STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

ILLINOIS COMMERCE COMMISSION ON ITS OWN MOTION,	)	
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V.	)	
	)	
THE PEOPLES GAS LIGHT AND COKE COMPANY	)	**DOCKET NO. 01-0707**
	)	
RECONCILIATION OF REVENUES COLLECTED UNDER GAS ADJUSTMENT CHARGES WITH ACTUAL COSTS PRUDENTLY INCURRED	)	

ADDITIONAL REBUTTAL TESTIMONY

OF

FRANK C. GRAVES

JANUARY 28, 2005

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INTRODUCTION

Q. What is your name and position?

A. I am Frank C. Graves, a principal with The Brattle Group who is testifying on behalf of The Peoples Gas Light and Coke Company ("Peoples").

Q. Are you the same Frank Graves who submitted rebuttal testimony in this proceeding?

A. Yes, I am.

Q. What is the purpose of your testimony?

A. I will rebut arguments offered by Citizens Utility Board and City of Chicago witness Ms. Lindy Decker and Staff witness Dr. David Rearden claiming to demonstrate that the Gas Purchase and Agency Agreement ("GPAA") contract was imprudent.

Q. What are your key findings?

A. I find that neither Ms. Decker nor Dr. Rearden have performed an analysis that is comprehensive enough to reach the conclusion that the GPAA was imprudent. To the contrary, Ms. Decker's analysis is entirely a hindsight analysis which is not appropriate for evaluating prudence. It also mixes inappropriate comparisons of a five-year, pre-GPAA benchmark period with specific years of performance under the GPAA. If her analysis were to be used on a more consistent basis, it actually supports the conclusion that the GPAA has been successful at reducing customer costs. Furthermore, I disagree

with her qualitative conclusion that the structure and terms of the GPAA were at odds with industry practice, hence imprudent.

Dr. Rearden's updated analysis of the GPAA primarily differs from his prior assessment by using specific field prices for natural gas rather than the Henry Hub price. This is consistent with the so-called "Aruba" analysis that was done by an employee (Roy Rodriguez) within a division of Peoples Energy Corporation shortly before the GPAA was signed. Dr. Rearden finds the GPAA could have been projected to cost customers around $37 million over its five-year life. However, his new analysis contains computational errors that, when corrected, reduce this cost disadvantage significantly. In addition, his new analysis continues to rely entirely on one scenario describing future possible basis prices (or equivalently, city-gate prices), when in fact that outlook was very uncertain and included possibilities much more favorable to the GPAA.

Although he acknowledges the existence of other scenarios that make the GPAA attractive, Dr. Rearden chooses to dismiss those scenarios and instead he criticizes the company for not completing a more formal analysis that demonstrated their belief that the GPAA was a good idea. This may be a valid criticism, but it is a complaint about the company's planning processes and documentation thereof, not a complaint about the prudence of the plans that were followed. Prudence rests on what a reasonable person might have concluded at the time, not on how the company reached its conclusions.

Finally, even if Dr. Rearden's view of how to assess prudence was accepted, I disagree with the way he has calculated a recommended disallowance amount. Specifically, Dr. Rearden fails to consider alternative terms that would have made the GPAA more

attractive. I have considered such alternative terms, and I provide a methodology that, unlike Dr. Rearden's, does not penalize Peoples for the highly anomalous gas price environment that occurred in the reconciliation period, but which was only evident after the fact.

Q. How is your testimony organized?

A. I first discuss my concerns with Ms. Decker's analysis, then Dr. Rearden's evaluation.

MS. DECKER'S ANALYSIS OF PRICE RATIOS DOES NOT PROVIDE A USEFUL QUANTIFICATION OF A DISALLOWANCE RELATED TO THE GPAA.

Q. Please summarize the analysis performed by Ms. Decker regarding the GPAA.

A. Ms. Decker's analysis examines the ratio of the prices paid by Peoples' customers to daily spot market prices at the Chicago city-gate, the Katy Hub, and the Henry Hub. She examines each of these ratios for four time periods: (1) January 1, 1995 to September 30, 1999 ("pre-GPAA period"), (2) October 1, 1999 to December 31, 2001 ("GPAA to Enron bankruptcy period"), (3) October 1, 2000 to September 30, 2001 ("Reconciliation period") and (4) January 1, 2002 to June 30, 2004 ("Post-Enron GPAA period").

Her analysis shows an increase in the Chicago city-gate ratio from 17.72% for the pre-GPAA Period to 22.28% for the GPAA to Enron bankruptcy period, within which there is a 25.98% increase for the Reconciliation period. For the Katy Hub ratio, she finds an increase in the ratio from 24.00% for the pre-GPAA period to 26.02% for the GPAA to

Enron bankruptcy period, with 30.30% in the Reconciliation period. Finally, for the Henry Hub ratio, she finds a slight increase in the ratio from 24.55% for the pre-GPAA period to 25.06% for the GPAA period to Enron bankruptcy period (and 29.78% for the Reconciliation period).

Q. How does Ms. Decker use these ratios to calculate a disallowance?

A. Ms. Decker compares the level of the Chicago city-gate ratio during the pre-GPAA period (17.72%) to the ratio during the Reconciliation period (25.98%) to calculate a "disallowance factor" of 7.01% (equal to 1.2598/1.1772 minus one, essentially the difference between these two increases). She applies this disallowance factor to the total cost of gas purchased under the GPAA ($572 million) to arrive at her disallowance recommendation of $37.5 million.[1]

Q. Does Ms. Decker's price-ratio analysis demonstrate that the decision to enter into the GPAA was imprudent?

A. No, her analysis is not appropriate for determining the prudence of the decision to sign the GPAA because it relies on hindsight information (specifically, realized spot gas prices). It also ignores other possible explanations for hindsight costs that turn out to be unattractive relative to an alternative supply strategy. Imprudence might cause that to occur, but so could uncontrollable or unexpected circumstances.

There is wide agreement among utility industry experts and many regulators that hindsight information should not be used for prudence determinations. Prudence is

[1] Specifically, Ms. Decker multiplies $572 million by 1- (1/1.0701).

about whether reasonable decisions were made using then-available information, not about whether those decisions paid off or succeeded as hoped. Thus, the Commission should ignore Ms. Decker's analysis when making its determination as to the prudence of Peoples' decision to enter into the GPAA. Rather, the Commission should evaluate the market circumstances and the range of uncertainty that existed at the time the contract was signed. Ms. Decker has failed to conduct any independent analysis of these market circumstances and uncertainties.

In regard to controllability, it is critical for the Commission to appreciate that the extremely anomalous conditions of winter 2000/2001 would not have been in anyone's planning analyses used to test the GPAA, so Peoples would likely have been exposed to those events to some extent under many alternative arrangements that the interveners in this case would have deemed *a priori* prudent. Such studies would have focused on how to deal with a likely pending reduction in basis, not how to cope with the unlikely possibility of a large increase in basis prices – even though that in fact did occur in December 2000 and January 2001 (as is discussed further below).

Q. Does Ms. Decker's analysis provide an appropriate quantification of a disallowance assuming the contract were found on other grounds to be imprudent?

A. No, I believe that her analysis is flawed and should be rejected by the Commission in the event it finds a disallowance is appropriate (on some other grounds). Her metric for measuring reasonableness (the ratio of prices paid to Chicago city-gate prices) is unstable and the time period she uses in calculating this ratio for the pre-GPAA period is

arbitrary. These flaws, combined with Ms. Decker's use of hindsight information, serve to artificially inflate her disallowance proposal.

Q. How is the ratio used in Ms. Decker's disallowance calculation unstable?

A. Her test compares a 5-year average cost ratio (prior to the GPAA) with the same ratio(s) in shorter periods since then, including the 1-year reconciliation period. But as shown in Exhibits FCG-AR1 and FCG-AR2, the 5-year, pre-GPAA cost ratio she uses had huge changes from year-to-year when calculated on an annual basis.[2] Specifically, the annual ratios fluctuated from a high of 75.67% (for Peoples' costs over Chicago city-gate, shown in Exhibit FCG-AR1) to a low of -7.59%. I understand that recovery of all of these prior costs was allowed as prudently incurred. Also, Ms. Decker is implicitly endorsing these pre-GPAA costs by using their average as a benchmark to test the GPAA, yet they exhibit variation that is much greater than the changes in the ratios she criticizes for the GPAA period. This variation shows that Ms. Decker's proposed metric is clearly unreasonable as the basis for a disallowance calculation.

Part of the reason for this internal contradiction is that she commits the statistical error of comparing a multi-period average of a volatile number to its value in a shorter period. Valid comparisons must be for ratios calculated over the same horizon, and they must also address whether the two periods are otherwise comparable. The extreme year-to-year variability in her gas index ratios during the benchmark period indicates that

[2] Exhibits FCG-AR1 and FCG-AR2 are modified versions of Ms. Decker's Table A (Chicago city-gate prices) and Table C (Henry Hub prices). I have not provided a modified version of her Table B since the prices at Katy Hub were not available over the same time periods I examined in Exhibits FCG-AR1 and FCG-AR2.

something much more complicated is affecting gas prices than whether or not the GPAA was in place. Those complicating factors could easily be responsible for the level of the ratios she criticizes in the reconciliation period. This shows that her performance metric is far too coarse to explain whether or not the GPAA was a good idea *ex ante*, or proved successful *ex post*.

Q. How does Ms. Decker justify the 5-year period as her choice of a baseline period?

A. She does not explain why she considers the five years preceding the GPAA to be the relevant benchmark. For instance, it might have been just as plausible to use the ratio from 1999 (27.43%), or an average of the 1998-1999 results (26.27%). Using these periods would have nullified her disallowance calculation (or even suggested that a reward was due to Peoples, for saving money). For example, using the 27.43% ratio for 1999 as a benchmark, the decline during the reconciliation period to 25.10% would suggest a negative disallowance (i.e., a GPAA benefit) of $10.4 million.

Q. Is there anything else that you believe is arbitrary about Ms. Decker's disallowance calculation?

A. Yes. Ms. Decker has divided the GPAA into pre- and post- Enron bankruptcy periods, but has offered no rationale for this arbitrary decision. Her decision to examine these periods separately seems unusual, especially since Ms. Decker seems to understand that the GPAA continued unaffected (with the identical terms) after Occidental assumed the contract following Enron's bankruptcy.[3] She offers no evidence that Occidental

[3] Additional Direct Testimony of Ms. Decker, p. 24 (lines 693-694).

administered the contract any differently than Enron. Moreover, her analysis shows a large decline (improvement) in the ratios during the post-Enron GPAA period relative to the GPAA prior to the Enron bankruptcy. Amazingly, Ms. Decker notices this fact but offers no interpretation of the improved performance of the GPAA during the Occidental period. Instead she merely observes, "Interestingly, PGL gas prices in comparison to spot prices improved considerably during the post-Enron management of the GPAA."[4]

Of course, the GPAA is a multi-year contract. One interpretation of her analysis is that it demonstrates the GPAA saves customers money in some years but not in others. It would be unfair to disallow the contract's costs in unsuccessful years and enjoy its benefits without any offsetting credits to Peoples in the successful years. Such an asymmetric, success-skimming practice would cause a utility to refuse to enter any agreement that was not assured of reducing costs in each and every year of its life. No such agreements are likely to exist, causing ratepayers to forego the benefits of agreements that would produce savings on average, but not under all circumstances.

Q. How do her results change if the entire GPAA period is compared to the pre-GPAA period as a whole?

A. As shown in my Exhibits FCG-AR1 and FCG-AR2, the ratios Ms. Decker uses, when calculated as one combined 5-year GPAA period, actually decline relative to the 5-year pre-GPAA period ratio she calculates. For example, Exhibit FCG-AR1 shows that the Chicago city-gate ratio actually fell from 17.72% in the pre-GPAA period to 16.41% in

[4] Ibid., p. 24 (lines 695-696).

the full five-year period the GPAA was in effect.[5] Likewise Exhibit FCG-AR2 shows that the Henry Hub ratio actually fell from 24.55% in the pre-GPAA period to 18.08% over the full five-year period the GPAA was in effect.

Q. Is there any way to use a simple metric such as Ms. Decker's ratio to assess whether realized results in the reconciliation period were reasonable?

A. It is almost impossible with her metric, because as I mentioned above, there is a great deal of unexplained complexity as to why the cost index ratio varies so much from year to year. Its annual changes obviously reflect much more than the influence of basis prices vs. pipeline variable costs, but those additional, larger factors have not been identified or explained by Ms. Decker. The influence of any uncontrollable and unpredictable circumstances need to be "netted out" of any comparison between years or periods before the differences can be attributed to good or bad management (prudence). In this situation, the extreme winter prices and the corresponding unusual basis prices that occurred during the reconciliation year would adversely affect almost any ex post test of whether the GPAA was successful or desirable.

Q. Do you agree with Ms. Decker's view that the price, quantity and length of the GPAA were each imprudent?

A. No, I find Ms. Decker's review of these components of the agreement to be quite superficial. She does not evaluate them in terms of tradeoffs between them, or in terms

[5] I note that the terms of the GPAA was actually five years and one month (October 1, 1999 through October 31, 2004), but for simplicity refer to it as a five-year agreement.

of how they match the problem the company was trying to solve. Instead, she criticizes them as if they were flawed on their face, simply because she finds these terms unusual.

With respect to price, Ms. Decker claims that the provisions of the contract that allowed Enron to choose between daily and first-of-month pricing were not prudent in that Peoples would "cede control" over prices to Enron. She also believes that the provisions of the contract that allowed Enron to choose the level of the Summer Incremental Quantity were imprudent. Again, here she views these terms as allowing Enron to "dictate the quantities" of gas Peoples would have to purchase. This claim, in reality, is similar to her claim with respect to pricing since the effect of the quantity provision she cites essentially gives Enron the option to charge Peoples for additional volumes at the first of month price.

Ms. Decker's claims that these provisions cede control to Enron are exaggerations that should be rejected as evidence of imprudence, since there is nothing *per se* imprudent about contractual terms that provide options to one (or both) of the counterparties. Options are commonplace in modern contracts, and they can be both beneficial in allocating responsibilities and reasonable in terms of benefits gained in exchange. Ms. Decker seems to ignore the fact that Enron did not receive these options for free, but rather had to pay for them in the form of the [redacted] discount it provided to Peoples off the Chicago city-gate price. Ms. Decker could have argued, like Dr. Rearden, that Peoples did not get a large enough discount from the city-gate price in exchange for granting these options, but she has provided no such evidence or analysis.

Q. What about Ms. Decker's contention that the length (term) of the contract was imprudent?

A. Again, I disagree and I find her support for this criticism to be quite weak. While generally acknowledging that five-year gas purchase agreements did exist during the late 1990s and early 2000s, she claims that they were an unusual, outmoded practice. As support for her claim, she cites a trade press article indicating that market participants now rely on spot market purchases rather than long-term supply contracts with pipelines.

I find Ms. Decker's use of this article as support for a finding of imprudence related to the GPAA to be confusing. The article seems to be contrasting the pre-1990 period when LDCs had fixed-price, take-or-pay supply contracts with pipelines (who, in turn, had fixed-price take-or-pay contracts with producers) with the period after FERC Orders 500 and 636 when price-indexed contracts became the norm. She overlooks the fact that the GPAA is not a long-term, fixed-price supply contract with a pipeline (the kind of contract that the article claims has become outmoded), but rather is a long-term, spot-indexed supply contract with a gas marketing company. Moreover, the article contradicts the Citizens Utility Board's position in this matter that Peoples was imprudent for relying on spot market pricing since it notes how common it had become for gas buyers to rely on the spot market. In general, the article provides no support for Ms. Decker's apparent view that a long-term contract that is indexed to spot market prices is *per se* imprudent.

Indeed, it is hard to imagine how a five-year, price-indexed contract (that also allows the mutually agreeable fixing of prices during specified sub-periods) could be considered

per se imprudent just because of its length. After all, there was no risk of the contract quantities or horizon exceeding the company's needs; Peoples' obligation to buy gas on behalf of its customers was not going to end before the end of the contract. Nor was there a risk of the GPAA prices departing from market levels.

Contrary to Ms. Decker's view that long-term contracts "were not a common choice among major industry buyers or sellers," my review of the evidence shows that long-term indexed contracts are still frequently used by LDCs. A survey by the American Gas Association found that long-term contractual agreements (one-year or more) accounted for 26% of 2000-2001 LDC peak-day gas purchases, with 67% of long-term supplies purchased under first-of-the month pricing.[6]

Finally, the five-year term of the contract was reasonable in light of Peoples' concern that there was an impending decline in the Chicago-Henry Hub basis that would manifest itself over a period of years. This was not something that was going to happen immediately or abruptly on a date-certain. Rather, it was an expected result of the process of pipeline development both up- and down-stream from Chicago that was going to take a while to play out. With that concern, a long-term contract with city-gate pricing was a reasonable way to protect ratepayers over what was forecast to be a multi-year change in market conditions.

Q. Are you aware of other long-term supply-management outsourcing and agency contracts that were signed in the late 1990s?

A. Yes, agreements in which LDC supply, transportation, and storage contracts are managed by a third-party started to become popular in the late 1990s, contradicting Ms. Decker's view that long-term contracts were not commonly used. Much like the GPAA, these agreements often involve a third-party marketer contracting to supply an LDC's gas requirements (or some portion of those requirements) at prices specified in the agreement, and they allow the marketer to use some of the LDC's contractual rights to their own benefit, within the constraints of their obligation to the LDC. Some examples of these types of arrangements include:

- Yankee Gas signed a three year agreement with Engage Energy effective November 1, 1997 and a three-year agreement with TransCanada Gas Services effective November 1, 1998 (as well as a separate one-year agreement with TransCanada effective November 1, 1998). Under these agreements, Engage and TransCanada managed Yankee's contractual rights to supply, transportation, and storage contracts and provided the quantity of gas specified by Yankee.[7]
- SEMCO Energy Gas Company signed a three-year agreement effective April 1, 1999 with TransCanada Gas Services under which TransCanada provided SEMCO's gas requirements and managed its natural gas supply.[8]
- Boston Gas and its affiliates Colonial Gas and Essex Gas entered into a three-year portfolio management contract with El Paso Energy Marketing effective November

[6] "LDC System Operations and Supply Portfolio Management During the 2000-2001 Winter Heating Season," American Gas Association, July 2, 2001.

[7] Connecticut Department of Public Utility Control, Decision (August 18, 1999), pp. 2-3.

[8] SEMCO Energy 1998 10-K, March 26, 1999.

> 1, 1999. Under the agreement, El Paso was to provide all of the city-gate supply requirements to the three LDCs at market prices and manage certain of the companies' upstream capacity, underground storage and term supply contracts.[9]

Of course, the specific terms and conditions of these agreements are not clones of the GPAA, but they exemplify a move towards increased out-sourcing of supply management services. In general, the rapid market development events of the late 1990s created an interest in alliances between traditional utilities and newer entities that were seemingly better equipped, via scale, scope, financial depth, and experience, to cope with the complex trading, risk management, and asset optimization opportunities arising under restructuring.

DR. REARDEN'S UPDATED ANALYSIS OF THE GPAA CONTAINS ERRORS AND IS NOT SUFFICIENT FOR A FINDING OF IMPRUDENCE.

Q. Dr. Rearden has performed an updated analysis in which he finds the GPAA appeared prospectively to be disadvantageous to ratepayers by around $37 million. Do you agree with his new analysis?

A. No. His revised analysis is a modification of the assessment in his original testimony, now with somewhat lower field prices as a result of using gas price projections from specific basins instead of from Henry Hub. In the new analysis, he is relying on some

[9] Boston Gas 1999 10-K, March 14, 2000.

parameters used in a simulation of the GPAA performed by Mr. Rodriguez (at Peoples Energy Corporation) in September 1999. This revision results in an $11 million increase in Dr. Rearden's delivered vs. city-gate comparison, bringing his calculated disadvantage of the GPAA (with respect to this delivered-city-gate element) from $24 million originally to $33 million now. However, he has made a few errors in his use of field price data, discussed below, which when corrected eliminate a significant portion of the GPAA cost disadvantage he believes he has identified.

In addition, like his prior analysis, this updated assessment just looks at the GPAA in terms of simulation parameters supplied by the company for a single scenario of how the market might evolve. Dr. Rearden does not look at structural conditions prevailing or emerging in the Chicago market area for any corroboration about how likely these assumptions were, nor does he assess the GPAA under any other market forecasts or scenarios.

Q. Why is this reliance on just Mr. Rodriguez's study a problem?

A. First, he is implicitly assuming that the analysis describes the company's expected scenario or planning scenario. That is certainly not established simply by virtue of it being (apparently) the only contemporaneous modeling of the GPAA that the company performed. The company's planners and managers were certainly aware of risks or potential changes in industry conditions that they did not model, but which they may have felt gave them ample confidence in a more subjective assessment.

Second, the results of a single study of a complex contract in a changing, uncertain market environment are not sufficient for judging prudence. This is readily seen by

imagining the opposite situation: If the study by Mr. Rodriquez had been very favorable to the GPAA, I doubt that Dr. Rearden or the Staff would be content to rely on it as proof of prudence, solely because it was the company's analysis and expectation. Instead, he would have compared the GPAA to alternative supply arrangements under a richer set of circumstances. Prudence ought to be based on what a reasonable analyst would have concluded is attractive across a range of circumstances foreseeable at the time, not on a single favorable or unfavorable company study.

Q. Dr. Rearden rejects the use of the CERA and PIRA scenarios in your prior rebuttal testimony. What are his criticisms?

A. There are three. First, Dr. Rearden argues that my analysis with CERA scenarios is "no more than an after-the-fact justification of [Peoples'] actions rather than a demonstration that the Company acted prudently when those actions were taken."[10] Of course, he is correct that the analysis was conducted after-the-fact, but that is what one does to test the prudence of a prior decision, as long as the calculations do not use hindsight information which was not available at the time. The calculations he rejects in my initial rebuttal testimony do not do that.

Second, Dr. Rearden argues that neither CERA nor Peoples provide any probability assessment of the likelihood of the CERA scenarios.[11] This is also true but not a sufficient reason for rejecting their use. CERA obviously regarded them as reasonable possibilities that they would advise their clients to consider. Substantial evidence was

[10] Additional Direct and Rebuttal Testimony of Dr. Rearden, at p. 22.

available indicating that basis prices into Chicago had been falling and were likely to continue to do so in the future, due to entering pipelines. These facts are described in my initial rebuttal testimony. Together, they would have made it very reasonable for a planner using these forecasts to put considerable weight on the scenarios with a larger decline in basis prices, such as CERA's "Market Rules" scenario or the PIRA outlook.

Third, Dr. Rearden noted that CERA provides annual price forecasts rather than monthly forecasts, preventing the CERA numbers from easily being assimilated into an analysis of Peoples' fiscal year. He is also correct about this data limitation, but again, it does not justify ignoring the CERA scenarios altogether. It may not be possible to apply them in a detailed model of GPAA operations, but they certainly represent evidence that the market could develop with much lower average basis prices than are used in Dr. Rearden's analysis.

Q. Did Dr. Rearden acknowledge the possibility that with the faster decline of the Chicago-Henry Hub basis, the GPAA contract could be economical?

A. Yes, Dr. Rearden did not dispute this.[12] However, he does not incorporate this into his recommendation regarding a finding of imprudence, because at p. 24, he states:

> But it is my view that actions – in particular, the Company's decision to sign the GPAA—cannot be shown to be prudent unless the Company can demonstrate through documentary evidence about how it viewed the relative probabilities of different events.

Q. Do you agree?

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[11] Ibid., at p. 22.

[12] Ibid., at p. 21.

A. No. I do not disagree that having a broad set of planning studies is often useful, but as I explain later, Dr. Rearden is largely complaining about the way the company analyzed and documented its plans, not the merits of the plans themselves.

Q. Do you agree with the way Dr. Rearden revised his analysis of the prospective benefits of the GPAA utilizing field prices?

A. No. Dr. Rearden relies on the basis price quotes that Mr. Rodriguez used. However, I find two areas of disagreement with how Dr. Rearden used this data. First, on reviewing his work papers, I find that his updated analysis contains a computational error that significantly impacts his results. Specifically, Dr. Rearden has accidentally used the Harper field price in his calculation of the delivered cost of gas from Ventura, and likewise, has used the Ventura field price in his calculation of the delivered cost of gas from Harper. The effect of this reversal is that Dr. Rearden has used too low a field price for Harper, a mistake which is magnified by the fact that the Harper volumes comprise a large share of the total delivered gas to Peoples. Correcting this error reduces the cost disadvantage for this element of the GPAA by about $7 million.

Second, the field-area basis prices he uses will tend to understate the actual field prices, since those areas are not as liquid as the larger trading hubs (like in Chicago or at Henry Hub). Significant purchases at those locations are likely to entail an additional cost beyond what is captured by the basis quotes surveyed by Peoples, as discussed further in the additional testimony by company witness Mr. Dave Wear. In fact, one sheet of the spreadsheet model by Mr. Rodriguez from which Dr. Rearden takes his basis outlooks,

includes a liquidity premium of 1.5 cents at the field locations, but Dr. Rearden's analysis overlooks or excludes that premium.

Accordingly, I have adjusted Dr. Rearden's delivered price versus city-gate price analysis to account for this illiquidity at the field locations, by applying a liquidity premium equal to 0.5% of the Henry Hub price. (A premium of 0.5% equates closely to a 1.5-cent premium at the market prices Dr. Rearden analyzes.) Accounting for the liquidity premium reduces Dr. Rearden's estimate of the delivered price versus city-gate price cost disadvantage by another $5.5 million. The combined effect of these two corrections is to bring his calculated delivered price versus city-gate cost disadvantage down from $33.2 million to $20.7 million, as shown in Exhibit FCG-AR3. Also in Exhibit FCG-AR3, I show for each scenario the per MMBtu discount that would be required to compensate for any cost disadvantage that arises solely from the delivered price versus city-gate element of the GPAA. For example, if Dr. Rearden's (uncorrected) analysis of a $33 million cost disadvantage was assumed to be correct, then it would imply that a discount to Peoples of 7.6 cents would be needed to remove the delivered price versus city-gate cost disadvantage in its entirety, versus the [redacted] discount already in the contract.[13]

Q. With these corrections, do you interpret Dr. Rearden's analysis as showing the GPAA was imprudent?

[13] There is another mistake in Dr. Rearden's testimony. The electronic version of Dr. Rearden's Exhibit 7.03 shows a total GPAA disadvantage of 36.7 million, whereas the same exhibit attached to his testimony shows a total of $37.4 million. The difference arises solely from the difference in the "Repricing Terms" (column c). My subsequent analysis is based on his electronic version.

A. No, I do not. Other market outlooks, such as the CERA and PIRA forecasts I presented in my prior rebuttal testimony, show clearly that there was reason to believe steeper declines or lower basis values than Dr. Rearden has modeled were possible and plausible. My exhibit FCG-AR4 compares the average annual basis levels in Dr. Rearden's analyses to the bases in each of the few CERA scenarios and to the PIRA scenario. For instance, the basis in CERA's Market Rules Scenario averages $0.06/MMBtu less than the basis used by Dr. Rearden.

While it is difficult to map this annual data into the monthly details of the GPAA, it is qualitative evidence that the GPAA could be more attractive than the (corrected) analysis by Dr. Rearden suggests.

DR. REARDEN'S DISALLOWANCE CALCULATIONS ARE FLAWED BECAUSE HE DOES NOT CONSIDER WHAT ALTERNATIVE GPAA TERMS HE WOULD HAVE DEEMED PRUDENT.

Q. Assuming the Commission were to agree with Dr. Rearden, has he appropriately calculated the disallowance that should be applied by the Commission?

A. No, I do not believe so. His calculations involve comparing the costs that would arise with and without the GPAA. But prudence is not a black-and-white, all-or-nothing attribute of a decision. If a decision is not prudent, there is typically a modified decision or variation on the chosen plan which would have been prudent. A utility should only be

penalized for the gap between what it chose and what would have been prudent. Dr. Rearden does not address the question of what alternative terms and conditions would have made the GPAA acceptable. However, my Exhibit FCG-AR5 does provide this information.

The last row of this exhibit is the additional city-gate, first of month discount (on top of the GPAA's [redacted] discount) that would have been necessary to make the scenario in that column an *ex ante* breakeven in a planning study of the GPAA, compared to continued transportation management and supply procurement by Peoples. It is hard to imagine that the Commission or most interveners would have challenged the GPAA, e.g., if it had been presented in 1999 with a discount of 11.4 cents below city-gate prices ([redacted] that was actually negotiated)! And that is a very stiff test of prudence, since this is the size of the FOM city-gate discount that would be sufficient to make all of Dr. Rearden's uncorrected GPAA cost disadvantages be eliminated. If the Commission felt, as I do, that some weight should be put on the CERA and PIRA outlooks, as well as the structural changes occurring for pipelines into Chicago, then a much smaller discount would have been required to make the GPAA a breakeven. Since the actual discount was [redacted], the GPAA should only be penalized, if found imprudent, for the gap between the required discount and [redacted]. That is the amount of increased costs/MMBtu borne by the company relative to having entered a contract with sufficiently better terms to be deemed prudent. That amount should be multiplied by the first of month volumes actually taken in the reconciliation period to determine the corresponding disallowance quantities.

Q. Have you calculated how much those amounts would be?

A. I have done so for Dr. Rearden's analysis, with and without corrections, and the resulting amounts are shown in the last column of FCG-AR6. As shown, the adjustments associated with marking the GPAA to breakeven discounts ranges from an $8.0 million disallowance (offsetting Dr. Rearden's uncorrected GPAA cost disadvantage) to a $5.3 million disallowance after the corrections. In contrast, Dr. Rearden has requested a $13.3 million disallowance for this period. Of course, these calculations are only applicable if Dr. Rearden's single-scenario analysis is all the Commission considers in deciding prudence. If it should regard his criticism as too strong, e.g., such that a 6 cent discount (instead of a [redacted] discount) would have been prudent, the corresponding disallowance would be $2.9 million this year.

Q. What explains the difference between the $8.0 million you would calculate if Dr Rearden's uncorrected scenario was given full weight, versus the $13.3 million he proposes?

A. His disallowance calculations treat all of the anomalous results of the 2000/2001 reconciliation period to be attributable to the GPAA – the extent to which basis increased rather than decreased, the value of the supplier options, and so forth. For instance, he finds (in his Exhibit 7.05) that $4.8 million of disallowance should ensue from the adverse basis prices in January of 2001. There are two problems with this. First, had the company entered a modified GPAA at an 11.4 cent discount to the city-gate prices, it still would have experienced some adverse costs in that month, when the bidweek basis from Henry Hub to Chicago increased dramatically from $0.12/MMBtu in December 2000 to $0.96/MMBtu in January 2001. The daily basis behaved

similarly, e.g., during the last ten days of December it ranged from $0.43/MMBtu to $5.22/MMBtu. Exposure to such a striking event was inevitable under the GPAA, even if it had modified terms that were expected to reduce costs more than it already does in most situations. Second, the basis prices in December and January did not involve a situation that was foreseeable or that should have been included in any prudence analysis of the merits of the GPAA. Indeed, Mr. Rearden himself does not include a bizarre January basis spike in his own critique of the GPAA. Instead, he uses Mr. Rodriguez's basis outlook, which is much smoother.

Q. Please summarize your views of Dr. Rearden's GPAA analysis.

A. Unlike Ms. Decker, Dr. Rearden has performed a type of *ex ante* analysis which is an appropriate input to a prudence review. However, I believe he has relied too heavily on a single analysis which does not appear to have been the foundation for the company's view of the GPAA. He neglects the possibility of scenarios more favorable to the GPAA, largely because the company itself did not formally analyze such alternatives. However, that is not an appropriate basis for assessing the prudence of decisions, even if it might be an important factor in auditing the quality of a company's planning processes. I believe reasonable people, using a more complete set of then-available information, could have easily concluded that the GPAA looked promising and prudent, albeit not a sure thing. Even accepting Dr. Rearden's narrow test of prudence, his recommended disallowance calculations go too far, by failing to consider what alternative parameters of the GPAA would have made it prudent by his tests.

WITNESSES DECKER AND REARDEN BOTH CONFUSE CRITICISMS OF PEOPLES' PLANNING PROCESSES WITH CRITICISMS OF ITS PLANS.

Q. Both Ms. Decker and Dr. Rearden contend that it was imprudent for Peoples to enter into the GPAA without more formal quantitative analysis by the company demonstrating the economic value to ratepayers. In your prior rebuttal testimony, you rejected this view. Do you see any new evidence in their additional testimonies to change your opinion?

A. No, my conclusion remains the same. At the heart of the GPAA contract is the delivered vs. city-gate cost tradeoff. The planning staff and management at Peoples are experienced industry analysts with seasoned intuitions about impending changes and emerging conditions in the industry. Relying on their industry knowledge, Peoples' management chose a city-gate procurement strategy that would provide economic value if pipeline supply imbalances were to shift towards Chicago. As argued in my rebuttal testimony (p. 49),

> Having such an analysis [formal quantitative analysis] would make it now easy for Peoples to show that they were not unreasonable (because benefits were likely) or imprudent, but they could have had such confidence without the calculations.

Much of this criticism about the extent of quantitative analysis by Peoples is really a complaint about the company's planning techniques and documentation, not about the merits of the plan(s) it chose. If this is a problem, it is a different one than the prudence of the GPAA.

The fact that the company did not prepare a large set of planning studies does not undermine the conclusion that a prudent planner could have reached the same decision as the company, namely to enter the GPAA. If there is a problem with the company's planning processes, then the remedies are much different than disallowing some of the costs of the plans themselves. Instead, the focus should be on requiring new procedures and documentation.

THE CATASTROPHIC FAILURE OF ENRON CORPORATION SHOULD NOT TAINT A REVIEW OF THE GPAA.

Q. What is the relevance of Enron's failure to this proceeding?

A. Shortly after the reconciliation period, Enron Corporation, Peoples' counterparty in the GPAA, went bankrupt in the wake of revelations of fraudulent financial representations, lack of credit, and mismanagement. That collapse was startling and dramatic, but it was also completely unforeseen a year or more prior to the collapse. At the time the GPAA was signed, Enron was widely regarded as the premier energy marketing company in the world, and Peoples reasonably assumed that Enron was a reputable counterparty.

Q. Does that conclude your testimony?

A. Yes it does.