

**STATE OF ILLINOIS  
ILLINOIS COMMERCE COMMISSION**

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

**ADDITIONAL DIRECT TESTIMONY**

**OF**

**LINDY DECKER, CPA**

**On Behalf of**

**City of Chicago  
Citizens Utility Board**

**CONFIDENTIAL INFORMATION HAS BEEN REDACTED**

**Filed January 7, 2005**



32 Corporation), Enron Midwest (a subsidiary of Enron North America), and Enron  
33 North America affected those charges.

34

35 **Q. Please summarize your professional qualifications.**

36 **A.** I am a Certified Public Accountant in Texas and Oklahoma. I have worked for  
37 Grant Thornton since January 2004. I worked for the public accounting firm of  
38 Cole & Reed, PC from August of 2002 through December of 2003. Prior to that,  
39 I worked for the accounting firm of Arthur Andersen LLP, (Andersen) from  
40 September 1997 to July 2002.

41

42 During that time, I conducted more than 30 financial audits on a variety of natural  
43 gas industry midstream and pipeline services companies, as well as related oil and  
44 gas client audits. Among the large clients I have audited on a continuing basis  
45 were FERC regulated interstate transporters and storers of natural gas. Included  
46 in these large clients was a refining, marketing, and pipeline services joint venture  
47 of two large clients (Texaco and Shell) that had assets of approximately \$16  
48 billion. These two very large companies also owned interests in other pipeline  
49 companies, which my firms and I also audited. My current audit clients include  
50 midstream service companies, as well as companies in other areas of the oil and  
51 gas industries.

52

53 In addition, I have completed due diligence assignments, large corporate financial  
54 transactions, and organizational transactions, including acquisitions and IPOs. I  
55 have also developed and taught courses in Oil and Gas Accounting as part of in-  
56 house educational programs for Andersen and Grant Thornton. My educational  
57 background and my full professional history are detailed in my resume, which is  
58 attached as City-CUB Ex. 1.1.

59

60 **Q. Why is your experience with the midstream gas industry relevant in this**  
61 **matter, which pertains to a regulated local distribution company (LDC),**  
62 **PGL?**

63 **A.** Midstream transportation and storage services are the critical link between gas  
64 production and gas distribution. Gas purchase and agency agreements, storage  
65 optimization contracts, and gas storage and management programs factor  
66 prominently in this proceeding. Understanding such issues goes beyond  
67 familiarity with regulated gas charges assessed by the LDC. Inventory valuation  
68 and volumetric measurements, capacity issues, peaking services, and hedging gas  
69 supplies, are matters with which I have had experience in the midstream services  
70 field. Further, some of the entities involved with PGL were unregulated gas  
71 market participants.

72  
73 The knowledge and skills required to conduct effective financial audits of  
74 midstream service companies include an understanding of revenue recognition  
75 practices in midstream businesses and the timing of revenue recognition, and an  
76 ability to match costs to revenues and identify documentation to verify the  
77 underlying transactions. I am well versed with operational issues concerning  
78 these types of enterprises.

79  
80 **Q. How is your testimony organized?**

81 **A.** Rather than address at once all the various transactions and arrangements in which  
82 PGL or PGL assets were involved, as well as the additional complexities of the  
83 midstream gas services industry, I have divided my testimony into manageable  
84 sections. I begin with a discussion of several discrete activities or arrangements.  
85 Each of these sections describes a specific activity, its relationship to or effect on  
86 Peoples' PGA collections, and the quantifiable economic harm, if any, resulting  
87 from the activity. After those discussions, I examine the likelihood that the  
88 transactions and arrangements were parts of a broader corporate initiative.

89

90 My testimony is divided into the following discussion areas:

- 91 • Management Imprudence – the GPAA Contract
- 92 • Improper Accounting -- Lost and Unaccounted for Gas
- 93 • Inventory Mismanagement -- Negative Hub Balances
- 94 • Improper Storage Transactions
- 95 • Midstream Services Strategic Plan
- 96 • Improper Affiliate Transactions

97

98 **Q. Please summarize the conclusions that you have reached with respect to these**  
99 **topics.**

100 **A. *The GPAA Contract.*** This section of my testimony shows that Peoples Gas’  
101 supply contract with Enron North America (ENA), a subsidiary of Enron  
102 Corporation (Enron) was imprudent. The three major components of the contract  
103 (known as the Gas Purchase and Agency Agreement or GPAA) – price, quantity,  
104 and term were each imprudent. My analysis shows that with respect to price and  
105 quantity, Peoples Gas ceded control over these vital terms to the supplier, ENA.  
106 During depositions, Peoples witness David Wear testified that the utility assumed  
107 that ENA would not act to take advantage of these provisions to maximize its  
108 profits – clearly an unreasonable and imprudent position. As to term, the GPAA  
109 was a five-year contract, an anomaly at the time the contract was signed, and a  
110 deviation from Peoples’ past gas procurement practices.

111

112 I also show evidence that an economic analysis of the GPAA that PGL conducted  
113 prior to signing the contract demonstrated that the contract was an economic loser  
114 for PGL and, as a result, ratepayers. Despite this, Peoples Gas entered into this  
115 unfavorable contract.

116

117 I estimate that the economic harm caused ratepayers during the reconciliation  
118 period because of GPAA imprudence was \$37,470,517. I recommend that  
119 amount be refunded to ratepayers.

120

121 *Lost and Unaccounted for Gas.* This section of my testimony shows that during  
122 Peoples' FY 2001 (and the utility's fiscal years 2002 and 2003), PGL suffered a  
123 dramatic increase in unaccounted for gas. The accepted industry range for  
124 unaccounted for gas is from 0% to 3% of gas purchases or throughput. During the  
125 reconciliation period, Peoples reported a lost and unaccounted for gas amount of  
126 8%. There are several internal Peoples documents showing that Peoples'  
127 employees were concerned about this dramatic increase in unaccounted for gas.  
128 Yet, Peoples took no steps to address or control the problem.

129

130 Peoples' failure to track, investigate, and mitigate the cause(s) of the dramatic  
131 increase in lost and unaccounted for gas was imprudent. Because Peoples Gas  
132 included the costs associated with lost and unaccounted for gas in its PGA  
133 charges, I recommend that the utility refund \$37,878,400 to ratepayers.

134

135 *Negative Hub Balances.* This section discusses how Peoples Energy Corporation  
136 (PEC) used utility assets for non-utility midstream profits and which benefited  
137 Peoples' affiliates and third parties. I show that utility customers shouldered the  
138 cost of the assets used by midstream segments to generate sales and profits and  
139 how PEC used Manlove storage assets. Gas inventory levels during the  
140 reconciliation period will be presented and the resulting low levels shown. The  
141 discussion includes how much PGL gas was available for ratepayers and the  
142 increased cost to the ratepayers if the working gas is depleted down to the cushion  
143 gas.

144

145 *Improper Storage Transactions.* This section reviews PGL's obligation to  
146 disclose and seek approval for transaction involving affiliated interests and  
147 concludes from the available evidence that the utility ignored that obligation. The  
148 materials I reviewed indicate that through a series of arrangements among  
149 affiliates of PGL and Enron, PGL bypassed ICC scrutiny of its activities. In

150 particular, PEC and Enron caused enovate and EMW to be functionally equivalent  
151 in order to obscure transactions between enovate and PGL that it neither disclosed  
152 to nor sought approval from the Commission. The adverse consequences for  
153 ratepayers likely included a failure to credit ratepayers with revenues earned using  
154 assets and activities for which ratepayers paid the costs. Accordingly, I  
155 recommend that unless PGL can demonstrate with appropriate documentation that  
156 PGA costs were not affected and that PGA assets and costs were not used to  
157 benefit entities other than ratepayers, the \$20 million profit attributed to enovate  
158 should be credited to PGL ratepayers.

159  
160 *Midstream Services Strategic Plan.* This section of my testimony (using FY 2001  
161 economic and market data) provides the industry environment context for the  
162 discrete activities addressed in earlier discussion areas. It reviews the  
163 involvement of Peoples or Peoples' PGA assets in other transactions or  
164 arrangements with wholesale market participants, including affiliates of PGL and  
165 Enron Corporation (Enron). It then examines the possibility that Peoples'  
166 questionable decisions and imprudent activities were part of a broader plan that  
167 subordinated the interests of ratepayers to the benefit of certain Peoples' corporate  
168 affiliates. An overview of the relationships among the activities identified in my  
169 testimony, and knowledge that those actions were consistent with an existing  
170 broader strategy help in understanding the likely purposes of PGL's questionable  
171 actions and the actual effects they had on FY 2001 PGA charges.

172  
173 Briefly, my review of the FY 2001 environment shows that to maintain its  
174 attractiveness to investors in relation to comparable firms in the gas industry, PEC  
175 would have needed to increase its revenues and income substantially. PEC chose  
176 to emphasize increasing midstream services revenues as its strategy to achieve  
177 those financial objectives. PEC's midstream services initiative was not a secret.  
178 It was highlighted in PEC's reports to the public and to securities regulators. In  
179 that context, PEC entered into a series of contracts and organizational

180 arrangements with affiliates of Enron Corporation (Enron) and its own affiliated  
181 interests that served those objectives. A number of PGL decisions or actions that  
182 have been described as unusual, or challenged as imprudent, were consistent with  
183 that broader strategy.

184

185 *Improper Affiliate Transactions.* This section reviews PGL's obligation to  
186 disclose and seek approval for transactions with affiliated interests. PGL has not  
187 met that obligation. I discuss how the various arrangements involving PEC and  
188 Enron affiliates served to bypass ICC scrutiny of interaction between PGL and  
189 related entities. The evidence shows that EMW and the PGL affiliate enovate  
190 were substantively the same for purposes of certain activities involving PGL or  
191 PGL's PGA assets. Given the apparent necessity of PGA assets to generate the  
192 EMW/enovate revenues, in the absence of proof from PGL that the permitted uses  
193 of its assets were prudent and properly compensated or documentary evidence  
194 that distinguish PGA revenues from other enovate profits, the revenues apparently  
195 generated with PGA assets (\$20 million) should be credited to ratepayers.

196

197 *Conclusion.* This final section of my testimony summarizes the economic harm  
198 attributed to imprudent, unlawful, or unreasonable actions by PGL. When  
199 quantification with reasonable precision was not possible, a qualitative discussion  
200 and an estimated range are provided.

201

202 I recommend a refund of approximately \$100 million, comprising ratepayer  
203 harms from imprudently incurred higher costs, revenues not properly credited to  
204 ratepayers, and economic opportunities imprudently given to other entities. The  
205 specific recommended refund amounts are as follows:

206

207	Imprudent GPAA costs:	\$37,470,517
208		
209	Lost and Unaccounted for Gas:	\$37,878,400

210

211	Inventory Mismanagement/	
212	Improper Accounting/Misuse	
213	of Assets	\$20,652,322
214		
<del>215</del> 215	TOTAL	\$96,001,239

MANAGEMENT IMPRUDENCE – THE GPAA CONTRACT

217  
218  
219  
220  
221  
222  
223  
224  
225  
226  
227  
228  
229  
230  
231  
232  
233  
234  
235  
236  
237  
238  
239  
240  
241  
242  
243  
244  
245

**Q. What is your understanding of the GPAA?**

**A.** Peoples Gas entered into the GPAA with Enron North America (“ENA”) in September of 1999, effective October 1<sup>ST</sup> of that year. Under the agreement, Enron would supply the major portion of PGL’s gas commodity needs. PGL granted ENA access to and a measure of control over several critical aspects of its gas supply through the GPAA. (Exhibit 1.2, GPAA, PGL Response to Staff DR ENG 2.054).

**Q. How does the GPAA compare with other gas supply contracts in the industry?**

**A.** The GPAA has been discussed extensively in the pre-filed testimonies of witnesses for the Commission Staff, the Illinois Attorney General, and CUB. Each of those witnesses has expressed an opinion that the agreement was not a prudent business decision by PGL. When I look at the contract from my perspective as an experienced observer of midstream industry firms and activities, and with the benefit of discovery not available earlier, I come to a similar conclusion. There are elements of the GPAA that, in my judgment (based on the circumstances at the time it was executed), were not prudent, reasonable, or in the best interests of PGL’s ratepayers.

In particular, the key elements of the GPAA were **price, quantity, and length** of the contract. Critical aspects of each of these three factors, as laid out in the agreement, were controlled by ENA, and PGL could reasonably have expected ENA to exercise them to its own advantage. Ceding control of the major cost determinants of a contract to one’s counterparty is not the decision of a reasonable businessperson under realistic circumstances.

246 **Q. Please explain in more detail what you find unreasonable or imprudent with**  
247 **respect to each of these key contract elements. Beginning with the price**  
248 **terms, what were the pricing provisions of the GPAA?**

249 **A.** Under the GPAA, PGL purchased from ENA, the Seller, three different quantities  
250 of gas: 1) baseload, 2) summer incremental quantity (SIQ), and 3) daily  
251 incremental quantity (DIQ). For baseload purchases, under Articles 4.2(b) and  
252 4.2(c), PGL had a default price of first-of-month Chicago Citygate Index, minus a  
253 three-cent discount. Enron had the right to re-price portions of the baseload  
254 quantities.

255

256 Article 4.2 (b) of the GPAA stated the following:

257 On or before October 1, 1999, Seller shall notify Buyer that Seller  
258 wishes to elect the following right to change the Gas Price:  
259 Notwithstanding anything to the contrary in this Agreement, in  
260 addition to the Baseload Price Adjustment, **Seller may** at any time  
261 and from time to time during a Winter Period, **change the Gas**  
262 **Price** for any Day in the Winter Period from the price set forth in  
263 Section 4.1(a) to the Daily Price for a portion of the Baseload  
264 Quantity equal to [REDACTED] MMBtu per Day. *(Bold added for*  
265 *emphasis).*

266

267 Article 4.2 (c) of the GPAA similarly stated:

268 On or before January 1, 2000, Seller shall notify Buyer that Seller  
269 wishes to elect the following right to change the Gas Price:  
270 Notwithstanding anything to the contrary in this Agreement, in  
271 addition to the Baseload Price Adjustment and the adjustment  
272 pursuant to Section 4.2(b) Seller may, at any time and from time to  
273 time during a Winter Period, change the Gas Price for any Day in  
274 the Winter Period from the price set forth in Section 4.1(a) to the  
275 Daily Price for a portion of the Baseload Quantity equal to [REDACTED]  
276 MMBtu per Day. *(Bold added for emphasis).*

277

278 These provisions gave ENA control over **pricing**. PGL gave the Seller (ENA) the  
279 flexibility to choose between two different pricing options. Under various market  
280 conditions, one or the other pricing option would be more advantageous to the  
281 Seller and less advantageous to PGL. These provisions allowed the Seller to

282 assure that the price in effect at any time would always be the one to its  
283 advantage. (If the pricing option in effect were not up to the Seller, a change in  
284 market conditions could make the contract price more advantageous to PGL,  
285 instead of to Enron. But, under the GPAA, the Seller could change the pricing  
286 based on actual or projected market fundamentals, providing Seller a no-lose  
287 opportunity.)

288

289 Granting this unilateral power to the Seller was not prudent on the part of Peoples  
290 Gas, the Buyer. (And, there is no indication in the documents reviewed that PGL  
291 investigated the economics of seeking termination of this unusual arrangement.)

292

293 **Q. What did the GPAA provide with respect to contract quantities?**

294 **A.** The quantities of certain other categories of gas that Peoples Gas was obligated to  
295 buy were also dictated by the Seller, ENA. The GPAA stated:

296

297 “Summer Incremental Quantity” means a quantity of Gas equal to  
298 a quantity from [REDACTED] MMBtu per Day to  
299 [REDACTED] MMBtu per Day as  
300 determined by Seller pursuant to Section 2.7 but in no event shall  
301 the total quantity of Summer Incremental Quantity for the Summer  
302 Period exceed 30,500,000 MMBtu. (Bold added for emphasis).

303

304 As a result of this provision, when market conditions (*e.g.*, high applicable prices)  
305 favored the Seller, it could maximize its profit opportunity by compelling PGL to  
306 buy greater amounts of gas at the favorable (to ENA) price. It is difficult to  
307 define conditions under which such contract provisions would be reasonable.  
308 From the materials I have reviewed, Peoples Gas had no practical or prudent  
309 business reason to allow its gas supplier to dictate the **quantities** of gas it would  
310 purchase.

311

312 The deposition of Peoples Manager of Gas Supply Administration David Wear  
313 underscores that entering into the GPAA was imprudent. Mr. Wear discussed the

314 GPAA in his deposition on November 10, 2004. Consider the following selected  
315 excerpts:

316

317 Q: Could you state the reasons why, under the GPAA, Enron was able to  
318 choose how much gas Peoples purchased – how much summer  
319 incremental quantity gas Peoples Gas purchased?

320

321

\*\*\*\*\*

322 A: The reason that – the simple reason is that what was written into the  
323 contract. The basis of that was that Peoples was indifferent to when those  
324 volumes showed up to some degree, because that quantity would over the  
325 summer period (be) expected to average out to somewhere in the middle  
326 and that quantity of gas would have been used for storage refill.

327

328 Q: Let me just make sure I understand. You said that Peoples was indifferent  
329 to some degree when that quantity of summer incremental gas showed up  
330 because it would average out to the middle. Could you explain a little bit  
331 further what you meant by that?

332

333 A: If the quantity was able to range from 45,000 to 125,000 a day, our  
334 expectation was that it would not be at one extreme or the other every day  
335 of that period. That over the life agreement that that quantity would  
336 probably be somewhere – would average somewhere in the middle, and  
337 that amount of gas at an average level fit well into our storage refill.

338

\*\*\*\*\*

339

340 Q: What was the basis of that belief?

341

342 A: I don't recall all the assumptions that went into that belief. I know that  
343 when I made that statement in testimony that it was based on some  
344 expectation that the seller would be behaving rationally to market  
345 conditions.

346

347 Q: Did you receive any communication from the seller that indicated that  
348 over time the amount that they were selling to Peoples would tend to  
349 average out to about the middle of that range of 45,000 to 125,000?

350

351 A: No.

352

353 (Ex. 1.3, Wear Tr. at 51 – 53) (*emphasis added*)

354

355 Mr. Wear’s expectation that ENA would “be behaving rationally to market  
356 conditions” ignores several salient factors surrounding the SIQ provision. (Wear  
357 Tr. at 53). First, rational behavior for a seller would be to maximize its profits, at  
358 the expense of the buyer, Peoples Gas. Second, even if its actions were not based  
359 solely on maximizing the revenue from each individual contract, rational behavior  
360 for a seller like ENA, which had customers across the country, would not  
361 necessarily translate into action that would be in the best interests of any single  
362 LDC buyer (PGL). As to these points, Mr. Wear acknowledges that he never  
363 received any assurance from ENA that it would, over time, require gas purchases  
364 that would average out to the middle of the 45,000 – 125,000 thousand Dth range.  
365 Finally, even if the assumption that there would be an averaging effect in SIQ  
366 quantities were valid, Mr. Wear and PGL ignore entirely the effect of price  
367 differences during the supply period. If the above-average SIQ purchases were  
368 required during high price periods and were “balanced” by below-average SIQ  
369 purchase quantities during low-price periods, the prices paid by ratepayers would  
370 not “average out to somewhere in the middle,” and PGL should not have been  
371 “indifferent to when those volumes showed up.” (Ex. 1.3, Wear Tr. at 52).

372

373 **Q. What was the term of the GPAA?**

374 **A.** The contract was effective for a period starting October 1, 1999 and ending in  
375 October 2004.

376

377 **Q. Was a five-year term agreement unusual at the time the GPAA was**  
378 **negotiated?**

379 **A.** Yes. The use of longer-term contracts by LDCs has gone through several cycles.  
380 Five-year gas purchase agreements did exist during the late 1990s and early 2000s  
381 period of the GPAA, but these were not common practice. An article in *FT*  
382 *Energy Newsletters – International Gas Report* dated May 12, 2000, cited the  
383 following from a Boston conference on gas distribution:

384

385                   The consensus among those at the meeting was the ‘good old  
386                   days’ when local gas distribution companies signed long-term  
387                   supply contracts with pipelines, are gone for good. While a few  
388                   such arrangements still surface from time to time, the practice  
389                   now is for distributors, and many direct end-users, to depend  
390                   primarily on the spot market, and take the chance that the market  
391                   conditions will not have an adverse impact on actual gas  
392                   deliveries. (Ex. 1.4, Northeast Is New Gas Powerhouse, *FT*  
393                   *Energy Newsletters – International Gas Report*, May 12, 2000).  
394

395                   While spot market purchases may have been a common industry practice, I do not  
396                   endorse it as a prudent one, without coverage of the price risks through some form  
397                   of price hedging. My point here is that in the prevailing market environment (an  
398                   active spot market and developed hedging instruments), long term contracts were  
399                   not a common choice among major industry buyers or sellers. Moreover, Staff  
400                   witness Dennis L. Anderson testified that the GPAA deviated from Peoples Gas’  
401                   past gas procurement practices, which were more typical of utility purchasing.  
402                   Mr. Anderson explained:

403  
404                   Purchasing its gas supply from numerous suppliers based on  
405                   swing and baseload contracts with terms ranging from four  
406                   months to five years certainly differs from Peoples’ gas-supply  
407                   approach in the GPAA agreement. Staff believes Company  
408                   witness Wear’s testimony supports Staff’s position that the  
409                   GPAA is substantially different than Peoples’ historic gas-  
410                   supply practices. (Staff Exhibit 2.0 at 9).  
411

412                   In fact, the 5-year term of the GPAA contradicted the advice of some in the PGL  
413                   organization. A document titled “FY 2000 Gas Supply Division Business Plan”  
414                   concluded, “To maintain flexibility, take advantage of rapidly developing market  
415                   opportunities and minimize threats, including minimizing risk for stranded costs,  
416                   utility will only negotiate short term contracts (one year or less).” (Ex. 1.5, Gas  
417                   Supply 2000 Business Plan, Sept. 10, 1999, 01PGL 089702 – 089725 at 089712).  
418

419 **Q. Do any of the discovery materials or other research you have reviewed**  
420 **provide a possible explanation for the unusual features of the GPAA?**

421 **A.** Yes. First, some useful background can be gained from an internal Enron  
422 memorandum retrieved from the document database assembled during the  
423 investigation into Enron’s activities in western energy markets by the Federal  
424 Energy Regulatory Commission (FERC). The Enron memorandum explains how  
425 deals like the GPAA fit into a larger, complex business strategy that closely  
426 resembles the “broader alliance”<sup>1</sup> between PEC and Enron. (These documents  
427 have been made available to the public on the FERC website.<sup>2</sup>) The document,  
428 entitled “Long Structure and Process for Deferred Payment Deals” explained:

429

430 Deferred payment deals are essentially loans to an ENA counter-  
431 party **in the form of delivery of gas** in one or more months with  
432 the deferred payment for this supply to a later period. Recent  
433 market interest in deferred payments has focused on the LDC  
434 market and has involved the delivery of gas over the summer  
435 months (ostensibly for filling storage) with a deferral of the  
436 payment for this gas to the winter months. (*Bold added for*  
437 *emphasis.*)

438

439 LDCs typically recover carrying costs in the form of a fixed \$  
440 amount in their base rates. Unless the LDC filed a rate case  
441 within the last 12 months (and almost none have), the LDC is  
442 upside-down on its carrying cost rate. Since the LDC cannot get  
443 an increase in base rates without filing a rate case, this structure  
444 allows LDCs to recover carrying costs by passing such costs  
445 through in the form of a gas cost. Market interest is higher than  
446 past years due to much higher gas prices (and associated carrying  
447 costs). (Ex. 1.6, SDOC\_NO304882, Apr. 24, 2001, from FERC  
448 website: <http://fercic.aspensys.com/iconect247/iconect247.exe>)

449

450 The document continued by identifying other essential components of the  
451 strategy, including a listing of “Contracts Required.”

452

---

<sup>1</sup> As discussed later in my testimony, PEC sought to form a “broad alliance” with Enron as part of its strategic plan to increase midstream revenues.

<sup>2</sup> FERC has made available on its website millions of e-mails and documents retrieved from Enron’s computer systems as part of FERC’s investigation into the west coast market manipulation scandals.

453 The following agreements will be required for this transaction:  
454 • Master firm purchase and sale agreement;  
455 • Transaction Agreement (confirmation) under the Master  
456 Firm covering the physical sale of gas at a fixed price;  
457 • ISDA if the customer prefers to purchase index supply.  
458 (Ex. 1.6, SDOC\_NO304882, Apr. 24, 2001, from FERC website:  
459 <http://fercic.aspensys.com/iconect247/iconect247.exe>)  
460

461 The agreements entered into between PEC (and its subsidiaries) and Enron (and  
462 its subsidiaries) conform to Enron's blueprint. The GPAA met the description of  
463 a master firm purchase sale agreement. The terms of the GPAA called for  
464 employing an index for pricing the gas (in this case at FOM Chicago Citygate).  
465 Per the Enron blueprint, because PGL was purchasing index supply, the deferred  
466 payment strategy would also require an ISDA agreement<sup>3</sup> – an agreement for  
467 settling trades between parties contemplating numerous transactions over an  
468 extended period. Peoples Energy entered into just such a Master ISDA  
469 Agreement with ENA on January 31, 2000. (Ex. 1.7, Master ISDA between PEC  
470 and ENA, Jan. 31, 2000, Bates No. 01PGL 013215 – 013242).

471

472 **Q. Would the problems you have noted be revealed by an analysis to determine**  
473 **the cost/benefit consequences of entering into the GPAA?**

474 **A.** Yes, and conducting such an analysis before entering the arrangement would  
475 certainly have been prudent. Staff witness Anderson estimated in his written  
476 testimony that 66% of PGL's natural gas supply had been provided by ENA  
477 through the GPAA during the Reconciliation Period. A five year gas purchase  
478 agreement that would place two-thirds of an LDC's gas supply needs exclusively  
479 with one vendor would represent a major commitment. A reasonable business  
480 enterprise would be expected to undertake some type of analytical process to  
481 determine if such a deal would be superior in comparison to their existing supply  
482 arrangements. An obvious objective in quantifying the benefit of an exclusive

---

<sup>3</sup> "ISDA" is an acronym referring to the International Swap Dealers Association, Inc.

483 supplier relationship would be to evaluate whether the LDC was likely to achieve  
484 cost savings in the purchase of its gas supply.

485

486 **Q. Did PGL undertake such an analysis of the GPAA?**

487 **A.** Peoples witness David Wear, in his rebuttal testimony, indicated that PGL did not  
488 prepare an economic analysis of the GPAA. Mr. Wear stated his opinion that:

489

490 “The GPAA is a multifaceted, large-scale supply agreement. To  
491 thoroughly, and completely, prepare a quantitative analysis over all  
492 possible outcomes is next to impossible. Such an analysis would  
493 require considerable use of assumptions, each of which could  
494 cover a wide range of possibilities.” (PGL Exhibit F, ICC Docket  
495 No. 01-0707 at 2).

496

497 Mr. Wear’s commentary is peculiar. An analysis of any future event, by  
498 definition, must rely on certain assumptions. Calculating more than one potential  
499 outcome, such as “best” and “worst” cases, is a practical and common way to take  
500 into consideration the potential volatility of the elements in such a forecast.  
501 Another approach would be to use the historical performance of prior supply  
502 arrangements to establish a baseline that any new supply contract would have to  
503 surpass. I acknowledge Mr. Wear’s contention that uncertainty exists in the  
504 process of creating forward-looking analyses. Choosing to abandon the process  
505 altogether as a solution to such uncertainty is not prudent.

506

507 Notwithstanding Mr. Wear’s assertion that such a process was impractical, an  
508 analysis of the GPAA was performed. Roy Rodriguez, a manager in the risk  
509 management group of PEC, prepared an analysis in August and September of  
510 1999 of the GPAA that was referred to as the “Aruba Analysis.” (As Mr.  
511 Rodriguez explained in his deposition, Aruba was apparently a codename Enron  
512 used for PGL.) Mr. Rodriguez described his work as follows:

513

514                   “...the Aruba Analysis was my attempt to try to capture the  
515                   agreement that Enron was proposing to Peoples Gas using a  
516                   forward-looking analysis based on basic capacity values on the –  
517                   going five years forward.” (Ex. 1.8, Rodriguez Tr. at 14).

518

519   **Q.    Did Mr. Rodriguez’s analysis suggest that the GPAA would achieve cost**  
520   **savings for PGL?**

521   **A.**    No. In fact in his deposition, Mr. Rodriguez acknowledged that based on the  
522           assumptions he relied on in his analysis, the “Enron deal was ...coming out more  
523           expensive than the weighted average delivered cost.” (Ex. 1.8, Rodriguez Tr. at  
524           56). Such an increase in the cost of purchased gas supplies would increase  
525           charges to ratepayers.

526

527   **Q.    Were members of PGL senior gas management team aware of the Aruba**  
528   **Analysis?**

529   **A.**    Yes. Mr. Rodriguez stated that he had participated in discussions on the topic,  
530           noting:

531

532                   “We didn’t come to a – any kind of agreement, you know across –  
533                   you know, within the group. All I was doing was saying here’s  
534                   another way of looking at this deal. Do with it as you may.” (Ex.  
535                   1.8, Rodriguez Tr. at 77).

536

537           When asked who participated in these discussions, Mr. Rodriguez recalled  
538           gas supply department management at the utility attended such a meeting.  
539           He listed David Wear, Raulando DeLara, and Charles Blachut as among  
540           the attendees. (Ex. 1.8, Rodriguez Tr. at 78).

541

542   **Q.    What conclusions have you drawn about PGL’s understanding of the**  
543   **prudence of the GPAA?**

544 A. PGL personnel did receive an analysis of the GPAA. Mr. Rodriguez's  
545 analysis, like the analysis of Staff witness Dr. Rearden, illustrated that the  
546 GPAA would cost PGL, and in turn, the ratepayers, more money than the  
547 various supply arrangements previously used. While Mr. Wear has  
548 suggested that the use of different assumptions in an analysis could have  
549 resulted in a different outcome, PGL has not provided any  
550 contemporaneous quantitative analysis that shows the GPAA as a better  
551 economic value in the purchase of gas supply.

552

553 **Q. Would an expectation that Enron would not exercise its rights to maximize**  
554 **profits under the contract be reasonable, under any circumstances suggested**  
555 **by the materials you have reviewed?**

556 A. Mr. Wear (and Peoples Gas) appeared to be operating on blind faith. In no way  
557 can decisions on such bases be considered prudent gas contracting behavior. No  
558 reasonably practical business would reasonably expect that its business interests  
559 would be given priority or tended to by its main supplier.

560

561 Whether ENA ever exercised its rights to use the Daily index to price gas or  
562 obligated Peoples Gas to buy quantities of gas that were unnecessary is not  
563 determinative on this point. The fact that Peoples Gas even entered into such an  
564 agreement was imprudent, and, on its face, contrary to the interests of the utility  
565 and its customers.

566

567 Though entering into the GPAA was contrary to the best interest of Peoples Gas  
568 and its ratepayers, it ultimately benefited Peoples Energy and the GPAA was a  
569 necessary component in implementing the business strategy Enron and PEC had  
570 with their joint venture, enovate.

571

572 **Q. Did you find indications that the GPAA played a role in a broader plan to**  
573 **advance PEC's objective of increasing its midstream revenues?**

574 A. There are indications that the GPAA is connected to other unusual aspects of  
575 PGL's dealings with PEC and Enron affiliates. In an e-mail dated January 31,  
576 2002 from Timothy Hermann to various PEC personnel (Kay Classen, Steve  
577 Richman, Daryll Fuentes, Roy Rodriguez, and others), Mr. Hermann addressed  
578 the impact of Enron's bankruptcy on various arrangements between ENA and  
579 PEC already in place, particularly the GPAA. Portions of that document are  
580 presented and discussed below.

581

582 Enron and PEC are throwing in the towel. **Enron wants to**  
583 **liquidate the gas supply agreement. PEC wants its Oil & Gas**  
584 **and PESC [Peoples Energy Services Company, a PGL**  
585 **affiliate] hedges (both via one PEC ISDA agreement) kept**  
586 **whole.** PERC [Peoples Energy Resources Corporation, a PGL  
587 affiliate] is gearing up to terminate the enovate LLC.

588

589 Yesterday Dave Delainey and Bill discussed these  
590 considerations, and it is agreed that both parties (Enron creditors  
591 and PEC) are best served by having **all of the Peoples**  
592 **agreements** going to the same party vs. selling them one by one.

593

594

\* \* \* \*

595

596

597

598

599

600

601

602

603

604

605

606

607

608

609

610

611

612

613

We are debating whether or not to put enovate on the table as part of this. I would like it to stay out, but that will make it harder for Enron to justify why **the IDSA had to go with the gas supply agreement.** The proposed argument is that these transactions require cooperation from PEC to get optimum value, and PEC will only cooperate if ALL of their agreements are involved. So it will probably be included. **The enovate LLC agreement does not say a whole lot about what enovate really is. So that gives us an opportunity to spin it.** The spin (I will be the spinner) is that we will insist on an equal contribution of assets from the partner, and a Chicago operating office. We will have a business plan that focuses on **new business outside the PEC affiliated family** (although there will of course be some of those opportunities). Oh, and we will have non-competes in the Chicago regional market. (Bold added for emphasis.)

(Ex. 1.9, Email from T. Hermann to K. Classen, et. al., re: Update, Jan. 31, 2002, 29711CFE-2ABD-794E-B10B-D254472B52E3.msg).

614 It is clear from this message that there was a connection between the GPAA and  
615 other agreements among PEC and Enron affiliates, a relationship that the affiliates  
616 understood. There was a slate of operational and organizational arrangements that  
617 was perceived as a package and that PGL treated as a package. The perceived  
618 value of those agreements came from participation in all the agreements.

619

620 **Q. Were ratepayers affected as a result of the GPAA or other arrangements**  
621 **involving PGL assets or activities?**

622 **A.** The apparent result of the arrangements that involved PGL and PGL assets  
623 immediately before and during the Reconciliation Period was an adverse effect on  
624 ratepayers. To determine whether there was an effect and what it might have  
625 been, I examined the relationship, in different time periods, of gas prices paid by  
626 PGL's customers to spot market prices in the corresponding periods. The periods  
627 of time I reviewed were as follows:

- 628 a) Pre-GPAA: Prior to October 1, 1999;  
629 b) GPAA to Enron Bankruptcy: October 1, 1999 through December 31,  
630 2001;  
631 c) Reconciliation Period: October 1, 2000 through September 30, 2001; and  
632 d) Post Enron: Subsequent to December 31, 2001.

633

634 The data are presented in Tables A to C below. The PGL pricing data (that is, the  
635 PGA charges to customers) were drawn from the Citizens Utility Board website  
636 (<http://www.citizensutilityboard.org/pgapeoplesgas.html>).<sup>4</sup> Pricing data for the  
637 Chicago Citygate, Henry Hub, and Katy Hub were obtained from the proprietary

---

<sup>4</sup> Historical data prior to 1999 was unavailable from the Peoples Energy website. Therefore, for consistency, the data used for analysis was drawn entirely from the CUB website. To the extent there was available data from Peoples Energy, a comparison was made between prices as reported on the CUB site and as reported on the Peoples Energy website. Comparable data existed for fiscal years 1999-2004. Throughout that entire period, data for Peoples Energy and for CUB agreed for all but five months. Four of the variances had a difference of one cent. One exception was a difference of 6 cents, for the month of February 2001. The Peoples Energy website lists a price of 89.92 cents and the CUB website lists a price of 89.32 cents. I have relied on the CUB website amount for consistency, and relying on the smaller number (89.32 cents) is more conservative.

638 database accessed through the Natural Gas Intelligence site  
 639 ([www.intelligencepress.com/subscribers/index.html](http://www.intelligencepress.com/subscribers/index.html)).

640

641 To calculate the average prices for given periods for the three hubs, daily  
 642 historical pricing information was used. Approximately five years of data from  
 643 prior to October 1, 1999 was used in the calculations, to provide an adequate,  
 644 representative population of prices before the GPAA was enacted. (In the case of  
 645 Katy Hub, data was available only from May 1996 through the present.) A small  
 646 price differential representing the cost of transporting gas to PGL from the hub's  
 647 locations is expected.

648

649 **Table A: PGL Prices Paid as Compared to Chicago Citygate**

PERIOD	DATE RANGE	PEOPLES GAS	CITYGATE DAILY	DIFFERENCE	% TO SPOT
PRE-GPAA	1/1/95 - 9/30/99	2.79	2.37	.42	17.72%
GPAA	10/1/99-12/31/01	4.94	4.04	.90	22.28%
RECONCILIATION	10/1/00-9/30/01	6.45	5.12	1.33	25.98%
POST ENRON	1/1/02 - 6/30/04	5.24	4.73	.51	10.78%

650

651 **Table B: PGL Prices Paid as Compared to Katy Hub**

PERIOD	DATE RANGE	PEOPLES GAS	KATYHUB DAILY	DIFFERENCE	% TO SPOT
PRE-GPAA	1/1/95 - 9/30/99	2.79	2.25	.54	24.00%
GPAA	10/1/99-12/31/01	4.94	3.92	1.02	26.02%
RECONCILIATION	10/1/00-9/30/01	6.45	4.95	1.50	30.30%
POST ENRON	1/1/02 - 6/30/04	5.24	4.57	.67	14.66%

652

653

653  
 654

**Table C: PGL Prices Paid as Compared to Henry Hub**

PERIOD	DATE RANGE	PEOPLES GAS	HENRYHUB DAILY	DIFFERENCE	% TO SPOT
PRE-GPAA	1/1/95 - 9/30/99	2.79	2.24	.55	24.55%
GPAA	10/1/99-12/31/01	4.94	3.95	.99	25.06%
RECONCILIATION	10/1/00-9/30/01	6.45	4.97	1.48	29.78%
POST ENRON	1/1/02 - 6/30/04	5.24	4.70	.54	11.49%

655

656 **Q. What do these tables show?**

657 **A.** These tables show that prior to the October 1, 1999, start date of the GPAA, PGL  
 658 prices were, on average, 17.72% higher than gas prices at the Chicago Citygate  
 659 during that same period. Gas prices, on average, for PGL compared to Katy and  
 660 Henry Hubs were, respectively 24.00% and 24.55% higher. If the GPAA were  
 661 economically prudent, one would expect that during the period that the GPAA  
 662 was in place (which encompasses the Reconciliation Period) the relationship of  
 663 PGL prices to spot prices would be closer to (or at the very least remain consistent  
 664 with) past ratios. The analysis results indicate the opposite. PGL prices in  
 665 relation to spot prices actually increased with respect to all three of the major  
 666 hubs.

667

668 The period beginning when the GPAA became effective, October 1, 1999, and  
 669 ending at December 31, 2001 (corresponding to the bankruptcy of Enron), saw the  
 670 trending relationship of PGL gas prices to spot market prices change significantly.  
 671 PGL gas prices jumped to a point of being 22.28% higher than Chicago Citygate  
 672 prices, 26.02% higher than Katy Hub prices and 25.06% higher than prices for  
 673 Henry Hub. This means that PGL prices as a percentage of spot market prices  
 674 increased during the GPAA period of October 1999 through December of 2001 by  
 675 4.56 percentage points and 2.02 percentage points, in relationship to prices for  
 676 Chicago Citygate and Katy Hub, respectively. The relationship to Henry Hub  
 677 prices remained approximately the same as the pre-GPAA period.

678

679 More significantly, the Reconciliation Period of October 1, 2000 through  
680 September 30, 2001, displayed the highest differences between PGL prices and  
681 market prices. PGL prices during the Reconciliation Period were higher than the  
682 market prices by 25.98%; 30.30%; and 29.78% for Chicago Citygate, Katy Hub  
683 and Henry Hub, respectively. The PGL gas prices in relation to Chicago Citygate  
684 prices during the Reconciliation Period, therefore, were **8.26 percentage points**  
685 higher than they were before the GPAA had been put into place. Similarly, the  
686 PGL prices in relation to the other hubs increased from the pre-GPAA period to  
687 the Reconciliation Period by 6.30 percentage points and 5.23 percentage points,  
688 for Katy and Henry Hub, respectively. A gas supply agreement that increased gas  
689 costs in relation to the rest of the market is a foreseeable consequence of  
690 imprudence in either the negotiation or subsequent management of the gas supply  
691 under the GPAA.

692

693 As a result of the Enron bankruptcy, the GPAA was acquired and assumed by  
694 Occidental Petroleum for the nearly three years' remaining life of the contract.  
695 Interestingly, PGL gas prices in comparison to spot prices improved considerably  
696 during the post-Enron management of the GPAA. PGL prices in relation to the  
697 hubs' drop down to being higher than Chicago Citygate prices by **10.78**  
698 **percentage points**, 14.66 percentage points higher than Katy Hub and 11.49  
699 percentage points higher than Henry Hub.

700

701 The large differences between PGL prices and the hub prices during the  
702 Reconciliation Period of October 1, 2000 through September 30, 2001 reflect the  
703 negative impact of the GPAA under the agency of Enron. The increased prices to  
704 PGL, and increased revenues to Enron, are logical and reasonably foreseeable  
705 consequences of PGL ceding control of its gas supply pricing and quantities.  
706 Those higher prices were passed on to the ratepayers.

707

708 **Q. What percentage of Peoples Gas’s gas supply was provided under the GPAA**  
709 **during the reconciliation period?**

710 **A.** Staff witness Dennis Anderson estimated in his written testimony that 66% of  
711 PGL’s natural gas supply had been provided by ENA through the GPAA during  
712 the Reconciliation Period. He estimated that the cost for that gas was  
713 approximately \$572 million. (Staff Exhibit 2.0 at 6)

714

715 **Q. Based on your analysis of the price differences between the market and**  
716 **transactions under the GPAA during the Reconciliation Period, what was the**  
717 **effect on Peoples Gas ratepayers of the GPAA?**

718 **A.** I have developed two scenarios to estimate that economic effect, using Mr.  
719 Anderson’s estimate. Both rely on the price data for the Chicago Citygate FOM,  
720 which was the index used to price the gas under the GPAA.

721

722 *Scenario 1:* The first calculation measures the GPAA’s effect on ratepayers by  
723 examining the difference between the prices paid by ratepayers during the  
724 Reconciliation Period and the prices paid before the GPAA was in effect when  
725 Peoples Gas employed a more traditional contracting strategy that did not cede  
726 control over contract prices, volumes, and term to its supplier. This baseline price  
727 comparison uses a level of costs that the ICC has already found to be reasonable  
728 and prudent. The calculation estimates the effect on total ratepayer payments as  
729 the percentage increase in prices relative to Citygate under the GPAA times the  
730 “prudent” costs for FY 2001.

731 PGL’s costs in relation to the Citygate were 7.01%  $((1.2598/1.1772)-1)$  higher  
732 during the Reconciliation Period than they had been pre-GPAA. PGL’s  
733 ratepayers paid 7.01% more in gas costs during the Reconciliation Period (in  
734 comparison to the Citygate market price) than they had historically. For the  
735 Reconciliation Period, excess costs to ratepayers equals:

736

737

738

1.0701 X Prudent FY 2001 Cost = \$572 million

Prudent FY 2001 Cost = \$534,529,483

739 Excess cost = \$572,000,000 - \$ 534,529,483= **\$37,470,517**

740

741

742

743

744

745

746

747

748

749

750

751

752

753

754

755

756

757

758

759

*Scenario 2:* The second calculation is similar in its logic, but uses different comparison periods. The second calculation uses the period following the dismantling of the Enron arrangements as an additional indicator of the level of imprudent costs recovered through the GPAA charges paid by Peoples Gas ratepayers. Looking at the removal of the various PEC and Enron affiliate arrangements as the point at which certain imprudent costs were eliminated, the result in terms of ratepayer harm is significantly larger.

PGL's costs in relation to the market price at the Citygate were 10.78% higher after the Enron bankruptcy versus 25.98% higher during the Reconciliation Period, when the Enron arrangements were in place. The difference (in percentage terms) between price levels while the Enron arrangements were in place and price levels after their elimination was 15.20 percentage points. The calculation estimates the effect on total ratepayer payments as the percentage increase in prices relative to Citygate under the Enron arrangements times the GPAA costs for FY 2001. Ratepayers were overcharged during the Reconciliation Period by 13.72% more than they should have paid under a prudently managed GPAA. For the Reconciliation period, excess costs to ratepayers equals:

760

761

762

763

764

765

766

767

768

769

770

1.1372 X Prudent FY 2001 Cost = \$572 million  
Prudent FY 2001 Cost = \$502,989,800  
Excess cost = \$572,000,000 - \$ 502,989,800= **\$69,010,200**

The above scenarios support the conclusion that PGL's "indifference," as stated by Mr. Wear, as to how certain aspects of the GPAA were managed by Enron had a significant negative impact on the ratepayers. Even if the gas volumes determined by Enron (for delivery at times specified by Enron) would average out to a volume near the middle were realized, that would not mean that ratepayers did not suffer harm. Compelling purchases of higher volumes of gas when market

771 prices are high and smaller volumes when prices are low exacerbates rather than  
772 moderates the price increases to ratepayers, while maximizing the revenues to the  
773 seller, Enron. By ceding control over the timing, quantity, and price of portions  
774 of its gas supply to an entity with conflicting economic interests, Peoples Gas  
775 significantly compromised its ability to manage gas procurement costs prudently  
776 on behalf of its ratepayers.  
777

777

778

**IMPROPER ACCOUNTING -- LOST AND UNACCOUNTED FOR GAS**

779

780 **Q. Did you examine People Gas' Unaccounted For Gas figures for the**  
781 **reconciliation period?**

782 **A.** Yes. I found an extraordinary increase in unaccounted for gas from previous  
783 years (FY 1999 and FY 2000) in the rate reconciliation period, FY 2001. Also, a  
784 trend of excessive quantities of unaccounted for gas continued through FY 2002  
785 and FY 2003.

786

787 **Q. Why do you consider the increases in Peoples Gas' Unaccounted for Gas**  
788 **figures extraordinary and the amounts excessive?**

789 **A.** The United States Department of Transportation's Transportation Safety Institute  
790 ([www.tsi.dot.gov/divisions/pipeline/Glossary](http://www.tsi.dot.gov/divisions/pipeline/Glossary)) defines "Unaccounted for Gas" as:

791

792

793

794

795

796

797

798

799

800

801

802

803

804

805

806

807

808

809

The difference between the total gas purchases and available from all sources, and the total gas accounted for as sales, net interchange, and company use. This difference includes leakage or other actual losses, discrepancies due to meter inaccuracies, variations of temperature, and/or pressure, and other variants, particularly billing lag.

This definition is consistent with the definition used by Staff witness Dennis Anderson in his pre-filed Direct Testimony submitted in this case. (Staff Exhibit 2.0 at 50-51).

To address billing lags, loans, or timing of the volume variants in Unaccounted For Gas, a trend analysis of several periods would reveal volume variants due to billing or timing lags. In a true billing or timing lag, the volumes "come back" in the next period. For example, if the Unaccounted for Gas was 3 BCF short in a period due to the timing of metering or a billing lag, then the subsequent period would be 3 BCF long in the next period. I developed a trend analysis for Peoples Gas. The 5-year analysis in Table D demonstrates extraordinary increases over

810 previous years starting in the FY 2001 reconciliation year and continuing through  
811 FY 2003.

812  
813 Normal operating practice of companies in the United States midstream industry  
814 is to take or consume small portions of the natural gas being transported as fuel to  
815 run pipeline compressors, pumps, meter stations, and storage devices as the gas  
816 travels through the pipelines. Generally, shippers acknowledge that a small  
817 percentage of this throughput will be taken or consumed along the way for such  
818 purposes and that spills and evaporation will also reduce the volume of gas  
819 actually delivered. Shippers term these expected losses “loss allowance.” And,  
820 for pipelines or distribution companies, Unaccounted For Gas is considered part  
821 of the cost of doing business.

822  
823 In the midstream industry, a standard industry ratio of Unaccounted For Gas to  
824 the quantity of gas purchased is used to evaluate the reasonableness of a  
825 company’s quantities of Unaccounted for Gas. Percentages of Unaccounted For  
826 Gas deemed acceptable in the industry range between 0% to 3% of gas purchases  
827 or of throughput.

828  
829 The Federal Energy Regulatory Commission’s (FERC’s) website<sup>5</sup>, posts for each  
830 pipeline in the country, “Fuel Reimbursement (compressor fuel, lost and  
831 unaccounted for gas) tariff sheets.” These data validate the 0-3% range. The  
832 FERC rate sheets for the Kansas Pipeline, for example, show a range of monthly  
833 figures for a given 12 month period of 0.6134% to 2.8411%.

834

835 **Q. What were the amounts describing Peoples Gas’ Unaccounted For Gas**  
836 **operations in the reconciliation period?**

837 **A.** Unaccounted for Gas is referred to in a number of Peoples Gas documents as Gas  
838 Lost and Unaccounted for (GLU). From this point forward, I will also refer to

---

<sup>5</sup> <http://www.ferc.gov>

839 Unaccounted For Gas as “GLU,” except where a quoted source uses a different  
 840 term.

841  
 842 The amounts shown in Table D below were taken from the data disclosed by  
 843 Peoples Gas in the SEC 10-K’s for PEC filed September 30, 2001 (Peoples  
 844 Energy Corp. SEC Form 10-K, available at:

845 [http://www.sec.gov/Archives/edgar/data/77385/000007738501500084/file10k.ht](http://www.sec.gov/Archives/edgar/data/77385/000007738501500084/file10k.htm)  
 846 [m](http://www.sec.gov/Archives/edgar/data/77385/000007738501500084/file10k.htm), pg. 11) and September 30, 2003 (Peoples Energy Corp. SEC Form 10-K,  
 847 available at:

848 [http://www.sec.gov/Archives/edgar/data/77385/000007738503000048/form10k.ht](http://www.sec.gov/Archives/edgar/data/77385/000007738503000048/form10k.htm)  
 849 [m](http://www.sec.gov/Archives/edgar/data/77385/000007738503000048/form10k.htm), pg. 7). Specifically, Peoples Gas’ GLU quantities are reported in Part I, Item

850 1, Business Section of the 10-K’s. I used these data because SEC reports usually  
 851 include only carefully verified data and are very reliable. Table A below

852 illustrates the extraordinary increase in the standard industry GLU ratio in FY  
 853 2000 in thousands of dekatherms:

854  
 855

TABLE D

	FY 1999	FY 2000	FY 2001	FY 2002	FY 2003
<b>GLU*</b>	3,765	3,371	9,972	6,338	9,139
<b>Gas Purchases*</b>	120,303	123,774	129,737	118,186	145,613
<b>GLU As % of Gas Purchases</b>	3%	3%	8%	5%	6%
<b>Total Gas Sendout *</b>	209,865	204,886	213,123	191,148	209,808

856  
 857

\* SEC data

858 The formula used for the above calculation “As % of Purchases” is:

859  
 860

$$\text{GLU} / \text{Purchases of Gas}$$

861  
 862

This ratio is the midstream industry’s customary measure of GLU performance.

863  
 864

**Q. Is this the ratio Peoples Gas used in discovery responses in this proceeding?**

865 A. No. In response to ICC Data Requests respecting its GLU, Peoples Gas used a  
 866 different ratio, comparing GLU to the amount of gas transported using the  
 867 following formula:

$$\text{GLU} / \text{Total Gas Send-Out}$$

870  
 871 Peoples Gas' alternative ratio is not consistent with the accounting categories  
 872 used by Peoples Gas to measure GLU costs for PGA purposes. A significant  
 873 portion of Peoples Gas' Total Gas Send-Out is "customer-owned gas." Peoples  
 874 Gas' transportation service tariff includes a loss allowance (called a "U Factor")  
 875 collected to cover any evaporation or losses. Customer owned gas is not part of  
 876 Peoples Gas's titled inventory of gas, nor is it part of the GLU Peoples Gas  
 877 reported to the SEC. The following table shows the high percentage of  
 878 "customer-owned gas" in People Gas' Send-Out. The formula used for the  
 879 calculation of "% Customer gas" is:

880 Customer-Owned Gas/Total Gas Send Out

881 **TABLE E**

	<b>FY 2003</b>	<b>FY 2002</b>	<b>FY 2001</b>	<b>FY 2000</b>	<b>FY 1999</b>
<b>Customer Owned Gas*</b>	82,968	80,208	89,516	86,738	95,492
<b>Total Gas Sendout*</b>	209,808	191,148	213,123	204,886	209,865
<b>% Customer Gas</b>	40%	42%	42%	42%	46%

884 \* SEC data

885  
 886 The use of Total Gas Send-Out as the denominator in the GLU percentage  
 887 calculation distorts the magnitude of the result. And, because the amount of  
 888 customer gas included in the denominator does not necessarily track Peoples Gas'  
 889 utility distributions, any trends or anomalies respecting the lost or unaccounted for  
 890 quantities of utility gas reflected in the Gas Charge could be obscured.

891  
 892 **Q. What do the GLU percentages you have reported show?**

893 A. The common industry calculation is shown in Table D, which is Peoples Gas'  
894 GLU as a percentage of purchases. Gas custody receipts brought into Peoples  
895 Gas' system shows that the GLU percentage for Peoples Gas in FY 2001 was 8%.  
896 This is a much higher GLU percentage than the customary industry expectations  
897 of 0% to 3%. The higher GLU percentages continued in the following years to  
898 5% in FY 2002, and 6% in FY 2003.

899

900 According to a published analysis by Rick Feldmann, a gas professional with 24  
901 years of operational midstream industry experience, GLU is a controllable  
902 component of the gas transportation business. In his article in the July, 2000 issue  
903 of Pipeline & Gas Journal  
904 ([http://www.undergroundinfo.com/PGJ/pgj\\_home.html](http://www.undergroundinfo.com/PGJ/pgj_home.html)), Feldman also reports  
905 that "leading pipeline transportation companies are currently controlling lost and  
906 unaccounted for gas (L&U) at an average rate of 0.25% (**less than 1%**) of custody  
907 receipts, or less." (*Bold added for emphasis.*)

908

909 The amount of gas represented by Peoples Gas's excessive GLU is not a trivial  
910 quantity. According to Peoples Gas's Gas Supply Director Thomas Zack, "a  
911 typical residential heating customer, single family unit, heating customer,  
912 probably use(s) around 1400 therms a year which would convert to 140  
913 dekatherms a year." (Ex. 1.10, Zack Tr. at 95). The GLU figure in the FY 2001  
914 period of 9,972 thousand dekatherms is the equivalent of heating 71,229 homes  
915 for an entire year. The quantity in excess of the high end of the industry  
916 expectation range norm (0-3%) would be 6,080 thousand dekatherms, which  
917 translates into enough gas for heating 43,428 homes for an entire year.

918

919 Peoples Gas' GLU increased from 3,371 thousand dekatherms in FY 2000 to  
920 9,972 thousand dekatherms in FY 2001. Using FY 1999 and FY 2000 as base  
921 years, the FY 2001 GLU figure is approximately triple the GLU of the base years.  
922 As noted earlier, the increase (slightly moderated) persisted in the following

923 years. Even if one attributes the increase to a higher volume of midstream  
924 activity, to the extent that increased GLU costs are included in the calculation of  
925 the Gas Charge, there is a demonstrable adverse effect on Peoples Gas' bundled  
926 service customers.

927

928 **Q. Are the amounts you have drawn from SEC reports consistent with the**  
929 **Peoples Gas' data provided in discovery?**

930 **A.** No. For reasons that I cannot explain, the SEC data that I used and the data  
931 Peoples Gas provided in discovery are not consistent. Table F below is drawn  
932 from Peoples Gas's Response to Staff's Data Request ENG 2.014 in this docket:

933

934

TABLE F

	<b>FY 1999</b>	<b>FY 2000</b>	<b>FY 2001</b>
<b>GLU*</b>	2,313	1,726	8,331
<b>Total Gas</b>	212,178	206,612	221,453
<b>Sendout*</b>			
<b>GLU as % of</b>	1%	1%	4%
<b>Total Sendout</b>			

935

\* Ex. 1.11, PGL Response to Staff DR ENG 2.014

936

937 Looking at the above table, prepared from information submitted to Staff, note  
938 that the GLU amounts in the three years, FY 1999, FY 2000, and FY 2001 are not  
939 consistent with the SEC filed amounts in Table D for the same periods. Nor are  
940 the Total Gas Send-Out totals consistent for the same periods. The Total Gas  
941 Send-Out and GLU for each of the corresponding years should be identical in the  
942 SEC report and the data request response. The variance is not in keeping with  
943 accepted accounting procedures due to the accounting irregularity that exists in  
944 one source or the other.

945

946 As shown in Table F, the GLU as a percentage of Total Gas Send-Out (based on  
947 Peoples Gas' discovery response) is 1%, 1% and 4%, respectively, for FY 1999 to  
948 FY 2001. The reasons for the variance are not disclosed by the data. However,  
949 one can observe that in all three years, the Data Request Response presents lower  
950 GLUs and higher Total Gas Send-Out than does the SEC Report. These variances  
951 have the effect of decreasing the numerator (GLU) and increasing the  
952 denominator (Total Gas Send-Out) for the evaluation ratio, resulting in a lower  
953 calculated ratio (GLU as a percentage of Total Gas Send-Out) for lost and  
954 unaccounted for gas. (Recall my earlier discussion regarding the  
955 inappropriateness of using Total Gas Send-Out to calculate Peoples Gas' GLU.)  
956

957 Nonetheless, the ratios Peoples Gas provided in discovery show the same trend as  
958 the 10-K's. That is, the numbers in the discovery response show the same  
959 dramatic increase in GLU in 2001, as compared to the two prior years. In fact,  
960 the increase is more pronounced. Using the data request information from Table  
961 F, the GLU volume for FY 2001 is 383% greater than in FY 2000 and 260%  
962 greater than in FY 1999.  
963

964 **Q. Was there confirmation of the GLU increases in business documents from**  
965 **Peoples Gas?**

966 **A.** Yes. In a number of internal communications, there were expressions of concern  
967 about the sudden increase and continuing high level of GLU at Peoples Gas. In  
968 an email dated March 28, 2001, to Kathy Donofrio, Vice President of Marketing,  
969 Rates and Business Development, Peoples Gas employee Sam Fiorella writes in  
970 reference to GLU that, "The amount has skyrocketed from (11.3) million to 46.4  
971 million therms, cal. Yr. 1999 to 2000." In the same chain of email messages to  
972 Donofrio and Valerie Grace, Director of Rates & Gas Transportation Services,  
973 with Mr. Blachut receiving copies, Ms. Donofrio states: "Talked to Charlie re:  
974 Peoples Gas's large amount of unaccounted for gas...I'm still concerned that a

975 large unacc(ounted) for might lead one to think that it's the symptom of  
976 accounting/control problems.”  
977 (Ex. 1.12, Email from S. Fiorella to K. Donofrio, et. al., Mar. 28, 2001, no  
978 subject). Peoples Gas has also indicated in its response to Staff data request ENG  
979 2.014 that the utility was undertaking an investigation into the GLU increases.  
980 The company's discovery response has not been updated to provide any  
981 indication that the investigation was conducted, and if conducted, what the results  
982 of the investigation were. Similarly, the depositions of PEC and Peoples Gas  
983 personnel, as well as an examination of other documents produced in discovery  
984 give no indication that corrective action was taken in 2001 with regard to GLU.

985 A 2003 series of Peoples Gas e-mail messages to various Peoples Gas gas  
986 management employees confirms that the GLU increases were a continuing issue.  
987 One noted that the “[GLU] problem has not gone away. We have 4% or about 8  
988 BCF unaccounted for a current market value of about \$40 million.” (Ex. 1.13,  
989 Email from R. Harrington to T. Nardi, et. al., Jul 10, 2003, re: Points for  
990 Operations Meeting). (The 4% and 8 BCF amounts, however, do not correspond  
991 with any of the other information we found in the discovery material or collected  
992 in the above tables.) PGL's Gas Supply division also prepared a “Gas Lost Work  
993 Plan” in 2003. The plan includes an “observation” that “past studies and rolling  
994 12 month totals suggest a fundamental shift and increase in GLU beginning in late  
995 calendar 1999 and continuing.” (Ex. 1.14, Gas Lost Work Plan, filepath: ).

996

997 **Q. Was there any activity that could explain Peoples Gas' increased GLU in the**  
998 **reconciliation period?**

999 **A.** During the reconciliation period, there was an emphasis at Peoples Gas on  
1000 increasing midstream business revenues of the utility, and a similar emphasis at  
1001 the utility's affiliates. An increase in gas throughput could result in a larger  
1002 amount of gas lost during transport. Thomas Zack, Peoples Gas' current Director,  
1003 Gas Supply, described the utility's non-tariff hub activity as follows:

1004

1005                   The hub generally utilizes excess – the hub is primarily – its primary  
1006                   assets of the hub are storage, Manlove Storage Field, and somewhat the  
1007                   Mohamet Pipeline, and so the hub utilizes excess capacity of those assets.”  
1008                   (Ex. 1.10, Zack Tr. at 59-60)  
1009

1010                   A 2003 Peoples Gas plan for addressing its GLU operational issue identifies  
1011                   several “Areas of Focus” for an investigation into the GLU that may be related to  
1012                   the increase. Those areas of focus include:  
1013

- 1014                   • “Increase in Hub transactions and management of Hub by enovate  
1015                   beginning early calendar 2000;”
- 1016                   • “Enron assumption of transportation and delivery of bundled  
1017                   Citygate supplies beginning in October 1999;” and
- 1018                   • “Understand business process and internal controls for write-off of  
1019                   volumes”

1020                   (Ex. 1.14, Gas Lost Work Plan, filepath: ).  
1021

1022                   These internal proposals for areas to examine suggest the possibility that the  
1023                   increase could have been caused by increased Hub activity, as I discuss later in  
1024                   my testimony, by reliance on another entity (Enron) for control of certain  
1025                   acquisition and delivery functions for bundled service gas supply, or by some  
1026                   characteristic or effect of the utility’s internal processes and controls.  
1027

1028                   **Q.   How could an increase in midstream services activities and the operation of**  
1029                   **the PGL HUB cause an increase in GLU, a component of PGA cost?**

1030                   **A.** I have been informed by counsel that the Commission rules governing the  
1031                   calculation of the Gas Charge would be affected by the midstream activity only if  
1032                   that activity involved assets or activities for which costs are included in the  
1033                   prescribed calculation. It is Peoples Gas’ position that that is not the case with the  
1034                   FERC operating statement services Peoples Gas offered through its hub.  
1035                   However, the inventory records included in Peoples Gas’s response to Staff data  
1036                   request POL 2.74 appear to confirm that Peoples Gas’ hub activity did involve  
1037                   PGA assets and activities.  
1038

1039 The inventory balance for Peoples Gas' non-GPAA hub activity shows a negative  
1040 balance from January 4, 2001 to May 2, 2001. Mr. Charles Blachut, who was in  
1041 charge of Peoples Gas' gas supply forecasts, explained the meaning of a negative  
1042 inventory balance for hub services (noting that he was unaware of such an  
1043 occurrence).

1044  
1045 This is the gas taken from Manlove Field which includes this plus the  
1046 system supply, so if you ran negative inventory, then it's, I think, a  
1047 reasonable assumption that it came from system supply. In other words, it  
1048 was a loan of gas. (Ex. 1.15, Blachut Tr. at 25).

1049  
1050 The testimony of PGL Gas Supply division personnel demonstrates that Peoples  
1051 Gas operated Manlove Field on the basis of the physically available volumes,  
1052 without designating the gas commodity assets as restricted to PGA use or to  
1053 midstream services use. (Ex. 1.16, DeLara Tr. at 92)

1054  
1055 From the available documents, we cannot determine whether negative balance gas  
1056 that was withdrawn for hub services in FY 2001 was returned to the system  
1057 supply or written off as "GLU." Neither do we know the price at which any  
1058 replacement gas was acquired. In any case, as shown in Table G below, it appears  
1059 that the gas supply acquired to serve Peoples Gas' bundled service customers was  
1060 used as a reserve supply for the hub. In effect, the hub had a call option on  
1061 Peoples Gas' bundled service inventory, to take gas as needed. It appears that this  
1062 option was neither acknowledged nor paid for in Peoples Gas' PGA accounting.  
1063 Conceptually, this is similar to the call option service Peoples Gas has  
1064 acknowledged providing and accounting for incorrectly as discussed in the  
1065 testimony of Jerome D. Mierzwa (CUB Exhibit 2.0 at 46). The utility gave an  
1066 option that was incorrectly valued for the benefit of its PGA customers.

1067

1068 **Q. Does Peoples Gas' management of its commodity supplies for bundled**  
1069 **service customers have any effect on the determination of the Gas Charge**  
1070 **paid by its customers?**

1071 A. Yes in at least two ways. The combination of GLU and the negative balance hub  
1072 activity could affect ratepayers. If gas were taken from Manlove Field when  
1073 ratepayers could have used that gas, ratepayers would have been harmed. If the  
1074 withdrawn ratepayer gas were replaced with higher priced gas, either from the  
1075 spot market or through the GPAA (at market indexed prices), the economic harm  
1076 would be obvious – exchange of lower cost gas for higher cost gas. Even if gas  
1077 were withdrawn for midstream services and later replaced with lower cost gas (or  
1078 if the gas were not needed immediately), then PGL’s ratepayers would have lost  
1079 the economic opportunity to make a midstream sale at high winter prices. From  
1080 January to May 2001, the ratepayers needed the gas. During the early months of  
1081 2001, Peoples Gas’ customers were paying above spot market prices due to the  
1082 market shortage of gas.

1083  
1084 Second, according to the Purchased Gas Adjustment Clause, Section 525.40 of the  
1085 Commission’s regulations, Recoverable Gas Costs include “Costs of natural gas  
1086 and any solid, liquid or gaseous hydrocarbons purchased for injection into the gas  
1087 stream or purchased as feedstock or fuel.” Under this regulation, I have been  
1088 advised by counsel that Peoples Gas recovers the cost of gas purchases, including  
1089 the portion of those purchases that is lost (GLU) and not available for customer  
1090 use. In his deposition, Mr. Zack confirmed that in its calculation of the gas  
1091 charge, Peoples Gas used (to represent the cost of the commodity) “The cost  
1092 coming through our accounting system ...weighted....within the components of  
1093 the gas charge.” (Ex. 1.10, Zack Tr. at 69). Peoples Gas’ customers paid a higher  
1094 cost for gas due to a higher GLU. To the extent that Peoples Gas’ GLU costs  
1095 were above the level consistent with prudent management of its gas supplies,  
1096 those additional costs were improper.

1097 **Q. What conclusions have you drawn from this information about Peoples Gas’**  
1098 **performance in gas inventory management that relate to issues in this**  
1099 **reconciliation proceeding?**

1100 A. In assessing Peoples Gas' gas procurement and storage operations, I have used the  
1101 following criteria, which I have been advised is the standard for prudence in  
1102 Illinois. I have also been advised that costs attributable to decisions or actions  
1103 that the utility fails to show meet this standard are improperly charged to  
1104 ratepayers. The Commission has defined prudence as "that standard of care  
1105 which a reasonable person would be expected to exercise under the circumstances  
1106 encountered by utility management at the time decisions had to be made," based  
1107 on "only those facts available at the time the judgment was exercised."

1108 From the information discussed in this portion of my testimony, I have reached  
1109 two main conclusions. First, Peoples Gas was not prudent in controlling its  
1110 runaway GLU in FY2001. As Peoples Gas has observed, rolling 12 month totals  
1111 indicated "a fundamental shift and increase in GLU beginning in late calendar  
1112 1999" (Underline added for emphasis). Yet, we see no evidence of Peoples Gas  
1113 taking decisive action to determine the causes of increased GLU costs or to  
1114 control them until 2003. This failure to act to control gas losses (and related  
1115 costs) that were far above industry norms or averages and even PGL's historic  
1116 levels, despite clearly discernible evidence of a problem in known and regularly  
1117 reported data, was not reasonable from a business perspective. As William  
1118 Morrow, Peoples Gas' Vice President for Gas Supply in FY 2001, observed: (Ex.  
1119 1.17, Morrow Tr. at 61-62), gas commodity costs were recognized as the utility's  
1120 largest category of expenses, expenses the utility purports to take pains to control.  
1121 Yet, when GLU increased by a factor of more than three and exceeded industry  
1122 norms by a similar factor, Peoples Gas failed to take decisive action. Under the  
1123 circumstances, and given the data available to Peoples Gas at the time, this failure  
1124 was imprudent, and it resulted in harm to the ratepayers in the reconciliation  
1125 period.

1126 Section 525.40(d) of the PGA rule states that:

1127 Recoverable gas costs shall be offset by the revenues derived from  
1128 the transactions at rates that are not subject to the Gas Charge(s) if  
1129 any associated costs are recoverable gas costs as prescribed by  
1130 subsection (a) of the Section. This Section shall not apply to  
1131 transactions subject to rates contained in tariffs on file with the  
1132 Commission, or in contracts entered into pursuant to such tariffs,  
1133 unless otherwise specifically provided for in the tariff. Taking into  
1134 account the level of additional recoverable gas costs that must be  
1135 incurred to engage in a given transaction, the utility shall refrain  
1136 from entering into any such transaction that would raise the Gas  
1137 Charge(s).

1138 My second conclusion is that to the extent that Peoples Gas's increased GLU  
1139 costs are attributable to increased gas losses due to transactions that were part of  
1140 Peoples Gas' increased Hub activity, those costs are not properly included in the  
1141 PGA. Alternatively, under the Commission's PGA regulations, if the costs are  
1142 included, then revenue associated with those costs also should be included in the  
1143 Gas Charge calculation.

1144 Finally, the apparent absence of a system of inventory accounting controls that  
1145 prevents the diversion of gas supplies acquired to provide bundled services to  
1146 other purposes, such as Hub services, is also a dubious business practice. On at  
1147 least one occasion during the reconciliation period, an actual diversion of bundled  
1148 services gas supply was produced by withdrawals to perform a Hub transaction.  
1149 Aside from this actual diversion, the availability of bundled service gas to  
1150 complete wholesale service transactions effectively granted to the Hub, and  
1151 possibly others, a no-cost call option on bundled services' gas supplies for the  
1152 entire reconciliation period. In addition to the cost of replacing gas actually  
1153 diverted to other uses, Peoples Gas denied its bundled services customers the  
1154 benefit of some compensation for the use of their gas supply as an on-call reserve  
1155 for Non-PGA transactions.

1156 **Q. Were Peoples Gas' bundled service customers harmed economically by the**  
1157 **imprudent decisions and actions you have described?**

1158 **A.** Yes. I calculated excess GLU costs as follows:

1159 If Peoples Gas is allowed the high end of the industry GLU range (3%), the  
1160 reconciliation period excess GLU is a very large quantity of gas. The following  
1161 formula calculates the excessive GLU during FY 2001 and the associated  
1162 imprudent costs.

1163 
$$\text{GLU less the normal 3\% GLU} = \text{Excess GLU}$$
  
1164 
$$9,972 - 3,892 = 6,080 \text{ thousand dekatherms}$$

1165 This quantity of gas would heat 43,428 homes for an entire year.

1166 According to Staff witness Anderson, the LIFO price for storage gas for fiscal  
1167 year 2001 was \$6.23 per dekatherm. (Staff Exhibit 2.0 at 53). Multiplying the  
1168 \$6.23/dekatherm times the imprudent GLU volumes yields:

1169 
$$6,080 \text{ thousand dekatherms} \times \$6.23/\text{dekatherms} = \mathbf{\$37,878,400}$$

1170 Actual replacement cost of gas could have been more than \$6.23/dekatherm,  
1171 which would have increased the harm to customers.

1172 **Q. What conclusion do you draw from the GLU calculations above?**

1173 **A.** Peoples Gas was imprudent in tracking, investigating, and mitigating the cause(s)  
1174 of the GLU increases. The costs for the gas purchases that ultimately became the  
1175 GLU should not be included in the Gas Charge and passed on to Peoples Gas's  
1176 ratepayers. This high reported GLU amount reflects either operational  
1177 imprudence or other cost/revenue activity such as using unaccounted for gas to  
1178 support the non-tariff hub activity. The total cost to ratepayers for this  
1179 imprudence during the rate reconciliation period is at least \$37,878,400.

1180

1181

**INVENTORY MISMANAGEMENT – NEGATIVE HUB BALANCES**

1182

1183 **Q. Did you find any indication that the PGA gas supply and storage assets of**  
1184 **PGL were used improperly?**

1185 **A.** I have reviewed documents that show clearly that PGA assets and activities of  
1186 Peoples were used to support the midstream initiatives of its affiliates and  
1187 affiliates of Enron. Such uses of the assets are not prohibited, so long as revenues  
1188 associated with costs recovered through the PGA are also included in the Gas  
1189 Charge calculation. I have not been able to confirm that all PGA revenues  
1190 properly attributable to ratepayers have been assigned as required by the ICC's  
1191 PGA regulations. And, I have seen some documents that suggest strongly that  
1192 some PGA revenues have not been credited to ratepayers.

1193

1194 PEC took advantage of the assets and capabilities of Peoples as a means to  
1195 accomplish sales and profit objectives it had set for Midstream Services. Benefits  
1196 derived from the assets of Peoples Gas were passed on to Peoples Energy and  
1197 ENA, while the associated costs remained with Peoples Gas and ultimately  
1198 ratepayers. Peoples' assets intended for ratepayers' use appear to have been used  
1199 to further PEC's midstream ambitions and ratepayers bore the costs for those  
1200 ambitions. Peoples' assets used included natural gas usage, pipeline  
1201 transportation capacity, and the gas storage field, Manlove.

1202

1203 **Q. What makes up the business segment that PEC describes as "Midstream**  
1204 **Services"?**

1205 **A.** While Peoples Gas participated in midstream activities with which I am familiar,  
1206 the utility apparently also used the phrase internally to refer to specific entities  
1207 and activities within its family of affiliates. The Peoples Energy Midstream  
1208 Services business segment consists of three sub-segments:

1209

- Peoples Gas Hub
- Natural Gas Liquids (NGL) Services

1210

1211                   • Wholesale Marketing services, such as physical and speculative trading.

1212

1213                   The Peoples Gas Hub, a functional subdivision of PGL, provided hub services  
1214                   such as storage and transportation to wholesale market participants. PGL was the  
1215                   manager of the Hub and provided services pursuant to its FERC Operating  
1216                   Statement. (Although there is some suggestion that the hub function may have  
1217                   been managed by another entity, I have not been able to confirm that with  
1218                   independent documentation. (Ex. 1.10, Zack Tr. at 60-61).

1219

1220                   The NGL Services include PERC's NGL peaking operations and refinery waste  
1221                   services. These services include "reclaiming" or buying and storing natural gas  
1222                   liquids (ethane and propane). The liquids are heated up and turned back into  
1223                   gaseous form to meet the peaking needs of PERC customers.

1224

1225                   The Wholesale Marketing services included physical and speculative trading  
1226                   activity on wholesale markets. During the Reconciliation Period, PEC used its  
1227                   enovate partnership as the vehicle for trading activity. PERC facilitated this joint  
1228                   venture between Enron Midwest (EMW), a subsidiary of Enron, and Peoples  
1229                   Midwest, a subsidiary of PERC.

1230

1231                   **Q. Are the profits generated from these midstream service enterprises relevant**  
1232                   **to the PGA reconciliation?**

1233                   **A.** Yes. I am advised by counsel that under the ICC's PGA regulations, the  
1234                   midstream revenues and profits relate to the PGA only if costs associated with the  
1235                   revenues are recovered through the PGA.

1236

1237                   The documentary materials addressing PGL's hub activities and enovate's trading  
1238                   activities raise issues about the extent to which PGL included revenues from those  
1239                   sub-segments in the Gas Charge calculation as part of the PGA process. Both of  
1240                   these sub-segments relied, at least in part, on the use of PGL assets to generate

1241 revenues, and costs associated with those assets pass through the PGA. The  
1242 profits of these sub-segments were shared among the entities participating in the  
1243 provision of these services. However, the details of some sharing arrangements  
1244 are uncertain. For example, according to the report of an internal audit on  
1245 enovate, performed by Peoples Energy’s internal audit department in August  
1246 2001, the sharing arrangements were not always in writing.

1247  
1248 The “revenue sharing between PEC and Enron related to the optimization  
1249 of the PGL Hub and the activities of Enron MW, (EMW) are not formally  
1250 documented. (EMW is an Enron subsidiary that trades on behalf of  
1251 enovate.) Although the revenue sharing arrangements have been widely  
1252 communicated to PEC senior management, PEC has no legal relationship  
1253 to revenues generated by EMW, and Enron has no legal relationship to  
1254 Hub related revenues.” (Ex. 1.18, Review of enovate, Aug. 24, 2001,  
1255 Bates 01PGL 097488 – 097494).

1256  
1257 **Q. What PGL assets did the Hub services use?**

1258 **A.** The Hub used portions of PGL assets to provide storage and transportation  
1259 services. Specifically, according to PGL, those assets consisted of “excess”  
1260 capacity in the Manlove storage field and Mahomet Pipeline system, and “excess”  
1261 natural gas i.e., assets not needed by the rate paying customers of the utility. Tim  
1262 Hermann, then the Director of Midstream Services and currently the Vice  
1263 President of Midstream Services for PERC, described the Hub as “storage and  
1264 transmission assets that are not needed by the ratepayers, excess capabilities if it  
1265 were.” (Ex. 1.19, Hermann Tr. at 18). Mr. Zack described the PGL Hub as a  
1266 functional unit of PGL engaged in the provision of certain midstream services  
1267 pursuant to the utility’s FERC operating statement. (Ex. 1.10, Zack Tr. at 60-61).

1268  
1269 The assets actually used by the HUB are not easily determined. PGL does not  
1270 segregate gas purchased for regulated PGA services from customer owned gas or  
1271 gas acquired for other services. Since natural gas is a fungible commodity, the  
1272 gas is commingled. Moreover, in gas trading and transport transactions, the  
1273 fungible nature of gas is often used in completing the transaction. According to

1274 Mr. De Lara, displacement is “used in the gas industry and -- this is mainly in the  
 1275 pipeline, natural gas pipeline industry -- is that we do not track molecules as it  
 1276 flows through the system. For example, if you purchase molecule A from the  
 1277 Gulf Coast, you may not actually receive molecule A in Chicago. You may  
 1278 receive, you know, D, E, F or some other -- so, that is what is meant by  
 1279 "displacement". (Ex. 1.16, DeLara Tr. at 65-66). Given these factors,  
 1280 coordination of accounting records and operating procedures would seem critical.

1281

1282 However, for operational purposes, PGL does not rely on ownership records to  
 1283 determine the availability of “excess” gas assets for Hub or other non-PGA  
 1284 services. PGL has not explained how it determines that there is “excess” gas or  
 1285 how much there would be that is “excess.”

1286

1287 **Q. What were the Manlove storage gas inventory levels during the rate**  
 1288 **reconciliation period?**

1289 **A.** The following table is drawn from PGL documents produced to reflect the  
 1290 capacity and distribution of assets within Manlove Field, a large underground  
 1291 storage cavern used by PGL to store natural gas until needed by the utility  
 1292 customers. Based on the information produced, the following table shows the  
 1293 natural gas available for utility customers.

1294

1295

TABLE G In thousand Dth

Peoples Utilities	Working Gas***	Cushion Gas-Recoverable****	Cushion Gas-Non-Recoverable****	Total Manlove Gas
PGL		3,877	106,101	143,534
NSG	-	341	9,346	9,687
Total		4,218	115,447	153,221

1296

1297

1298

1299

1300

\*\*\*(Ex. 1.20, Deliverability Decline Calculation 2001/2002 Withdrawal Season, Bates 01PGL 090041).

\*\*\*\*(Ex. 1.21, Determination of Percentage Used, Bates 01PGL 062836).

1301 A brief discussion of terms is necessary to analyze TABLE G. The following are  
1302 commonly used definitions according to the Energy Information Administration  
1303 website at [www.naturalgas.org/naturalgas/storage](http://www.naturalgas.org/naturalgas/storage):

1304 Working Gas is the volume of natural gas in the storage reservoir that can be  
1305 extracted during the normal operations of the storage facility. This is the natural  
1306 gas being stored and withdrawn.

1307 Cushion Gas-Recoverable is the volume of gas that remains underground;  
1308 however, it can be extracted using special compression equipment.

1309 Cushion Gas-Non-Recoverable is the volume of gas that may never be extracted.  
1310 It is known as physically unrecoverable gas; it is permanently embedded in the  
1311 formation.

1312

1313 Using the table above, note that Working Gas is listed as a total quantity for both  
1314 regulated utilities. No breakout of NSG was found in the materials provided.  
1315 Taking this limitation into consideration, the Working Gas portion of Peoples'  
1316 utilities is only [REDACTED]. PGL uses the supply of Working Gas to  
1317 meet its utility obligations to the ratepayers.

1318

1319 While it is possible to draw on Cushion Gas-Recoverable, that is not the purpose  
1320 of that gas supply. It is not economically feasible to utilize Cushion Gas-Non-  
1321 Recoverable. So, for purposes of analyzing the change in PGL's gas inventory,  
1322 that category of gas is essentially irrelevant. Showing the full field demonstrates  
1323 the vastness of the storage field capacity available for PGA service and gives  
1324 perspective to the available volumes.

1325

1326 **Q. How much gas did PGL have available for PGA service ratepayers?**

1327 **A.** The table below shows the materially significant stored gas that was available for  
1328 utility customers during FY 2001. Gas identified as having been available for the  
1329 Hub is also included as available for PGA services because PGL deponents  
1330 consistently testified that for operational purposes, the regulated customers always

1331 get the highest priority with respect to having gas available to meet their needs.  
 1332 Moreover, as I have noted, there is no accounting system that would override the  
 1333 operational availability of gas from Manlove. Accordingly, HUB assets are  
 1334 included in the “Total PGL Gas.”

1335  
 1336

TABLE H In thousand Dth

FY 2001 Utility Inventory Balances	Manlove Field*	LNG*	HUB/ Non-Tariff Activity**	Total PGL Gas
October 2000				
November 2000				
December 2000				
January 2001				
February 2001				
March 2001				
April 2001				
May 2001				
June 2001				
July 2001				
August 2001				
September 2001				

1337

1338 \*(Ex. 1.22, Inventory Balance, Jul. 18, 2001, Bates 01PGL 083382).

1339

1340 \*\*\*(Ex. 1.23, PGL response to Staff DR POL 2.74, Staff Ex. 3.03).

1341

1342 Note that the Manlove Field inventory balances dropped to very low levels during  
 1343 the rate reconciliation period, especially from January to May 2001, according to  
 1344 documents produced in the case. (Ex. 1.22, Inventory Balance, Jul. 18, 2001,  
 1345 Bates 01PGL 083382).

1346

1347 During that same time period, the Hub was showing negative balances. According  
 1348 to Mr. Blachut, had withdrawals like those shown above occurred, it would  
 1349 represent a “loan” of gas out of the gas supply of PGL, for the benefit of Hub and  
 1350 other non-PGA customers. Given the shortages (shown in Table H) that occurred  
 1351 during the winter of 2000-2001, Hub transactions do not appear to be limited to  
 excess assets. Further, the negative balances reported for the Hub in January,

1352 February and March of 2001 indicate that gas being used for non-PGA activity  
1353 was greater than the supposed “excess” gas supply PGL had available.

1354

1355 **Q. What is the significance of depleting the inventory of working gas?**

1356 **A.** According to the information provided by Peoples Gas, during the heart of the  
1357 winter season in January 2001, PGL found itself with a mere [REDACTED]  
1358 available to rate payers out of a storage capacity of [REDACTED].  
1359 February of 2001 saw the depletion of regulated service supplies get even worse  
1360 with only [REDACTED] as the month end balance.

1361

1362 Any suggestion that the shortfall was related to a particularly cold winter (and  
1363 therefore increased customer usage) ignores the fact that Non-PGA activity had  
1364 used at least [REDACTED] more than could be reasonably considered  
1365 “excess” gas. The overall negative position of PGL’s gas inventory in February  
1366 of [REDACTED] would not have existed but for Hub and other non-PGA  
1367 activity.

1368

1369 Whenever gas supplies needed for ratepayers were used for non-PGA services,  
1370 ratepayers were harmed, since there is little reason to believe that the gas could  
1371 have been replaced in the prevailing market conditions except at prices that  
1372 exceeded the low prices associated (under PGL’s LIFO-type costing) with the last  
1373 to be withdrawn older gas. “Excess” gas or not, the benefits of such trading,  
1374 which was supported by the expenditures to acquire the gas on which trading was  
1375 based, were never passed on to the ratepayers.

1376

1377 Moreover, there are minimum capacity thresholds for storage fields, that is, a  
1378 minimum quantity of gas in storage. A Deliverability Decline Calculation  
1379 provided by PGL shows that for Manlove, that threshold is [REDACTED].  
1380 (Ex. 1.20, Deliverability Decline Calculation 2001-2002 Withdrawal Season,  
1381 Bates 01PGL 090041.) Additional commodity costs to replenish the storage

1382 facility after any depletion (especially of the lower priced gas last withdrawn)  
1383 would have been almost certain in the FY 2001 high-cost market environment.  
1384 Expert engineering analysis is needed to determine whether withdrawals below  
1385 this minimum decline threshold would damage the facility or cause the utility to  
1386 incur additional storage costs. If the performance capabilities of Manlove Field  
1387 were diminished, additional increased costs to utility ratepayers would result.

1388

1389 **Q. Did PGL allow Manlove inventory balances to drop below the threshold or to**  
1390 **levels outside operating norms?**

1391 **A.** Yes. According to a Manlove Field Underground Storage Update dated  
1392 September 26, 2001, [REDACTED] of Cushion Gas was removed during the  
1393 2000-2001 season. (Ex. 1.20, Deliverability Decline Calculation 2001/2002  
1394 Withdrawal Season, Bates 01PGL 090041). The [REDACTED]  
1395 that was planned for the 2001/2002 Withdrawal Season included within it the  
1396 3,507 thousand dekatherms of cushion gas that had to be replaced. (Ex. 1.20,  
1397 Deliverability Decline Calculation 2001/2002 Withdrawal Season, Bates 01PGL  
1398 090041).

1399

1400 In Table H above, note that in February 2001, the total available for ratepayers  
1401 was a [REDACTED]. This may have corresponded with the period  
1402 that PGL had to “dip” into the cushion gas.

1403

1404 **Q. Were there any other increased costs due to PGL allowing the balances to get**  
1405 **so low?**

1406 **A.** Yes. One effect of shortages is increased market prices locally. A rise in market  
1407 prices ultimately leads to increased prices to the ratepayers for commodity costs,  
1408 especially since most of PGL’s gas supply came at the market-indexed prices of  
1409 the GPAA. The shortage that existed (or was created) during the winter forced  
1410 PGL to buy gas at the GPAA indexed prices or at spot market prices that were  
1411 almost certainly higher than the cost of the old gas that was last to be withdrawn.

1413

1414

**IMPROPER STORAGE TRANSACTIONS**

1415

1416 **Q: Were there other mechanisms used by PGL that facilitated non-PGA**  
1417 **activities?**

1418 **A.** Yes. PGL and EMW entered into a storage optimization agreement on September  
1419 29, 2000. The storage EMW was to optimize were two nominated storage service  
1420 (NSS) contracts that PGL had with Natural Gas Pipeline Company of America  
1421 (NGPL) that were ostensibly intended to provide PGL with no-notice supply to  
1422 meet peaking needs. The agreement between PGL and EMW enabled EMW to  
1423 have access to PGL's Unrestricted Capacity, which EMW would utilize for  
1424 hedging arrangements.

1425

1426 Article VI: Optimization Program, section (3), of the Storage Optimization  
1427 Contract stated the following:

1428

1429 EMW shall execute, in its own name, all trading and risk  
1430 management transactions necessary and appropriate to  
1431 implement the Optimization Program. The Optimization  
1432 Program strategies shall include: (a) the strategy  
1433 associated with hedging a portion of the Initial  
1434 Unrestricted Capacity in accordance with the Hedging  
1435 Strategy; (b) optimizing the remaining Initial Unrestricted  
1436 Capacity; (c) optimizing Initial Restricted Capacity if,  
1437 and to the extent, Peoples Gas designates such capacity as  
1438 Unrestricted Capacity; and (d) modifying Hedges entered  
1439 into pursuant to the Hedging Strategy. (Ex. 1.24, PGL  
1440 Response to CUB D.R. 5.019)

1441

1442 The maximum storage volume (MSV) of gas for the optimization program was  
1443 defined under the two NSS contracts. The contract periods began April 1, 2000  
1444 with total MSV, Initial Unrestricted Capacity (IUC), and Initial Restricted  
1445 Capacity (IRC) for each as follows in MMBtus:

1446

1447

VOLUME	NSS CONTRACT 1 (# 113417)	NSS CONTRACT 2 (# 117162)
IUC		
IRC		
MSV	9,943,725	9,275,025

1448

1449

1450 **Q. What was the purpose of the NSS contracts?**

1451 **A.** According to Thomas Patrick, then President and now Chief Executive Officer of  
1452 PEC, the NSS contracts were valuable because they provided no-notice service to  
1453 PGL. That is, PGL could call on as much or as little of gas it had nominated  
1454 under the contracts on any day. This service was especially valuable on cold  
1455 days, when market requirements varied.

1456

1457 Mr. Patrick further explained that PGL needed only 10 to 15 days of NSS service  
1458 to meet its needs, but that FERC mandated that NSS service be provided in 75 day  
1459 increments.

1460

1461 **Q. If PGL needed only 10 to 15 days of service, why did it have two 75 day**  
1462 **contracts?**

1463 **A.** That is not clear. The most logical explanation and the explanation that is  
1464 consistent with PEC's strategic objectives, is that by having two NSS contracts, a  
1465 much greater volume of gas in Manlove field could be transmitted to EMW.

1466

1467 **Q. What relationship was there between the storage optimization contract and**  
1468 **gas in Manlove Field?**

1469 **A.** Article IV.2 of the Storage Optimization Contract obligated EMW to cause gas to  
1470 be injected into Peoples Gas' NSS storage inventory. Article V.1 of the Storage  
1471 Optimization Contract provided that when EMW caused gas to be injected into  
1472 PGL's NSS storage inventory, the utility was obligated to transfer title to the same  
1473 amount of gas to EMW as third party storage in Manlove Field (per Article XI.1).

1474

1475 **Q: Was entering into a storage optimization agreement of this scope reasonable**  
1476 **and prudent business behavior?**

1477 **A.** There are sound business reasons why a utility would enter into an optimization  
1478 arrangement. The hedging aspect of PGL's deals can reduce gas price volatility  
1479 and create a portfolio of natural gas supplies. However, there are costs associated  
1480 with storage optimization and hedging. For example, the LDC could have its gas  
1481 costs "out of market" if the prices locked in through hedges are higher than actual  
1482 market prices. Given such risks, a prudent and reasonable LDC would contract  
1483 for no more storage than absolutely necessary and optimize any "excess"  
1484 capacity.

1485

1486 Thomas Patrick understood and acknowledged this concept during his deposition.

1487

1488 Q: ...Do you know how many contracts Peoples Gas had  
1489 with Natural Gas Pipeline -- NSS contracts that Peoples  
1490 Gas had with Natural Gas Pipeline during fiscal year  
1491 2000?

1492 A: During the fiscal year? No, I don't know.

1493 Q: How about fiscal year 2001?

1494 A: I would have guessed there was one contract in each of  
1495 those years, but I really don't know.

1496 Q: One -- why would you guess that it would be one  
1497 contract?

1498 A: Just because it was a single service. I mean, an NSS  
1499 service. Usually we had -- for each of the services we  
1500 purchased, we had a service agreement with the pipeline.

1501 Q: When you say it was a single contract, would it be a  
1502 contract for the 75 days of service?

1503 A: Yes. That would be my assumption.

1504 Q: And 75 days of service was sufficient to meet Peoples  
1505 Gas' needs?

1506 A: No. No. 15 days or so is what we wanted for Peoples  
1507 Gas' needs. The remaining 60 days or whatever the  
1508 number was, was the piece that was generally placed in  
1509 the hands of a marketer to manage. (Ex. 1.25, Patrick Tr.  
1510 at 96-99).

1511

1512 **Q. Were the ratepayers adversely impacted by PGL's excessive NSS contracts?**

1513 **A.** Yes. As defined by Mr. Patrick, a given NSS contract had 75 days of capacity.  
1514 With NSS 1 and NSS 2 in place concurrently, PGL effectively had 150 days of  
1515 capacity while needing at most only 15 days. The costs related to this excess  
1516 storage capacity were passed onto the ratepayers as a component of the gas  
1517 charge. Those excess costs borne ultimately by the ratepayers included the  
1518 storage management fee and the carrying costs. (See also the section on  
1519 "Improper Affiliate Transactions" for further discussion of the imprudence of the  
1520 storage management fee).

1521

1522 **Q. Were ratepayers harmed by PGL's participation in the storage optimization**  
1523 **contract with EMW?**

1524 **A.** Yes. The storage optimization contract essentially allowed EMW to gain control  
1525 of gas within Manlove field, which PGL presumably had purchased for  
1526 ratepayers, by injecting gas into PGL's NSS storage accounts. PGL ceded control  
1527 of more than [REDACTED] of gas within Manlove field to EMW. Also,  
1528 PGL could have and may have granted EMW control over even more gas within  
1529 Manlove by moving gas from the Restricted Capacity category to the Unrestricted  
1530 Capacity category.

1531

1532 **Q. Are you able to estimate the amount of harm ratepayers may have suffered**  
1533 **as a result of PGL ceding control over significant portions of its Manlove**  
1534 **storage to EMW?**

1535 **A.** Not at this time. Certain key factors would have to be known to determine the  
1536 quantitative effect of the storage optimization and NSS agreements. This includes  
1537 the pricing (on both the buys and sells), quantity transferred, and the timing of  
1538 transactions. PGL has yet to provide documentation that proves that the storage  
1539 optimization and related NSS agreements were prudent or that benefits derived by  
1540 EMW through hedging PGL's gas were appropriately passed on to the ratepayers.

1541 If PGL had produced the data that has been requested, I would have been able to  
1542 offer an assessment.

1543

1544 **Q. Did PGL engage in any other questionable transactions relating to its**  
1545 **Manlove storage field?**

1546 **A.** Yes. PGL apparently worked with its affiliate, enovate, [REDACTED]  
1547 [REDACTED] in a transaction called “38 Special.” (Ex.  
1548 1.26, Memo from K. Radous to T. Klussmann, March 22, 2000, Bates No. 01PGL  
1549 052041-052042). PGL and enovate [REDACTED]  
1550 [REDACTED].

1551

1552 According to the Radous memo, the “38 Special” transaction generated \$300,000  
1553 in income. However, only a \$50,000 [REDACTED] was returned to the ratepayers. *Id.*  
1554 enovate received the remaining \$250,000 in a separate transaction. *Id.* It is not  
1555 clear if ratepayers bore the costs of this transaction and if so, whether they should  
1556 have received all of the income generated from the transaction.

1557

1561

1561  
1562  
1563  
1564  
1565  
1566  
1567  
1568  
1569  
1570  
1571  
1572  
1573  
1574  
1575  
1576  
1577  
1578  
1579  
1580  
1581  
1582  
1583  
1584  
1585  
1586  
1587  
1588  
1589  
1590

**MIDSTREAM SERVICES STRATEGIC PLAN**

**Q. Are the actions and activities you have discussed connected?**

**A.** It appears from the available evidence that they are more likely than not connected. The activities I found problematic from a ratepayer's perspective are consistent with a strategy described by Enron and enabled by the services of contracts and arrangements between Enron affiliates and affiliates of PGL owned by PEC.

**Q. What is PEC?**

**A.** PEC is a publicly traded enterprise listed on the New York Stock Exchange. The business composition of PEC is described in its Annual Report on Form 10-K (fiscal year ended September 30, 2001) as the following:

Peoples Energy Corporation (Company) is solely a holding Company and does not engage directly in any business of its own. Income is derived principally from the Company's utility subsidiaries, The Peoples Gas Light and Coke Company (Peoples Gas) and North Shore Gas Company (North Shore Gas). The Company also derives income from its other subsidiaries, Peoples District Energy Corporation (Peoples District Energy), Peoples NGV Corp. (Peoples NGV), Peoples Energy Resources Corp. (Peoples Energy Resources), Peoples Energy Services Corporation (Peoples Energy Services), Peoples Energy Ventures, LLC (Peoples Energy Ventures) and Peoples Energy Production Company (Peoples Energy Production). ... (Peoples Energy Corp. SEC Form 10-K, available at: <http://www.sec.gov/Archives/edgar/data/77385/000007738501500084/file10k.htm>, pg. 5-6)

1591 **Q. During the FY 2001 period of that report, which also was the Reconciliation**  
 1592 **Period being examined in this case, what was the relative importance of PGL**  
 1593 **and the other affiliates to PEC’s income?**

1594 **A.** As the report notes, PEC’s income came primarily from the gas distribution  
 1595 companies, which the FY 2001 Form 10-K describes as PEC’s “core business.”  
 1596 An analysis of PEC’s revenues bears this out. PEC’s revenues for 1996 through  
 1597 2003 are shown below in Table I. PGL brought revenues that accounted for  
 1598 60.40% to 86.48% of PEC’s totals over that time period.

1599

1600

1601

**Table I - PEC Revenues: 1996 – 2003**

1602

(in \$000s)

	1996	1997	1998	1999	2000	2001	2002	2003
<b>Net Operating Revenue- Peoples Gas</b>	1,036,575	1,099,484	907,520	851,515	956,609	1,569,896	913,523	1,291,669
<b>Net Operating Revenue- North Shore Gas</b>	163,809	168,875	144,206	135,720	157,446	274,516	156,734	232,005
<b>All Other Operating Revenue</b>	(1,727)	5,330	81,002	207,146	303,478	425,806	412,277	614,720
<b>Net Operating Revenue - Peoples Energy Corp. (Total)</b>	1,198,657	1,273,689	1,132,728	1,194,381	1,417,533	2,270,218	1,482,534	2,138,394

1603

1604

1605 However, despite the dominant portion of revenues from PGL operations, the  
 1606 operating margin (profit) contributed by PGL to PEC was only 7.26% on average.  
 1607 This apparent anomaly is attributable to the fact that the sale of gas does not  
 1608 generate profits for PGL. The gas procurement costs incurred by PGL (the  
 1609 utility’s largest cost) are passed to its customers via the PGA and are recovered on  
 1610 a dollar-for-dollar basis. PGL and North Shore Gas (NSG), PEC’s operating  
 1611 utilities, derive profits through the return on their investments for the distribution

1612 of gas. By setting the utility's distribution rates, the Commission effectively  
1613 limits the amount of profits that PGL (and NSG) can make through charges to  
1614 customers of their state authorized monopoly services.

1615

1616 **Q. Earlier you referred to "midstream services." What are midstream services?**

1617 **A.** It appears that PGL may have had a specific understanding of that term, at least as  
1618 it related to the PEC strategic plan. However, for purposes of explaining the  
1619 scope of activities we are discussing, midstream is a term sometimes used to refer  
1620 to those industry activities that fall between exploration and production  
1621 (upstream) and refining and marketing (down stream.) The term is most often  
1622 applied to pipeline transportation of crude oil and natural gas. (Source:  
1623 [www.spe.org](http://www.spe.org) - Glossary of Industry Terms).

1624

1625 **Q. Did PEC or its affiliates provide midstream services during the reconciliation**  
1626 **period?**

1627 **A.** Yes. According to PEC's FY 2001 10-K:

1628

1629 The Midstream Services segment is engaged in wholesale activities that  
1630 provide value to gas distribution marketers, utilities, and pipelines. The  
1631 Company, through Peoples Gas, operates a natural gas hub. It also owns  
1632 and operates, through Peoples Energy Resources, a natural gas liquids  
1633 peaking facility and is active in other asset-based wholesale activities.  
1634 The Company and Enron North America Corp. (Enron) are equal partners  
1635 in enovate, L.L.C. (enovate), which engages in a comprehensive wholesale  
1636 business for the Chicago marketplace, including new product  
1637 development, marketing and trading. (Peoples Energy Corp. SEC Form  
1638 10-K, available at:  
1639 [http://www.sec.gov/Archives/edgar/data/77385/000007738501500084/file](http://www.sec.gov/Archives/edgar/data/77385/000007738501500084/file10k.htm)  
1640 [10k.htm](http://www.sec.gov/Archives/edgar/data/77385/000007738501500084/file10k.htm), pg. 5-6)

1641

1642 **Q. Are there other segments of the natural gas industry in which PGL or its**  
1643 **affiliates are involved?**

1644 **A.** The greater energy marketplace encompasses, in addition to local gas distribution  
1645 companies like PGL, natural gas producers, natural gas marketers, natural gas  
1646 traders, and pipeline transportation firms. PGL or PGL affiliates are engaged in

1647 activities in each of these areas. These gas industry segment participants are not  
1648 regulated in their activities in those areas, providing an opportunity to earn  
1649 unregulated (and potentially greater) profits. The midstream services and natural  
1650 gas trading components, in particular, provide gas companies like PEC and its  
1651 affiliates opportunities to increase revenues and shareholder value significantly.

1652  
1653 The opportunities presented are illustrated by looking at data for the key players  
1654 in the midstream services industry during the late 1990s and early 2000s. The  
1655 largest and most active midstream market participants included Enron, Duke,  
1656 Aquila and Dynegy. For example, in 1997, Dynegy reported a market  
1657 capitalization (the number of shares a company has outstanding multiplied by the  
1658 stock price) of \$4,516,959,356, which decreased (21.01%) to \$3,567,767,753 in  
1659 1998, then increased 75.32% to \$6,254,933,306 in 1999. In 2000, Dynegy's  
1660 market capitalization went up 173.16% to \$17,085,805,800 and later decreased  
1661 (38.49%) to \$10,508,638,552. (These data are shown in Table J below.)

1662  
1663 Although market capitalization was at times volatile, so were the opportunities for  
1664 dramatic growth in shareholder value. These characteristics of that market were  
1665 recognized by various players in the industry, and shareholder value and market  
1666 capitalization increased significantly for the largest companies in what was  
1667 perceived as a growth market.

1668

1669 **Q. How was PEC performing in comparison to those other firms in the gas**  
1670 **industry at that time?**

1671 A. Table J compares the growth in market capitalization of PEC to other energy-  
1672 related enterprises during the years 1997-2001.

1673

1674

1675  
 1676

**Table J – Growth in Market Capitalization from Year to Year: 1997 – 2001**

	1998	1999	2000	2001
Enron	52.21%	124.30%	3.61%	N/A
Duke Energy	3.32%	-13.98%	70.02%	-9.15%
Aquila	74.13%	-28.76%	112.86%	0.73%
Dynegy	-21.01%	75.32%	173.16%	-38.49%
Peoples Energy Corp.	3.82%	-2.33%	11.36%	-6.35%

1677  
 1678  
 1679  
 1680  
 1681  
 1682  
 1683  
 1684  
 1685

\* NA denotes “Not Applicable” due to Enron’s Bankruptcy.

Although the price spikes of 2000-2001 appear to have affected the industry generally, ahead of the 2001 Reconciliation Period, competitors of PEC in the midstream arena saw their stock prices rise and their respective market capitalizations increase dramatically in the late 1990s. The data indicate that PEC may have been perceived as falling behind.

1686

**Q. How did PEC react to these market indicators?**

1687  
 1688  
 1689  
 1690  
 1691  
 1692  
 1693  
 1694

**A.** It was in this context that PEC and its affiliates developed their strategic plan to increase midstream services activity, revenues, and earnings contributions. PEC’s need to remain competitive in this diversified marketplace (and among investors) provided an economic spur for PEC and its affiliates to venture more aggressively into non-regulated products and services. Doing so provided an opportunity for revenue or earnings growth at a faster rate than could be expected from the operations of PEC’s regulated utilities. Faster growth in these areas would eventually have a positive effect on the company’s stock price.

1695  
 1696  
 1697  
 1698  
 1699  
 1700  
 1701  
 1702

Although the revenues generated by regulated utility operations are secure, the margins and the opportunities for growth are constrained. Midstream services present higher risks, but have greater potential for revenue and earnings growth. If PEC was to be perceived as a comparably attractive investment as other firms heavily engaged in unregulated industry activities (on performance measures like those noted in Tables J and K), PEC needed to maintain its regulated utilities business, while also having the opportunity for growth and higher margins

1703 unconstrained by regulation. The Midstream Services strategy described in  
1704 PEC's public reports indicates that a new emphasis on midstream services was the  
1705 centerpiece of PEC's response.  
1706

1707 **Q. Peoples Gas has engaged in midstream activities for many years. Why was**  
1708 **its Midstream Service plan problematic for the PGA?**

1709 **A.** I am not suggesting that a plan to increase revenues and profits from midstream  
1710 service activities (or even an achieved increase) would necessarily create  
1711 problems for the PGA. As always, the details matter, and it was the manner in  
1712 which PEC implemented that strategy that presented PGA problems. In  
1713 particular, PGL's involvement with Enron, both direct and indirect, resulted in the  
1714 questionable uses of Peoples Gas' PGA assets I discuss in this testimony. The  
1715 desire to increase revenues led to PEC's decision to form a strategic partnership  
1716 with Enron, since there is a common expectation that market capitalization  
1717 correlates with revenues.  
1718

1719 **Q. How did PEC first become involved with Enron?**

1720 **A.** It appears that PGL's expansive involvement with Enron (the GPAA and other  
1721 arrangements discussed earlier) was a result of the failure of PGL's initial plan to  
1722 increase revenues from the utility's PGA assets and operations.  
1723

1724 In 1998, PGL (and NSG) filed with the ICC a proposal to eliminate their  
1725 respective PGAs and to establish a fixed gas charge. Enron was selected as part  
1726 of a Request for Qualification (RFQ) process to provide gas supply services as  
1727 part of PGL's fixed rate proposal.

1728 Then PEC President (and now PEC CEO) Thomas Patrick described the  
1729 services that Enron would provide as part of the fixed rate proposal:  
1730

1731 Obviously, what they (Enron) were going to do for us would involve an  
1732 awful lot of financial and physical hedge-type arrangements so that they  
1733 had to, basically, get a good understanding of what the needs would be

1734 across a five-year period, including changes of demand that were likely to  
1735 occur during that period. (Ex. 1.25, Patrick Tr. at 63).

1736

1737 When asked about possible optimization of PGL storage contracts by Enron, he  
1738 responded:

1739

1740 The concept of a fixed gas charge, of course, is that you fix the charge and  
1741 then you can work with whatever charge there is in terms of, you know,  
1742 future optimization, yes and, hopefully, achieving a better rate. (Ex. 1.25,  
1743 Patrick Tr. at 64).

1744

1745 Mr. Patrick's deposition testimony makes clear that PEC was hoping to expand  
1746 revenues and earnings from PGL's PGA assets and operations through its fixed  
1747 rate proposal.

1748

1749 **Q. What came of PGL's (and NSG's) fixed rate proposals?**

1750 **A.** The Commission issued orders that accepted the fixed rate concept but would  
1751 have established fixed gas rates lower than the utilities had requested. Peoples  
1752 Gas and North Shore chose to reject the Commission's amendments and to  
1753 continue to collect their gas costs through the PGA.

1754

1755 **Q. After PGL and NSG rejected the Commission's fixed gas charge orders,  
1756 what happened next?**

1757 **A.** According to Mr. Patrick, after having developed a working relationship with  
1758 Enron in developing the fixed charge proposal, PEC continued discussions with  
1759 Enron hoping to build a "broader alliance" with the company. (Ex. 1.25, Patrick  
1760 Tr. at 66, *see also*, 27, 49-50).

1761

1762 **Q. What were the objectives of the alliance that PEC eventually formed with  
1763 Enron?**

1764 **A.** Of course, the ultimate objectives were increased revenues and profits for the  
1765 corporation. As with its utilities' fixed gas charge proposals, PEC viewed the

1766 “broader alliance” as an opportunity to increase its revenues, using existing utility  
1767 rate base and PGA assets to accomplish its financial goals.

1768 **Q. What were the principal instruments for furthering the PEC-Enron strategic**  
1769 **alliance?**

1770 **A.** The major vehicles of the alliance were: (a) the GPAA; (b) the formation of the  
1771 enovate joint venture; (c) “optimization” of storage assets, including Manlove  
1772 Field and leased storage; and (d) access to PGL’s gas commodity supplies. In  
1773 each case, the particulars of the arrangements and activities, rather than just the  
1774 entities involved, are the cause of problematic effects on the PGA.

1775  
1776 The GPAA had a direct effect on costs PGL recovered through PGA charges. It  
1777 also seems to have a role in PEC’s “broader alliance” with Enron.

1778  
1779 enovate was another vehicle for complex arrangements among PEC and Enron  
1780 affiliates. The effects of those arrangements on the PGA were indirect and more  
1781 removed organizationally from PGL, but the effects on PGL ratepayers were  
1782 significant.

1783  
1784 The operational use of PGL’s storage and gas assets by affiliates, when not  
1785 properly accounted for, had the effect of increased charges to ratepayers.  
1786 Sometimes the effect stemmed from increased costs; in other cases, the effect  
1787 resulted from the diversion of revenues or economic opportunities related to PGA  
1788 assets.

1789  
1790 **Q. What was enovate?**

1791 **A.** enovate came into existence on April 26, 2000. PEC’s 2000 10-K described the  
1792 entity as follows: “The Company and Enron North America Corp. (Enron) are  
1793 equal partners in enovate, L.L.C. (enovate), which will expand the Peoples Gas  
1794 hub by offering additional hub services and peaking services, developing new  
1795 products and pursuing strategic asset acquisitions.”

1796

1797

1798

1799

1800

1801

1802

1803

1804

1805

1806

1807

1808

1809

1810

1811

1812

1813

1814

1815

1816

1817

1818

1819

1820

1821

1822

1823

1824

1825

enovate was viewed as a “Means to an end” to increase growth potential. (Ex. 1.27, Business Plan Document – EXPECTATIONS FOR JV, Bates 01PGL 059310). Other corporate presentations regarding the former PGL affiliate (which ceased operations in 2001) identified the objectives of the organization as follows:

- Meet budget (\$25MM)
- Create and deliver innovative products that shape the new Chicago market
- Be around 5 years from now
- Exceed JV goals

(Ex. 1.28, Business Plan Document - EXPECTATIONS, Bates 01PGL 059303)

Increased earnings from unregulated business segments were an integral part of PEC’s financial projections. In a PEC presentation to the Board of Directors (on February 2, 2000), PEC projected that those areas would generate an escalating share of earnings: 8%, 17%, 21% and 24% of earnings for 1999, 2000, 2001 and 2002, respectively.

As part of its Strategy Implementation, PEC set the following objective: “Grow diversified businesses: 25% earnings contribution from diversified by 2002.” (Ex. 1.29, Meeting of Board of Directors presentation, Bates 01PGL 084594 – 084595). Historically, in contrast, PEC’s returns had been below 10%, due primarily to its reliance on returns from gas distribution, where profits were constrained. The opportunity to generate higher returns from unregulated activities would have resulted in an increase in the Company’s overall returns. The Company’s financial ratios are illustrated in Table K.

1826

1827

**Table K – Liquidity/Leverage Ratios: 1996 – 2003**

1828

	1996	1997	1998	1999	2000	2001	2002	2003
<b>Current Ratio</b>	<b>106.11%</b>	<b>133.68%</b>	<b>122.99%</b>	<b>90.72%</b>	<b>54.68%</b>	<b>70.23%</b>	<b>50.91%</b>	<b>81.61%</b>
<b>Working Capital</b>	<b>16,288</b>	<b>82,823</b>	<b>58,724</b>	<b>(37,396)</b>	<b>(384,560)</b>	<b>(313,560)</b>	<b>(377,919)</b>	<b>(110,430)</b>
<b>Leverage</b>	<b>77.37%</b>	<b>73.55%</b>	<b>69.68%</b>	<b>67.87%</b>	<b>54.00%</b>	<b>79.99%</b>	<b>68.71%</b>	<b>87.78%</b>
<b>Return on Assets</b>	<b>5.80%</b>	<b>5.40%</b>	<b>4.17%</b>	<b>4.41%</b>	<b>3.45%</b>	<b>3.24%</b>	<b>3.27%</b>	<b>4.78%</b>

1829

1830

1831 **Q. How could the affiliates’ new unregulated initiatives, which were not yet**  
 1832 **established in midstream markets, generate such returns so quickly?**

1833 **A.** The main strength of the PEC affiliates lay in the regulated service assets of their  
 1834 operating utilities, i.e., storage capacity and gas supply. It was through the use of  
 1835 rate base and PGA assets and operations that the affiliated enterprises were able to  
 1836 generate significant income so rapidly.

1837

1838 As I understand the provision of the ICC’s PGA regulations, this practice is  
 1839 allowed, under specified conditions. One of those conditions is that if revenues  
 1840 are generated by activities for which costs are recovered through the PGA, the  
 1841 resulting revenues must also be included in the calculation of PGA charges.  
 1842 However, with respect to the activities I discuss in my testimony, the revenues  
 1843 generated as a result of these growth strategies were not passed on to ratepayers.

1844

1845

1846 **Q. Please explain why you believe enovate earned its revenues through the**  
 1847 **uncompensated use of PGL assets without compensating ratepayers.**

1848 **A.** One need only look at enovate’s financial results to understand that something  
 1849 very unusual was at play. enovate’s first fiscal year spanned only about five  
 1850 months, April 26, 2000 through September 30, 2000. As of the end of that first  
 1851 year of enovate’s existence and operation (September 30, 2000), enovate reported

1852 total revenues of \$4,319,083. (Ex. 1.30, enovate Income Statement, Bates 01PGL  
1853 043494 – 043495, 043499 - 043500). However, no capital contributions were  
1854 made into enovate until October of 2000. As of September 30, 2000, additional  
1855 paid-in-capital (PIC) was \$0; as of October 31, 2000, additional PIC was  
1856 \$200,000. (Ex. 1.30, enovate Income Statement, Bates 01PGL 043494 – 043495,  
1857 043499 - 043500). Further, there is no indication that PEC or Enron loaned the  
1858 funds to establish enovate, nor is such a funding scheme reflected in enovate's or  
1859 PEC's financial reports. In fact, there is little to suggest that enovate was  
1860 adequately funded and able to function as a stable business enterprise.

1861  
1862 According to the documents made available during discovery, each partner (PEC  
1863 and Enron) made a \$100,000 capital contribution to enovate as an initial  
1864 investment. The return in ordinary income on this modest investment for  
1865 enovate's trade or business activities was **over \$10,000,000** for each joint venture  
1866 partner for the year ended September 30, 2001, **a return exceeding 10,000%**.  
1867 (Ex. 1.31, Schedule K-1, Bates 01PGL 091777). Such astronomical earnings are  
1868 not commonplace in the industry. How enovate was able to generate over  
1869 \$20,000,000 in income for the year ended September 30, 2001 is unclear.

1870  
1871 Also, when comparing enovate's balance sheet and income statement for the year  
1872 ended September 30, 2000 and for the month ended October 31, 2000, enovate's  
1873 **Accounts Receivable – Trade – Third Party** (Sep 2000) was equal to its  
1874 **Natural Gas Revenues – Sales for Resale** (Oct 2000) and its **Accounts Payable**  
1875 **– Trade – Third Party** (Sep 2000) was equal to **Costs of Gas – Third Party**  
1876 (Oct 2000). These income statements indicate that enovate was able to achieve  
1877 100% collection on all outstanding accounts, without incurring any selling,  
1878 general or administrative expenses, and without having any cash on its books.  
1879 (Ex. 1.30, enovate Income Statement, Bates 01PGL 043494 – 043495, 043499 -  
1880 043500).

1881

1882 **Q. Do you have any recommendations for how the more than \$20 million**  
1883 **enovate “earned” in FY 2001 should be treated in this case?**

1884 **A.** Yes. The most likely explanation for enovate’s remarkable ability to generate  
1885 such substantial amounts of income with such meager investments is that enovate  
1886 used ratepayer assets to make its money. In the absence of proof that the enovate  
1887 revenues were not associated with PGA assets or costs, I recommend that  
1888 enovate’s \$20,652,322 in earnings in FY 2001 be refunded to ratepayers.  
1889

1889 **IMPROPER AFFILIATE TRANSACTIONS**

1890

1891 **Q. Did PGL have an obligation to disclose and seek approval from the ICC for**  
1892 **gas procurement transactions with affiliates?**

1893 **A.** I am advised by counsel that there is such an obligation for Illinois public utilities,  
1894 stemming from the provisions of Article VII of the Public Utilities Act. The  
1895 relevant language provides that “No management, . . . supply, financial or similar  
1896 contract and no contract or arrangement for the purchase, sale, lease or exchange  
1897 of any property or for furnishing of any service, property or thing, hereafter made  
1898 with **any affiliated interest** . . . shall be effective unless it has first been filed with  
1899 and consented to by the Commission” or is exempt from the provision. 220 ILCS  
1900 5/7-101(3). This broad provision refers to an equally broad definition of an  
1901 “affiliated interest,” which, I am further advised does include wholly owned  
1902 subsidiaries of Peoples Energy Corporation and its affiliates.

1903

1904 PGL would have to disclose and seek approval from the ICC for transactions or  
1905 dealings with PGL’s parent PEC, with PEC’s wholly owned subsidiary PERC or  
1906 with enovate or enovate’s predecessors Chicago Energy Exchange or Midwest  
1907 Energy Hub (MEH), since more than 10% of each was held by a common owner.

1908

1909 **Q. Did the transactions among PEC and Enron affiliates involving PGL’s assets**  
1910 **adhere strictly to these requirements?**

1911 **A.** Ultimately, that will be a legal determination. However, with respect to the  
1912 substance of transactions among affiliated enterprises involving PGL assets and  
1913 activities, there were some unusual arrangements. Although PGL and its affiliates  
1914 were certainly aware of this prohibition, I found documents relating to  
1915 transactions that had (if not the purpose) the effect of evading this regulatory  
1916 requirement with respect to some PGA assets.

1917

1918 In Deposition Exhibit 30, a review of critical issues pertinent to the launch of an  
1919 enovate predecessor listed this regulatory requirement. (Ex. 1.32, Memo from W.  
1920 Morrow, et al. to K. Donofrio, et al., Re: Midstream Services Critical Issues,  
1921 February 7, 2000, PE-AC 010563-010564 at 010564).

1922

1923 An electronic message to William Morrow, who was at the center of  
1924 PGL's and PERC's midstream efforts, noted previous discussions that  
1925 considered ways to avoid the regulatory filing requirement.

1926

1927 We discussed using ENA-MW as a vehicle around affiliate filing  
1928 in the interim. It was our conclusion that ENA-MW might be set  
1929 up as Hub customer and market Hub services until ICC approves  
1930 structure with LLC as administrator and customer of Hub. This  
1931 structure would mean utility and ENA-MW would offer Hub  
1932 services in the interim. (Ex. 1.33, E-mail from unknown to W.  
1933 Morrow, et al Re: Contract Structure b/w Hub and LLC, date  
1934 unknown, Bates No. 01PGL 094970).

1935

1936 So, there is little doubt that all involved parties were aware of the regulatory  
1937 requirements. However, I am not aware of any Commission order approving the  
1938 intersecting midstream services activities of PGL, enovate, and EMW during the  
1939 reconciliation period.

1940

1941 An Enron memo describing enovate's predecessor, MEH, stated that EMW's  
1942 transactions, occurring with affiliates of either Peoples or Enron, were "subject to  
1943 the 50/50 split as if they had occurred inside Midwest Energy Hub." (Ex. 1.34,  
1944 Memo from W. Colwell to G. Hodges, re: Midwest Energy Hub (MEH), July 11,  
1945 2000, 01PGL 033573-033574 (hereafter "MEH memo")). It further appears that  
1946 relying on EMW as a conduit was not simply an interim solution. EMW was  
1947 utilized throughout the life of enovate, including with respect to contracts  
1948 involving PGL's GPAA and storage optimization contracts.

1949

1950 **Q. Was this revenue sharing an anomalous aspect of the operations of EMW**  
1951 **and enovate as distinct business enterprises?**

1952 A. The distinction between EMW and enovate may have been little more than on  
1953 paper. PERC and EMW, the parties in the enovate joint venture, provided  
1954 personnel to conduct the activities of enovate, but the joint venture never had  
1955 employees of its own. Indeed, there was little in the way of assets, employees, or  
1956 office facilities that would distinguish enovate as a real going concern. Mark  
1957 Mixon, a project manager and senior gas trader with Peoples Energy Wholesale  
1958 Marketing (previously known as PERC according to Mr. Mixon), was uncertain  
1959 as to what entity employed him or what entity he traded on behalf of when he  
1960 performed functions for enovate during the reconciliation period.

1961  
1962 Q: At that time -- well, let me back up. The first line under professional  
1963 experience in your -- in Exhibit 99 is Peoples Energy Resources slash  
1964 enovate, LLC, and the time period is September 2000 through the present.  
1965 Do you see that?

1966 A: I do.

1967 Q: So is it fair to say that you were co-managing the 18 bcf of storage for  
1968 Peoples Energy Resources slash enovate?

1969 A.: No.

1970 Q: Why?

1971 A: By just an explanation here, it was Peoples Energy Resources was one  
1972 company that I worked for. Enovate was another -- I suppose it wasn't --  
1973 **I'm not sure if I worked really by enovate but got paid by Enron**  
1974 **during that time period of 2000 to the present.**

1975 (Ex. 1.35, Mixon Tr. at 29 (*emphasis added.*)).

1976  
1977 It is, at best, difficult to understand how Mr. Mixon, an experienced trader, could  
1978 trade on behalf of entities whose nature and business he did not understand.

1979  
1980 Kay Classen Cittadine was a trading manager with PERC through November  
1981 2004. Ms. Cittadine similarly maintained that she lacked knowledge about the  
1982 nature of the entities using the PGL assets and failed to draw a distinction in  
1983 business structure, personnel or purpose between EMW and enovate in her  
1984 deposition. (Ex. 1.36, Cittadine Tr. at 36-37).

1985

1986 **Q. Were ratepayers affected by the unusual arrangements among affiliates of**  
1987 **PGL with respect to the use of certain PGL assets?**

1988 **A.** Yes, it appears that they were. At least one purpose of the unusual arrangements  
1989 was to provide an avenue by which revenues and profits could be shared by ENA  
1990 and PEC. Another purpose, indicated by the surprisingly candid description of  
1991 the accounting for a deal involving PGL and enovate in an electronic message,  
1992 was to avoid having to pass all of the benefits of transactions through the PGA to  
1993 the ratepayers of the regulated utility PGL. (Ex. 1.26, Memo from K. Radous to  
1994 T. Klusmann, 01PGL 052041-052042). Partial ENA accounting records  
1995 provided in discovery show examples of revenues that were earned by EMW for  
1996 services purportedly provided to PGL, but that were in turn shared with PEC.  
1997 Consider the transactions in the table below:

1998

<b>Schedule of Annuities</b>					
				<b>CHARGES TO PGL</b>	<b>CREDITS TO PEC</b>
<b>1</b>	Receivable from PGLC for 3 month of Management Fee	July -00		█	
	Payable to PEC for 3 months of Management Fee	July-00			█
<b>2</b>	PEC's Share of Management Fee	July-00			█
	MEH's Share of Management Fee	July-00		█	
<b>3</b>	MEH's Share of Management Fee	Aug-00		█	
	PEC's Share of Management Fee	Aug-00			█
<b>4</b>	PEC's Share of Management Fee	Sept -00			█
	MEH's Share of Management Fee	Sept -00		█	
<b>Schedule of Annuities</b>					
				<b>CHARGES TO PGL</b>	<b>CREDITS TO PEC</b>
<b>5</b>	MEH value to PGLC (PEC only Rolling Thunder, Tidal Wave, back out half of \$344K for PGL HUB)	Sept-00			█
<b>6</b>	EMW earnings to PEC	Dec-00			█

1999  
 2000  
 2001  
 2002  
 2003  
 2004  
 2005

(Ex. 1.37, Schedule of Annuities, Bates No. 01 PGL 044110).

The Storage Optimization Contract for PGL storage assets that resulted in the above payments and distributions provides for a monthly fee to be paid by PGL for certain management services:

2006 Article V: Price and Value Sharing, sub-point (3) of the Storage Optimization  
2007 Contract stated that:

2008  
2009 Each month, Peoples Gas shall owe EMW a fee of [REDACTED]  
2010 [REDACTED] (“Management Fee”) of which  
2011 one-half is for the management of NSS Contract 1 and the  
2012 remaining one-half is for the management of NSS Contract 2.  
2013 The parties agree that such Management Fee shall compensate  
2014 EMW fully for its fixed costs associated with marketing, trading,  
2015 risk management, pipeline scheduling, strategic planning and  
2016 optimization services (“Management Services”).  
2017 (Ex. 1.24, Storage Optimization Contract, September 29, 2000,  
2018 PGL Response to CUB DR 5.019).

2019  
2020 (Note that although the Storage Optimization Contract was formalized in  
2021 September of 2000, the contract year commenced April 1, 2000 and  
2022 hence the reason that management fees dated prior to September 2000  
2023 appear in the table above). (Ex. 1.24, Storage Optimization Contract  
2024 between EMW and Peoples Gas, February 21, 2001, PGL Response to  
2025 CUB DR 5.019).

2026  
2027 Transactions 1 through 4 in the table above illustrate the regularity of the  
2028 distribution to PGL’s parent of funds from PGL through EMW. PGL paid  
2029 EMW [REDACTED] a month for management fees as prescribed in the Storage  
2030 Optimization Contract. In turn, EMW contemporaneously paid [REDACTED], or [REDACTED]  
2031 of the monthly management fee, to PEC.

2032  
2033 I am not aware that PGL requested or received approval from the ICC to engage  
2034 in a transaction under which its parent PEC would be entitled to earn  
2035 management fees from PGL through a cooperative arrangement with EMW.  
2036 EMW’s role had the effect of hiding PEC’s dealings with PGL and allowing  
2037 PEC to recognize management fees indirectly. The documents suggest several  
2038 possible explanations, none of them harmless to ratepayers. The possibilities  
2039 are: (a) that PEC actually provided services to PGL -- without ICC approval; (b)

2040 that PGL imprudently paid PEC for services it did not actually provide; or (c)  
2041 that PGL grossly overpaid EMW, since it was willing to perform whatever  
2042 service it did perform for half the fee PGL paid.

2043

2044 An operational analysis of the deal leads to a similar conclusion of imprudence.  
2045 Given the proportion of the revenue sharing between PEC and EMW, the very  
2046 nature of the management fee is called into question. The Storage Optimization  
2047 Contract stated that the fees represented EMW's "fixed costs associated with  
2048 marketing, trading, risk management, pipeline scheduling, strategic planning  
2049 and optimization services" for two NSS agreements. However, EMW had the  
2050 latitude to share a full [REDACTED] of those monthly fees with PEC. This would suggest  
2051 that: 1) PEC was actively participating in the optimization services for PGL; 2)  
2052 the costs required by EMW to provide optimization services were considerably  
2053 less than expected when the contract was signed; or 3) the services that were  
2054 provided by EMW were less substantial than suggested in the terms of the  
2055 contract. Any of these scenarios suggest imprudence on the part of PGL,  
2056 creating unnecessary or unapproved costs that were ultimately borne by the  
2057 ratepayers.

2058

2059 The nature of Transaction 5 included in the table above is not entirely clear.  
2060 The description, though, states "MEH value to PGLC." PGL would have been  
2061 expected to meet the same regulatory requirements with respect to MEH, the  
2062 predecessor entity to enovate, as it would with any other utility affiliate. This  
2063 transaction description suggests that MEH and PGL had direct dealings with  
2064 each other. Again, I am not aware of an ICC order approving this activity  
2065 between MEH and PGL. Moreover, whatever "value" (as stated in the  
2066 transaction description) PGL was entitled to as a result of this transaction was  
2067 passed on to PEC (refer to the description in the table, "PEC only ...") and not  
2068 through the PGA calculations.

2069

2070 Transaction 6 generates more questions about EMW's true nature. PEC  
2071 received a credit during December of 2000 in excess of [REDACTED]. (Note that  
2072 the print quality of Bates No. 01PGL 044110 is such that [REDACTED] is legible  
2073 but the remaining digits in the number are not clear.) The description for the  
2074 transaction was "EMW Earnings to PEC." EMW was reportedly a wholly  
2075 owned subsidiary of Enron. PEC was supposed to be a non-owner of EMW and  
2076 so expectations would be that PEC would not have been eligible for any portion  
2077 of EMW's earnings. PEC was, however, an owner of enovate through PERC.  
2078 PEC was eligible for distributions from enovate. As noted above in the  
2079 discussion of the MEH Memo and the depositions of Mr. Mixon and Ms.  
2080 Classen, clear distinctions between EMW and enovate essentially did not exist.  
2081 The EMW entity, as ultimately utilized when enovate did not become fully and  
2082 independently operational, may simply have provided a convenient opportunity  
2083 to bypass ICC regulations.

2084

2085 **Q. Have you seen other evidence of improper affiliate transactions?**

2086 **A.** Yes. In a schedule dated September 30, 2000 (and executed on October 19 and  
2087 20, 2000) to a Master Consulting Agreement between PERC and EMW, PERC  
2088 agreed to provide certain consulting services to EMW. The agreement provided  
2089 that EMW would pay PERC the seemingly odd sum of [REDACTED] for the services.  
2090 (Ex. 1.40, Schedule, Sept. 30, 2000, Master Consulting Services Agreement,  
2091 Bates 01PGL 094861- 094862). PERC invoiced EMW for that amount on  
2092 September 30, 2000 – the same day that the schedule was dated. (Ex. 1.41,  
2093 Consulting Services Invoice, Bates 01PGL 094630). In another document,  
2094 entitled "Chicago Office Expected 3<sup>rd</sup> Quarter P&L 9/30/00", there is a summary  
2095 of what appears to be numerous gas transactions with titles like "38 Special",  
2096 "Hub Bailout", and "NSS Tidal Wave". (Ex. 1.42, Chicago office Expected 3<sup>rd</sup>  
2097 Quarter P&L 9/30/00, Sept. 30, 2000, Bates 01PGL 094632). The document  
2098 summarizes enovate's profits under the various transactions. The document also  
2099 describes how the enovate profits are to be allocated to EMW and PEC.

2100

2101 The document is a focus of interest for at least two reasons. First, under the  
2102 column entitled “Total enovate Profit,” the document states that the net payable  
2103 amount to PEC and EMW is ██████ – the precise amount that EMW agreed to  
2104 pay PERC under the September 30, 2000 Schedule to the PERC-EMW Master  
2105 Consulting Agreement. This is an unlikely coincidence.

2106

2107 **Q. Can you explain this unlikely coincidence?**

2108 **A.** The reasons remain unclear. However, it appears that the consulting agreement  
2109 served as a vehicle for transferring PEC’s share of enovate’s profits under the  
2110 enumerated deals from EMW to PEC.

2111

2112 **Q. What are the other areas of interest about the enovate profits document?**

2113 **A.** There is a column at the far right that is entitled “Total PGA Credit.” The  
2114 numbers in the column appear as a debit against enovate’s profits – that is, the  
2115 PGA credit amounts were subtracted from the enovate profit amounts.

2116

2117 **Q. What is the significance of this column?**

2118 **A.** The column clearly implies that Peoples Gas was somehow involved in these  
2119 transactions – why else would there be a PGA credit? These were apparently  
2120 transactions with an affiliated company (enovate) for which there is no evidence  
2121 that the utility had received Commission approval.

2122

2123 **Q. How was the “Total PGA Credit” calculated?**

2124 **A.** The reasons remain unclear. PERC employee Timothy Hermann was asked about  
2125 this document during his deposition and could not explain the meaning of this  
2126 column. (Ex. 1.19, Hermann Tr. at 47).

2127

2128 **Q. Are there other documents you have reviewed that suggest improper affiliate**  
2129 **transactions?**

2130 A. Yes. For example, an attachment to a March 21, 2001 e-mail from Maria C.  
2131 Divito to Richard E. Dobson and Timothy Hermann describes the “revenue  
2132 stream for Trunkline”. (Ex. 1.43, Email from M. Divito to R. Dobson, et. al.,  
2133 March 21, 2001, re: Trunkline Revenue, Bates 01PGL 073111 - 073112). PGL  
2134 apparently entered into a transaction with enovate involving the Trunkline  
2135 pipeline. Under the deal, enovate would receive payment from Peoples Gas and  
2136 then pay Trunkline. According to the attachment to the e-mail, the net proceeds  
2137 of the transaction were distributed evenly between enovate and PERC, another  
2138 PGL affiliate. It is unclear why PGL was, in effect, paying its affiliate PERC for  
2139 a transaction with Trunkline. Under questioning, PGL employees could not  
2140 explain either the transaction or the flow of revenues. (Ex. 1.44, Kallas Tr. at 38-  
2141 42); (Ex. 1.45, Divito Tr. at 66-70). Also, I do not know whether PGL reported  
2142 this transaction to the ICC, as I have been advised by counsel it should have.  
2143

2143

2144

CONCLUSION

2145

2146 **Q. Please summarize the conclusions that you have reached with respect to these**  
2147 **topics.**

2148 **A.** While this case is complex, my conclusions and recommendations are  
2149 straightforward. I have summarized the ratepayer harms resulting from PGL's  
2150 imprudent actions below.

2151

2152 A number of experts, who have looked at PGL's activities that affected FY 2001  
2153 PGA costs and revenues, have independently concluded that quantifiable  
2154 economic harm to PGL ratepayers occurred during the reconciliation period. I  
2155 have reviewed their testimony on the topics I discuss and on related topics.

2156

2157 The amounts I have presented in my ratepayer harm analysis are not duplicative  
2158 and represent a conservative effort to make rate-paying customers whole.

2159

2160 The following amounts are the result of my calculations:

2161

2162	Harm done to rate paying customers relating to the GPAA	\$ 37,470,517
2163	Missed Profits resulting from Rate Based Assets	20,652,322
2164	Gas Lost and Unaccounted for (GLU)	<u>37,878,400</u>
2165	Total Damages due to Customers	\$96,001,239

2166

2167 With respect to CUB witness Mierzwa's testimony for the exchange transactions,  
2168 I have examined his analytical approach and accept his results, although I have  
2169 not independently verified those results. I have also concluded that his results do  
2170 not duplicate the harms quantified in my testimony. I recommend that the  
2171 Commission adopt the \$51,206,708 Mr. Mierzwa recommends be refunded  
2172 because of exchange transactions involving the Peoples Gas Hub.

2173

2174 Since source documentation was not as available as would normally be expected,  
2175 say in an audit, I was forced to rely to a greater than usual extent on estimates and  
2176 assumptions. In those cases, I have made conservative estimates and assumptions  
2177 that are, in my judgment, reasonable. Nonetheless, my findings are the result of  
2178 my understanding of the information that has been provided in the huge electronic  
2179 and massive paper production.

2180

2181 The relationships and connections among the activities discussed in the preceding  
2182 sections of my testimony would be clearer if I had been able to obtain all the  
2183 information originally sought from Peoples. For example, with access to certain  
2184 requested ledger information, I would have been able to follow transactions  
2185 among the PEC and Enron affiliates from beginning to end, verify the economic  
2186 substance of specific transactions, and discern the working relationships of the  
2187 parties. Nevertheless, even where I have not quantified a recommended refund, I  
2188 have identified the areas (relating mainly to PGL interactions with PEC or Enron  
2189 affiliates) that appear to warrant further investigation by the ICC and more  
2190 detailed responses from PGL.

2191

2192 Some of the complexity in the contractual and organizational arrangements  
2193 among PEC and Enron affiliates appears to have been by design. For example,  
2194 the **nature** of the ██████████ in revenues for enovate has not yet been clearly  
2195 defined or supported by PEC; even though ██████████ was recognized in their  
2196 corporate earnings related to those revenues. The unanswered questions and the  
2197 documentation, that does exist, in my judgment, demands that PGL explain its  
2198 decisions respecting the web of transactions involving itself, its affiliates, Enron  
2199 and its affiliates and PGA assets.

2200

2201 **Q. Does this conclude your testimony?**

2202    **A.**    Yes, however I reserve the right to update my testimony if additional information  
2203           is provided or the information that the City and CUB requested is provided.