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

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

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

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

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

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

GLU less the normal 3% GLU= Excess GLU

9,972 - 3,892 = 6,080 thousand dekatherms

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

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

6,080 thousand dekatherms X $6.23/dekatherms =**$37,878,400**

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

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

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

<u>INVENTORY MISMANAGEMENT – NEGATIVE HUB BALANCES</u>

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

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

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

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

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

- Peoples Gas Hub

- Natural Gas Liquids (NGL) Services
- Wholesale Marketing services, such as physical and speculative trading.

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

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

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

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

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

The documentary materials addressing PGL's hub activities and enovate's trading activities raise issues about the extent to which PGL included revenues from those sub-segments in the Gas Charge calculation as part of the PGA process. Both of these sub-segments relied, at least in part, on the use of PGL assets to generate revenues, and costs associated with those assets pass through the PGA. The profits of these sub-segments were shared among the entities participating in the provision of these services. However, the details of some sharing arrangements are uncertain. For example, according to the report of an internal audit on enovate, performed by Peoples Energy's internal audit department in August 2001, the sharing arrangements were not always in writing.

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

Q. What PGL assets did the Hub services use?

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

The assets actually used by the HUB are not easily determined. PGL does not segregate gas purchased for regulated PGA services from customer owned gas or gas acquired for other services. Since natural gas is a fungible commodity, the gas is commingled. Moreover, in gas trading and transport transactions, the fungible nature of gas is often used in completing the transaction. According to Mr. De Lara, displacement is "used in the gas industry and -- this is mainly in the pipeline, natural gas pipeline industry -- is that we do not track molecules as it flows through the system. For example, if you purchase molecule A from the Gulf Coast, you may not actually receive molecule A in Chicago. You may receive, you know, D, E, F or some other -- so, that is what is meant by "displacement". (Ex. 1.16, DeLara Tr. at 65-66). Given these factors, coordination of accounting records and operating procedures would seem critical.

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

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

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

TABLE G In thousand Dth

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

***(Ex. 1.20, Deliverability Decline Calculation 2001/2002 Withdrawal Season, Bates 01PGL 090041).
****(Ex. 1.21, Determination of Percentage Used, Bates 01PGL 062836).

A brief discussion of terms is necessary to analyze TABLE G. The following are commonly used definitions according to the Energy Information Administration website at www.naturalgas.org/naturalgas/storage:

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

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

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

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

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

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

A. The table below shows the materially significant stored gas that was available for utility customers during FY 2001. Gas identified as having been available for the Hub is also included as available for PGA services because PGL deponents consistently testified that for operational purposes, the regulated customers always get the highest priority with respect to having gas available to meet their needs. Moreover, as I have noted, there is no accounting system that would override the operational availability of gas from Manlove. Accordingly, HUB assets are included in the "Total PGL Gas."

TABLE H In thousand Dth

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

*(Ex. 1.22, Inventory Balance, Jul. 18, 2001, Bates 01PGL 083382).
**(Ex. 1.23, PGL response to Staff DR POL 2.74, Staff Ex. 3.03).

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

During that same time period, the Hub was showing negative balances. According to Mr. Blachut, had withdrawals like those shown above occurred, it would represent a "loan" of gas out of the gas supply of PGL, for the benefit of Hub and other non-PGA customers. Given the shortages (shown in Table H) that occurred 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, February and March of 2001 indicate that gas being used for non-PGA activity was greater than the supposed "excess" gas supply PGL had available.

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

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

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

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

Moreover, there are minimum capacity thresholds for storage fields, that is, a minimum quantity of gas in storage. A Deliverability Decline Calculation provided by PGL shows that for Manlove, that threshold is [redacted]. (Ex. 1.20, Deliverability Decline Calculation 2001-2002 Withdrawal Season, Bates 01PGL 090041.) Additional commodity costs to replenish the storage facility after any depletion (especially of the lower priced gas last withdrawn) would have been almost certain in the FY 2001 high-cost market environment. Expert engineering analysis is needed to determine whether withdrawals below this minimum decline threshold would damage the facility or cause the utility to incur additional storage costs. If the performance capabilities of Manlove Field were diminished, additional increased costs to utility ratepayers would result.

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

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

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

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

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

IMPROPER STORAGE TRANSACTIONS

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

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

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

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

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

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

Q. What was the purpose of the NSS contracts?

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

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

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

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

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

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

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

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

Thomas Patrick understood and acknowledged this concept during his deposition.

> Q: ...Do you know how many contracts Peoples Gas had with Natural Gas Pipeline -- NSS contracts that Peoples Gas had with Natural Gas Pipeline during fiscal year 2000?
> A: During the fiscal year? No, I don't know.
> Q: How about fiscal year 2001?
> A: I would have guessed there was one contract in each of those years, but I really don't know.
> Q: One -- why would you guess that it would be one contract?
> A: Just because it was a single service. I mean, an NSS service. Usually we had -- for each of the services we purchased, we had a service agreement with the pipeline.
> Q: When you say it was a single contract, would it be a contract for the 75 days of service?
> A: Yes. That would be my assumption.
> Q: And 75 days of service was sufficient to meet Peoples Gas' needs?
> A: No. No. 15 days or so is what we wanted for Peoples Gas' needs. The remaining 60 days or whatever the number was, was the piece that was generally placed in the hands of a marketer to manage. (Ex. 1.25, Patrick Tr. at 96-99).

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

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

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

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

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

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

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

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

A. Yes. PGL apparently worked with its affiliate, enovate, [redacted] in a transaction called "38 Special." (Ex. 1.26, Memo from K. Radous to T. Klussmann, March 22, 2000, Bates No. 01PGL 052041-052042). PGL and enovate [redacted].

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

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)

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

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

Table I - PEC Revenues: 1996 – 2003

(in $000s)

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

However, despite the dominant portion of revenues from PGL operations, the operating margin (profit) contributed by PGL to PEC was only 7.26% on average. This apparent anomaly is attributable to the fact that the sale of gas does not generate profits for PGL. The gas procurement costs incurred by PGL (the utility's largest cost) are passed to its customers via the PGA and are recovered on a dollar-for-dollar basis. PGL and North Shore Gas (NSG), PEC's operating utilities, derive profits through the return on their investments for the distribution of gas. By setting the utility's distribution rates, the Commission effectively limits the amount of profits that PGL (and NSG) can make through charges to customers of their state authorized monopoly services.

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

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

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

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

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

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

A. The greater energy marketplace encompasses, in addition to local gas distribution companies like PGL, natural gas producers, natural gas marketers, natural gas traders, and pipeline transportation firms. PGL or PGL affiliates are engaged in activities in each of these areas. These gas industry segment participants are not regulated in their activities in those areas, providing an opportunity to earn unregulated (and potentially greater) profits. The midstream services and natural gas trading components, in particular, provide gas companies like PEC and its affiliates opportunities to increase revenues and shareholder value significantly.

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

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

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

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

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%**

* 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.

Q. How did PEC react to these market indicators?

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.

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

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

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

Q. How did PEC first become involved with Enron?

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

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

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

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

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

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

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

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

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

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

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

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

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

A. Of course, the ultimate objectives were increased revenues and profits for the corporation. As with its utilities' fixed gas charge proposals, PEC viewed the "broader alliance" as an opportunity to increase its revenues, using existing utility rate base and PGA assets to accomplish its financial goals.

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

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

The GPAA had a direct effect on costs PGL recovered through PGA charges. It also seems to have a role in PEC's "broader alliance" with Enron.

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

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

Q. What was enovate?

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

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.

Table K – Liquidity/Leverage Ratios: 1996 – 2003

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

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

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

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

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

A. One need only look at enovate's financial results to understand that something very unusual was at play. enovate's first fiscal year spanned only about five months, April 26, 2000 through September 30, 2000. As of the end of that first year of enovate's existence and operation (September 30, 2000), enovate reported total revenues of $4,319,083. (Ex. 1.30, enovate Income Statement, Bates 01PGL 043494 – 043495, 043499 - 043500). However, no capital contributions were made into enovate until October of 2000. As of September 30, 2000, additional paid-in-capital (PIC) was $0; as of October 31, 2000, additional PIC was $200,000. (Ex. 1.30, enovate Income Statement, Bates 01PGL 043494 – 043495, 043499 - 043500). Further, there is no indication that PEC or Enron loaned the funds to establish enovate, nor is such a funding scheme reflected in enovate's or PEC's financial reports. In fact, there is little to suggest that enovate was adequately funded and able to function as a stable business enterprise.

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

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

Q. Do you have any recommendations for how the more than $20 million enovate "earned" in FY 2001 should be treated in this case?

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

IMPROPER AFFILIATE TRANSACTIONS

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

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

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

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

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

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

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

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

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

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

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

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

> Q: At that time -- well, let me back up. The first line under professional experience in your -- in Exhibit 99 is Peoples Energy Resources slash enovate, LLC, and the time period is September 2000 through the present. Do you see that?
> A: I do.
> Q: So is it fair to say that you were co-managing the 18 bcf of storage for Peoples Energy Resources slash enovate?
> A.: No.
> Q: Why?
> A: By just an explanation here, it was Peoples Energy Resources was one company that I worked for. Enovate was another -- I suppose it wasn't -- **I'm not sure if I worked really by enovate but got paid by Enron during that time period of 2000 to the present.**
> (Ex. 1.35, Mixon Tr. at 29 *(emphasis added.)*).

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

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

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

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

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

(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:

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

> Each month, Peoples Gas shall owe EMW a fee of [redacted] ("Management Fee") of which one-half is for the management of NSS Contract 1 and the remaining one-half is for the management of NSS Contract 2. The parties agree that such Management Fee shall compensate EMW fully for its fixed costs associated with marketing, trading, risk management, pipeline scheduling, strategic planning and optimization services ("Management Services").
> (Ex. 1.24, Storage Optimization Contract, September 29, 2000, PGL Response to CUB DR 5.019).

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

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

I am not aware that PGL requested or received approval from the ICC to engage in a transaction under which its parent PEC would be entitled to earn management fees from PGL through a cooperative arrangement with EMW. EMW's role had the effect of hiding PEC's dealings with PGL and allowing PEC to recognize management fees indirectly. The documents suggest several possible explanations, none of them harmless to ratepayers. The possibilities are: (a) that PEC actually provided services to PGL -- without ICC approval; (b) that PGL imprudently paid PEC for services it did not actually provide; or (c) that PGL grossly overpaid EMW, since it was willing to perform whatever service it did perform for half the fee PGL paid.

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

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

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

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

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

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

Q. Can you explain this unlikely coincidence?

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

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

A. There is a column at the far right that is entitled "Total PGA Credit." The numbers in the column appear as a debit against enovate's profits – that is, the PGA credit amounts were subtracted from the enovate profit amounts.

Q. What is the significance of this column?

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

Q. How was the "Total PGA Credit" calculated?

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

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

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

<u>CONCLUSION</u>

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

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

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

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

The following amounts are the result of my calculations:

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

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

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

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

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

Q. Does this conclude your testimony?

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