

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois Commerce Commission)	
On Its Own Motion,)	
)	
v.)	
)	
The Peoples Gas Light and)	01-0707
Coke Company)	
)	
Reconciliation of revenues)	
collected under gas)	
adjustment charges with actual)	
costs prudently incurred.)	

PRE-HEARING MEMORANDUM
OF THE PEOPLES GAS LIGHT AND COKE COMPANY

1 Pursuant to the Administrative Law Judge's May 12, 2004 Notice and
2 Order, The Peoples Gas Light and Coke Company ("Peoples Gas" or
3 "Respondent"), by its attorneys McGuireWoods LLP, hereby submits its pre-
4 hearing memorandum regarding the issues in this proceeding that have been the
5 subject of testimony served to date in the above-captioned proceeding.

6 **STATEMENT OF THE CASE**

7 On November 7, 2001, the Illinois Commerce Commission ("Commission")
8 initiated this annual gas charge reconciliation case pursuant to Section 9-220(a)
9 of the Public Utilities Act. 220 ILCS 5/9-220(a). Respondent has served direct,
10 additional direct and rebuttal testimony in this proceeding demonstrating the
11 accuracy of its reconciliation of costs and revenues and the prudence of the gas
12 costs it recovered during the reconciliation period, which is the twelve months

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13 ended September 30, 2001. Staff and intervenors have submitted direct
14 testimony in this proceeding, which raised several issues that Respondent
15 refuted in its rebuttal testimony.

16 First, intervenors argued that Respondent's gas costs were imprudent
17 because Respondent decided not to financially hedge winter gas purchases.
18 Respondent's testimony showed that, under applicable Commission policy and
19 the circumstances in effect at the time hedging decisions were made, prudence
20 did not require it to enter into financial hedges for any portion of its winter gas
21 purchases.

22 Second, Staff and intervenors argued that Respondent's Gas Purchase
23 and Agency Agreement with Enron North America Corporation was imprudent
24 and the costs incurred under that agreement were imprudent. Respondent's
25 testimony showed that the agreement was a reasonable and prudent way to
26 address market conditions at the time the agreement was entered into. In the
27 reconciliation year, customers received market-priced gas.

28 Third, Staff and intervenors argued that Respondent's use of its
29 company-owned storage field, including offering interstate services supported by
30 that field, was imprudent and resulted in customers paying higher gas costs.
31 Respondent's testimony showed that the use of its storage field was consistent
32 with historical practices. Providing interstate services benefited customers by
33 improving the performance of the field, without increasing gas costs.

34 Fourth, Staff and intervenors argued that three of Respondent's 103 off-
35 system transactions were imprudent and increased gas costs. Respondent

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36 conceded the Staff's proposed cost disallowance with respect to two of the
37 transactions. With respect to the third transaction, Respondent showed that the
38 transaction was a prudent operational decision.

39 Fifth, Staff argued that Respondent's recovery of maintenance gas costs
40 through the Gas Charge was inconsistent with Commission policy and, thus,
41 imprudent. Respondent conceded Staff's proposed cost disallowance and
42 agreed to adopt Staff's recommended accounting for maintenance gas.

43 Finally, Staff recommended that the Commission require internal and
44 external audits related to gas supply practices. Respondent's testimony showed
45 that such audits were unnecessary.

46 **I. Uncontested Facts**

47 In September 1999, Respondent entered into a five-year gas supply
48 agreement with Enron North America Corporation ("ENA"). The agreement was
49 called the "Gas Purchase and Agency Agreement" ("GPAA"). Respondent began
50 negotiating with ENA about a long-term gas supply agreement in early 1999
51 when its fixed gas charge proposal was before the Illinois Commerce
52 Commission ("Commission") in Docket No. 98-0820. In that proceeding,
53 Respondent proposed to fix its gas charge for five years at a rate of 31.08 cents
54 per therm. A fixed gas charge would eliminate price volatility for customers in a
55 more effective way than a financial hedge. See The Peoples Gas Light & Coke
56 Company, Docket No. 98-0820, 1999 Ill. PUC LEXIS 414, at * 9-12 (June 7,

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57 1999).¹ After considering Respondent's position and opposition from Staff, the
58 Citizens Utility Board ("CUB") and others, the Commission set a fixed gas charge
59 at 25.63 cents per therm. Id., at *26. Respondent did not fix its gas charge
60 because, based on its analysis of historical and projected test year data, that
61 price could not be supported in a gas supply contract.

62 Unless otherwise stated, the facts below pertain to the reconciliation
63 period, which is the twelve months ended September 30, 2001.

64 **A. Hedging**

65 Winter gas prices are often volatile, but price volatility can be managed
66 either through gas storage, which can be used as a physical hedge against price
67 volatility, or through the purchase of options contracts and other financial
68 instruments, which can be used as a financial hedge. During the 2000-2001
69 winter, Respondent served its end users, in part, through purchased and
70 company-owned storage.

71 With respect to financial hedging, the Commission issued a January 26,
72 2000 order in Respondent's fiscal year 1997 gas charge reconciliation case
73 (Docket No. 97-0024) that included the following holding: "[c]learly, the
74 Commission has not created an obligation or responsibility to mitigate price
75 volatility through the use of such financial tools and we decline to do so in this
76 proceeding." Respondent decided not to use financial hedging instruments for
77 gas purchases made during the winter (November 2000 through March 2001) of
78 2000-2001.

¹ The Illinois Commerce Commission may take administrative notice of its order in Docket No. 98-0820. See 83 Ill. Admin. Code §200.640(a)(2) (allowing administrative notice of orders in other Illinois Commerce Commission proceedings).

79 Additionally, on January 24, 2002, the Commission issued an order in
80 Respondent's fiscal year 2000 gas charge reconciliation case (Docket No. 00-
81 0720) in which the Commission stated that "the Commission recommends that
82 Respondent consider the use of non-index based pricing in a portion of its future
83 gas supply agreements." Docket No. 00-0720, Order at p. 9 (January 24, 2002).

84 **B. Gas Purchase and Agency Agreement**

85 The GPAA had a term of October 1, 1999 - October 31, 2004, and
86 Respondent purchased gas under it in fiscal year 2000. The Commission's order
87 in Respondent's fiscal year 2000 gas charge reconciliation case (Docket No. 00-
88 0720) did not disallow recovery of any gas costs. During this reconciliation
89 period, as in fiscal year 2000, Respondent purchased a significant portion of its
90 gas supply under the GPAA at the Chicago citygate. Respondent released to
91 ENA, pursuant to applicable Federal Energy Regulatory Commission regulations,
92 certain pipeline firm transportation capacity.

93 The GPAA provided for published, market prices for all gas purchased by
94 Respondent under the GPAA. The "baseload quantity" and "Summer
95 Incremental Quantity" were priced at the [REDACTED]
96 [REDACTED] Respondent also
97 received a demand credit of [REDACTED] per MMBtu for these purchased
98 quantities. Purchases of "Daily Incremental Quantity" were priced at the [REDACTED]
99 [REDACTED] The GPAA did
100 not include a stated reservation charge or demand charge.

101 **C. Use of Storage**

102 Respondent owned and operated a storage field called Manlove storage
103 field, which had a capacity of approximately 35 billion cubic feet (“Bcf”).
104 Respondent used Manlove during the 2000-2001 winter to provide gas to its end
105 use customers. As in prior years, Respondent did not purchase gas to fill the full
106 capacity of this field for those customers.

107 Respondent also provided interstate services, supported by Manlove
108 storage field, pursuant to Federal Energy Regulatory Commission authority.
109 Respondent refers to its interstate services as “Hub” services, which include park
110 and loan services. Under an interstate park service, a shipper delivers a quantity
111 of gas to Respondent (“parks”), and Respondent later delivers a like quantity of
112 gas to the shipper. Under an interstate loan service, Respondent delivers a
113 quantity of gas to a shipper (“loans”), and the shipper later delivers a like quantity
114 of gas to Respondent. Respondent sold loan services pursuant to its Federal
115 Energy Regulatory Commission Operating Statement during the 2000-2001
116 winter. Respondent did not flow the revenues resulting from its Federal Energy
117 Regulatory Commission jurisdictional services through its Gas Charge.

118 Respondent also had a Storage Optimization Contract with Enron MW,
119 LLC (“EMW”), pursuant to which EMW managed certain Rate Schedule NSS
120 capacity purchased by Respondent from Natural Gas Pipeline Company of
121 America. Revenues from EMW’s management were shared with Respondent,
122 and Respondent flowed these revenues through the Gas Charge.

123 **D. Off-System Transactions**

124 In fiscal year 2001, Respondent entered into 103 off-system transactions.
125 Off-system transactions are sales for resale to purchasers who are not end
126 users. Issues have been raised with only three of these transactions,
127 Transaction Nos. 16, 22 and 19. Transaction Nos. 16 and 22 referred to a
128 service Respondent sold EMW, under which Respondent sold gas to EMW on
129 ten days in November and December 2000 at a first of month index price
130 (November 2000 index for November sales and December 2000 index for
131 December sales). Respondent does not contest the Staff's proposed
132 disallowance and, accordingly, did not burden the record with a response to
133 allegations about Transaction Nos. 16 and 22, including the methodology
134 underlying Staff's proposed disallowance.

135 Under Transaction No. 19, Respondent [REDACTED] on
136 each day in December 2000. The sales price for Transaction No. 19 was the
137 [REDACTED] price. Respondent contests this proposed
138 disallowance.

139 **E. Maintenance Gas**

140 Respondent recovered costs for what it called "maintenance gas" through
141 its Gas Charge as gas lost and unaccounted for. Respondent does not contest
142 the Staff's proposed disallowance or accounting treatment and, accordingly, did
143 not burden the record with a response to allegations about maintenance gas.

144 **II. Contested Facts**

145 **A. Hedging**

146 1. Respondent used gas storage as a physical hedge and customers
147 benefited because seasonal (winter/summer) price differentials produced
148 approximately \$130 million in savings in fiscal 2001.

149 2. It was reasonable for Respondent to consider regulatory policies
150 and precedent in deciding whether to enter into financial hedging
151 transactions.

152 3. Prior to April 2001, the Commission and Commission Staff did not
153 encourage financial hedging and questioned its value to customers.

154 4. In the 2000 reconciliation proceedings, testimony offered by the
155 Commission Staff and, in several orders, the Commission recommended
156 that utilities consider the use of non-index based pricing for a portion of
157 their future gas supply agreements. This was a change in Commission
158 policy with respect to its view of financial hedging by gas utilities.

159 5. Gas prices and price spikes in the 1996-1997 winter period were
160 not a useful precedent for gas prices in the 2000-2001 winter and are not
161 useful for evaluating whether hedging would have been appropriate.

162 6. The 2000-2001 winter gas prices were unprecedented and
163 unpredictable.

164 7. Measures of price volatility during the 2000 spring and summer
165 period did not show that hedging was an obvious strategy for a gas utility.

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166 8. Considerations relevant to a non-utility in deciding whether to
167 financially hedge gas purchases differ from the considerations relevant to
168 a regulated public utility.

169 9. It was reasonable for Respondent's non-utility affiliates to engage in
170 financial hedging for reasons that do not apply to a regulated public utility.
171 Whether non-utilities engaged in financial hedging has no relevance or
172 impact on Respondent's decisions whether to use financial hedging.

173 10. Hedging by regulated gas utilities in the United States was not
174 customary. It was as likely as not that regulated gas utilities in 2000-2001
175 entered into financial hedging transactions or entered into fixed price
176 agreements with marketing companies.

177 **B. Gas Purchase and Agency Agreement ("GPAA")**

178 1. The GPAA resulted in end use customers receiving gas at
179 reasonable, market-based prices during the reconciliation period.

180 2. The GPAA was a reasonable and prudent way to address expected
181 declines in basis value that would diminish the value of transportation
182 capacity that Respondent had under contract with interstate pipelines.

183 3. The GPAA's [REDACTED] credit provision, applicable to baseload
184 quantities and the Summer Incremental Quantity, locked in a reasonable
185 value for transportation capacity agreements released by Respondent to
186 Enron North America Corporation pursuant to the GPAA.

187 4. The GPAA was consistent with Respondent's historical purchasing
188 practices.

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189 5. Price was an important factor in Respondent's assessment of the
190 GPAA.

191 6. A request for qualification process, in which Respondent evaluated
192 the supply and capacity management capabilities of nine potential gas
193 suppliers, was a reasonable way to select a gas supplier and ascertain
194 what services were available in the market.

195 7. The GPAA was the product of rigorous review and analysis by
196 Respondent. The GPAA was the result of the request for qualification
197 process, begun in December 1998 shortly after Respondent filed its fixed
198 gas charge proposal (October 1998), and continuing through June 1999
199 when the Commission issued an unfavorable fixed gas charge order and
200 culminating with the execution of the GPAA in September 1999.

201 8. The value of difficult to quantify benefits of the GPAA, such as gas
202 resale rights, was not reflected in Staff and intervenor calculations of the
203 costs and benefits of the GPAA.

204 9. The quantification of an expected basis decline in Staff's analysis of
205 the GPAA undervalues the benefits of the GPAA because it does not
206 reflect a range of reasonable outcomes, and, therefore, gives a misleading
207 impression that it precisely measures the GPAA's costs and benefits.

208 10. Staff's analysis of the GPAA is inconsistent with Staff's description
209 of its analytical methodology.

210 **C. Use of Storage**

- 211 1. Use of purchased and company-owned storage, in November-
212 December 2000, was comparable to prior years.
- 213 2. Use of purchased and company-owned storage, during the 2000-
214 2001 winter, was comparable to prior years.
- 215 3. The amount of Manlove storage field capacity planned to meet
216 Respondent's end use customers' requirements was reasonably set at
217 approximately 25.5 Bcf, as had been the case for several years.
- 218 4. Had Respondent provided no Hub services during the reconciliation
219 year, it would not have planned to inject additional gas in Manlove storage
220 field for use by its end use customers.
- 221 5. There would have been no effect on Respondent's service to end
222 use customers had Respondent interrupted service to its Hub customers.
- 223 6. Providing interstate Hub services, supported by Manlove storage
224 field, improves the performance of the field.
- 225 7. Use of displacement to provide Hub services was not inconsistent
226 with Respondent's revenue treatment for Hub revenues and did not
227 adversely affect end use customers.
- 228 8. Hub services, including loan services, did not increase
229 Respondent's recoverable gas costs.
- 230 9. The Storage Optimization Contract with Enron MW, LLC was a
231 reasonable tool and a prudent way to manage certain purchased storage

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232 capacity and benefited end use customers through revenue flowed
233 through the gas charge.

234 **D. Off-System Transaction No. 19**

235 1. Transaction No. 19, a [REDACTED] in
236 December 2000, was a reasonable sale, based on sound operational
237 considerations evaluated by Respondent at the time it decided to enter
238 into the transaction in late November 2000.

239 2. Transaction No. 19 had no relationship to the baseload price
240 adjustment in the GPAA.

241 3. Respondent reasonably used its daily gas supply planning and
242 dispatch model in evaluating whether to enter into Transaction No. 19.

243 4. Staff's proposed disallowance calculation for Transaction No. 19 is
244 overstated.

245 **E. Off-System Transaction No. 16/22**

246 None. Respondent testified that it would not contest the Staff's proposed
247 disallowance as to Transaction Nos. 16 and 22.

248 **F. Maintenance Gas**

249 None. Respondent testified that it would not contest the Staff's proposed
250 disallowance or accounting treatment for maintenance gas.

251 **G. Audit/Intercompany Services Agreement**

252 1. Transactions identified by the Staff do not support the Commission
253 imposing a requirement for internal or external audits because they

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254 involve an entity that no longer exists and they focus on processes that
255 have been changed.

256 2. The Intercompany Services Agreement was inapplicable to
257 Respondent's Hub services to enovate, LLC.

258 **III. Stipulations**

259 1. The uncontested facts set forth in Section I, *supra*.

260 2. Factor O, the means by which a utility includes a refund ordered by
261 the Commission in its Gas Charge, in the amount of \$538,225 with respect
262 to Transaction Nos. 16/22.

263 3. Factor O, the means by which a utility includes a refund ordered by
264 the Commission in its Gas Charge, in the amount of \$4,628,267 with
265 respect to maintenance gas.

266 4. Adoption of Staff witness Knepler's proposed accounting treatment
267 for maintenance gas.

268 **IV. Legal Issues -- Contested and Uncontested**

269 **A. Prudence**

270 The Commission's November 7, 2001 Order states, in relevant part:

271 Each gas utility shall reconcile total revenue collected
272 under the purchased gas adjustment ("PGA") with total
273 cost of gas. The reconciliation balance shall be the
274 difference between (1) costs as recorded in the books
275 and records, excluding refund credits, which are allowed
276 as recoverable costs through the Uniform PGA, and (2)
277 applicable revenues. Each utility shall also demonstrate
278 that its gas supplies purchased during the reconciliation
279 period were prudently purchased. In addition, the
280 company shall describe the measures, if any, taken by
281 the utility during the reconciliation year to insulate the
282 PGA from price volatility in the wholesale natural gas
283 market explaining any hedging strategies utilized, the

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284 extent to which the strategies were actually
285 implemented, and the actual impact on the PGA of
286 implementing the strategies.

287
288 The proceeding is subject to Section 9-220(a) of the Public Utilities Act
289 (220 ILCS 5/9-220(a)). The standard of review for prudence under Section 9-
290 220(a) is:

291 Prudence is that standard of care which a reasonable
292 person would be expected to exercise under the same
293 circumstances encountered by utility management at the
294 time decisions had to be made. In determining whether
295 a judgment was prudently made, only those facts
296 available at the time judgment was exercised can be
297 considered. Hindsight review is impermissible.

298 Imprudence cannot be sustained by substituting one's
299 judgment for that of another. The prudence standard
300 recognizes that reasonable persons can have honest
301 differences of opinion without one or the other
302 necessarily being 'imprudent'.

303 Commonwealth Edison Company, Order dated October 7, 1987, in Docket No.
304 84-0395, (1987 Ill. PUC LEXIS 68 at *34); *also see* Commonwealth Edison
305 Company, Order dated November 5, 1998, in Docket No. 95-0119 (1998 Ill. PUC
306 LEXIS 1018 at *13)

307 **B. Financial Hedging**

308 1. Whether it was prudent for Respondent to decide not to purchase
309 financial hedges for any portion of its 2000-2001 winter gas purchases.

310 2. Whether Respondent's decision not to financially hedge was
311 consistent with Commission precedent.

312 3. Whether recommended gas cost disallowances based on
313 Respondent's decision not to financially hedge are based on
314 impermissible hindsight review.

315 **C. Gas Purchase and Agency Agreement**

316 1. Whether the Gas Purchase and Agency Agreement was prudent
317 based on information available to Respondent at the time it entered into
318 the agreement.

319 2. Whether costs incurred under the Gas Purchase and Agency
320 Agreement in fiscal year 2001 were prudent.

321 3. Whether a request for qualification process, involving a review of
322 nine potential suppliers, was sufficient to show the prudence of a gas
323 supply agreement such as the GPAA.

324 4. Whether, in light of Illinois Power Co. v. Illinois Commerce Comm.,
325 339 Ill. App. 3d 425, 439 (5th Dist. 2003), the specific analysis developed
326 by Staff witness Rearden was required to show prudence.

327 5. Whether recommended gas cost disallowances are contrary to the
328 Commission's decision in Respondent's fiscal year 2000 gas charge
329 reconciliation proceeding in which the Commission found that all gas
330 costs, including those incurred under the GPAA, were prudently incurred.

331 **D. Use of Gas Storage**

332 1. Whether recording revenues from transactions conducted pursuant
333 to Respondent's Federal Energy Regulatory Commission Operating
334 Statement above-the-line is consistent with Commission precedent.

335 2. Whether recording revenues from transactions conducted pursuant
336 to Federal Energy Regulatory Commission rules and policies above-the-
337 line is consistent with Commission precedent.

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338 3. Whether the amount of Manlove storage field capacity that
339 Respondent planned to use for its end use customers was prudent.

340 **E. Off-System Transaction No. 19**

341 1. Whether off-system Transaction No. 19 was prudent.

342 2. Whether recommended gas cost disallowances represent
343 impermissible hindsight review.

344 **F. Off-System Transaction Nos. 16/22**

345 None. Respondent testified that it would not contest the Staff's proposed
346 disallowance.

347 **G. Maintenance Gas**

348 None. Respondent testified that it would not contest the Staff's proposed
349 disallowance.

350 **H. Audit/Intercompany Services Agreement**

351 1. Whether Staff's recommended internal audit and the external
352 management audit, which would presumably be conducted pursuant to
353 Section 8-102 of the Public Utilities Act, are properly ordered in the
354 context of a proceeding pursuant to Section 9-220(a) of the Public Utilities
355 Act (220 ILCS 5/9-220(a)) or whether Respondent's development of a gas
356 procurement policy, made available for Staff's review, would be a more
357 appropriate and less costly means of addressing these issues.

358 2. Whether Staff's recommendations related to Respondent's
359 Intercompany Services Agreement are relevant to this proceeding, which
360 is conducted under Section 9-220(a) of the Public Utilities Act.

361 **V. Witnesses**

362 A. **Raulando C. de Lara:** Mr. de Lara's testimony has been superseded by
363 Mr. Wear's rebuttal testimony.

364 B. **Valerie H. Grace:** Ms. Grace, formerly Respondent's Director of Rates
365 and Gas Transportation Services and currently Peoples Energy Corporation's
366 Director of Strategic Planning, testified:

367 1. As required by the order initiating the proceeding, Ms. Grace
368 sponsored the reconciliation statement for the twelve months ended
369 September 30, 2001, Respondent's fiscal 2001, showing that Respondent
370 properly reconciled costs and revenues and described each of the
371 fourteen specified data for each of Respondent's Gas Charges. Grace
372 Direct Testimony, *passim*.

373 2. Gas storage costs are included in monthly gas charge filings such
374 that customers receive the full benefit of summer/winter price differentials.
375 LIFO accounting does not diminish the benefit to customers. Grace
376 Rebuttal Testimony at 2-4.

377 3. Dollars associated with two issues that Respondent elected not to
378 contest would be handled in the Gas Charge through Factor O if the
379 Commission issues an order requiring a disallowance for these two
380 recommendations. Grace Rebuttal Testimony at 4-5.

381 C. **Frank Graves:** Mr. Graves, Principal of The Brattle Group, testified that:

382 ▪ Mr. Graves' Financial Hedging Testimony

383 1. The Commission should assess Respondent's gas management
384 performance in light of whether those decisions:

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- 385 a. were appropriate on a before-the-fact basis, without reliance on
386 hindsight arguments;
- 387 b. reflected competitive unit costs; and
- 388 c. were consistent with Commission guidelines, regulatory precedents
389 and incentives. Graves Rebuttal Testimony at 7-8.
- 390 2. Compared with spot market purchases, a hedging program is as
391 likely to increase as to reduce gas costs. A hedging program should only
392 be expected to reduce volatility. Graves Rebuttal Testimony at 9-10.
- 393 3. The City of Chicago (“City”) and Citizens Utility Board (“CUB”)
394 recommendations for cost disallowances associated with Respondent’s
395 decision not to purchase financial hedges in the 2000-2001 winter are
396 flawed because the recommendations are based on a proposed hedging
397 program that was designed to reduce gas costs, rather than to control a
398 specified amount of gas cost volatility. Graves Rebuttal Testimony at 5,
399 12-13.
- 400 4. The City and CUB hedging recommendations unfairly use hindsight
401 information. For example, by excluding the possible hedging of summer
402 purchases from their hedging program, they created after-the-fact
403 programs tailored to produce a disallowance. Including hedges for
404 summer gas purchases, made months in advance of delivery like their
405 winter hedging, would have lowered their recommendations because
406 prices declined in the summer far below what the forward curves

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407 suggested during the winter period. Graves Rebuttal Testimony at 6, 29-
408 31.

409 5. The City and CUB gas cost disallowances and hedging proposals
410 ignore the Commission's regulatory views on hedging, in particular, that
411 "the Commission has not created an obligation or responsibility to mitigate
412 price volatility through the use of such financial tools." The Peoples Gas
413 Light and Coke Company, Docket No. 97-0024 (January 26, 2000).
414 Graves Rebuttal Testimony at 6, 13-15.

415 6. CUB's citation to New York PSC decisions as support is flawed
416 because there was an explicit policy shift by the New York PSC (requiring
417 New York gas utilities to hedge), but there was no such guidance from the
418 Commission until it issued the 2001 NOI report in April 2001. Graves
419 Rebuttal Testimony at 16-18.

420 7. The City's analysis of volatility does not show a dramatic change
421 until during the price spike. Graves Rebuttal Testimony at 24-25.

422 8. The risk management activities of non-utility subsidiaries of
423 Peoples Energy Corporation are irrelevant to whether Respondent should
424 have used financial hedges. Hedging by unregulated companies
425 establishes certainty, whether the hedged price is higher or lower than
426 market prices. Hedging by a regulated company is subject to an after-the-
427 fact review and possible cost disallowances. Graves Rebuttal Testimony
428 at 6, 22-24.

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429 9. The extreme run-up in gas prices during the 2000-2001 winter was
430 unprecedented and unpredictable. Graves Rebuttal Testimony at 6, 25-
431 27.

432 ▪ Mr. Graves' Gas Purchase and Agency Agreement Testimony

433 10. Respondent's use of gas supply contracts, such as the Gas
434 Purchase and Agency Agreement ("GPAA"), indexed to spot gas prices,
435 was not unusual and not imprudent. Graves Rebuttal Testimony at 7.

436 11. Staff's analysis of the GPAA is flawed because it relies on just one
437 view of potential outcomes related to expected basis declines (value of
438 transportation as measured by the price of gas at a receipt point in the
439 production areas and at a Chicago delivery point). Equally plausible
440 alternatives to the Staff analysis would show that the GPAA produced
441 savings. Respondent had reason to believe that there was a risk of basis
442 value reductions much steeper than the outlook used by Staff in its
443 analysis, with such belief based on factors such as proposed pipeline
444 projects in the Chicago area and experience elsewhere. Graves Rebuttal
445 Testimony at 7, 32-48.

446 12. Respondent's decision not to use an RFP process was reasonable
447 because RFPs are most useful for relatively narrow, standard services
448 that can be judged almost entirely on price. The GPAA was not
449 particularly conducive to an RFP, since it involved the transfer of several
450 supply and transportation contracts. Graves Rebuttal Testimony at 49.

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451 D. **Thomas L. Puracchio:** Mr. Puracchio, Respondent's Manager of Gas
452 Storage, described the physical characteristics and operations at Manlove
453 storage field in detail (Puracchio Rebuttal Testimony at 2-3, 5-7) and further
454 testified that:

455 1. Staff's conclusions drawn from certain studies prepared by
456 Respondent and its consultants are flawed because Manlove storage field
457 and the associated aquifer is a difficult reservoir system to describe and
458 predict, which means that there is greater uncertainty of reservoir
459 simulation forecasts. Consequently, the results of reservoir studies should
460 be considered specific to the conditions for which they were run and
461 caution should be used when attempting to extrapolate beyond those
462 conditions. Puracchio Rebuttal Testimony at 3-5.

463 2. Cycling additional volumes of gas through Respondent's Hub
464 services has improved the performance of Manlove storage field, as
465 shown by: an extension in the field decline point, improved field
466 performance as measured by end-of-season water-gas ratios, and less
467 gas becoming trapped as compared to the top gas volume. Puracchio
468 Rebuttal Testimony at 7-10.

469 3. If Respondent did not offer Hub services, there is a high probability
470 that Respondent's major objective of cycling 35 Bscf of system supply
471 would not be met during a warmer than normal winter period because of
472 the limited withdrawal period of Manlove storage field. Puracchio Rebuttal
473 Testimony at 13.

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474 4. If Respondent injected but did not withdraw 35 Bscf, this could lead
475 to increased volumes of gas being trapped or lost. Puracchio Rebuttal
476 Testimony at 10-11, 13.

477 E. **David Wear:** Mr. Wear, Respondent's Manager of Gas Supply
478 Administration, testified:

479 ▪ Mr. Wear's Testimony about Gas Purchasing Practices

480 1. Respondent's fiscal 2001 gas supply costs and practices were
481 prudent as exemplified by its supply and capacity procurement practices,
482 reserve margin and steps taken to address gas price volatility. Wear
483 Direct Testimony at 3-8.

484 2. Respondent takes steps to ensure that pipelines serving
485 Respondent provide reliable services. Wear Direct Testimony at 8-9.

486 3. Respondent has detailed auditing and monitoring procedures in
487 place related to capacity and commodity contracts. Wear Direct
488 Testimony at 9-14.

489 ▪ Mr. Wear's Gas Purchase and Agency Agreement Testimony

490 4. The Gas Purchase and Agency Agreement ("GPAA") was the
491 product of lengthy negotiations that began with Respondent's October
492 1998 filing to implement a fixed gas charge and an RFQ to nine potential
493 suppliers; after many months and several iterations of what became the
494 GPAA, the process concluded with the execution, in September 1999, of a
495 contract that would provide approximately two-thirds of Respondent's

496 requirements for a five-year period. Wear Additional Direct Testimony at
497 2-10.

498 5. Respondent had five objectives in negotiating the GPAA and the
499 agreement achieved each objective (Wear Additional Direct Testimony at
500 10-29; Wear Rebuttal Testimony at 15-16; Exs. 8, 9, 10):

501 (a) market-based commodity pricing with no reservation or demand
502 charges;

503 (b) flexible pricing options;

504 (c) preserve the value of Respondent's transportation capacity in the
505 face of shrinking basis projections;

506 (d) provide a level of flexibility that would assist Respondent in meeting
507 different weather conditions; and

508 (e) comparable to the aggregate gas supply contracts that had been
509 commonly held by Respondent in prior years.

510 ▪ Mr. Wear's Off-System Transaction Testimony

511 6. Respondent used off-system transactions for operational reasons
512 and, because revenues from such transactions are flowed through the
513 Gas Charge, to reduce gas costs. Wear Additional Direct Testimony at
514 29-32; Wear Rebuttal Testimony at 47-49.

515 7. Transaction No. 19, a [REDACTED] of gas in
516 December 2000 was prudent for operational reasons to address a
517 potential oversupply had warm weather occurred in December. Wear
518 Rebuttal Testimony at 49-50.

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519 8. Transaction No. 19 was the result of a prudent decision to begin
520 withdrawals from Manlove storage field in late November, rather than the
521 second week of December; consequently, because of the operational
522 characteristics of an aquifer storage field, the risk of a December
523 oversupply under warm weather conditions was exacerbated. Wear
524 Rebuttal Testimony at 49-51.

525 9. The sale to Enron North America Corporation preserved the [REDACTED]
526 [REDACTED] credit for baseload quantities and it preserved the full sellback
527 quantity. Wear Rebuttal Testimony at 49.

528 10. Staff's proposed disallowance calculation includes three errors and
529 is overstated by approximately \$1.3 million (out of \$6.4 million). Wear
530 Rebuttal Testimony at 52.

531 ▪ Mr. Wear's Hub Services Testimony

532 11. Federal Energy Regulatory Commission jurisdictional services
533 ("Hub" services), such as park and loan services, provided by
534 Respondent, for which revenues are properly accounted for above-the-
535 line, do not increase gas costs because Respondent establishes its
536 seasonal storage plan first *i.e.*, the use of Manlove to meet the
537 requirements of its end use customers; North Shore Gas Company, a firm
538 storage customer, provides its seasonal storage plan; then Respondent
539 determined a Hub seasonal plan. Wear Additional Direct Testimony at 32-
540 35; Wear Rebuttal Testimony at 42-43.

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541 12. At no time did Hub services displace end user service. Respondent
542 used Manlove storage field in a manner that preserved its peaking
543 characteristics and kept an appropriate amount of seasonal storage
544 capacity available to end use customers throughout the withdrawal period.
545 Wear Rebuttal Testimony at 42-44.

546 13. Staff's claim that certain winter loan activity resulted in third party
547 inventory being negative and increased gas costs by requiring daily gas
548 purchases on each day with net loan activity is erroneous. During the fifty-
549 nine day period for which there was negative third party inventory and net
550 loan activity, there was, at most, incremental purchase activity on seven
551 days; the avoided purchase costs on the days the loans associated with
552 these purchases were paid back exceeds the incremental purchase costs.
553 The loan activity reduced total gas costs. Wear Rebuttal Testimony at 45-
554 47.

555 14. Respondent used Manlove storage field in conjunction with
556 purchased storage services to meet customer requirements in an efficient
557 and prudent manner. Wear Rebuttal Testimony at 33-35.

558 15. Each storage service (purchased and Manlove storage field)
559 performs a unique function to meet Respondent's load. For example,
560 Respondent purchased services with no-notice rights and swing flexibility
561 while Manlove storage field, which comprised approximately 50% of the
562 storage portfolio, does not have no-notice capabilities. Wear Rebuttal
563 Testimony at 38-40.

564 ▪ Mr. Wear's Hedging Testimony

565 16. Contrary to the City's claim, gas storage was an effective physical
566 hedge. Respondent's end use customers received the full value of the
567 differentials that existed between prices during the withdrawal season and
568 the price to replace storage gas. Respondent calculated that the
569 replacement cost savings were approximately \$130 million. Wear
570 Rebuttal Testimony at 58.

571 17. The City's proposed financial hedging quantities, which are
572 purportedly baseload purchases under a warm weather scenario, are
573 overstated for two reasons. (Wear Rebuttal Testimony at 58-59). The
574 City's witness:

- 575 a. ignored all storage activity, which would reduce the purchase
576 quantities significantly; and
- 577 b. failed to recognize that purchases have a great deal of daily
578 variability, but, in the City witness's analysis, hedge quantities must
579 be purchased at the same level each day of the month.

580 F. **Thomas E. Zack:** Mr. Zack, Respondent's Director of Gas Supply,
581 testified:

582 1. From a policy perspective, the Commission should consider the
583 need for consistency in regulation, both relative to prior Peoples Gas
584 decisions and decisions in other utility cases. Zack Rebuttal Testimony at
585 4-6.

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586 2. The Commission has consistently not required Respondent or other
587 Illinois utilities to financially hedge gas supplies and imposed no obligation
588 to mitigate price volatility through the use of financial hedges. Zack
589 Rebuttal Testimony at 6-8.

590 3. The Gas Purchase and Agency Agreement was in effect in fiscal
591 2000 and neither Staff nor intervenors raised any issues; contrary to
592 Staff's claim, there was adequate time for review of that agreement in
593 fiscal 2000. Zack Rebuttal Testimony at 10, 14-21.

594 4. Respondent's Hub services have been offered since 1998 and
595 have never been found imprudent or inappropriate. The Commission was
596 a party to the 1998 proceeding in which Respondent received its Federal
597 Energy Regulatory Commission certificate to provide Hub services. Zack
598 Rebuttal Testimony at 23-24.

599 5. Respondent's treatment of Hub revenues (above-the-line) is
600 consistent with Commission precedent. Zack Rebuttal Testimony at 23.

601 6. The magnitude of certain proposed disallowances (\$230 million by
602 the City and \$110 million by CUB) is unreasonable in light of
603 Respondent's total recoverable gas costs of \$883.5 million. Zack Rebuttal
604 Testimony at 10-11.

605 7. The facts in this case provide no basis for a management audit,
606 and, in any event, an audit is a forward looking exercise and Respondent
607 has taken and continues to take steps to improve its internal controls.
608 Zack Rebuttal Testimony at 24-28.

609 **VI. Issues and Suggested Disposition**

610 **A. Financial Hedging:** Whether Respondent's decision not to
611 financially hedge 2000-2001 winter gas purchases was imprudent and, if
612 so, whether gas costs were increased above a prudent level.

613 **Disposition:** Respondent's decision not to financially hedge 2000-2001
614 winter gas purchases was prudent based on Commission precedent and
615 market circumstances at the time hedging decisions for that winter would
616 have been made (the spring and summer of 2000). The City's (\$230
617 million) and CUB's (\$53.2 million) proposed disallowances should be
618 rejected as contrary to Commission policy and relevant Commission
619 orders. Moreover, the recommendations are based on hindsight review
620 and are thus impermissible under Section 9-220(a) of the Public Utilities
621 Act.

622 **B. Gas Purchase and Agency Agreement:** Whether the Gas
623 Purchase and Agency Agreement ("GPAA") was prudent and whether
624 costs incurred under that agreement in fiscal year 2001 were prudent.

625 **Disposition:** The GPAA was a prudent agreement. Costs incurred under
626 the GPAA in fiscal year 2001 were prudent. The GPAA and resulting gas
627 costs were prudent because it was a reasonable way for Respondent to
628 address changing market conditions, preserve the value of Respondent's
629 transportation assets and assure customers a reliable, long-term supply of
630 market-priced gas. Staff's (\$9 million), the Attorney General's (\$8 million)
631 and CUB's (\$2.8 million) proposed disallowances should be rejected as
632 unsupported by the evidence, inconsistent with Commission precedent

633 regarding costs incurred under the agreement and little more than a
634 difference of opinion.

635 **C. Use of Storage:** Whether Respondent's use of its Manlove
636 storage field was prudent and, if not, whether that use increased costs to
637 customers. Whether revenues resulting from Respondent's use of
638 Manlove storage field for purposes other than serving end users should be
639 credited to customers through the gas charge.

640 **Disposition:** Respondent's use of its Manlove storage field to serve its
641 end use customers and support Federal Energy Regulatory Commission
642 jurisdictional services ("Hub" services) was reasonable and prudent, and
643 customers benefited from this use of the field. The quantity of Manlove's
644 capacity used by Respondent reflected the prudent use of this asset as a
645 part of its storage portfolio. Consistent with Commission precedent and
646 applicable Commission rules, revenues derived from Hub services were
647 properly accounted for above-the-line and not as a credit against gas
648 costs in the Gas Charge. Staff's (\$10.3 million) and CUB's (\$51.2 million)
649 proposed disallowances related to Hub services and the use of Manlove
650 storage field should be rejected as unsupported by the evidence. Staff's
651 proposed accounting treatment of Hub revenues should be rejected as
652 contrary to Commission precedent and Commission rules.

653 **D. Off-System Transaction No. 19:** Whether off-system Transaction
654 No. 19, a [REDACTED] in December 2000, was
655 prudent.

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656 **Disposition:** Off-system Transaction No. 19 was a reasonable and
657 prudent operational decision by Respondent based on the information
658 available at the time the decision was made. Staff's (\$6.4 million)
659 proposed disallowance should be rejected as unsupported by the facts
660 and impermissible hindsight review.

661 **E. Off-System Transaction Nos. 16/22:** Whether off-system
662 Transaction Nos. 16/22 was prudent.

663 **Disposition:** Respondent testified that it would not contest Staff's
664 proposed disallowance of \$538,225. This exceeds CUB's proposed
665 disallowance, which is the only other disallowance proposed for this issue.
666 Accordingly, this issue is moot and should be disposed of through the
667 Commission's order requiring Respondent to implement a Factor O in the
668 amount of Staff's proposal.

669 **F. Maintenance Gas.** Whether Respondent's recovery of
670 maintenance gas costs as lost and unaccounted for gas was proper.

671 **Disposition:** Respondent testified that it would not contest Staff's
672 proposed disallowance of \$4,628,267 and proposed accounting treatment.
673 Staff's proposal exceeds CUB's proposed disallowance, which is the only
674 other disallowance proposed for this issue. Accordingly, this issue is moot
675 and should be disposed of through the Commission's order requiring
676 Respondent to implement a Factor O in the amount of Staff's proposal and
677 a finding that Staff's proposed accounting treatment will be adopted by
678 Respondent.

679 **G. Audit/Intercompany Services Agreement.** Whether internal and
680 external audits of Respondent’s gas purchasing processes are necessary.
681 Whether the Commission should order Respondent to revise its
682 Intercompany Services Agreement (also called an Operating Agreement).
683 **Disposition:** Respondent showed that Staff’s proposed audits (internal
684 and external) are unsupported by the evidence and further unnecessary in
685 light of Respondent’s continual efforts to improve its internal controls and
686 processes. Staff’s audit proposals should be rejected. The transactions
687 cited by Staff as support for ordering Respondent to revise its
688 Intercompany Services Agreement do not support Staff’s recommendation
689 because they were not transactions conducted pursuant to that
690 agreement.

691 **VII. Acronyms**

- 692 ▪ AGA: American Gas Association
- 693 ▪ Bcf: billion cubic feet
- 694 ▪ Bcf/d: billion cubic feet per day
- 695 ▪ Bscf: billion standard cubic feet
- 696 ▪ CERA: Cambridge Energy Research Associates
- 697 ▪ CGC: commodity gas charge
- 698 ▪ DGC: demand gas charge
- 699 ▪ DIQ: daily incremental quantity
- 700 ▪ Dth: dekatherm
- 701 ▪ EIA: Energy Information Administration
- 702 ▪ EMW: Enron MW, LLC

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- 703 ▪ ENA: Enron North America Corporation
- 704 ▪ FERC: Federal Energy Regulatory Commission
- 705 ▪ FOM: first of month
- 706 ▪ FY: fiscal year
- 707 ▪ FY01: fiscal year 2001, the reconciliation period in this proceeding, which
- 708 is the twelve-month period October 1, 2000 to September 30, 2001
- 709 ▪ GAO: General Accounting Office
- 710 ▪ GMS: Gas Management System
- 711 ▪ GPAA: Gas Purchase and Agency Agreement
- 712 ▪ Hub: Federal Energy Regulatory Commission jurisdictional services
- 713 provided by Respondent
- 714 ▪ LDC: local distribution company
- 715 ▪ LIFO: last in, first out (the method by which Respondent accounts for
- 716 storage activity)
- 717 ▪ Mcf: one thousand cubic feet
- 718 ▪ MDth: one thousand dekatherms
- 719 ▪ MMBtu: one million British thermal units
- 720 ▪ MMcf/d: one million cubic feet per day
- 721 ▪ MMDth: one million dekatherms
- 722 ▪ NCGC: non-commodity gas charge
- 723 ▪ NGPL: Natural Gas Pipeline Company of America
- 724 ▪ NGI: Natural Gas Intelligence Weekly Gas Price Index
- 725 ▪ NOI: Notice of Inquiry

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- 726 ▪ PBR: performance based rates
- 727 ▪ PGA: purchased gas adjustment
- 728 ▪ PSC: public service commission
- 729 ▪ psig: pounds per square inch gauge
- 730 ▪ RFP: request for proposal
- 731 ▪ RFQ: request for qualification
- 732 ▪ SIQ: summer incremental quantity
- 733 ▪ TCPL: TransCanada Pipeline
- 734 ▪ TS: transition surcharge
- 735 ▪ WCSB: Western Canadian Supply Basin or Western Canadian
- 736 Sedimentary Basin
- 737 ▪ WGR: water-gas ratio
- 738 **VIII. Organization Chart**
- 739 See the attachment.
- 740 **IX. Federal Laws and Regulations**
- 741 ▪ 15 U.S.C. §717(c)
- 742 ▪ 15 U.S.C. §3371
- 743 ▪ 18 C.F.R. 284.224
- 744 ▪ 18 C.F.R. 284.402

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Respectfully submitted,

The Peoples Gas Light and Coke Company

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Dated at Chicago, Illinois this
26th day of May, 2004

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STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Illinois Commerce Commission)	
On Its Own Motion)	
)	
v.)	
)	
The Peoples Gas Light and)	01-0707
Coke Company)	
)	
Reconciliation of revenues)	
collected under fuel and gas)	
adjustment charges with actual)	
costs.)	

NOTICE OF FILING AND CERTIFICATE OF SERVICE

To: Service List

PLEASE TAKE NOTICE that on this 26th day of May, 2004, I have filed with the Chief Clerk of the Illinois Commerce Commission, the Pre-Hearing Memorandum of The Peoples Gas Light and Coke Company, a copy of which is hereby served upon you by electronic mail and United States Mail on May 26, 2004.

By: /S/ MARY KLYASHEFF
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