures price they would not have to search for a better price in some other corner of the overall market since presumably the futures price was the most accurate overall price. Second, by specifying that their spot market transactions would take place at the futures price, Physical Hedgers were able to fully and effectively hedge their transactions using futures contracts. Their only residual risk was the local basis, or differential, that under normal market conditions typically reflected the cost of transportation between various spot markets.

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[54] "The Structure of Global Oil Markets—A Backgrounder," Platts, A Division of McGraw Hill Companies, July 2007, page 5. http://www.platts.com/Resources/whitepapers/index.xml. Additionally, conversation with Tom Buis, President of National Farmers Union, June 10, 2008.

Price Discovery in Grains

The CFTC describes the price discovery function this way: "In many physical commodities (especially agricultural commodities), cash market participants base spot and forward prices on the futures prices that are "discovered" in the competitive, open auction market of a futures exchange."[55]

As an example, a wheat farmer delivering crops to the local grain elevator will be paid the Chicago Board of Trade (CBOT) wheat futures price plus or minus the local basis spread. Any grain elevator's website will typically refer to the CBOT futures prices, along with a quote of the local basis. That means that if Wheat futures prices rise by 20 cents, then if the local basis does not change, then spot Wheat prices will also rise by 20 cents.

Price Discovery in Energy

Platts, which is the leading pricing service for the energy industry, describes this pricing mechanism this way: "In the spot market, therefore, negotiations for physical oils will typically use NYMEX as a reference point, with bids/offers and deals expressed as a differential to the futures price. Using these differentials, Platts makes daily and in some cases intra-day assessments of the price for various physical grades of crude oil, which may be referenced in other spot, term or derivatives deals."[56]

As an example of how this works, a New England Heating Oil distributor buying heating oil from the local wholesaler is going to be paying the NYMEX heating oil futures price plus or minus a local differential. That means that when the futures price rises by 20 cents, if the differential does not change, then the spot price will also rise by 20 cents, typically the same day.

The same is true for WTI crude oil. If a U.S. oil refinery wants to buy a tanker of crude oil, then the price it pays will be the NYMEX WTI crude oil futures price, plus or minus a local differential. Therefore, when the paper barrel price rises by one dollar, then the physical barrel price will also rise by one dollar.

Under this present system, price changes for key agricultural and energy commodities originate in the futures markets and then are transmitted directly to the spot markets. For these commodities, what happens in the futures markets does not stay in the futures markets, but is felt almost immediately in the spot markets.

All Storable Commodities with Physical Delivery Provisions Can Be Arbitraged

When there is a significant difference between futures prices and spot prices, market participants can enter into arbitrage transactions, which will enable them to earn risk-

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[55] "The Economic Purpose of Futures Markets and How They Work - Price Discovery or Price Basing," Commodities Futures Trading Commission Website, http://www.cftc.gov/educationcenter/economicpurpose.html

[56] "Platts Oil Pricing and Market-on-Close Methodology Explained - A Backgrounder," Platts, A Division of McGraw Hill Companies, July 2007, page 3. http://www.platts.com/Resources/whitepapers/index.xml

free profits. The net result of these arbitrage transactions is to drive futures and spot prices together and ensure that they move in lockstep.

As an example, if the price for copper in the spot market is $1,700 a ton and the price of the copper futures contract with three weeks to delivery is $1,900 per ton, then a copper producer could sell a futures contract, store the copper in a warehouse for three weeks, and deliver the copper against that contract. By doing this, the copper producer is taking this supply of copper off the spot market, which will cause spot prices to rise relative to the futures, while their sale of the futures contract will cause futures prices to come down.

Alternatively, a Speculator could do the same thing by selling the futures contract, renting storage space, buying the copper on the spot market at $1,700, paying the storage costs to store the copper for three weeks, and then delivering the copper against the futures contract. In this case, their purchase of the copper on the open market is going to push spot prices up while their sale of the futures contract would push futures prices down.

The net effect of this strong linkage between futures prices and spot prices is that historically, when futures prices rise, spot prices rise along with them. So when Institutional Investors drive futures prices higher, the effects are felt immediately in spot prices and the real economy.

Futures Prices Are the Benchmark for Spot Market Transactions

For all commodities with active futures markets, the spot market participants are keenly aware of what futures prices are doing and generally look at futures prices as a gauge for pricing their spot market transactions. They make business decisions based on futures prices, which then affect the spot market and its prices.

One of the reasons that Goldman Sachs and Dow Jones based their commodities indices on commodities futures rather than spot commodities is the fact that futures prices are the best benchmark for overall spot prices. When they say on the news that a certain commodity reached a record-high price, they are typically referring not to spot prices but instead to the nearest-to-expiration futures contract. There is not a spot market trader in any physical commodity market that is not continuously aware of what futures prices are doing.

The Effect of Over-the-Counter Derivatives Markets on the Price Discovery Function of Futures Markets

The physical markets, futures markets and over-the-counter (OTC) swaps markets are all part of one big market. Physical Hedgers, Swaps Dealers and Speculators are participating in all three markets. If an oil producer can get a better price in the swaps market than the futures market or the physical market, then that producer will sell production via swaps. If a swaps dealer can get better prices on hedges in the futures market than in the swaps market, then the dealer will hedge with futures. For this reason there are strong arbitrage links between all three markets.

When an Index Speculator purchases a commodity index swap from a Wall Street Bank, that swaps dealer will turn around and hedge that swap in either the OTC or the futures markets.[57] If the swaps dealer buys futures as a hedge, then the Index Speculator's purchase directly impact the futures price. If they match the Index Speculator's purchase against a Physical Hedger's sale then it still impacts the futures price because that Physical Hedger's sale would otherwise flow to the floor of the futures exchange.

As an example, if Index Speculators want to buy one million barrels of crude oil in swap form and Exxon wants to sell one million barrels of crude oil in swap form, then one cancels out the other. If the Index Speculator had not been there demanding crude oil in the swaps market, then in order to hedge Exxon's sale of one million barrels the swaps dealer would have sold one million barrels worth of crude oil futures on the exchange. So by intercepting the sale of one million barrels in the swaps market, the Index Speculator has prevented one million barrels of selling pressure in the futures market. This means that (all things being equal), prices in the futures market will be higher than they otherwise would be.

Whether an Index Speculator buys in the futures market or the swaps market it has the same impact on prices since both are part of the overall market. This highlights the importance of looking at the OTC markets in conjunction with the futures markets. According to Bank of International Settlements data the notional value of OTC commodity derivatives is now over $9 trillion.[58] This means that futures markets are the tip of the iceberg when compared with OTC markets. And just like an iceberg we have no idea what lies below the surface since these are completely unregulated "dark" markets with zero transparency.

Summary

Physical commodity producers and consumers trust and rely upon the price discovery function of the commodities futures markets to accurately reflect the overall level of supply and demand, pricing their spot market transactions in many cases directly off the applicable futures price. Unfortunately, their trust has been betrayed. Excessive speculation is inflating prices beyond what supply and demand fundamentals would suggest. If this trend continues unabated, then physical commodity producers and consumers will be forced to roll back the progress of the last 25 years and revert to the old pricing system.

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[57] It is also possible for them to hedge the position with physical commodities since most swaps dealers have the ability to take and make delivery, especially in energy. See for instance: http://www.ubs.com/1/e/canada/about/commodities/presence.html

[58] "Semi-Annual OTC Derivatives Statistics" Bank of International Settlements, December 31, 2007. http://www.bis.org/statistics/otcder/dt1920a.pdf and http://www.bis.org/statistics/derstats.htm

CHAPTER FIVE: EXCESSIVE SPECULATION

Introduction

The commodities futures markets are capable of reaching a state of excessive speculation. This occurs when Speculators replace Physical Hedgers as the dominant force in the marketplace. When commodities futures markets become excessively speculative, the price discovery function becomes damaged and eventually destroyed. The dramatic influx of Index Speculators has now brought us to a tipping point where our commodities futures markets are descending into a state of excessive speculation.

Because Speculators, both Index and Traditional, have distinctly different supply and demand curves when compared with Physical Hedgers, two states of the market are possible. We examine these differences in detail and then look at the state of the commodities futures markets today.

Physical Hedgers: Normal Supply and Demand Curves

Physical commodity producers and consumers have supply and demand curves that match what one would expect. As commodity prices rise, a producer wants to sell more and a consumer wants to buy less. As commodity prices fall, a producer wants to sell less and a consumer wants to buy more.

Notice that these production and consumption decisions have the effect of tempering price moves and reducing price volatility. If prices rise then demand decreases and supply increases, causing prices to revert toward equilibrium. If prices fall then demand increases and supply decreases also causing prices to revert toward equilibrium.

These supply and demand curves translate directly into the futures markets when physical commodity producers and consumers buy and sell futures to hedge their production and consumption. If a producer has more production, then it can sell more futures contracts and vice versa. If a consumer wishes to consume more, then more futures contracts can be bought and vice versa.

Note that Physical Hedgers are motivated to buy and sell in order to reduce their price risk. Therefore, they do not buy or sell in quantities greater than their underlying physical commodity exposure.

For these reasons, the buying and selling of physical commodity producers and consumers is always a direct reflection of the actual supply and demand that they are experiencing firsthand in the underlying commodity markets. Their trading decisions always strengthen the critical price discovery function of the futures markets.

Index Speculators: Insensitive Supply and Demand Curves

Index Speculators are insensitive to the supply and demand fundamentals in the individual commodity markets to which they are allocating money. By definition, these Institutional Investors invest in a broad basket of commodities and have little, if any, view on individual commodities. Chances are very good that the trustees making these investment decisions could not even name the 25 commodities that make up the major commodity indices.

If a pension fund decides to allocate $500 million to a commodities futures strategy that replicates the S&P GSCI, the $200 million that consequently flows into WTI Crude Oil futures has nothing to do with the actual supply or demand for crude oil in the real world. The $15 million that flows into Wheat futures has nothing to do with the actual supply and demand for wheat.

The reasons an Institutional Investor might want to allocate money to commodities vary widely. Perhaps their investment committee recently voted to allocate millions of dollars to commodities for the purpose of diversification. They might manage a commodity index mutual fund or ETF, and have received cash inflows from investors. Perhaps they are seeking to hedge against inflation or to make a bet against the U.S. dollar. Or perhaps the performance in another part of their portfolio has been great and they want to rebalance by adding to their commodities futures position to maintain it at a fixed percentage of their portfolio's total value.

All of the aforementioned reasons have almost nothing to do with the actual supply and demand of the individual commodities that are part of the index basket. Therefore, every single contract traded for one of these reasons is a contract that weakens the price discovery function.

It is clear that hundreds of billions of dollars have poured into the 25 commodities that make up the major commodities futures indices, for reasons other than supply and demand. The consequent price increases we have seen are a result of excessive speculation and not real world supply and demand fundamentals. This greatly damages the price discovery function.

Traditional Speculators: Adaptive Supply and Demand Curves

Traditional Speculators are always motivated by profit.[59] Unlike the Physical Hedger who always buys and sells due to supply and demand and the Index Speculator who almost never buys and sells due to supply and demand, Traditional Speculators can and will adapt their buy and sell decisions to the reality they experience in the commodities futures marketplace.

Two States of the Commodities Futures Markets

There are two general states of the commodities futures markets. There is the normal state in which Physical Hedgers are the dominant force and prices are determined predominantly by supply and demand. And there is an abnormal state of excessive speculation in which Speculators are the dominant force and prices are determined by factors other than supply and demand.

This two-state phenomenon is only possible because there are two distinct classes of market participants. There are no other markets that we know of that have two classes of participants and therefore two distinct possible states.

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[59] We do not in any way seek to imply that there is anything dishonorable about making a profit. We are Speculators and we try to make profits every day – there is nothing wrong with generating returns for investors or for one's self.

Normal State

In a market that is dominated by the buying and selling decisions of Physical Hedgers who trade strictly based on supply and demand fundamentals, Traditional Speculators will base their trading decisions on those same supply and demand fundamentals. Traditional Speculators do this because they know that Physical Hedgers will move the prices (due to their dominance) and since Traditional Speculators want to profit from price moves, they go along.

If, for instance, Traditional Speculators observe that a flood in the Midwest is threatening the supply of corn, then they know that physical corn consumers will be motivated to hedge their price risk fearing price increases. They also know that physical corn producers will not be as motivated to sell futures contracts since they either have a reduced corn crop or they also anticipate rising prices. Therefore Traditional Speculators will make trading decisions according to this fundamental information.

Just like fellow Speculators in the capital markets, Traditional Speculators experience the same two governing emotions of fear and greed.[60]

Greed, in the prior example, will make them want to buy futures contracts in anticipation of what others in the market will do. At the same time fear will encourage them to not get carried away. They know that in a normal market if prices rise sufficiently, then physical consumers will reduce their purchases of futures contracts while physical producers will increase their sales of futures contracts to lock in the higher prices.

Notice that Traditional Speculators totally match their trading behavior to the buy and sell decisions of the Physical Hedgers. They buy and sell based on supply and demand fundamentals. They also do not get carried away because they know that price moves will be tempered by the supply and demand responses of physical commodity producers and consumers.

State of Excessive Speculation

In a market that is dominated by Speculators and not by Physical Hedgers, Traditional Speculators' trading is not necessarily disciplined by traditional supply and demand considerations because the "enforcers" of supply and demand, the Physical Hedgers, are no longer wielding the influence over prices that they once were.

In this scenario, Speculators that see prices rising for any reason at all (it does not have to be based on fundamental supply and demand, although it could be) will want to jump on the bandwagon and profit too. There are many trading strategies, such as trend-following and momentum investing, that encourage exactly this type of trading.[61] Add to this the fact that managers of other people's money are paid on relative performance and if Manager A is achieving higher returns in a particular commodity index, then Managers B & C have a strong incentive to participate in

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[60] See http://en.wikipedia.org/wiki/Behavioral_finance for a list of books on the topic

[61] Remember there is no "value investing" in commodities futures since commodities have no investment value. Their only value is in consumption.

order to not fall behind. It is this phenomenon that leads to another hallmark trait of capital markets – herd investing.[62]

All of these factors have the strong potential to lead to upward price pressure and the amplification of an existing upward price trend.

When this happens, Traditional Speculators' fear of price reversion is replaced by the fear of selling short in the face of this strong upward price trend. Traders will say things like "I'm not going to step in front of a freight train," meaning that when there is considerable momentum, Traditional Speculators are afraid of selling short and consequently being "run over."

In fact, some of the Traditional Speculators that fail to adapt their trading strategies to the new market reality will get run over and go out of business due to trading losses. This will leave the surviving Traditional Speculators to thrive in the new environment and it will strengthen their motivation to follow the new trading strategies.

The amplified positive price trend that is created in a state of excessive speculation draws the attention of other Speculators. These new Speculators decide to jump on the bandwagon and that begins a vicious cycle of accelerating price increases and greater price volatility.

Traditional Speculators are capable of surviving and thriving in both types of markets. If Physical Hedgers dominate the markets, then the trading decisions of Traditional Speculators will mimic them and will strengthen the price discovery function. But if Speculators rule the markets then Traditional Speculators will, by necessity, adapt to the new reality, which will weaken the price discovery function.

Implications of the Differing Supply and Demand Curves of Commodities Futures Markets Participants

When commodities futures markets enter a state of excessive speculation then they become susceptible to the formation of speculative price bubbles. The longer commodities futures markets remain in a state of excessive speculation, the more damage is done to the price discovery function.

As long as physical commodity producers and consumers are the dominant market participants they will "enforce" supply and demand fundamentals through their hedging decisions. If Speculators become dominant, then the commodities futures markets can become excessively speculative. Just like in the capital markets, speculative price bubbles can form.

There is a big difference, however, between price bubbles in the capital markets and price bubbles in the commodities futures markets. When internet stocks double or triple in value, then it does not affect the health or livelihood of your average citizen. But when food and energy prices skyrocket, then the economies of the developed world suffer greatly and the populations of developing countries are threatened with starvation.[63]

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[62] See http://en.wikipedia.org/wiki/Behavioral_finance for a list of books on the topic

[63] "The silent tsunami," The Economist, April 17, 2008. http://www.economist.com/opinion/displaystory.cfm?story_id=11050146

The Tipping Point Where Speculation Becomes Excessive

If we were academics we would say that speculation becomes excessive at the point that the marginal benefit of the liquidity that Speculators provide is exceeded by the marginal cost of the damage that they do to the price discovery function. Since we cannot quantify that point, as a practical matter, if the price discovery function is being damaged in a noticeable way, then a market has already passed the point of excessive speculation. Given that most physical commodity producers and consumers today believe that the futures markets have become un-tethered from supply and demand fundamentals, this is one of the strongest indications that the commodities futures markets are currently excessively speculative.

At the point that commodities futures markets "tip" into excessively speculative territory, Traditional Speculators wake up to the new market reality and abandon the "supply and demand" camp in favor of the "inflation hedge," "weak dollar," "uncorrelated alpha," et cetera camp. They begin to base their trading decisions not on supply and demand but on the current market conditions they see around them.

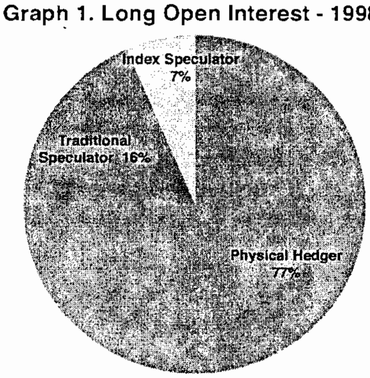
As we discuss in the next chapter, it is precisely this type of tipping point phenomenon that speculative position limits were originally designed to prevent. It would not be possible for a market to reach the tipping point if all Speculators were subject to reasonable and rigid position limits.

Today's Commodities Futures Markets Are Excessively Speculative

In the last five years Index Speculators have become the single most dominant force in the commodities futures markets. Graph 1 from Table 10 shows that in 1998, Physical Hedgers were dominant on the long side of the market. Physical Commodity Consumers represented 77% of the reported long open interest. Physical Hedgers outnumbered Speculators by an average of more than 3 to 1.

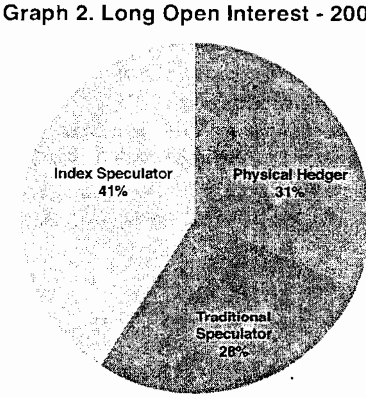
Graph 2 from Table 10 shows that in 2008 the market looks radically different. First, Index Speculators are the dominant force on the long side of the market, with an average of 41% of the reported long open interest. When combined with Traditional Speculators, fully 68% of the long positions are speculative in nature meaning that Speculators now outnumber Physical Hedgers by more than 2 to 1.

Graph 1. Long Open Interest - 1998



Source: see notes on Table 10

Graph 2. Long Open Interest - 2008



Source: see notes on Table 10

Table 10. Commodities Futures Markets - Long Open Interest Composition

	1998			2008		
	Physical Hedger	Traditional Speculator	Index Speculator	Physical Hedger	Traditional Speculator	Index Speculator
Cocoa	89.3%	9.2%	1.5%	34.4%	44.7%	20.9%
Coffee	80.6%	17.7%	1.7%	28.7%	29.6%	41.7%
Corn	87.2%	8.5%	4.4%	40.6%	22.5%	36.8%
Cotton	84.4%	13.5%	2.2%	36.3%	22.6%	41.1%
Soybean Oil	72.7%	27.3%	0.0%	45.5%	19.8%	34.8%
Soybeans	86.6%	11.0%	2.4%	28.5%	28.2%	43.3%
Sugar	87.2%	9.4%	3.4%	36.0%	17.4%	46.5%
Wheat	67.5%	21.3%	11.3%	15.9%	18.2%	65.9%
Wheat KC	86.3%	5.4%	8.3%	38.1%	27.6%	34.2%
Feed Cattle	52.4%	37.3%	10.3%	17.0%	45.2%	37.8%
Lean Hogs	56.6%	27.6%	15.8%	13.6%	19.1%	67.3%
Live Cattle	67.6%	23.8%	8.6%	11.7%	27.3%	61.0%
WTI Crude Oil	84.1%	3.5%	12.4%	42.5%	28.6%	28.8%
Heating Oil	87.8%	2.0%	10.2%	36.5%	14.0%	49.5%
Unleaded Gas	80.0%	4.3%	15.7%	36.5%	23.4%	40.0%
Natural Gas	90.0%	3.0%	7.0%	58.3%	12.7%	29.0%
Gold	90.1%	8.5%	1.3%	19.8%	54.5%	25.7%
Silver	40.7%	59.0%	0.4%	24.2%	44.1%	31.7%
AVERAGE	77.3%	16.2%	6.5%	31.3%	27.8%	40.9%

Source: CFTC Commitments of Traders CIT Supplement, calculations based upon CFTC COT/CIT report (see Appendix: How to Calculate Index Speculators' Positions). Note that Physical Hedgers in this table are equivalent to the Commercial category. Any Traditional Speculators utilizing the swaps loophole (see Ch. 6) show up here as Physical Hedgers. This table does not include spread trades or non-reported trades. WTI crude oil figures include NYMEX, ICE and NYMEX financial contracts as well as recent CFTC reclassification. Figures represent annual averages and 2008 is average through 7/1/08.

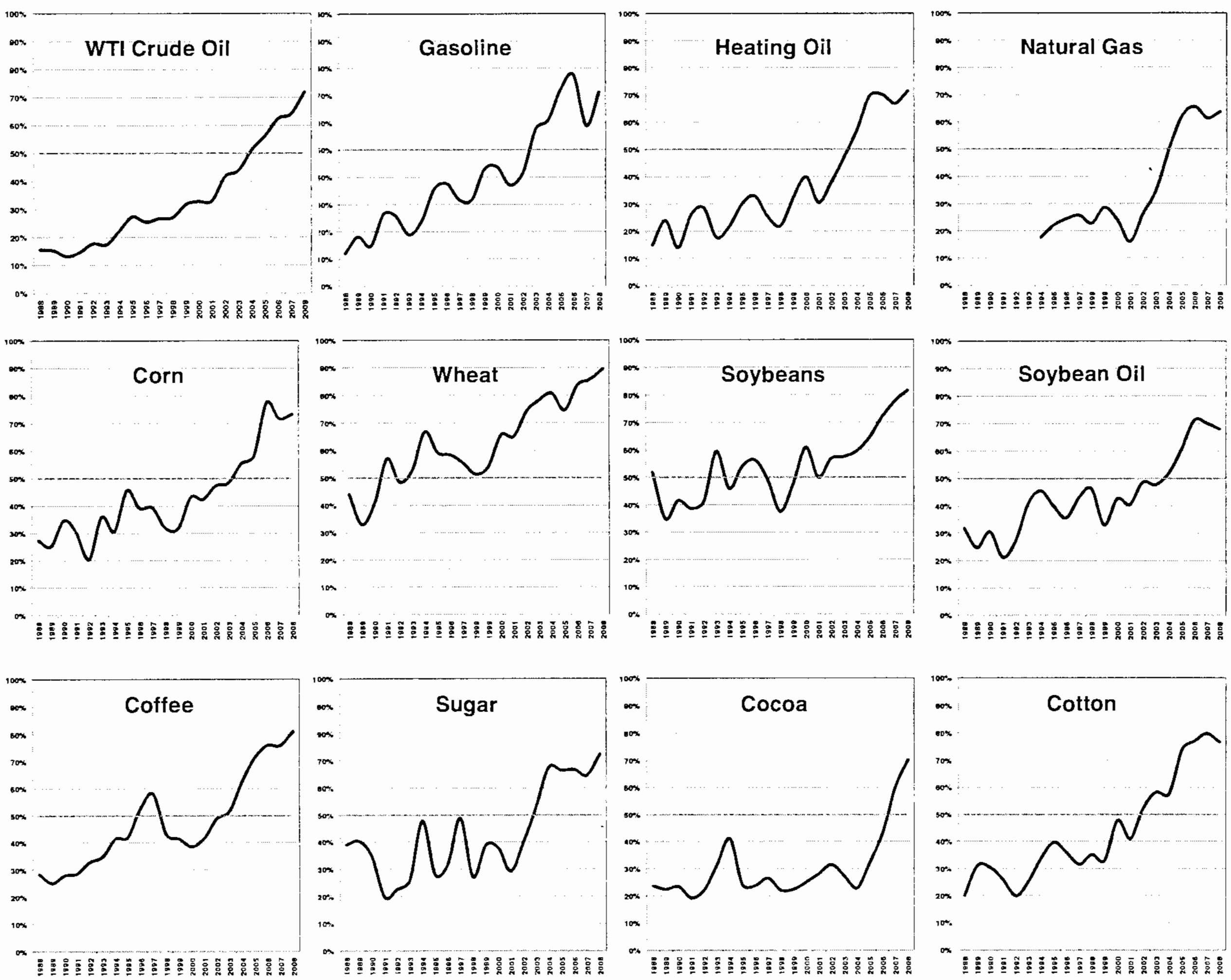
It is important to understand what a monumental shift this represents.[64] In the last 10 years Physical Hedgers' positions have risen by 90%. During the same time Speculators' positions have grown by more than 1300%. And this does not include the growth in speculative spread trading which has also been very large.

[64] As a hypothetical example: in order to go from a 3:1 ratio of Hedgers to Speculators to a 2:1 ratio of Speculators to Hedgers the size of speculative positions has to increase 500%. If Hedgers own 3 contracts and Speculators own 1 contract, then Speculators need to buy 5 contracts before their positions (now 6 to 3) will be double the size of Hedgers.

Speculation Has Grown To Excessive Levels in Almost All Commodities

This enormous growth in speculation has not been limited to just a few commodities. The charts below show that speculation has grown tremendously in almost all the commodities that are part of the major commodity indexes. Index Speculation is affecting all the index commodities in the same detrimental way. One can see that in each of these cases we went from a market dominated by Physical Hedgers ten years ago to a market that is dominated by Speculators today.

Chart Compilation: Speculation Percentage in Energy, Grains and Softs (1988-2008)



Source: CFTC Commitments of Traders CIT Supplement, calculations based upon CFTC COT/CIT report (see Appendix: How to Calculate Index Speculators' Positions). Since spread trades are speculative trades according to the CFTC they are included. WTI Crude Oil includes NYMEX, ICE and NYMEX financial contracts as well as recent CFTC reclassification. Figures represent annual averages and 2008 is average through 7/1/08.

Summary

When two-thirds of all positions and an even larger fraction of all trading is done by Speculators, it becomes apparent that the ability of physical commodity producers and consumers to influence price determination is seriously diminished. Many Physical Hedgers have started to question their participation in markets that no longer reflect supply and demand.

It is clear that the price discovery function has been grossly distorted and that because the commodities futures markets are now dominated by Speculators (of which the Index Speculator is the most damaging type), prices in these markets move for reasons that increasingly have little to do with specific commodity supply and demand fundamentals.

Because of this disassociation between futures prices and the supply and demand realities in the physical markets, the commodities futures markets are no longer able to serve the only constituency they were ever intended to serve: bona fide Physical Hedgers. Many bona fide Physical Hedgers, now greatly outnumbered and having to transact in a market that is mainly driven by the activities of large institutional Speculators, are questioning the value of the futures markets for hedging purposes.

If this trend continues, we can expect to see many physical commodity producers and consumers abandon the futures markets entirely as a vehicle for hedging purposes and price discovery. At that point, the futures markets' destruction from excessive speculation will be complete.

CHAPTER SIX: SPECULATIVE POSITION LIMITS

Introduction

The remedy for excessive speculation has been well-known since at least 1936. The speculative position limits put in place by the Commodity Exchange Act did a good job of protecting the commodities futures markets for over 50 years. Unfortunately, beginning in 1991, speculative position limits have been raised, circumvented and eliminated, with the result being the excessively speculative markets we are experiencing today.

Condensed History of Speculative Position Limits

The Commodity Exchange Act of 1936 prescribed speculative position limits for agricultural commodities in order to prevent commodities futures markets from becoming overly speculative.

> "The fundamental purpose of the measure is to insure fair practice and honest dealing on the commodity exchanges and to provide a measure of control over those forms of speculative activity which too often demoralize the markets to the injury of producers and consumers and the exchanges themselves."[65]

> "It should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations."[66]

> "The bill authorizes the Commission . . .to fix limitations upon purely speculative trades and commitments. Hedging transactions are expressly exempted. That this power of the Commission will be exercised judiciously and for the purposes merely of preventing overspeculation and a type of 'racketeering' by a few large professional traders, may be assumed as a matter of course."[67]

These limits were very effective in preventing excessive speculation and commodity price bubbles. The CFTC in 1981 mandated that all commodities futures should be covered by speculative position limits.[68]

Then, throughout the 1980s and the 1990s, financial futures gained in popularity until they came to dwarf commodities futures in terms of volume and dollar value of open interest. This meant that the CFTC was devoting most of its time and resources to regulating financial futures and not commodity futures.

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[65] Report No. 421, U.S. House of Representatives 74th Congress, Accompanying the Commodity Exchange Act, March 18, 1935.

[66] President Franklin D. Roosevelt message to Congress February 9, 1934.

[67] Report No. 421, U.S. House of Representatives 74th Congress, Accompanying the Commodity Exchange Act, March 18, 1935.

[68] October 16, 1981—The CFTC adopts Regulation 1.61 (now part of CFTC Regulation 150, 17 CFR 150) requiring exchanges to establish speculative position limits in all futures contracts. http://www.cftc.gov/aboutthecftc/historyofthecftc/history_1980s.html

There is no threat of excessive speculation in financial futures because every participant in that market is an Investor / Speculator. Financial futures only need position limits in order to prevent a single Speculator from manipulating the market.[69]

Commodities futures are the only markets where two distinct classes of market participants transact – Physical Hedgers and Speculators. Speculative position limits in the commodities futures markets are needed not only to prevent manipulation but to ensure that Physical Hedgers remain dominant.

Somehow it appears that during this time period the CFTC lost sight of the crucial differences between financial futures and commodities futures. The CFTC began to equate excessive speculation with manipulation and they came to believe that position limits were only necessary to prevent manipulation.[70]

Excessive Speculation Is Not the Same as Manipulation

The Commodity Exchange Act clearly does not consider "excessive speculation" and "manipulation" to be the same thing. If it did, then it would not mention them separately and propose different remedies for each.[71] Physical commodity producers and consumers are capable of manipulating the market and the CFTC has to provide strong oversight to make sure that this does not happen. But because Physical Hedgers are not Speculators, they can never make the market excessively speculative.

It seems clear that Congress saw the dangers of excessive speculation in the commodities futures markets, and that is why they prescribed a specific remedy of speculative position limits. And for decades regulators recognized the inherent value of speculative position limits and set them at levels that truly were a limit to speculation.

Position Limits Raised

As commodities futures markets grew in terms of volume and open interest, the size of a position that a Speculator would need to manipulate the market grew as well. Since the CFTC has recently been focused on preventing manipulation and not excessive speculation, the CFTC has raised speculative position limits for agricultural

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[69] "In general, position limits are not needed for markets where the threat of market manipulation is non-existent or very low. Thus, speculative position limits are not necessary for contracts on major foreign currencies and other financial commodities that have highly liquid and deep underlying cash markets. A contract market may impose, for position accountability *[sic]* provisions in lieu of position limits for contracts on financial instruments, intangible commodities, or certain tangible commodities, which have large open interest, high daily trading volumes, and liquid cash markets." – "Speculative Position Limits," CFTC Website http://www.cftc.gov/industryoversight/marketsurveillance/speculativelimits.html#P8_883

[70] ibid.

[71] "However, Section 4a (7USC6a) is expressly concerned with "excessive speculation" and thus is not specifically an anti(-)manipulation provision. Rather, section 4a focuses upon market disorders attributable to unbridled speculative activity, without regard to whether that speculative frenzy has a manipulative purpose." Section 5.02[1] "Derivatives Regulation," Philip McBride Johnson and Thomas Lee Hazen, Aspen Press, 2004, page 1235.

commodities several times in the last decade.[72] By raising speculative position limits the CFTC has allowed speculation to increase and become excessive.

Position Limits Evaded

In 1991 the CFTC started to give commercial exemptions from position limits to swaps dealers for the purposes of hedging their over-the-counter swaps transactions.[73] The rationale was that, like a physical commodity producer or consumer, these swaps dealers had an exposure that they were trying to offset and that they were not entering into these large positions for the purpose of manipulating prices. Since the CFTC did not see the potential for manipulation (which was their focus), the CFTC allowed these swaps dealers virtually unlimited access to the futures markets on par with what bona fide Physical Hedgers enjoy.

In so doing, the CFTC has opened a loophole for unlimited speculation. If a Speculator wants to take a large futures position for which they would normally face a speculative position limit, they can get around that by going to a Wall Street Bank and entering into a swap contract. These Wall Street Banks offer swaps on solitary commodities, which means they become a surrogate for Speculators wanting to circumnavigate position limits.[74] As an example, a Speculator that wants to take a $500 million position in Wheat (clearly outside speculative position limits) can do so via a single commodity index (Wheat) swap.

This has opened up a loophole that allows unlimited speculation through swaps. There is clearly a big difference between a bona fide Physical Hedger who is trying to reduce price risk and a Wall Street Bank that is not in the physical commodities business at all and is simply serving as a conduit for Speculators.

Note finally that the inclusion of swaps dealers in the commercial category of the CFTC's "Commitments of Traders" reports has made these reports essentially meaningless. One can no longer look at the commercial category to gauge the amount of speculation present in the marketplace. This has left regulators and policymakers without the ability to accurately assess the level of speculation present in the commodities futures markets.

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[72] See for instance, 63 FR 38525 (July 17, 1998), 70 FR 24705 (May 11, 2005), 72 FR 65483 (November 21, 2007). We could find no evidence that speculative position limits have ever been tightened by the CFTC or an exchange in the last 10 years.

[73] "And that actually happened in 1991 with a particular swap dealer that was hedging an OTC transaction with a pension fund, and the swap dealer came to us, and we said, "yeah, that qualifies for a hedge exemption," so we granted a hedge exemption to the swap dealer. And in the years since then, we've done the same for other swap dealers, as well." - Remarks of Don Heitman, Division of Market Oversight, CFTC Agricultural Advisory Committee Meeting, Washington, D.C., December 6, 2007
www.cftc.gov/stellent/groups/public/@aboutcftc/documents/file/aac_12062007.pdf

[74] "Similar hedge exemptions were subsequently granted in other cases where the futures positions clearly offset risks related to swaps or similar OTC positions involving both individual commodities and commodity indexes." 72 FR 66097, Notice of Proposed Rulemaking, Risk Management Exemption From Federal Speculative Position Limits, November 27, 2007.
http://www.cftc.gov/stellent/groups/public/@lrfederalregister/documents/file/e7-22992a.pdf

Position Limits Eliminated

In 1998 the CFTC codified a practice they had been engaged in for several years that basically allowed commodities futures exchanges in "large and liquid" commodities futures markets to replace speculative position limits with position accountability limits.[75] Position accountability limits do not actually limit Speculators in the size of the positions they can take. Instead, they represent a threshold after which the futures exchange is supposed to watch the Speculator's position with greater vigilance in order to prevent manipulation.[76]

Since exchanges get paid based on the volume of futures contracts that are traded and Speculators trade much more frequently than Physical Hedgers, the exchanges have a strong incentive to set the position accountability limits as high as possible and then to only intervene if there is manipulation taking place. The prevailing attitude is that *manipulation* is bad for business but *speculation* is great for business. Since the largest U.S. futures exchanges are now publicly traded for-profit corporations who are promising earnings growth to their shareholders, they cannot be relied upon to combat excessive speculation.

The CFTC sets federal speculative position limits for enumerated agricultural commodities, but the exchanges set all other position limits. In WTI crude oil, for instance, the NYMEX has replaced speculative position limits with position accountability limits except in the last three days prior to expiration. So effectively, there are no limits for WTI crude oil. Foreign Boards of Trade like the Intercontinental Exchange (ICE) are happy to comply with NYMEX's position limits because there essentially are none.

Summary

As we have shown, there is only one class of commodities futures market participant that can be counted upon to always buy and sell based on supply and demand and always strengthen price discovery: the Physical Hedgers. That is why speculative position limits are necessary in order to ensure that they remain dominant.

To repair the damage to the price discovery function and to bring food and energy prices down to levels that more accurately reflect supply and demand, Congress should take action to undo the changes made to speculative position limits.

[75] "the Commission is proposing to codify an exemption permitting exchanges to substitute position accountability rules for position limits for high volume and liquid markets." 63 FR 38525 (July 17, 1998) http://www.cftc.gov/foia/comment98/foi98--028_1.htm.
See also footnote 69.

[76] In many ways this is a semantic charade because futures exchanges are actively monitoring all market participants. It is a foolish notion that someone with 21,000 WTI futures contracts will be actively monitored but someone with 19,000 WTI futures contracts will not be.

CHAPTER SEVEN: LEGISLATIVE SOLUTIONS

Introduction

The erosion and elimination of speculative position limits has made it possible for hundreds of billions of dollars to flow unimpeded into the commodities futures markets. This unbridled flow of money is one of the principal causes of the dramatic price increases we have seen. Congress must re-establish real speculative position limits in order to reverse the flow of speculative money and to wring the excess out of the commodities futures markets. Speculative position limits have worked effectively for decades and will work again without unintended consequences if Congress will take action.

In addition, Congress must tackle the issue of Index Speculation head on. Solving the excessive speculation problem will help reduce Index Speculation somewhat but many Index Speculators will still be able to slip in underneath the new speculative position limits. Because of the damage they do to the price discovery function they need to be prohibited or severely restricted in their ability to buy commodities futures.

Step One: Re-Establish Federal Speculative Position Limits for All Speculators in All Commodities in All Markets

Congress should convene separate panels composed **exclusively** of physical commodity producers and consumers for each individual commodity. These panels shall recommend reasonable speculative position limits in the spot month as well as in all other individual months, and as an aggregate across all months. For commodities where real limits have been replaced by "accountability" limits, real limits must be re-established. Speculative position limits for all commodities should be Federal and should be enforced by the CFTC and not the exchanges, in order to ensure compliance.

The commodities futures markets exist solely for the benefit of bona fide Physical Hedgers, so they are best qualified to set the limits. These physical market participants understand the benefits of liquidity and will do nothing to jeopardize their ability to hedge. The CFTC can reject the Congressional panels' recommendations, but they must be required to explain their rationale to Congress as well as their proposed alternative.

Speculative position limits must apply to every market participant (exempting bona fide Physical Hedgers) whether they access a futures market directly or trade in the over-the-counter market through swaps and other derivatives. Speculative position limits must "look through" any swap transaction and apply to the ultimate counterparty as if the transaction had been done on an exchange.

These position limits must be made to apply to any foreign boards of trade that are trading futures contracts that involve physical delivery inside the United States or that cash settle against contracts that involve physical delivery or cash settle against an index of U.S. prices. In other words the Swaps loophole, the London loophole and all other loopholes must be fully closed. If all the loopholes are not fully closed, then investors will be able to maintain access to U.S.-based commodities through one of these loopholes and the excessively speculative money will not flow out of the markets.

Under this regulatory regime, if a panel of oil producers and oil consumers sets the speculative position limit at 3,000 contracts (equal to three million barrels of oil or about $400 million at today's prices) then a Speculator can trade the equivalent of three million barrels through an OTC swap or on the NYMEX or on ICE. But their total position across all three markets cannot exceed three million barrels.

Further, these speculative position limits must be established at the control entity level so that a Speculator cannot establish five shell subsidiaries and then trade 15 million barrels of oil.

Congress has two options for ensuring that speculative position limits apply in the over-the-counter swaps markets. Option one is to force all swaps dealers to clear their swaps transactions through the applicable futures exchange. This would have the added benefit of strengthening the current system and increasing its transparency Option two would be to require swaps dealers who want to access the futures markets for any purpose to report all of their swaps transactions directly to the CFTC.[77] With this data the CFTC could calculate how much of a hedging exemption these swaps dealers would qualify for.

As a final note, Wall Street Banks that own physical commodity businesses should not have an unlimited commercial exemption from position limits. If a Wall Street Bank wants to take positions that are bigger than its swaps book or its underlying commodity business then it must be subject to the same speculative position limits as every other Speculator in the marketplace.

Step Two: Define Excessive Speculation Numerically

Part of the reason that the term "excessive speculation" became synonymous with "manipulation" was that the Commodity Exchange Act lacked a concrete definition of the term. Congress should clearly define excessive speculation and go the extra step of providing a specific remedy for situations in which individual Speculators are within their position limits and yet a specific commodity futures market as a whole is still excessively speculative.

Each Congressional panel of physical commodity producers and consumers should define numerically, based on a percentage of open interest, what constitutes "excessive speculation." As an example, physical crude oil producers and consumers may decide that the crude oil futures markets should never be more than 35% speculative (not including spreads) on a percentage of open interest basis.

The CFTC should be instructed to establish "circuit breakers" (a concept familiar to equity market participants) that adjust individual speculative position limits downward in order to prevent any individual commodity futures markets from reaching the overall limit established by the panel. These adjustments to individual limits should happen in a gradual fashion and be based on data that is averaged over time in order to minimize the impact on the markets. A Speculator whose existing position exceeds the newly established limit, by virtue of the downward adjustment in limits, would not be required to sell; they would simply be unable to add to their position.

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[77] Congress might consider requiring any financial institution that desires access to any of the CFTC's regulated markets (including financial futures markets) to submit to the reporting requirement for over-the-counter commodity swaps transactions.

Building on our earlier crude oil example, the CFTC could publish a sliding scale from 25% to 35% of speculative open interest that pares back the individual position limits from 100% to 20% of their normal size. So if the established aggregate speculative position limit was normally 3,000 contracts at an overall speculative percentage of 25% or less, then if overall speculation reaches 30%, perhaps the individual position limit would adjust downward to 1,800 contracts.[78]

Step Three: Eliminate (or Severely Restrict) Index Speculation

Index Speculators consume liquidity for the ultra long-term. Every single futures contract they trade damages the price discovery function. They have made the commodities futures markets excessively speculative. And they are one of the most dominant forces in the commodities futures markets today. If they were removed from the markets then Physical Hedgers would once again become the dominant force in the commodities futures markets. This action is necessary to repair the price discovery function.

There lies a problem within a problem. Index Speculation has led to excessive speculation. If you solve the excessive speculation problem through speculative position limits, the Index Speculation problem will remain, since many Index Speculators will still be beneath the limits. Additional measures must be taken to address Index Speculation head on.

We offer 6 possible avenues for restricting or eliminating Index Speculation knowing that "where there is a will there is a way." There might be more and creative ways to address the problem and we support any solution that eliminates Index Speculation.

1. Legislation could be passed which prohibits any Institutional Investor from investing in commodity index replication or substantially similar trading strategies that involve a pre-specified trading methodology and portfolio composition of three or more U.S. based commodities with the intention of maintaining a substantially uni-directional position for a largely uninterrupted and extended period of time. The CFTC could then develop guidelines for what constitutes an index replication or substantially similar strategy.

2. Number 1 above could be modified to impose a position limit on Index Speculators (expressed in dollars or in contracts) that is substantially less than the new limits that are imposed on Traditional Speculators. Index Speculators provide no beneficial liquidity to the commodities futures markets and instead inflict significant damage upon the price discovery function so they should be treated separately from all other Speculators.

3. By purchasing commodities futures contracts, in direct competition with U.S. corporations attempting to hedge their physical consumption, Institutional Investors are driving up prices and squeezing out actual businesses that need the futures markets to hedge. For that reason, it makes sense that tax-exempt entities that generate profits from trading futures contracts should have those profits taxed as Unrelated Business Taxable Income (UBTI). This is a clear case of a tax-exempt entity directly competing with a taxable entity.

[78] If position limits range between 3,000 contracts (100%) and 600 contracts (20%) based on an overall speculative percentage of 25% to 35%, then at 30% (the midpoint) speculative position limits would equal 1,800 contracts, which is halfway between 3,000 and 600.

4. We would advocate eliminating indexing strategies at their source by modifying the Prudent Investor rule to make it clear that commodities futures are speculative instruments that are not prudent investments for trustees' portfolios.

5. The Commodities Exchange Act states, when discussing speculative position limits, that "such limits upon positions and trading shall apply to positions held by, and trading done by, two or more persons acting pursuant to an expressed or implied agreement or understanding, the same as if the positions were held by, or the trading were done by, a single person."[79] Since Index Speculators are all acting in express agreement by following the exact same published trading methodology, they should all be collectively subject to the speculative position limits of a single Speculator. Congress could compel the CEA to enforce this provision. Then the amount of money allocated to index replication would have to drop from the current level of $317 billion to the limits of a single Speculator, approximately $8 billion.

6. Congress could also compel the CFTC to use its emergency powers to make Index Speculator positions "liquidation only" so that positions cannot be increased in size.

Benefits of these Proposals

There are two key benefits related to these three proposed legislative changes.

First, there are no unintended consequences associated with speculative position limits. We have had them since 1936 and they have been very effective at preventing excessive speculation while at the same time allowing for a healthy amount of liquidity within the commodities futures markets. By enacting these proposals, Congress would simply be updating the Commodity Exchange Act to reflect the new realities found in today's markets.

The second key benefit of these proposals is that they get to the heart of the problem. A wall of speculative money flowed into the commodities futures markets because there were effectively no hard and fast speculative position limits to stop it, causing commodities futures prices to skyrocket. By re-establishing speculative reasonable and rigid position limits, much of the speculative money that was able to flow in must, by necessity, flow out. That will result in commodities prices coming down to levels that accurately reflect true supply and demand in the physical commodity markets.

Ten years ago the commodities futures markets were functioning properly and no one was complaining about a lack of liquidity. Rolling back the clock on Index Speculation and forcing Index Speculators out of these markets will simply return things to the way they were ten years ago.

Empty Threats of Offshore Migration

Many of the groups that are profiting from the practices addressed by this legislation threaten that if Congress takes action then futures trading in U.S. commodities will simply move offshore. This is an empty threat.

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[79] U.S. Code, Title 7, Chapter 1, Section 6a, http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=browse_usc&docid=Cite:+7USC6a

Any futures contract that calls for physical delivery inside the United States is automatically subject to CFTC regulation.[80] Any futures contract that cash settles against a U.S. contract with physical delivery provisions is also automatically subject to CFTC regulation unless specifically exempted.[81] If not exempted, then no person inside the United States may lawfully trade that contract.[82]

So for instance, 60% of the volume of the cash-settled WTI crude oil contract on the Intercontinental Exchange (ICE) is traded by U.S. entities.[83] If the CFTC had not exempted the ICE from regulation then those U.S. entities would not be able to trade that contract. The ICE WTI contract would have never gotten off the ground if the CFTC had not exempted it from regulation.

In order for any futures contract to be successful it must reach a "critical mass" of volume.[84] Market participants always prefer the contract that has the most liquidity. They also prefer a marketplace located in a country with strongly established legal and banking systems.

Since the United States is the largest consumer of energy in the world and the largest producer of food in the world, every U.S.-based physical commodity producer and consumer will favor a U.S.-regulated futures contract with physical delivery provisions inside the United States. This will be the contract that they choose as their benchmark for spot market transactions, which will encourage non-U.S. physical market participants to choose this contract as well.

These Physical Hedgers will never abandon an established and fully regulated U.S. exchange in order to trade on a non-U.S.-regulated foreign exchange. They face no speculative position limits as bona fide Physical Hedgers, so they will prefer an exchange with tight speculative position limits. As a result, U.S.-regulated exchanges will have prices that most accurately reflect supply and demand fundamentals. Therefore, the volume from Physical Hedgers will grow rather than diminish.

Re-establishing speculative position limits will significantly reduce the speculative volume on commodities futures exchanges. But these limits will only affect the largest traders. The majority of small and mid-sized Speculators likely will remain well under the speculative position limits and will not be affected. If they are not bumping up against position limits, then they also would have no incentive to shift their trading to non-regulated foreign exchanges.

The only market participants with any incentive to trade elsewhere are the Speculators that are above the position limits. Since the purpose of position limits is to prevent these Speculators from trading beyond the limits, restriction of this trading would result in a net benefit to the commodities futures markets due to the elimination of excessive speculation.

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[80] Section 4.05[2] "Derivatives Regulation," Philip McBride Johnson and Thomas Lee Hazen, Aspen Press, 2004, pages 977-980.

[81] Section 4.05[6] "Derivatives Regulation," Philip McBride Johnson and Thomas Lee Hazen, Aspen Press, 2004, pages 983-986. See also Testimony of Michael Greenberger - June 3, 2008: http://commerce.senate.gov/public/_files/IMGJune3Testimony0.pdf

[82] ibid.

[83] Conversations with House Energy Committee Staff

[84] "Financial Futures and Options," Todd E. Petzel, Quorum Books, New York, 1989, page 4.

In enacting legislaton Congress should not allow any exemptions from speculative position limits for any arbitrage traders trying to arbitrage price differentials between U.S. regulated and foreign non-regulated futures exchanges. This will effectively de-link the prices between the two exchanges and will prevent any foreign non-regulated futures exchange from trying to "piggyback" off of our futures markets.

Summary

The implementation of the solutions outlined in this report will greatly increase the confidence of market participants around the world that our futures contracts prices are an accurate reflection of true supply and demand fundamentals. In the long term this will lead to greater participation in our futures markets and therefore greater volume.

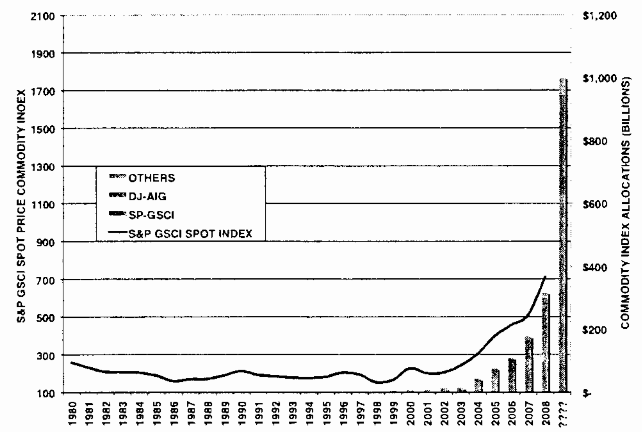
CONCLUSION

More Institutional Investors Want to Invest in Commodity Indexes

Because commodity futures prices have risen dramatically, Index Speculators have made large paper profits. This has encouraged other Institutional Investors to actively consider pouring billions more dollars into the commodities futures markets.

Pension fund consultants have been advocating portfolio allocations of between 5%[85] and 12%[86] to commodities indices. Considering that worldwide institutional assets are about $29 trillion[87], if Institutional Investors heed the advice of their consultants, index replication could easily reach $1 trillion.[88] Chart 8 asks the reader to consider what will happen to prices if institutional investment hits the $1 trillion mark?

Chart 8. S&P GSCI Spot Price Index vs. Index Speculator Assets



Where will prices be if assets reach $1 trillion?

Source: Bloomberg, Goldman Sachs, CFTC Commitments of Traders CIT Supplement, calculations based upon CFTC COT/CIT report (see appendix). 2008 figure is as of 7/1/08.

Wall Street Is Now Promoting This Investment to Retail Investors

Wall Street Banks have seen how much money their peers are making and they want to start selling commodities index investments as well. There have been several new commodities indices launched in the last five years. Perhaps the most ominous sign is the recent spate of Exchange Traded Funds (ETFs) that have been launched to

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85 "Investing In Collateralised Commodities Futures," Russell's Research For Excellence, Yvonne Ooi and David Rae, 2005.

86 "Strategic Asset Allocation and Commodities," Ibbotson Associates, Thomas M. Idzorek, March 27, 2006.

87 Pension Funds $26 trillion: "UK pension fund returns at five-year low," IFAonline, Jennifer Bollen, January 28, 2008. http://www.ifaonline.co.uk/public/showPage.html?page=698204

Sovereign Wealth Funds $3 trillion: "Sovereign Wealth Funds," Council On Foreign Relations, Lee Hudson Teslik, January 18, 2008. http://www.cfr.org/publication/15251/

88 $1 trillion on $29 trillion would represent an average allocation of just 3.5%.

appeal to retail investors.[89] This opens up a whole new source of potential profits for Wall Street if they can get retail investors to buy into the same strategies.

While Institutional Investors account for $30 trillion in worldwide assets, retail investors (including high net worth individuals) account for over $50 trillion in wealth.[90] If left unchecked, they could pour billions into commodity index strategies as well.

The Problem Will Not Solve Itself

As long as there are effectively no hard and fast speculative position limits in the commodities futures markets, speculative money will continue to flow in and prices will continue to rise. The increase in food and energy prices can continue as long as Institutional Investors continue to pour more money into these markets.

Because futures price increases directly result in spot price increases, the world is experiencing dramatic food and energy price inflation as a result of Institutional Investors' portfolio allocation decisions. The high prices caused by this artificial financial demand are holding Americans hostage because they cannot simply stop eating or driving to work.

Today's markets are clearly suffering from excessive speculation. Physical commodity producers and consumers are already beginning to abandon these markets. And the price discovery function continues to be damaged with each passing day. This problem will continue to grow until Congress takes action.

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[89] "Commodity ETFs: Hot Asset Wrappers," Forbes, Joshua Lipton, April 17, 2008. http://www.forbes.com/etfs/2008/04/17/commodities-etf-etn-pf-etf_jl_0417etf_inl.html

[90] "Global High Net Worth Assets Reach $50 Trillion, But Economic Woes Trim Growth Rate to 9%," Business Wire, March 27, 2008. http://www.streetinsider.com/Press+Releases/Global+High+Net+Worth+Assets+Reach+$50+Trillion,+But+Economic+Woes+Trim+Growth+Rate+to+9%25/3492452.html

APPENDIX: HOW TO CALCULATE INDEX SPECULATORS' POSITIONS

If one knows the total dollar figure invested in an index, then it is easy to calculate how much must be in each commodity, in dollars as well as in futures contracts.

Total Dollars Invested in Index	X	Weight of Individual Commodity	=	Dollars in Individual Commodity

Total Dollars Invested in Index	X	Weight of Individual Commodity	/	Dollar Value of a Commodity Contract	=	# Of Contracts in an Individual Commodity

And therefore, if one knows how many contracts are in an individual commodity along with the dollar value of a contract and the weight of that commodity in the index, then the total dollars invested in the index can be calculated as follows:

# Of Contracts in an Individual Commodity	X	Dollar Value of A Commodity Contract	/	Weight of Individual Commodity	=	Total Dollars Invested in Index

The CFTC, starting in January 2006, has been publishing the Commodity Index Trader Supplement to the Commitments Of Traders report. This supplemental report shows the reported positions of Index Speculators in 12 different agricultural commodities. Of the 12, two commodities - KC Wheat and Feeder Cattle, are only part of the S&P GSCI and one commodity: Soybean Oil, is only part of the DJ-AIG.

Both the S&P-GSCI and DJ-AIG publish on a daily basis the individual weights of their constituent commodities. Also, futures market data providers like Bloomberg publish daily closing prices for commodities. Since futures contract terms do not change, one can use this data to calculate the daily dollar values of the individual commodity contracts.

With these three data points, it is simple to calculate the total dollars invested in the S&P-GSCI and the DJ-AIG on a weekly basis. Once the total dollars invested in these two indices is known, then one can calculate the number of contracts held by Index Speculators in the other 13 non-agricultural commodities.

A detailed example of this 3-step process follows.

Step One - Estimate Total Amount Invested in S&P-GSCI and DJ-AIG

According to the CFTC's January 17, 2006 CIT report, Index Speculators had positions in KC Wheat, Feeder Cattle and Soybean Oil of 21,366, 5,613 and 59,264 contracts respectively. Plugging in the weights and contract values from the appropriate sources yields the following calculations:

21,366 X $18,762.50 / 0.82% = $48,887,753,049

5,613 X $56,137.50 / 0.68% = $46,338,204,044

59,264 X $12,732.00 / 2.77% = $27,240,045,054

The resulting calculations show that the S&P-GSCI had somewhere between $46 and $49 billion invested in it and the DJ-AIG had around $27 billion invested in it. This corresponds well to the figures published by Goldman Sachs and Dow Jones.

Step Two - Calculate Position Sizes for Other Commodities

Using $47.6 billion as an estimate for the S&P-GSCI, and $27.2 billion for the DJ-AIG, it is possible to calculate (using the formulas above) Index Speculators positions' in all the other commodities. The table below shows the results.

Calculation of Index Speculators' Positions (January 17, 2006)

	Percentage Weights		Positions (millions)		Contract Value	Positions (contracts)		Combined Position	CFTC Actual
	S&P-GSCI	DJ-AIG	S&P-GSCI	DJ-AIG		S&P-GSCI	DJ-AIG		
Cocoa	0.20%	0.00%	$95.50	$0.00	$15,710	6,081	0	6,081	9,390
Coffee	0.80%	2.90%	$373.20	$799.00	$46,425	8,039	17,201	25,240	28,777
Corn	2.00%	5.90%	$954.00	$1,600.00	$10,438	91,398	153,292	244,689	305,264
Cotton	0.90%	3.20%	$444.90	$862.00	$27,995	15,891	30,777	46,668	53,741
Soybean Oil	0.00%	2.80%	$0.00	$753.00	$12,732	0	59,173	59,173	59,264
Soybeans	1.40%	7.80%	$672.50	$2,116.00	$28,563	23,543	74,073	97,617	103,304
Sugar	1.90%	3.00%	$884.90	$808.00	$17,438	50,742	46,352	97,094	124,487
Wheat	2.10%	4.80%	$1,009.10	$1,300.00	$16,438	61,393	79,082	140,475	181,986
Wheat KC	0.80%	0.00%	$396.00	$0.00	$18,763	21,106	0	21,106	21,366
Feed Cattle	0.70%	0.00%	$329.50	$0.00	$56,138	5,869	0	5,869	5,613
Lean Hogs	1.40%	4.40%	$663.80	$1,185.00	$23,790	27,902	49,824	77,726	69,591
Live Cattle	2.70%	6.10%	$1,293.20	$1,660.00	$38,620	33,486	42,982	76,468	71,834
Brent Crude Oil	14.50%	0.00%	$6,901.30	$0.00	$64,900	106,337	0	106,337	
WTI Crude Oil	31.30%	12.80%	$14,888.00	$3,482.00	$66,310	224,521	52,516	277,036	
Gasoil	3.10%	0.00%	$1,472.70	$0.00	$54,725	26,911	0	26,911	
Heating Oil	8.00%	3.80%	$3,823.70	$1,048.00	$75,243	50,818	13,924	64,742	
Gasoline	7.90%	4.10%	$3,780.50	$1,105.00	$76,579	49,368	14,424	63,792	
Natural Gas	10.60%	12.30%	$5,030.80	$3,355.00	$91,680	54,873	36,591	91,464	
Aluminum	3.10%	6.90%	$1,464.40	$1,866.00	$59,475	24,621	31,383	56,004	
Lead	0.30%	0.00%	$156.40	$0.00	$31,800	4,918	0	4,918	
Nickel	0.70%	2.70%	$312.80	$724.00	$88,182	3,547	8,214	11,762	
Zinc	0.70%	2.70%	$355.60	$736.00	$51,900	6,852	14,184	21,036	
Copper (LME)	2.80%	0.00%	$1,335.10	$0.00	$116,575	11,453	0	11,453	
Copper (CMX)	0.00%	5.90%	$0.00	$1,602.00	$54,225	0	29,542	29,542	
Gold	1.80%	6.20%	$875.90	$1,694.00	$55,430	15,802	30,568	46,370	
Silver	0.20%	2.00%	$99.20	$545.00	$45,100	2,201	12,080	14,280	
TOTAL	100%	100%	$47,613.00	$27,240.00					

Source: Goldman Sachs, Dow Jones, Bloomberg, CFTC Commitments of Traders Report, CIT supplement and calculations

Step Three - Compare with Actual CFTC Figures for Accuracy

The final column in the table shows the actual figures released by the CFTC. In almost all cases the estimates generated using this method yield results that are less than the actual reported results. This shows that this method yields conservative estimates.

Final Note

This method of calculating Index Speculators' positions is almost identical to the methods used by Philip Verleger (www.pkverlegerllc.com), Steve Briese (www.commitmentsoftraders.org) and others. It is not clear who deserves the credit for developing this method but it clearly is not us.