

City-CUB Exhibit 1.0  
Redacted

Admitted

4/19/05  
a)

**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. )

**OFFICIAL FILE**

I.C.C. DOCKET NO. 01-0707  
City/CUB Exhibit No. 1.0  
Witness: Decker  
Date 4/19/05 TR

**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/ Improper Accounting/Misuse of Assets	\$20,652,322
212		
213		
214		
215	TOTAL	\$96,001,239
216		

MANAGEMENT IMPRUDENCE – THE GPAA CONTRACT

216  
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

**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.*

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

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

254

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

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

265

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

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

276

277

278

279

280

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

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

287

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

291

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

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

295

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

302

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

310

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

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

315

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

319

320

\*\*\*\*

321

322

323

324

325

326

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

327

328

329

330

331

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

332

333

334

335

336

337

A: If the quantity was able to range from 45,000 to 125,000 a day, our  
expectation was that it would not be at one extreme or the other every day  
of that period. That over the life agreement that that quantity would  
probably be somewhere – would average somewhere in the middle, and  
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

343

344

345

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

346

347

348

349

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

371

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

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

375

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

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

383

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

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

402  
403 Purchasing its gas supply from numerous suppliers based on  
404 swing and baseload contracts with terms ranging from four  
405 months to five years certainly differs from Peoples' gas-supply  
406 approach in the GPAA agreement. Staff believes Company  
407 witness Wear's testimony supports Staff's position that the  
408 GPAA is substantially different than Peoples' historic gas-  
409 supply practices. (Staff Exhibit 2.0 at 9).  
410

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

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

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

428

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

437

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

449 The document continued by identifying other essential components of the  
450 strategy, including a listing of "Contracts Required."

451

---

<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.

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

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

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

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

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

484

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

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

488

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

495

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

505

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

512

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

517

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

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

525

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

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

530

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

535

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

540

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

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

551

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

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

559

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

565

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

570

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

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

580

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

587

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

592

593

\* \* \* \*

594

595

596

597

598

599

600

601

602

603

604

605

606

607

608

609

610

611

612

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).

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

618

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

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

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

632

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

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

639

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

647

648

**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%

649

650

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

PERIOD	DATE RANGE	PEOPLES GAS	KATY HUB 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%

651

652

652

653

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

PERIOD	DATE RANGE	PG&L PRICE	HENRY HUB PRICE	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%

654

655

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

656

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

666

667

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

674

675

676

677

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

691

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

699

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

706

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

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

713

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

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

720

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

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

735

736 1.0701 X Prudent FY 2001 Cost = \$572 million  
737 Prudent FY 2001 Cost = \$534,529,483

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

739

740

*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.

741

742

743

744

745

746

747

748

749

750

751

752

753

754

755

756

757

758

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:

759

760

761

762

763

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**

764

765

766

767

768

769

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*

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

776

777

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

778

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

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

785

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

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

790

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

797

798 This definition is consistent with the definition used by Staff witness Dennis  
799 Anderson in his pre-filed Direct Testimony submitted in this case. (Staff Exhibit  
800 2.0 at 50-51).

801

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

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

811

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

821

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

827

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

833

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

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

---

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

838 Unaccounted For Gas as "GLU," except where a quoted source uses a different  
839 term.

840

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

844 [http://www.sec.gov/Archives/edgar/data/77385/000007738501500084/file10k.ht](http://www.sec.gov/Archives/edgar/data/77385/000007738501500084/file10k.htm)  
845 [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,  
846 available at:

847 [http://www.sec.gov/Archives/edgar/data/77385/000007738503000048/form10k.ht](http://www.sec.gov/Archives/edgar/data/77385/000007738503000048/form10k.htm)  
848 [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  
849 1, Business Section of the 10-K's. I used these data because SEC reports usually  
850 include only carefully verified data and are very reliable. Table A below  
851 illustrates the extraordinary increase in the standard industry GLU ratio in FY  
852 2000 in thousands of dekatherms:

853

854

TABLE D

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

855

\* SEC data

856

857

The formula used for the above calculation "As % of Purchases" is:

858

859

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

860

861

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

862

863

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

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

867

868

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

869

870

871

872

873

874

875

876

877

878

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

879

880

881

882

$$\text{Customer-Owned Gas} / \text{Total Gas Send Out}$$

TABLE E

	FY 2003	FY 2002	FY 2001	FY 2000	FY 1999
<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%

883

884

885

886

887

888

889

890

\* SEC data

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

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

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

898

899 According to a published analysis by Rick Feldmann, a gas professional with 24  
900 years of operational midstream industry experience, GLU is a controllable  
901 component of the gas transportation business. In his article in the July, 2000 issue  
902 of Pipeline & Gas Journal

903 ([http://www.undergroundinfo.com/PGJ/pgj\\_home.html](http://www.undergroundinfo.com/PGJ/pgj_home.html)), Feldman also reports  
904 that "leading pipeline transportation companies are currently controlling lost and  
905 unaccounted for gas (L&U) at an average rate of 0.25% (*less than 1%*) of custody  
906 receipts, or less." (*Bold added for emphasis.*)

907

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

917

918 Peoples Gas' GLU increased from 3,371 thousand dekatherms in FY 2000 to  
919 9,972 thousand dekatherms in FY 2001. Using FY 1999 and FY 2000 as base  
920 years, the FY 2001 GLU figure is approximately triple the GLU of the base years.

921 As noted earlier, the increase (slightly moderated) persisted in the following  
922 years. Even if one attributes the increase to a higher volume of midstream  
923 activity, to the extent that increased GLU costs are included in the calculation of  
924 the Gas Charge, there is a demonstrable adverse effect on Peoples Gas' bundled  
925 service customers.

926

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

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

932

933

TABLE F

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

934

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

935

936

937

938

939

940

941

942

943

944

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

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

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

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

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

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

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

995

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

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

1003

1004 The hub generally utilizes excess – the hub is primarily – its primary  
1005 assets of the hub are storage, Manlove Storage Field, and somewhat the  
1006 Mohamet Pipeline, and so the hub utilizes excess capacity of those assets.”  
1007 (Ex. 1.10, Zack Tr. at 59-60)  
1008

1009 A 2003 Peoples Gas plan for addressing its GLU operational issue identifies  
1010 several “Areas of Focus” for an investigation into the GLU that may be related to  
1011 the increase. Those areas of focus include:  
1012

- 1013 • “Increase in Hub transactions and management of Hub by enovate  
1014 beginning early calendar 2000;”
- 1015 • “Enron assumption of transportation and delivery of bundled  
1016 Citygate supplies beginning in October 1999;” and
- 1017 • “Understand business process and internal controls for write-off of  
1018 volumes”

1019 (Ex. 1.14, Gas Lost Work Plan, filepath: ).  
1020

1021 These internal proposals for areas to examine suggest the possibility that the  
1022 increase could have been caused by increased Hub activity, as I discuss later in  
1023 my testimony, by reliance on another entity (Enron) for control of certain  
1024 acquisition and delivery functions for bundled service gas supply, or by some  
1025 characteristic or effect of the utility’s internal processes and controls.  
1026

1027 **Q. How could an increase in midstream services activities and the operation of**  
1028 **the PGL HUB cause an increase in GLU, a component of PGA cost?**

1029 **A.** I have been informed by counsel that the Commission rules governing the  
1030 calculation of the Gas Charge would be affected by the midstream activity only if  
1031 that activity involved assets or activities for which costs are included in the  
1032 prescribed calculation. It is Peoples Gas’ position that that is not the case with the  
1033 FERC operating statement services Peoples Gas offered through its hub.  
1034 However, the inventory records included in Peoples Gas’s response to Staff data  
1035 request POL 2.74 appear to confirm that Peoples Gas’ hub activity did involve  
1036 PGA assets and activities.  
1037

1038 The inventory balance for Peoples Gas' non-GPAA hub activity shows a negative  
1039 balance from January 4, 2001 to May 2, 2001. Mr. Charles Blachut, who was in  
1040 charge of Peoples Gas' gas supply forecasts, explained the meaning of a negative  
1041 inventory balance for hub services (noting that he was unaware of such an  
1042 occurrence).

1043  
1044 This is the gas taken from Manlove Field which includes this plus the  
1045 system supply, so if you ran negative inventory, then it's, I think, a  
1046 reasonable assumption that it came from system supply. In other words, it  
1047 was a loan of gas. (Ex. 1.15, Blachut Tr. at 25).

1048  
1049 The testimony of PGL Gas Supply division personnel demonstrates that Peoples  
1050 Gas operated Manlove Field on the basis of the physically available volumes,  
1051 without designating the gas commodity assets as restricted to PGA use or to  
1052 midstream services use. (Ex. 1.16, DeLara Tr. at 92)

1053  
1054 From the available documents, we cannot determine whether negative balance gas  
1055 that was withdrawn for hub services in FY 2001 was returned to the system  
1056 supply or written off as "GLU." Neither do we know the price at which any  
1057 replacement gas was acquired. In any case, as shown in Table G below, it appears  
1058 that the gas supply acquired to serve Peoples Gas' bundled service customers was  
1059 used as a reserve supply for the hub. In effect, the hub had a call option on  
1060 Peoples Gas' bundled service inventory, to take gas as needed. It appears that this  
1061 option was neither acknowledged nor paid for in Peoples Gas' PGA accounting.  
1062 Conceptually, this is similar to the call option service Peoples Gas has  
1063 acknowledged providing and accounting for incorrectly as discussed in the  
1064 testimony of Jerome D. Mierzwa (CUB Exhibit 2.0 at 46). The utility gave an  
1065 option that was incorrectly valued for the benefit of its PGA customers.

1066  
1067 **Q. Does Peoples Gas' management of its commodity supplies for bundled**  
1068 **service customers have any effect on the determination of the Gas Charge**  
1069 **paid by its customers?**

1070 A. Yes in at least two ways. The combination of GLU and the negative balance hub  
1071 activity could affect ratepayers. If gas were taken from Manlove Field when  
1072 ratepayers could have used that gas, ratepayers would have been harmed. If the  
1073 withdrawn ratepayer gas were replaced with higher priced gas, either from the  
1074 spot market or through the GPAA (at market indexed prices), the economic harm  
1075 would be obvious – exchange of lower cost gas for higher cost gas. Even if gas  
1076 were withdrawn for midstream services and later replaced with lower cost gas (or  
1077 if the gas were not needed immediately), then PGL’s ratepayers would have lost  
1078 the economic opportunity to make a midstream sale at high winter prices. From  
1079 January to May 2001, the ratepayers needed the gas. During the early months of  
1080 2001, Peoples Gas’ customers were paying above spot market prices due to the  
1081 market shortage of gas.

1082  
1083 Second, according to the Purchased Gas Adjustment Clause, Section 525.40 of the  
1084 Commission’s regulations, Recoverable Gas Costs include “Costs of natural gas  
1085 and any solid, liquid or gaseous hydrocarbons purchased for injection into the gas  
1086 stream or purchased as feedstock or fuel.” Under this regulation, I have been  
1087 advised by counsel that Peoples Gas recovers the cost of gas purchases, including  
1088 the portion of those purchases that is lost (GLU) and not available for customer  
1089 use. In his deposition, Mr. Zack confirmed that in its calculation of the gas  
1090 charge, Peoples Gas used (to represent the cost of the commodity) “The cost  
1091 coming through our accounting system ...weighted....within the components of  
1092 the gas charge.” (Ex. 1.10, Zack Tr. at 69). Peoples Gas’ customers paid a higher  
1093 cost for gas due to a higher GLU. To the extent that Peoples Gas’ GLU costs  
1094 were above the level consistent with prudent management of its gas supplies,  
1095 those additional costs were improper.

1096 Q. **What conclusions have you drawn from this information about Peoples Gas’**  
1097 **performance in gas inventory management that relate to issues in this**  
1098 **reconciliation proceeding?**

1099 A. In assessing Peoples Gas' gas procurement and storage operations, I have used the  
1100 following criteria, which I have been advised is the standard for prudence in  
1101 Illinois. I have also been advised that costs attributable to decisions or actions  
1102 that the utility fails to show meet this standard are improperly charged to  
1103 ratepayers. The Commission has defined prudence as "that standard of care  
1104 which a reasonable person would be expected to exercise under the circumstances  
1105 encountered by utility management at the time decisions had to be made," based  
1106 on "only those facts available at the time the judgment was exercised."

1107 From the information discussed in this portion of my testimony, I have reached  
1108 two main conclusions. First, Peoples Gas was not prudent in controlling its  
1109 runaway GLU in FY2001. As Peoples Gas has observed, rolling 12 month totals  
1110 indicated "a fundamental shift and increase in GLU beginning in late calendar  
1111 1999" (Underline added for emphasis). Yet, we see no evidence of Peoples Gas  
1112 taking decisive action to determine the causes of increased GLU costs or to  
1113 control them until 2003. This failure to act to control gas losses (and related  
1114 costs) that were far above industry norms or averages and even PGL's historic  
1115 levels, despite clearly discernible evidence of a problem in known and regularly  
1116 reported data, was not reasonable from a business perspective. As William  
1117 Morrow, Peoples Gas' Vice President for Gas Supply in FY 2001, observed: (Ex.  
1118 1.17, Morrow Tr. at 61-62), gas commodity costs were recognized as the utility's  
1119 largest category of expenses, expenses the utility purports to take pains to control.  
1120 Yet, when GLU increased by a factor of more than three and exceeded industry  
1121 norms by a similar factor, Peoples Gas failed to take decisive action. Under the  
1122 circumstances, and given the data available to Peoples Gas at the time, this failure  
1123 was imprudent, and it resulted in harm to the ratepayers in the reconciliation  
1124 period.

1125 Section 525.40(d) of the PGA rule states that: