STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Illinois Commerce Commission On Its Own Motion, v. The Peoples Gas Light and Coke Company Reconciliation of revenues collected under gas adjustment charges with actual costs prudently incurred.	))))))))))	Docket No. 01-0707

INITIAL BRIEF

OF

THE PEOPLES GAS LIGHT AND COKE COMPANY

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Pursuant to Section 200.800 of the Illinois Commerce Commission's ("Commission") Rules of Practice (83 Ill. Admin. Code §200.800) and the schedule established by the Administrative Law Judge on May 5, 2005, Respondent, The Peoples Gas Light and Coke Company (the "Company" or "Peoples Gas"), hereby submits its Initial Brief in the above-captioned proceeding.

INTRODUCTION AND EXECUTIVE SUMMARY

Introduction

The length and complexity of Peoples Gas' fiscal year 2001 reconciliation proceeding – including the number and proposed sizes of certain disallowances sought by various parties – is the result of the confluence of two events: (1) Peoples Gas' and its affiliates' business dealings with Enron Corporation ("Enron") and its subsidiaries, including a long term gas purchase agreement, which came under heightened scrutiny after Enron's fall from grace, and (2) the unpredictable and unprecedented run-up of natural gas prices during the 2000-2001 winter. Furthermore, Staff and the other parties have raised additional categories of recommended disallowances wholly unrelated to Enron -- such as hedging, lost gas and accounting issues -- that the Company has addressed directly on their individual merits.

Stripped of the rhetoric about Peoples Gas' business dealings with Enron, the evidence regarding these business dealings and high gas prices, viewed under the appropriate legal standards, established that Peoples Gas' conduct and gas purchases in fiscal year 2001, given the available information, were prudent. Moreover, these gas purchases resulted in gas costs to Illinois ratepayers that reasonably were in line with Peoples Gas' prior purchasing practices and gas costs approved for other utilities.

Although Enron Was Involved, The Transactions At Issue Were Legal and Prudent

A significant aspect of Staff's and intervenors' criticisms of Peoples Gas during the 2001 reconciliation year was based upon the formation of enovate LLC ("enovate"), a gas marketing company, by a Peoples Gas affiliate and an Enron subsidiary. enovate was not regulated by the Commission and therefore was able to make profits in which Peoples Gas' parent company shared. Based upon the enovate transaction, ~~Any suggestion by~~ Staff or intervenors may suggest, explicitly or implicitly, that by entering into the Gas Purchase and Agency Agreement ("GPAA"), a five-year gas purchase contract with Enron, Peoples Gas breached some duty to Illinois ratepayers. This suggestion is baseless. The evidence showed that Peoples Gas' choice of Enron for the GPAA was made independent of the decision of Peoples Gas and its parent to enter into the enovate transaction. Moreover, based ~~both~~ upon the information available when the parties executed the GPAA, as well as by what actually occurred, the GPAA did not increase the gas costs of Illinois ratepayers. Regarding the latter, the GPAA was a reasonable proxy for Peoples Gas' prior contracts, its pricing was reasonable and it was within the pricing range set by the Commission for another Illinois utility. Likewise, Peoples Gas did not use its storage assets or enter into other transactions to further enovate's ~~this~~ profit-making activity.

Indeed, during the 2001 reconciliation period, enovate neither purchased gas from nor sold gas to Peoples Gas. Moreover, Staff's and intervenors' claims for a disallowance based upon enovate's profits should fail for lack of any connection between enovate's transactions and the gas costs at issue here.

Further, a~~A~~part from what was learned about Enron's business activities years after Peoples Gas entered into the GPAA, the impropriety of Staff's and intervenors' criticisms was demonstrated by evidence establishing that Peoples Gas' business dealings with Enron: (1) were fully disclosed to the Commission to and above the extent required by law and regulation, and (2) fully complied with all applicable laws and regulations concerning affiliate transactions.

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Additionally, ~~Further,~~ Peoples Gas' decisions concerning its use of storage, provision of hub services and other challenged transactions were operational decisions reasonably made based upon available information. These decisions likewise did not increase the cost of gas to Illinois ratepayers. Given the evidence, many of Staff's and intervenors' criticisms of Peoples Gas seemingly were premised upon nothing more substantial than Enron's involvement. While hindsight is beneficial, Enron's fraudulent business dealings and accounting procedures should not taint Peoples Gas' activities at a time when Enron's misdeeds not only were unknown but it was a well-respected company and the largest natural gas marketer in the United States.

~~Likewise,~~ Moreover, Staff's and intervenors' claims that Peoples Gas' decision to enter into the GPAA was imprudent because: (a) Peoples Gas did not perform a formal, written economic analysis of the contract, and (b) intervenors found two informal analyses in the volumes of documents produced by Peoples Gas – the "Aruba" analysis prepared by Roy Rodriguez and a single-page chart found on David Wear's computer – are without merit. While Staff and intervenors may claim ~~posit~~ these two analyses suggest that prior to the entry of the GPAA Peoples Gas knew, under particular assumptions, that the GPAA could produce higher gas costs, this argument ignores substantial record evidence, as well as what the Aruba and Wear documents actually show.

First, Peoples Gas established that long before the 2001 reconciliation year it conducted a lengthy investigation into Enron as part of a request for qualification procedure. Further, in choosing Enron to support a fixed gas charge proposal, Peoples Gas engaged in an exhaustive negotiation process. In September 1999, when Peoples Gas was investigating a gas purchase agreement with Enron and then executed the five-year GPAA, Enron had proven capabilities, superior deal structuring ability, trading skills and logistic support, as well as an excellent credit rating and a strong record of providing reliable supplies. Significantly, without the benefit of hindsight, during Peoples Gas' fiscal year 2000 proceeding (Docket No. 00-0720) that assessed gas purchased from Enron under the same GPAA, Staff concluded that Peoples Gas' gas purchases were prudent. Likewise, the Commission's order found no evidence that Peoples Gas had acted unreasonably or imprudently in its gas purchases.

Second, Peoples Gas established that the Aruba and Wear analyses were not considered, or even seen, by those at Peoples Gas who made the decision to enter into the GPAA. Nonetheless, the substance of these analyses supports Peoples Gas' September 1999 decision to enter into the GPAA. Indeed, the Wear analysis showed that, even under the particular assumptions made in that limited analysis, the GPAA could produce better results than prior purchasing practices as the natural gas market evolved into that which Peoples Gas faced in September 1999. Specifically, in attempting to apply the terms of the GPAA to the years leading up to 1999, the Wear analysis showed directionally improving results under the GPAA leading up to 1999; GPAA losses from the earliest years of the analysis decreased and turned into gas cost savings over prior purchasing practices as it approached 1999. Meanwhile, the Aruba analysis was ~~is~~ consistent with the analysis of Peoples Gas' expert, Frank Graves, in showing that over a range of possible assumptions, entry into the GPAA was reasonable in light of the potential outcomes in terms of obtaining value for the Company's transportation capacity. Therefore, rather than suggesting that Peoples Gas breached its duties to ratepayers, the Aruba and Wear analyses corroborated the prudence of Peoples Gas' September 1999 decision to enter into the GPAA.

Third, Peoples Gas established affirmative reasons why it prudently entered into the GPAA. In particular, the GPAA met five objectives addressing Peoples Gas' reasonable operational concerns to ensure a reliable supply of gas at market-based commodity pricing for its end-use consumers. Accordingly, the gas costs at issue prudently were incurred and the proposed disallowances should be rejected.

Peoples Gas Did Not Have The Benefit of Hindsight When Dealing With the Unpredictable and Unprecedented Gas Prices of Winter 2000-2001

Any criticism of Peoples Gas or request for disallowance relating to the 2001 reconciliation year must recognize the extreme, unpredictable and unprecedented price spikes that occurred during the 2000-2001 winter. To the extent that these price increases – which could not have been predicted and were beyond Peoples Gas' control – have caused the intervenors to seek disallowances based on the provision of hub services and use of storage, these disallowances should be denied. Only the impermissible benefit of hindsight can give rise to claims that if certain actions were taken, gas costs would have been lowered. At the time Peoples Gas had to make decisions about securing its gas supply for the 2000-2001 winter, it did not and could not have known what would happen to gas prices and the weather that heating season. Moreover, the intervenors' analyses in support of the disallowance sought were flawed.

Peoples Gas' Decision Not to Hedge Was Prudent

As fully set forth in Peoples Gas' previously filed motion for summary determination, the intervenors' claim that Peoples Gas was imprudent for not using financial hedging for fiscal year 2001 winter purchases is meritless. Putting aside that only through hindsight could it be known that hedging would have saved money, the Staff's own witness, Dr. Rearden, testified that Peoples Gas was not imprudent in its hedging decisions. Moreover, Peoples Gas' decision not to hedge was based upon its knowledge of recent Commission decisions that did not require a gas utility to use financial hedging to be prudent. Accordingly, Peoples Gas' conduct during the 2001 reconciliation year was prudent and the various disallowances sought by Staff and intervenors should be rejected.

Executive Summary

This reconciliation proceeding is almost four years old. The events at issue began almost six years ago. On November 7, 2001, pursuant to Section 9-220 of the Public Utilities Act (the "Act"), the Commission initiated this proceeding to reconcile Respondent's collections with actual gas costs and to determine whether Respondent's purchased gas costs for Respondent's fiscal year (October 1, 2000, through September 30, 2001), were prudent.

In response to various requests and subpoenas, Peoples Gas and its affiliates produced enormous volumes of paper and electronic documents. Staff and intervenors deposed seventeen employees of Peoples Energy Corporation and its subsidiaries as well as an outside consultant. The parties submitted several rounds of pre-filed written testimony -- five by the Company and three by Staff and other parties. This litigation culminated in a week of evidentiary hearings at which all parties had the opportunity to cross-examine witnesses.

The actual reconciliation of Respondent's costs has not been challenged. Rather, this exhaustively litigated proceeding has focused upon the prudence of Peoples Gas' costs and decision-making. Peoples Gas filed detailed evidence about all aspects of the gas costs it recovered during the reconciliation year. In response to other parties' testimony, Peoples Gas also filed considerable evidence about matters with scant, if any, relationship to those gas costs. Except for two recommended disallowances it chose not to contest, Peoples Gas met its burden of showing that the gas costs it recovered during the year were prudently incurred (*i.e.*, its customers paid a reasonable price for gas during the reconciliation year). This brief sets forth the substantial record support for the prudence of Peoples Gas' fiscal year 2001 gas costs.

The recommended cost disallowances fall into ten categories. In addition, there are two categories of recommendations for which no cost disallowance is sought but for which there would be a substantial cost burden imposed on the Company and the Commission to carry out. The recommended disallowances are deficient for a variety of reasons. In particular, the recommendations fail for one or more of the following reasons: they (1) are the product of impermissible hindsight review, (2) are contrary to relevant Commission precedent and rules, (3) fail to establish a nexus between Peoples Gas' gas costs and the recommended disallowance, and/or (4) are unsupported by substantial evidence. The following is a brief summary of each category of recommendation and the reasons for its deficiency:

1. **Financial Hedging:** While Peoples Gas used its storage assets to physically hedge during fiscal year 2001, which saved end users $130 million, Peoples Gas did not financially hedge its winter 2000-2001 gas purchases. The City and CUB witnesses recommended disallowances based on Peoples Gas' winter hedging decisions. Their recommendations are inconsistent with relevant Commission precedent, rely on hindsight review and are unsupported by substantial evidence. Peoples Gas showed that the City and CUB analyses were flawed and the specific recommendations were tailored, based on after-the-fact information, to produce substantial cost disallowances, rather than being based on before-the-fact standards about the proper amount of price risk management.

2. **Gas Purchase and Agency Agreement ("GPAA"):** During the 2001 reconciliation year, Peoples Gas purchased about two-thirds of its gas supply from Enron North America Corporation ("ENA") under the GPAA. The Staff, AG and CUB/City witnesses recommended disallowances for gas costs incurred under the GPAA. The recommendations are inconsistent with relevant Commission precedent, rely on hindsight review and are unsupported by substantial evidence. Peoples Gas showed that the GPAA was prudent and it refuted testimony criticizing the agreement. In particular, Peoples Gas showed that, based on the

information available in 1999 when Peoples Gas negotiated and entered into the GPAA, the agreement was a prudent way to purchase gas and ensured that end users would receive market-priced gas while being protected against changing market conditions that were expected to adversely affect the value of pipeline transportation capacity held by Peoples Gas. The agreement and costs incurred under the GPAA where the subject of Peoples Gas' fiscal year 2000 reconciliation proceeding when the Commission neither disallowed any gas costs nor found the GPAA imprudent. That case -- Docket No. 00-0720 -- is the subject of a final, non-appealable order.

3. Interstate Hub Services: Since 1998, Peoples Gas has provided storage, transportation and exchange services in interstate commerce pursuant to the Federal Energy Regulatory Commission's ("FERC") authority. These are referred to as Peoples Gas "hub" services. The Staff witnesses recommended two disallowances related to these services, one claiming that certain hub loan transaction increased gas costs and the other claiming that hub revenues should be flowed through the purchased gas adjustment ("PGA" or "Gas Charge"). First, Peoples Gas showed that the questioned gas loan activity did not increase gas costs; if anything, the loans slightly decreased gas costs. Second, under relevant Commission precedent and the Commission's rules, hub revenues properly are accounted for "above-the-line" and addressed in a general rate case.

4. Use of Manlove Field Storage: Peoples Gas owns and operates a storage field (Manlove Field) that represents about 50% of Peoples Gas' storage portfolio and almost 40% of its design day requirements. Staff and CUB witnesses recommended disallowances based on the way that Peoples Gas used Manlove Field to serve end users. Staff argued that withdrawal activity should have been moved from February and March into December and January, thereby decreasing gas costs. CUB argued that storage use, including the provision of hub services, resulted in higher gas costs. Both recommendations largely were based upon impermissible hindsight review and were unsupported by the evidence. Moreover, these recommendations presupposed that Manlove Field should be used solely to optimize its economic value to end users even though the field is a critically important operational part of the way Peoples Gas serves its customers. In addition, Peoples Gas showed that its use of Manlove Field was prudent under the conditions that existed during the 2000-2001 winter. In particular, Peoples Gas adjusted withdrawal activity to respond to weather and fluctuating customer requirements.

5. Storage Optimization Contract ("SOC"): Peoples Gas entered into the SOC with Enron MW, LLC ("EMW"). As in prior years under another, similar agreement, the SOC's purpose was for a third party to manage storage capacity that Peoples Gas did not need to serve its end users but, because of pipeline tariff requirements, must be purchased to obtain the capacity and service features that Peoples Gas required. As in prior years, Peoples Gas received a share of the revenue earned by the third party and flowed 100% of that revenue through its Gas Charge. The Staff witnesses erroneously challenged the SOC's prudence and recommended a disallowance based on the third party's profits. First, the Commission rules contemplate the use of third parties for supply management and recovery of costs associated with such management. 83 Ill. Admin. Code §525.40(a)(4). Second, the SOC was a prudent way to mitigate the costs of a storage service that was a key component of Peoples Gas' design day, seasonal and annual portfolio to serve its customers. Third, aside from failing to show imprudence, the Staff failed to establish a nexus between Peoples Gas' gas costs and the recommended disallowance, which was based on a third party's profits.

6. **enovate, LLC:** enovate was a limited liability company formed by a second tier subsidiary of Peoples Energy Corporation and a second tier subsidiary of Enron Corporation. enovate was not a public utility. enovate did not recover any costs or flow any revenues through Peoples Gas' Gas Charge. enovate did not sell gas to or purchase gas from Peoples Gas. enovate did not manage the GPAA. enovate did not manage Peoples Gas' hub services. In short, enovate and its transactions had no effect upon the gas costs paid by Peoples Gas' end users. The Staff witnesses and the CUB-City witness recommended that enovate's fiscal year 2001 gas costs be disallowed. These witnesses offered nothing but unsupported speculation about how enovate earned its profits and how, in some undefined way, those profits affected Peoples Gas' gas costs. These witnesses failed to establish any nexus between Peoples Gas' gas costs and the recommended disallowance, which is based on the profits of two third parties.

7. **Gas Lost and Unaccounted For ("GLU"):** Peoples Gas, like all Illinois gas utilities, recovers the costs associated with GLU through its Gas Charge. GLU varies from year to year. In fiscal year 2001, although Peoples Gas' GLU percentage increased from the preceding year, it well was within the range experienced by other Illinois utilities. The CUB-City witness recommended a disallowance based on two entirely different, but equally flawed, theories. The first theory was replete with factual inaccuracies and distortions and should be entitled to no weight. The second theory was based upon comparing Peoples Gas' GLU to an arbitrary standard, with no regard for whether the GLU experienced by Peoples Gas was imprudent.

8. **Off-System Transactions:** Off-system transactions, which are sales by Peoples Gas to non-end use customers, are, and historically have been, a routine part of Peoples Gas' operations. Of the 103 off-system transactions Peoples Gas conducted in the reconciliation year, Staff recommended disallowances on four of those transactions. Peoples Gas conceded the disallowance with respect to two of the transactions. Peoples Gas showed the operational prudence of the other two transactions giving rise to Staff's disallowance recommendation, which recommendations were the product of hindsight review and of viewing operational transactions through the prism of economic considerations. Neither approach was valid.

9. Trunkline Transaction: Peoples Gas entered into a citygate purchase transaction that also had a system balancing function (*i.e.*¸ Peoples Gas could divert gas away from its citygate when needed to ameliorate an oversupply situation). The market-based pricing of the transaction was not unusual. The Staff witnesses proposed a disallowance based on profits that the seller supposedly earned from the transaction. As with the enovate and SOC recommendations, the Staff failed to establish any nexus between Peoples Gas' gas costs and the recommended disallowance.

10. Refinery Fuel Gas ("RFG"): Peoples Gas purchased RFG from a refinery at a price equal to 95% of a citygate index. Under a predecessor agreement with that refinery, Peoples Gas had purchased RFG at 75% of that index. While Staff witnesses argued that the purchase was imprudent and stated that Peoples Gas' affiliate had taken over the older, lower-priced contract, purchasing supply at a discount to a citygate index is prudent.

11. Re-Open Fiscal Year 2000 Case: Peoples Gas' fiscal year 2000 case is the subject of a final non-appealable order. The Staff witnesses recommended re-opening that proceeding. The Staff has not met the requirements of Section 200.900 of the Commission's rules, which requires a party requesting re-opening to show that conditions of fact or law have so changed as to require, or that the public interest requires, such reopening. Those circumstances do not exist.

12. Audit Requirements: The Staff proposed that the Commission impose internal and external management audit requirements on Peoples Gas. Peoples Gas demonstrated that these requirements are unnecessary. Peoples Gas proposed an alternative that would be a better use of the Commission's and the Company's resources. Namely, the Company proposed to submit to Staff a report that addresses Staff's concerns one year from the date of an order in this proceeding; that time frame allows for the above activities to be completed.

* * * * * *

On each contested issue, Peoples Gas has satisfied its burden of proving with substantial evidence the prudence of the gas costs it recovered from its customers. Peoples Gas also demonstrated that it complied fully with applicable Commission rules and its Schedule of Rates. The Staff and intervenor recommendations are deficient and, in many instances, are contrary to applicable Illinois law prescribing the scope of this proceeding and the standard of review. Accordingly, the recommendations should be denied.

STATEMENT OF FACTS

Events Leading Up to the Gas Purchase and Agency Agreement with Enron North America Corporation

The Federal Energy Regulatory Commission ("FERC"), in Order Nos. 436/500 and 636, changed the way gas utilities like Peoples Gas purchased gas and managed their systems. These changes increased the complexity of day-to-day operations. Prior to late 1993, when FERC Order No. 636 was implemented, Respondent purchased most of its gas under bundled citygate supply services offered by pipelines. Beginning with the 1993-1994 winter, Respondent contracted with producers and marketers to secure a sufficient quantity of firm gas supply to meet its customers' requirements, including filling its storage capacity. These contracts were the subject of individual negotiations with suppliers and pricing generally was tied to market-based, published indices.

To insure its gas supply, Respondent historically entered into both “baseload” and “swing” contracts. Under a “baseload” agreement, Respondent was obligated to take 100% of a specified contract quantity each day. Under a “swing” agreement, Respondent could choose the amount of supply it purchased each day. Swing contracts could include some take requirements or they could include other requirements that governed the nomination of service.

Prior to September 1999, when Peoples Gas entered into the Gas Purchase and Agency Agreement (“GPAA”) with Enron North America Corporation (“ENA”), Peoples Gas’ firm gas supply contracts had terms ranging from four months to five years. Resp. Ex. C, pp. 3-4. Respondent also purchased gas in the daily spot market. Resp. Ex. B, p. 5.

The market continues to evolve, but the pace of change in the late 1990s was remarkable. Numerous interstate pipeline projects were proposed, several of which were expected to have a direct impact on the Midwest market.

In April 1997, the Energy Information Administration (“EIA”) identified 11 major proposed pipeline construction projects in the Midwest with planned in-service dates between 1997 and 2000. According to that EIA study, “[t]he most extensive development is focused on expanding the deliverability of Canadian gas to the U.S. Midwest and Northeast and to Canadian markets” (EIA Natural Gas Monthly April 1997, p. viii) and “... service to the Midwest Region will grow with 6,200 MMcf per day of new interstate capacity planned…” (p. xii). From Respondent’s perspective, the most notable projects were the expansion/extension of Northern Border Pipeline Company (“Northern Border”) and the Alliance project (“Alliance”). These projects would add 2 Bcf of capacity to the Chicago area. Resp. Ex. F, pp. 4-5.

In October 1998, Peoples Gas filed a fixed gas charge with the Commission. Docket No. 98-0820. In December 1998, Respondent sent a "request for qualification" ("RFQ") to nine gas marketers. As part of the RFQ process, Respondent examined the ability of marketers to structure a full-requirements, fixed-price, gas supply proposal and also determined their competency and level of available resources to function as asset manager for Respondent's supply portfolio if Respondent implemented a fixed gas charge.

In the spring of 1999, Respondent selected ENA over the other RFQ participants. ENA demonstrated superior deal structuring ability, trading skills and logistics support. ENA also possessed excellent assets, credit ratings and a strong record of providing reliable supplies. During 1998 and 1999 when Respondent was evaluating marketers and then negotiating the GPAA, ENA was one of the nation's preeminent gas marketers, with both a national presence and a regional presence in the Chicago market. Resp. Ex. C, p. 6; Resp. Ex. F, p. 9.

Respondent had submitted a proposal for a fixed gas charge of 31.08¢ per therm. In June 1999, Respondent received an unfavorable order on its fixed gas charge proposal, approving a fixed charge of only 25.63¢ per therm, a price that was too low for Respondent to obtain the necessary supply contract(s). The Peoples Gas Light and Coke Company, Order dated June 7, 1999, in Docket No. 98-0820 (1999 Ill. PUC LEXIS 414). As a result, Respondent did not implement a fixed gas charge. In the absence of a fixed gas charge, Respondent moved away from a full requirements contract that included outside management of storage services.

As part of the fixed gas charge process, Respondent re-examined its traditional method of supply acquisition, which coupled field-purchased supplies with firm pipeline transportation. From this re-examination, Respondent concluded that there was a strong likelihood that basis[1] at

[1] The term "basis" means the difference between the NYMEX futures contract at Henry Hub in Louisiana and the cash price at other market points. More generally, "basis" describes the difference in gas prices at a location in the

its field-purchase locations would be affected negatively by the proposed incremental pipeline capacity to the Chicago area, especially the Northern Border and Alliance capacity. This increase in capacity would erode the value of Respondent's firm transportation assets, resulting in relatively higher delivered costs for gas supplies connected with field purchases versus those at the citygate. Resp. Ex. C, pp. 5-6. It was these events that led Peoples Gas to ENA and the negotiation of the GPAA.

The Negotiation of the GPAA

On September 16, 1999, the Peoples Gas and ENA executed the GPAA, a sixty-one month firm gas supply contract (October 1, 1999 – October 31, 2004).[2] Prior to execution, Peoples Gas' goals in negotiating the contract were to achieve quantity and pricing terms that met the following important business criteria:

- Market-based commodity pricing with no reservation or demand charges.
- Flexible pricing options.
- Preservation of the value of Peoples Gas' transportation capacity.
- Sufficient flexibility to help Peoples Gas meet different weather conditions.
- A reasonable proxy for Peoples Gas' prior gas supply contracts.

Resp. Ex. C, pp. 10-11.

The GPAA provided for the citygate purchase of a significant quantity, but not all, of Respondent's end users' annual gas requirements. To facilitate the citygate service, Respondent released to ENA, per FERC rules, some of its firm transportation capacity. The GPAA did not

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field area and gas prices at the Chicago citygate. For example, if gas at the Houston Ship Channel is priced at $3.00 and gas at the Chicago citygate for the same time period is priced at $3.15, the "basis" is $0.15. The basis changes from day-to-day and within the day, and it can even be negative. The differential represents the value that the market is placing on the pipeline transportation required to move the gas from Houston Ship Channel to Chicago. Resp. Ex. C, p. 7.

[2] Attachment 1 of ICC Staff Ex. 2.00 is a copy of the GPAA.

provide for the release of any purchased storage capacity and Respondent did not release any of this capacity. Respondent continued to operate its Manlove Field. The GPAA also included a firm right for Respondent to move gas away from its citygate, by a sale to ENA, when operational conditions limited Respondent's ability to accept deliveries. Resp. Ex. C, pp. 2-3.

<u>The Terms and Conditions of the GPAA</u>

The terms and conditions of the GPAA provided an amount and mix of services comparable to what Peoples Gas had sought to achieve in prior contracts, produced a significant credit to customers and did not involve a release of storage capacity.

The GPAA's Three Quantity Categories

1) Baseload Quantity

Baseload quantity was the amount of gas that ENA contractually was obligated to deliver each month and Respondent was required to purchase. The baseload quantity, which changed during the term of the GPAA, was related to changes in demand. Throughout the term of the GPAA, the baseload quantities reflected similar baseload purchases by Respondent in pre-GPAA years.

Notably, the GPAA allowed Respondent to shape the baseload quantities by month. This was an important feature of the contract because Respondent has a very weather sensitive load. *See* Resp. Ex. 4.[3] Under prior agreements, Respondent typically was limited to purchasing baseload quantities either on an annual basis or for the five-month November through March period. Resp. Ex. C, p. 14.

[3] During the reconciliation period, one heating degree day in December and January would equate to roughly 22,400 MMBtu of demand on Respondent's system. Resp. Ex. L, p. 26. For example, the baseload quantity in November 2000 was 100,000 MMBtu less than the December 2000 baseload quantity and the March 2001 baseload quantity was less than the January and February 2001 baseload quantity. Schedule 2.1 of the GPAA, ICC Staff Ex. 2.00, Attach. 1.

The baseload quantity reflects Respondent's judgment and experience in balancing relevant operational considerations. Respondent does not and cannot design its baseload purchase requirements to match baseload consumption. First, Respondent is not the only entity that provides natural gas supplies to its system. Transportation customers account for approximately 40% of annual deliveries to Respondent's system, and these deliveries are uneven and unpredictable. Second, baseload purchases are generally for a term of one month to one year. Even under the GPAA, to determine the baseload purchase requirement that would match system baseload consumption, Respondent would have to have set this amount at no more than would be required on the warmest day during that month or year. For any period that actually was not the warmest ever for that period, Respondent would be undersupplied. To make up the difference, Respondent would have to have relied upon variable purchases or storage and to do so to a large extent would be impractical, if not impossible. Resp. Ex. L, pp. 15-16.

2) Summer Incremental Quantity ("SIQ")

The SIQ was an amount within a range that ENA would elect to deliver during the summer period (April through November), which Respondent would purchase. The SIQ and the months in which the SIQ would be delivered were determined such that Respondent would refill storage with this gas. The range of SIQ deliveries was from a minimum of 10,980,000 MMBtu (45,000 MMBtu per day for each month in the summer period) to a maximum of 30,500,000 MMBtu (125,000 MMBtu per day for each month in the summer period).[4] On average, Respondent expected to receive an amount near the midpoint of that range, (*i.e.*, approximately 20,740,000 MMBtu per year). Resp. Ex. C, p. 14.

As discussed below, the pricing for the SIQ included a credit. Granting a seller option rights (in this case, selecting the delivery quantity within a range) in exchange for a discount is a

[4] Secs. 1.47, 1.48, Sch. 2.1 of the GPAA, ICC Staff Ex. 2.00, Attach. 1.

common practice. This is particularly true for storage refill programs where the buyer is not specifically concerned with which days' gas is injected into storage and is willing to accept a varying amount of deliveries from day to day. Resp. Ex. F, p. 30.

~~3)~~3) Daily Incremental Quantity ("DIQ")

DIQ was the difference between the total pipeline transportation capacity that Respondent released to ENA and the sum of the baseload quantity and the SIQ. [5] Sec. 1.15 of the GPAA, ICC Staff Ex. 2.00, Attach. 1. Respondent could nominate any portion, including zero, of the DIQ on any day. Resp. Ex. C, pp. 11-12.

The three categories of contract quantities -- baseload quantity, SIQ and DIQ -- considered together, provided Respondent with an amount and mix of services comparable to what it previously had sought to achieve in several contracts. Resp. Ex. C, p. 15.[6]

[5] For example, if Respondent released 350,000 MMBtu of capacity to ENA and the baseload plus SIQ on a day was 250,000 MMBtu, the DIQ available for nomination would be 100,000 MMBtu.

[6] Respondent's gas supply portfolio has historically included a mix of baseload and swing quantities. The DIQ represents the swing quantities under the GPAA. For example, if baseload plus SIQ quantities were insufficient to fill storage in the summer or meet requirements, Respondent could nominate a portion of the DIQ. Likewise, on any day that the baseload quantities were insufficient to meet winter demand, the DIQ was available for nomination by Respondent. Resp. Ex. C, p. 14.

The GPAA's Terms Regarding the Release of Any Purchased Storage Capacity

The GPAA did not provide for the release of any purchased storage capacity.[7] Under the GPAA, Respondent purchased gas at the Chicago citygate. To facilitate this service, Respondent released to ENA, per FERC's rules[8], some of its firm transportation capacity. Under the GPAA, the fixed charges payable by ENA were equal to the amount payable by Peoples Gas under the released agreement.[9]

Notably, Peoples Gas retained recall rights to the capacity. Thus, if necessary to address service problems, Peoples Gas could get its capacity back from the pipeline.[10] This was unnecessary as ENA was a reliable supplier. Resp. Ex. C, p. 5.

The GPAA Price Terms

The price terms under the GPAA were favorable to Peoples Gas' customers. Specifically, the price applicable to a given purchase under the GPAA was determined by the category (baseload, SIQ and DIQ) into which the gas fell; the GPAA also provided that the parties could agree to alternative pricing. Resp. Ex. C, p. 15.

The price for the baseload quantity was a Chicago citygate, first of month index, minus three cents. The price was solely a variable commodity charge with no demand or reservation charge.[11] The price for the SIQ was the same as for the baseload quantity.[12] The 3¢ credit produced savings to customers during the reconciliation period of $2.7 million. This credit was

[7] Resp. Ex. C, p. 3; Sch. 6.1 of the GPAA, ICC Staff Ex. 2.00, Attach. 1.
[8] The FERC's rules provide that, when capacity is released, the releasing shipper (Peoples Gas) receives a credit on its pipeline invoice in an amount equal to the fixed charges paid by the replacement shipper (ENA). 18 C.F.R. 284.8(f).
[9] Sec. 6.1 of the GPAA, ICC Staff Ex. 2.00, Attach. 1.
[10] Sec. 6.1 of the GPAA, ICC Staff Ex. 2.00, Attach. 1.
[11] Resp. Ex. C, p. 16; Sec. 4.1(a) of the GPAA, ICC Staff Ex. 2.00, Attach. 1.
[12] Resp. Ex. C, p. 16; Sec. 4.1(b) of the GPAA, ICC Staff Ex. 2.00, Attach. 1.

the mechanism by which Respondent guaranteed value for its transportation assets and offset the expected decline in basis. Resp. Ex. C, p. 16.

The price for the DIQ was the daily price applicable to the day of flow. As with the baseload and the SIQ, there was no demand or reservation charge associated with the DIQ. Therefore, if Respondent did not need to nominate any DIQ on any day, no charge was assessed.[13]

Peoples Gas' Dealings With enovate, LLC

enovate LLC ("enovate") was a limited liability company, formed by a non-utility subsidiary of Peoples Energy Corporation ("PEC")[14] and a subsidiary of ENA. enovate's formation was documented by a "Limited Liability Company Agreement" dated April 26, 2000. Resp. Ex. N, p. 3.

enovate's members were Peoples MW, LLC ("PMW") and Enron MW, LLC ("EMW"). Each had a 50% interest. PMW was a wholly owned subsidiary of Peoples Energy Resources Corp. ("PERC"), which was a wholly owned subsidiary of PEC. Resp. Ex. N, p. 3.

enovate, which engaged in wholesale physical and financial gas transactions, was in business throughout the fiscal year 2001 reconciliation period. Resp. Ex. N, pp. 3-4. Like other gas marketers, enovate entered into physical and financial gas purchase and sale transactions.

enovate's physical gas transactions were focused in the Midwest, including Illinois, Indiana, and Michigan. Enron and PEC typically provided financial assurances, in the form of parent guaranties, to support enovate's purchases of services and gas. Resp. Ex. N, p. 6. enovate also had firm pipeline transportation with Trunkline Gas Company, interruptible services that it purchased from interstate pipelines and local distribution companies and physical gas supply

[13] Resp. Ex. C, pp. 16-17; Sec. 4.1(c) of the GPAA, ICC Staff Ex. 2.00, Attach. 1.
[14] Peoples Energy Corporation is the parent company of, *inter alia*, Peoples Gas.

agreements with several counterparties. enovate's financial transactions included speculative trading.[15] Enron and PEC made capital available to cover trading risk associated with enovate's activities.

As its Managing Member, Enron was responsible for enovate's administrative, middle and back office functions[16] and bore 100% of the expenses for these functions, many of which were performed by personnel located in Enron's Houston office. Through its back office functions, enovate had access to sophisticated tracking and trading systems. enovate also had access to PERC and Enron personnel with considerable expertise in physical and financial sales of gas. Resp. Ex. N, pp. 4-5.

Prior to its bankruptcy, Enron leased office space in Chicago, a portion of which was used for enovate's operations. These offices were separate from the offices of PEC and its subsidiaries. PERC and Enron bore the labor costs for the employees who staffed enovate's offices, including the expenses incurred by their respective employees in the performance of their duties (such as travel).

enovate purchased hub services from Peoples Gas pursuant to its FERC Operating Statement, at rates permitted under that Operating Statement. Resp. Ex. N, p. 5. During the reconciliation period, enovate did not sell gas to or purchase gas from Peoples Gas. Resp. Ex. C, pp. 37-38.

[15] Speculative trading means entering into commitments to purchase or sell natural gas and related products at a defined price, in which the company bears the risks and opportunities associated with ongoing changes in these prices. Resp. Ex. N, p. 4.

[16] Administrative, middle, and back office functions mean functions such as commodity risk management, accounting, invoicing, credit risk oversight, scheduling, the data systems that supported all of these functions, and general management of the partnership. Resp. Ex. N, p. 6.

enovate's costs and revenues did not flow through Peoples Gas' Gas Charge. enovate did not manage Respondent's hub. Resp. Ex. L, pp. 20-21. enovate did not administer the GPAA. Resp. Ex. O, p. 2.

Manlove Field

Manlove Field is a natural gas storage field owned by Peoples Gas that is located in Champaign County, Illinois. Each fiscal year, Peoples Gas typically plans to use 25.5 Bcf of Manlove Field's storage capacity to inject and store gas for use by end users. The 25.5 Bcf of Manlove Field inventory comprises approximately 50% of Respondent's storage portfolio and is the single largest component of the resources used to meet heating load from December to January. Under design day conditions, Manlove Field would meet 39.5% of Peoples Gas' supplies. Resp. Ex. F, p. 33, 38-40.

Manlove Field is operated with an "injection season," during which gas is put into the field for storage, and a "withdrawal season," during which gas is taken out to meet Peoples Gas' supply needs. The injection season typically begins in the first or second week of March and ends in the first or second week of December. The withdrawal season typically begins in the first or second week of December and ends in the first or second week of March. Resp. Ex. I, pp. 5-7.

Before withdrawal begins, a withdrawal plan is developed for the season showing monthly targeted withdrawal volumes and average daily withdrawal volumes for each month. A decline curve is developed showing the cumulative withdrawal quantity at which field peaking begins to decline from its maximum of 800,000 Dth per day. The decline curve is constructed considering field performance from the previous year and any changes in working gas volumes. As the withdrawal season progresses, Respondent adjusted the monthly targets. Weather is a primary driver of variations from the schedule. The end-date of withdrawal is determined based on the seasonal target, weather, and other gas supply issues, such as leased storage inventories and actual deliveries of customer-owned gas. A major objective of the storage operation is to fully cycle the working gas volumes each year. Resp. Ex. I, p. 6.

In fiscal year 2001, withdrawal began approximately two weeks early on November 21, 2000. The reasons for this difference were both the colder than normal weather and the unprecedented gas prices at the time. Given that November 2000 gas prices were higher than the forward prices for December 2000 and January 2001, and given the *possibility* that the colder than normal weather would subside, Respondent decided to begin Manlove withdrawals on November 21, 2000. Other than this event, storage operations for fiscal year 2001 conformed to that of a typical year. Resp. Ex. F, p. 35; Resp. Ex. I, p. 7.

To the extent Manlove Field's capacity is not needed to provide service for end users, Peoples Gas uses Manlove Field to support hub services – interstate transportation, storage and exchange services – that Peoples Gas provides pursuant to authority granted by the FERC. *See* Resp. Ex. F, p. 42-43; Resp. Ex. L. 21, 24-25, 28-29.

Hub Services

The FERC, pursuant to the Natural Gas Policy Act of 1978, can authorize local distribution companies (like Peoples Gas) to offer transportation and storage services in interstate commerce. 15 U.S.C §3371. Together with exchange services that it provides, Peoples Gas calls these services "hub" services. The transportation and storage services are governed by FERC Order No. 63 (45 Fed. Reg. 1872 (1980)) and the FERC's rules at 18 C.F.R. 284.224.

In November 1997, Peoples Gas filed for authority (called a "Hinshaw blanket certificate") to provide firm and interruptible transportation services (Docket CP98-84) and for approval of rates for those services (Docket PR98-1). The Commission intervened in both cases. Peoples Gas then filed for approval for rates for firm and interruptible storage and interruptible park and loan services (Docket PR98-13). The FERC issued the Hinshaw blanket certificate by order dated March 2, 1998 (The Peoples Gas Light and Coke Company, 82 FERC ¶62,145), approved the transportation rates by order dated March 11, 1998 (The Peoples Gas Light and Coke Company, 82 FERC ¶61,239) and approved the storage and park and loan rates by order dated March 3, 1999 (The Peoples Gas Light and Coke Company, 86 FERC ¶61,226).

In the above-cited orders dated March 11, 1998, and March 3, 1999, the FERC directed Peoples Gas to file an application for rate approval on or before November 12, 2000, to justify the rates approved by the FERC or to establish new maximum rates. Peoples Gas did so in Docket PR01-2 and the FERC issued an order, dated March 31, 2001, addressing that filing (The Peoples Gas Light and Coke Company, 94 FERC ¶61,402) and, by letter order dated May 29, 2001, approved the compliance filing. The terms and conditions under which Peoples Gas offers its hub transportation, storage and park and loan services are contained in what the FERC calls an Operating Statement. 18 C.F.R. 123(e).

Parks and loans are the most common service provided by Peoples Gas under its Operating Statement. Under that service, a customer, called a "shipper," may request that Peoples Gas provide a park and loan service. If Peoples Gas determines that it can meet the shipper's request through Company-owned assets, it enters into an agreement with the shipper. The shipper delivers gas to Peoples Gas' system on an agreed upon schedule, subject to interruption by Peoples Gas in accordance with the Operating Statement. This is the "park." Peoples Gas then has an obligation to deliver a like quantity of gas to the shipper at a point on Respondent's system (*i.e.*, not using any pipeline transportation services), on an agreed upon schedule, subject to interruption by Respondent in accordance with the Operating Statement. This is the "loan." The transaction also could be structured such that the loan occurs before the park. Respondent supports this type of service through its Manlove Field. Respondent recovers the costs of Manlove Field through base rates. No purchases and sales of gas occur in connection with this transaction, nor does Peoples Gas use any purchased storage or transportation services in support of the transaction. Resp. Ex. C, pp. 33-34.

In addition to Operating Statement transactions, Peoples Gas enters into exchange services. An exchange is the same as a park and loan agreement in terms of the physical assets that Respondent uses to support the transaction. Under a typical exchange, a shipper delivers gas to Respondent under agreed upon terms and conditions and Respondent commits to deliver a like quantity of gas to the shipper at some later dates. The receipt of gas occurs at a point on Respondent's transmission and distribution system and the delivery by Peoples Gas also occurs at such a point. In other words, Peoples Gas does not need to use pipeline services to accept or receive the gas, nor does Peoples Gas need to purchase or sell gas to perform the service. The gas that is exchanged is valued at zero cost, as no purchase and sale actually occurs. The authority for these transactions is FERC Order No. 547. Resp. Ex. C, p. 34; *also see* 18 C.F.R. 284.402.

<u>Storage Optimization Contract ("SOC")</u>

The SOC was a contract under which Respondent contracted with Enron MW ("EMW") to optimize excess storage capacity associated with a storage service purchased by Respondent from Natural Gas Pipeline Company of America ("Natural") under Natural's Rate Schedule NSS ("NSS"). When coupled with the NB ("no-notice balancing") option under Natural's Rate Schedule Firm Transportation Service ("FTS"), NSS can provide the no-notice balancing function that is critical to Respondent's operations (i.e., ability to inject or withdraw gas from this storage without advance notice). Resp. Ex. L, p. 37-38.

NSS is a 75-day storage service. This means that, for each MMBtu of peak withdrawal capability that a shipper wants, the shipper must also acquire 75 times that amount in storage capacity. Respondent wanted additional no-notice rights in its portfolio, but it did not need 75 days of peaking capability. Through the associated discounted, firm transportation agreements with Natural and by entering into the SOC with EMW, Respondent converted its two 75-day NSS contracts (total storage capacity of 19,218,750 MMBtu) into a 10-day storage service (90,000 MMBtu per day for a total of 900,000 MMBtu) and a 20-day storage service (85,000 MMBtu per day for a total of 1,700,000 MMBtu). The capacity not needed or used by Respondent was optimized by EMW (*i.e.*, used to support revenue generating transactions) under the SOC.[17] Resp. Ex. L, p. 37-38.

[17] Of the 19,218,750 MMBtu of total NSS storage capacity, Respondent retained firm rights to 2,600,000 MMBtu – which the SOC referred to as "Restricted Capacity." Respondent was responsible for acquiring the gas supplies to fill this "Restricted Capacity" and had sole rights to its use. EMW was responsible for acquiring the supplies and coordinating with Respondent for the dispatch of those supplies for the purpose of optimizing the remaining "Unrestricted Capacity." Resp. Ex. L, p. 38.

Gas Lost and Unaccounted For ("GLU")

Gas lost and unaccounted for ("GLU") is the difference between gas sendout and sales/deliveries to end use customers. Sendout includes the Company's purchases plus transportation deliveries to its system plus net storage and exchange activities minus purchased storage compressor fuel. Sales/deliveries to end use customers include metered consumption (adjusted for month end estimates) from retail sales and transportation customers. Resp. Ex. K, p. 4. During fiscal year 2001, Respondent's GLU was 3.76% (obtained by dividing the unaccounted for gas of 8,330,912 Dth by the total gas sendout of 221,453,486 Dth). Id. at 3.

Respondent, as well as all Illinois utilities, utilizes the methodology set forth in the Commission's Form 21, page 706, Summary of Gas Account to calculate GLU. Form 21 prescribes that a GLU percentage be derived as a percentage of a category called "Total gas available for distribution." This category includes customer-owned gas received. Id. at 9-10.

Empirical evidence shows that GLU fluctuated from year to year for all major Illinois gas utilities over the past five years. Respondent's management has been vigilant in monitoring GLU and was aware of a GLU increase in 2001. Respondent took steps to control GLU including, for example, installing new ultrasonic meters on the compressor discharge piping at Manlove Field as a precaution to improve the accuracy of storage injection measurement. Id. at 10-11.

Off-System Transactions

Off-system transactions, *i.e.*, sales for resale by Peoples Gas, are a routine aspect of an LDC's management of its system. Pursuant to the Commission's rules, the costs and revenues for such transactions are flowed through the Gas Charge because recoverable gas costs are involved in the transactions. 83 Ill. Admin. Code §525.40(d). Of Peoples Gas' 103 off-system transactions during the reconciliation year, Staff has challenged only four of which two Peoples Gas has chosen not to contest.

Off-system transactions are an essential operational tool. Under Peoples Gas' evaluation, an off-system must accomplish one or more of the following: (1) provide a positive commodity credit, (2) provide a positive demand credit, (3) serve to meet an operational need, or (4) serve the purpose of testing the logistics and/or feasibility of future transactions that would meet one of the first three criteria. Resp. Ex. C, p. 29; Resp. Ex. F, pp. 47-48.

Off-system transactions can reduce gas costs through a positive demand or commodity credit.[18] In November 1992, with the issuance of FERC Order No. 547 (codified in Subpart H of 18 C.F.R. Part 284), which permitted sales for resale at negotiated rates, off-system transactions became possible. Every year since the issuance of FERC Order No. 547, Respondent has entered into off-system transactions and, in its annual reconciliation proceeding, has described the type and amount of transactions accounted for in the Gas Charge. Resp. Ex. C, p. 31.

There is no typical number of annual off-system transactions in which Respondent has engaged. In fiscal year 2001, Respondent entered into 103 off-system transactions. In fiscal years 1998, 1999 and 2000, Respondent had 346, 358 and 114 such transactions, respectively. *See* Resp. Ex. F, p. 49.

Off-system transactions are unrelated to the GPAA. However, the number of off-system transactions declined under the GPAA. This decline primarily was due to the GPAA's sellback provision that allowed Respondent to rely upon a single source (ENA) to which it could make off-system sales of up to 150,000 MMBtu per day when operational conditions required. Prior to

[18] For example, assume that Respondent had an obligation to purchase 1,000 MMBtu of gas at $3.00 per MMBtu, but conditions were such that it did not need that gas and was able to sell it for $3.10 per MMBtu. The purchase of gas is a recoverable gas cost ($3,000) and would be flowed through the Gas Charge as a cost of gas. This requires that the revenues ($3,100) from the sale would also be flowed through the Gas Charge as a credit. Resp. Ex. C, p. 29.

the GPAA, sales of smaller quantities of gas to several parties (*i.e.*, more operational off-system transactions) may have been required. Resp. Ex. C, pp. 31-32.

Transaction No. 19

Transaction No. 19, entered into in December 2000, was a baseload sale of 50,000 MMBtu per day to ENA. In late November 2000, Peoples Gas decided to enter into this transaction after reviewing forecasting data and determining that the sale would be a reasonable way to guard against possible "long" (oversupply) situations[19] that could occur in December, 2000. Respondent sold the gas to ENA under the GPAA but, unlike the normal resale under that agreement, retained the 3¢ credit to achieve a $46,500 savings. This transaction also preserved the full amount of Respondent's firm sell-back rights. Resp. Ex. F, p. 49.

Transaction No. 19 was the result of the decision to begin Manlove storage withdrawals in the month of November, 2000. The field's operational characteristics do not allow withdrawals to be interrupted once they begin. Additionally, the first 15 days of withdrawal operations are critical to the overall performance of the field. During this time, the gas "bubble" must be reversed or else it will continue to invade remote portions of the formation and become trapped. Therefore, during this start-up period not only must storage withdrawals not be interrupted, they should not fall below a minimum level. Resp. Ex. F, pp. 49-50.

Transaction No. 103

Peoples Gas entered into Transaction No. 103 with EMW to help Peoples Gas avoid a pipeline cycling charge. In April 2000, Peoples Gas' inventory levels in its Rate Schedule DSS (Delivered Storage Service) purchased from Natural were such that, in the absence of paying a

[19] In response to oversupply situations, the Company can either reduce its baseload purchase requirements and potentially be exposed to higher levels of daily purchases, or it can sell volumes on days as needed to balance the system. Gas sales during such oversupply conditions result in negative margins when the daily sale price is less than the first of month purchase price. This can be avoided if the baseload purchases are at the same daily price as the daily sales. Resp. Ex. F, pp. 50-51.

cycling charge to the pipeline, Peoples Gas would have faced reduced injection rights in the coming injection period. To preserve its injection rights, Peoples Gas could have paid that charge to the pipeline. Alternatively, under Transaction No. 103, EMW offered to pay the entire charge. Respondent sold a baseload quantity to EMW in December 2000. The price paid by EMW was the October 2000 Chicago first of month index. Resp. Ex. L, pp. 44-45.

Trunkline Transaction

Peoples Gas entered into a gas purchase transaction with EMW under which it had the firm right to purchase supplies year-round on a 100% swing basis, with the exception of ten days out of every winter period. In addition to swing purchase rights, Peoples Gas had the right to divert supplies away from its citygate as a means to balance its system. Resp. Ex. L, p. 42. This transaction is referred to by Staff as the "Trunkline deal."

Refinery Fuel Gas ("RFG")

Prior to fiscal year 2001, Peoples Gas purchased refinery fuel gas ("RFG") from Citgo at 75% of a Chicago first of month price ("FOM"). During fiscal year 2001, the Citgo agreement terminated and Peoples Gas instead purchased gas, much of it likely RFG, from EMW at 95% of FOM.

STANDARD OF REVIEW

On November 7, 2001, the Commission initiated the above-captioned proceeding pursuant to Section 9-220(a) of the Act.

The November 7, 2001 order, states, in relevant part, that:

> Each gas utility shall reconcile total revenue collected under the purchased gas adjustment ("PGA") with total cost of gas. The reconciliation balance shall be the difference between (1) costs as recorded in the books and records, excluding refund credits, which are allowed as recoverable costs through the Uniform PGA, and (2) applicable revenues. Each utility shall also demonstrate that its gas supplies purchased during the reconciliation period were prudently

> purchased. In addition, the company shall describe the measures, if any, taken by the utility during the reconciliation year to insulate the PGA from price volatility in the wholesale natural gas market explaining any hedging strategies utilized, the extent to which the strategies were actually implemented, and the actual impact on the PGA of implementing the strategies.

Section 9-220(a) of the Act states, in relevant part:

> Annually, the Commission shall initiate public hearings to determine whether the [purchased gas adjustment] clauses reflect actual costs of fuel, gas, power, or coal transportation purchased to determine whether such purchases were prudent, and to reconcile any amounts collected with the actual costs of fuel, power, gas, or coal transportation prudently purchased.

220 ILCS 5/9-220(a).

The Commission defines prudence as follows:

> Prudence is that standard of care which a reasonable person would be expected to exercise under the same circumstances encountered by utility management at the time decisions had to be made. In determining whether a judgment was prudently made, only those facts available at the time judgment was exercised can be considered. Hindsight review is impermissible.
>
> Imprudence cannot be sustained by substituting one's judgment for that of another. The prudence standard recognizes that reasonable persons can have honest differences of opinion without one or the other necessarily being 'imprudent'.

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

This is consistent with Illinois case law, which has held that the Commission's assessment of prudence must be based on information available at the time the decision is made, *i.e.*, hindsight review is impermissible. <u>Illinois Power Co. v. Illinois Commerce Commission</u>, 245 Ill. App. 3rd 367, 374 (3rd Dist. 1993). ("We also agree with Illinois Power that, to determine prudence, the contracts, decisions, and actions that make up fuel procurement and management must be reviewed in the light of the facts available at the time they occurred or were made.")

Finally, the Commission cannot create a new standard and apply it retroactively in assessing the prudence of a utility's gas purchases. Illinois Power Co. v. Illinois Commerce Comm., 339 Ill. App. 3d 425, 439-440 (5th Dist. 2003) (Illinois Power). In reversing a Commission finding of imprudence based on the Commission determination that Illinois Power Company failed to conduct a particular type of economic analysis, the Court stated that the Commission cannot "create[] *after the fact* the standard of care a reasonable person should have followed …." Id. at 440 (emphasis in original).

ARGUMENT

I. Respondent's Decision Not to Use Financial Hedging Instruments for 2000-2001 Winter Gas Purchases Was Prudent

In the gas industry, hedging is the use of physical or financial tools to mitigate gas commodity price volatility. Physical tools primarily include the use of storage but also include strategies such as purchasing gas from diverse sources of supply. Financial hedging is instruments such as forward contracts and options such as puts and calls. Neither physical nor financial hedging is designed to produce the lowest cost gas. Resp. Ex. H, p. 9. Historically, relative to market prices, hedging has resulted in *higher* gas prices. NOI Manager's Report dated April 17, 2001 in Docket 01-NOI-1 (Zack Cross Ex. 6) at p. 43.

For many reasons, not the least of which was that the Commission consistently has ruled that prudence does ***not*** require financial hedging when it was planning for its yearly gas purchases Peoples Gas chose not to use financial hedging instruments for its 2000-2001 winter gas purchases nor purchase gas under fixed price contracts.[20] The City and CUB however sponsored testimony asserting that Peoples Gas' decision not to use financial hedges during the 2000-2001 winter was imprudent. City Ex. 1.0, p. 58; CUB Ex. 1.0, p. 2. City witness Herbert claimed that Respondent's decision increased gas costs by $229,984,352. City Ex. 1.0, p. 58. CUB witness Ross claimed that Respondent's decision increased gas costs by $53,166,127. CUB Ex. 1.0, p. 21. The proposed disallowances were based upon a comparison of actual gas costs with those that each witness assumed would have been incurred under his hypothetical hedging program.

The City's and CUB's claims that Respondent's decision not to use financial hedging was imprudent lack merit. These claims are undermined by: (a) the testimony of Staff witness Dr. Rearden who stated that Peoples Gas' level of hedging was not imprudent, and (b) the Commission's rulings on the prudence of gas costs incurred by other utilities for the time period that did not find pricing conditions required financial hedging. The City and CUB therefore ignored longstanding Commission policy and precedent. Moreover, their analyses are flawed and inappropriately rely on hindsight review for only hindsight could reveal that market prices

[20] While it did not engage in financial hedging, Peoples Gas took several steps during the 2001 reconciliation period to address price volatility. Peoples Gas' supply portfolio contained storage resources, both owned and purchased, that allowed it to use the natural physical hedge that seasonal storage provides. Peoples Gas also purchased gas supplies from a variety of parties and from different producing regions to protect against regional price anomalies. Resp. Ex. B, p. 7. Respondent's customers received the full value of the differentials that existed between prices during the withdrawal season and the price to replace storage gas. Respondent showed that for fiscal year 2001, these replacement cost savings were approximately $130 million. Resp. Ex. F, p. 58.

In addition, Respondent followed two separate price protection programs, both of which were based on the tenet that mitigating volatility and dampening price spikes is prudent, even though this may not produce the lowest cost of gas. The first program was a pre-existing strategy that relied, in part, on historical price considerations. Under the second program, established in May 2001, Peoples Gas locked in the price of certain baseload quantities under the GPAA (approximately 15% of purchases during the May - September 2001 period) in addition to receiving the three-cent credit. Resp. Ex. C, pp. 19-20. Peoples Gas' purchases under this second program mitigated price volatility for its customers for gas consumed both during the May through September period in which the deliveries were made and also for the reinjection of gas withdrawn to satisfy customer requirements during the preceding winter months. Resp. Ex. B, p. 8.

during the 2000-2001 winter would have fluctuated such that hedging would have reduced gas costs and mitigate volatility to the customers' benefit.

A. Based Upon Staff Testimony and Commission Rulings for the Reconciliation Period, Peoples Gas' Hedging Decisions Were Prudent

Significantly, while the City and CUB claimed that Peoples Gas was imprudent for not using financial hedging, testimony submitted by Staff witness, Dr. Rearden, took a completely different position. Specifically, Dr. Rearden testified that no disallowance should be imposed for Peoples Gas' decision to not use financial hedging in fiscal year 2001:

> Q. Do you support a disallowance because the Company did not sufficiently hedge its purchases during the fiscal year's heating season?
>
> A. ***No. I do not believe that the Company's level of hedging was imprudently low.***

ICC Staff Ex. 7.00, at 54-55, emphasis added.

Dr. Rearden's testimony is consistent with a long line of Commission rulings and statements supporting Peoples Gas' hedging decision. Indeed, the Commission has never found that prudence requires the use of financial hedges.

Indeed, in all of its year 2000 gas charge reconciliation proceedings, the Commission's orders never concluded that a utility was imprudent for failing to use financial hedging instruments from October 2000 through December 2000 – the exact time period during which the City and CUB claim that Peoples Gas should have used financial hedging. *See* Orders in Docket Nos. 00-0710 - 00-0723.[21] Given that the Commission has not disallowed any other utilities' gas costs for failure to use financial hedges for Peoples Gas' 2001 reconciliation period, the same results should obtain here.

[21] With the exception of Peoples Gas and North Shore, Illinois gas utilities have a reconciliation year beginning on January 1; Peoples Gas' and North Shore's reconciliation year runs from October through September of the following year. Order Commencing PGA Reconciliation Proceedings, November 8, 2000, Docket Nos. 00-0710 - 00-0723.

Similarly, in ten of the fourteen 2001 gas charge reconciliation cases, the Commission's orders did not conclude that any utility was imprudent for failing to use financial hedging instruments.[22] In the remaining pending 2001 reconciliation proceedings, hedging is an issue only for the Peoples Gas and North Shore cases.[23]

Given the Commission's prior rulings that have not found a gas utility imprudent for failure to hedge, any contrary request regarding Peoples Gas improperly would treat Peoples Gas differently and hold it to a different standard of care than that applied to other Illinois utilities.

B. Respondent's Fiscal Year 2001 Hedging Decisions Were Prudent in Light of the Commission's Prior Decisions and Statements Concerning Financial Hedging

As noted above, to determine whether Peoples Gas' decision not to use financial hedging for fiscal year 2001 was prudent, the Commission must examine whether that decision was reasonable based upon the available facts and information, as well as the "standard of care" evident from the Commission's prior decisions or other sources existing at the time the decision was made.[24] Significantly, when Peoples Gas decided not to use financial hedges for its 2000-2001 winter gas purchases, the Commission had ***not*** announced any ruling or standard of care that would have suggested prudence required Peoples Gas to use financial hedging. Rather, the Commission had ruled that prudence does ***not*** require financial hedging.

In two of Respondent's recent gas charge reconciliation proceedings (Docket Nos. 97-0024 and 00-0720) as well as a case involving North Shore Gas Company ("North Shore") (Docket No. 97-0023), the Commission addressed the issue of whether prudence required hedging. In all three cases, the Commission determined that it did not. In Docket No. 97-0024,

[22] *See* Orders in Docket Nos. 01-0697, 01-0698, 01-0699, 01-0700, 01-0701, 01-0702, 01-0704, 01-0708, 01-0709 and 01-0710.

[23] In one of the other cases (MidAmerican Energy Company, Docket No. 01-0703), non-hedging questions are at issue. The remaining case involves Northern Illinois Gas Company (Docket No. 01-0705), which had performance-based rates in effect during 2001 and was not subject to traditional prudence review.

[24] *See* Illinois Power, 339 Ill. App. 3d at 440.

the Commission's annual prudence review for Respondent' fiscal year 1997 gas costs, Mr. Ross, testifying for CUB, claimed that Respondent was imprudent for not using financial hedges. Both Staff and the Commission rejected Mr. Ross' claims. Indeed, "the Staff urged the Commission not to order the Company to hedge more of its gas supply or to threaten a disallowance if hedging were not done to the extent discussed in Mr. Ross' testimony."[25] Similarly, the Commission's order in the 1997 case stated that "[c]learly, ***the Commission has not created an obligation or responsibility to mitigate price volatility through the use of such financial tools and we decline to do so*** in this proceeding."[26] In January 2000, the Commission also issued an order that made substantially identical findings regarding North Shore's fiscal year 1997 gas costs in Docket No. 97-0023.[27]

Significantly, the Commission issued these orders only a few months before Peoples Gas had to decide whether to use and begin purchasing financial hedges for the 2000-2001 winter. For example, City witness Herbert based his recommended disallowances on hedging programs that began purchases in April 2000 and CUB witness Ross' proposal was based on purchases beginning in May 2000. City Ex. 1.6; CUB Ex. 1.0, p. 16. Thus, when Peoples Gas was deciding about the use of financial hedging instruments for the 2001 reconciliation period, the Commission's recent orders in Docket Nos. 97-0024 and 97-0023 stated that a utility had no obligation or responsibility to use financial tools to mitigate price volatility.

Similarly, in Respondent's 2000 gas cost reconciliation case, Docket No. 00-0720, the City alleged that Peoples Gas' decision not to hedge was imprudent. Based upon its order in Docket No. 97-0024, Peoples Gas' 1997 reconciliation case, the Commission rejected the City's

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[25] Illinois Commerce Commission v. The Peoples Gas Light and Coke Company, Order dated January 26, 2000, in Docket 97-0024 (2000 Ill. PUC LEXIS 84 at *12-13).
[26] Id. at *15, emphasis added.
[27] Illinois Commerce Commission v. North Shore Gas Company, Order dated January 26, 2000, in Docket 97-0023 (2000 Ill. PUC LEXIS 85 at *13-15).

position. Specifically, the Commission found that, even assuming price volatility, failing to use financial hedging instruments was not imprudent.[28] Additionally, in Peoples Gas' 2001 reconciliation case, the Commission found:

> The City has failed to show that the gas supply tools that [Peoples Gas] did choose to use were inadequate to prudently control gas costs while providing safe and reliable service. At best, the Commission is presented with "honest differences of opinion" and finds that there is no basis for substituting the City's judgment for [Peoples Gas'] on the issue of using financial instruments.

Id. at 12-13.[29]

Here, City witness Herbert based his disallowance recommendation upon his view that during the 2001 reconciliation period and the months leading up to that period, there was volatility and Respondent should have used financial hedging instruments. City Ex. 1.0, pp. 20, 23. Similarly, CUB witness Ross based his disallowance recommendation upon price risk and price volatility. CUB Ex. 1.0, pp. 11, 15-16. Both witnesses' recommendations therefore were based on conclusions that if there is price volatility, prudence requires the use of financial hedging. As described above, the Commission has rejected this argument repeatedly.

In sum, finding Peoples Gas' gas costs imprudent because it decided not to use financial hedging would be an impermissible and arbitrary departure from past practice. See Illinois Power, 339 Ill. App. 3d at 440. Consequently, the intervenors' proposed hedging-related disallowances should be rejected.

[28] Illinois Commerce Commission v. The Peoples Gas Light and Coke Company, Order dated January 24, 2002, in Docket No. 00-0720 (2002 Ill. PUC LEXIS 170 at *12).
[29] See also Illinois Commerce Commission v. Central Illinois Light Company, Order dated May 20, 1998, in Docket No. 97-0013 (1998 Ill. PUC LEXIS 383 at *20-21) (allowing CILCO to recover costs of hedging programs while expressly declining to impose an obligation on utilities to use financial hedging instruments).

C. Intervenors' Analyses Are Flawed and Impermissibly Rely Upon Hindsight Review

Respondent's witness Frank Graves, a principal with The Brattle Group, reviewed the City's and CUB's testimony and submitted his own testimony demonstrating that intervenors' conclusions and analyses regarding the use of financial hedging were flawed. Mr. Graves showed that, in addition to regulatory policy considerations, the disallowances proposed by the intervenors' witnesses are inappropriate and should be rejected by the Commission.

1. Intervenors' Analyses Only Work in Hindsight and Fail to Establish a Basis for How Much Volatility to Hedge

A hedging program only should be expected to reduce volatility and not produce the lowest gas costs. In fact, relative to a non-hedged position (*i.e.*, spot market purchases), a hedging program is as likely to increase as to reduce gas costs. There is no way to know beforehand whether a hedging program will result in higher costs or lower costs compared with non-hedged purchases.[30] Thus, the intervenors' analyses that hedging would have been beneficial to Peoples Gas's customers only could be possible through hindsight for only hindsight can reveal whether, for a given period of time, hedging would give rise to lower gas costs. See ICC Staff Ex. 7.00, at 55 (testimony of Dr. Rearden).

The City and CUB witnesses acknowledged that hedging is about volatility (risk) management, not cost reduction efforts.[31] Each witness presented proposals that were tailored to trim off some of the high-priced spot gas that was purchased in the winter of 2000-2001. Resp. Ex. H, p. 5. Neither of these proposals however was based upon any notion of how much volatility ought to be hedged. Instead, as Mr. Graves testified, intervenors relied upon three observations: (1) volatility appeared to be increasing by the fall of 2000, (2) hedging is a normal

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[30] Resp. Ex. H, p. 9; *also see* NOI Manager's Report dated April 17, 2001 in Docket 01-NOI-1 (Zack Cross Ex. 6) at p. 43.

[31] City Ex. 1.0, pp. 17-18; CUB Ex. 1.0, p. 8.

part of prudent business management, and (3) it would have been easy, familiar and (in hindsight) beneficial to have hedged the ultimate conditions that occurred. Even if true, these observations are not a sufficient basis to require a utility to pursue a hedge program. How much volatility is unacceptable must be evaluated and appropriate risk mitigation strategies must be determined. Resp. Ex. H, pp. 12-13.

2. Hedging by Non-Utility Companies Is Not Relevant to the Prudence of Peoples Gas' Decision Not to Hedge

Messrs. Herbert's and. Ross' reliance upon how Peoples Energy Corporation's non-utility subsidiaries used financial hedging is misplaced.[32] Non-utility firms operate in a completely different environment than a regulated utility. Non-utility firms hedge to reduce their financial risk and avoid undesirable outcomes, such as reduced profitability, for their capital providers. Importantly, non-utility firms have symmetric risk outcomes from their use of hedging instruments. Either they "win," in which case they obtain the profits of their hedging strategy, or they "lose," in which case they bear the costs of the hedging strategy. In either case, they have increased certainty in what their future will hold. There is no potential for non-utility companies' hedging decisions to be reversed, after-the-fact, by a third party. Resp. Ex. H, p. 23.

In contrast, Peoples Gas does not enjoy symmetrical risk outcomes – it only can break even or lose. In particular, if the Commission retrospectively determines that the hedging programs were unnecessary or that different hedging schedules would have produced "better" outcomes, cost recovery may be disallowed. Exposure to retrospective rejection of prior hedging commitments therefore actually can increase gas utilities' hedging risk. Thus, an unregulated company has completely different motives and exposures from a gas utility regarding its decision to hedge. As a result, hedging decisions by Peoples Gas' affiliates provides no guidance for

[32] *See* City Ex. 1.0, pp. 24-26; CUB Ex. 1.0, pp. 9-10.

assessing any hedging that Peoples Gas could or should have undertaken. Resp. Ex. H, pp. 23-24.

3. In the 2000-2001 Winter, Hedging by Other Gas Utilities Was Not the Norm

City witness Herbert opined that hedging was prevalent among regulated gas utilities. City Ex. 1.0, p. 29. While some gas utilities did use financial hedging for 2000-2001 purchases, it by no means was the norm. Mr. Herbert's conclusion seemed based upon a July 2001 AGA Report that found 21 of the 49 local distribution companies ("LDCs") that answered an AGA survey question indicated that during the 2000-2001 winter, they used financial instruments and fixed-price contracts to hedge a portion of their gas supply purchases. This conclusion, of course, indicates that 28 LDCs (or more than half that answered the questionnaire) did *not* use financial instruments and fixed price contracts to hedge. The AGA sample upon which Mr. Herbert relied, showed that unhedged gas procurement was more prevalent than gas procurement. Resp. Ex. H, p. 19. Moreover, regarding the 21 gas utilities that hedged, Mr. Herbert did not know where or under what regulatory schemes they operated, R. 1274-1275, or whether the hedging was done with the support or pursuant to the mandate of their commissions. As a result, Mr. Herbert's testimony provided no basis for a cost disallowance based upon Peoples Gas' failure during the 2000-2001 winter to hedge.

4. Gas Prices for the 2000-2001 Winter Were Unprecedented and Unpredictable

The extreme run-up in gas prices during the 2000-2001 winter period was unprecedented and unpredictable and the rapid decline in gas prices was equally unforeseeable.[33] This is contrary to City witness Herbert's suggestion (City Ex. 1.0, pp. 30-31) that the circumstances heading into 2000-2001 (high levels of price risk, high prices and tight supplies) were sufficiently self-evident that Peoples Gas should have hedged or it should have hedged in a fashion similar to his recommendations. This extreme run-up in gas prices also is contrary to CUB witness Ross' claim (CUB Ex. 1.0, pp. 3, 11-12) that the 1996-1997 winter price experience was a useful precedent for the 2000-2001 winter because the 2000-2001 winter price run-up was far more extreme and unpredictable than what occurred during the 1996-1997 winter. Resp. Ex. H, p. 6.

In addition, futures prices during 2000 showed the unexpected nature of the price spike. Mr. Graves graphed the 36-month ahead Henry Hub monthly futures prices for contracts available immediately prior to and continuing through the price spike. He then compared these prices to the actual spot prices. This comparison showed that the futures price and the spot price were very similar for the month the futures were to be delivered. This was an expected result because spot and futures prices must converge as the contract maturity date and the spot price date converge. However, Mr. Graves' data showed that in most months prior to February 2001, forward prices rose from month to month but consistently suggested that future prices were

[33] Mr. Graves illustrated the unprecedented nature of the 2000-2001 prices by graphing daily prices at Henry Hub over the ten-year period January 1991-December 2001. During this period, daily prices averaged $2.45 per MMBtu with a standard deviation of $1.26 per MMBtu. The peak daily price in the winter of 2000-2001 was more than six standard deviations over the average, meaning that it was a very rare and unlikely event. Even this understates the extremity of this situation because the $1.26 standard deviation is based on data that includes the high price period itself. As a result, it is nearly double the standard deviation in the previous nine years. Excluding the 2000-2001 period (and the anomalous winter of 2000-2001), the standard deviation would have been $0.68. The average price for the months of December 2000 and January 2001 exceeded $8.50 per MMBtu. Every daily price remained above $5 per MMBtu for the 123 consecutive days between November 10, 2000, and March 13, 2001. This is more than two standard deviations above the ten-year average daily price, indicating that each such day (if it were independent) would have about a 1/40 chance of occurring. In this case, it occurred 123 times in a row. The probability of such a sustained period of high prices is infinitesimal. To say that the 2000-2001 winter price spikes were unprecedented, hardly does the situation justice. Resp. Ex. H, p. 26; Resp. Ex. FCG-2.

expected to drop, because the futures prices generally are lower in the farther forward months after the issue date. Resp. Ex. H, pp. 26-27; Resp. Ex. FCG-3.

Given the unprecedented and unpredictable nature of prices during the reconciliation period, the intervenors' conclusions that when, in early 2000, Peoples Gas was making its decision whether to hedge, it should have known a financial hedging program would have reduced gas costs during the 2000-2001 winter, is based on impermissible hindsight. When Peoples Gas made the decision not to hedge, as Staff witness, Dr. Rearden, explained, Peoples Gas could not have known whether it would "win" or "lose" that particular year by hedging and could not have predicted the highly unusual nature of the market it would face that upcoming year. Peoples Gas' decision not to use financial hedging therefore was reasonable at the time it was made. Any other conclusion necessarily would be based by impermissibly reviewing that decision with the benefit of hindsight. Accordingly, the intervenors' hedging analyses and their proposed hedging disallowances should be rejected.

II. The Gas Purchase and Agency Agreement (GPAA) Was Prudent

The GPAA ensured that Peoples Gas' end use customers would receive market-based prices for a sixty-one month term and a three-cent credit per MMBtu of most gas purchased under the agreement. The structure of the contract, which provided for citygate purchases, protected Peoples Gas' customers from expected declines in basis values[34], which would erode the value of the transportation services that Peoples Gas purchased from interstate pipelines.

[34] The term "basis" means the difference between the NYMEX futures contract at Henry Hub in Louisiana and the cash price at other market points. More generally, "basis" describes the difference in gas prices at a location in the field area and gas prices at the Chicago citygate. For example, if gas at the Houston Ship Channel is priced at $3.00 and gas at the Chicago citygate for the same time period is priced at $3.15, the "basis" is $0.15. The basis changes from day-to-day and within the day, and it can even be negative. The differential represents the value that the market is placing on the pipeline transportation required to move the gas from Houston Ship Channel to Chicago. Resp. Ex. C, p. 7.

Notably, the GPAA was not Peoples Gas' sole source of supply. Nor did Peoples Gas relinquish any of its Company-owned or purchased storage services to ENA.

Significantly, this is not the first time the GPAA is before the Commission. The GPAA was in effect for all of Respondent's fiscal year 2000 and was provided to the Staff more than one year prior to the initiation of the fiscal year 2000 reconciliation case. In the fiscal year 2000 case, Staff testified that they conducted a thorough review of Peoples Gas' gas costs and found the agreement prudent. Likewise, the City, the AG, CUB and the Cook County State's Attorney were parties to the fiscal year 2000 case and raised no issues related to the GPAA. Additionally, in fiscal year 2001, Peoples Gas continued to purchase a significant portion of its gas supply, approximately one-third, from other sources and under other terms and conditions, thus retaining a diversity of supply sources that had characterized its historical purchasing practices. Resp. Ex. B, pp. 3-4; Resp. Ex. C, pp. 4, 10.

The GPAA was designed to accommodate flexible pricing and, when the Commission's policy became more favorable to the use of financial hedging, Peoples Gas entered into fixed price purchases under the GPAA to mitigate price volatility. Both the basic agreement and the fixed price transactions preserved a three-cent credit. Resp. Ex. C, pp. 19-20.

The GPAA's pricing was a good proxy for Peoples Gas' historical purchasing practices, as exemplified by several comparisons -- looking backward and projecting the GPAA's performance historically, looking at purchases and costs during the year, and looking at a mix of historical and future data. Finally, the flat index price with the three-cent credit compared favorably with a benchmark gas price approved by the Commission for Northern Illinois Gas Company. For all of these reasons, the GPAA and the costs incurred under it were prudent.

A. The Commission Found No Imprudence Regarding the GPAA during Respondent's Fiscal Year 2000 Case

The GPAA was in effect during fiscal year 2000 and was included in the reconciliation of that year's gas costs and revenues. In connection with Respondent's fiscal year 2000 case, Docket No. 00-0720, which is closed, the Commission found no imprudence. Illinois Commerce Commission v. The Peoples Gas Light and Coke Company, Order dated January 24, 2002, in Docket No. 00-0720 (2002 Ill. PUC LEXIS 170) ("Peoples Gas Fiscal Year 2000 Order").

In both fiscal years 2000 and 2001, the GPAA was a major contract under which Respondent incurred significant gas costs. In fiscal year 2000, those costs were approximately $336 million, which represented approximately 74% of Respondent's total gas costs in fiscal year 2000. In fiscal year 2001, Respondent actually incurred less gas costs on a percentage basis than in 2000 when Staff and intervenors and the Commission had no objection to the GPAA. The percentage of gas costs incurred under the GPAA in fiscal year 2001 was 64%. Resp. Ex. G, p. 21.

Likewise, the GPAA's terms in fiscal year 2000 were substantially the same as the GPAA's terms in fiscal year 2001. Resp. Ex. C, p. 28. Significantly, neither Staff nor any party recommended any disallowances in fiscal year 2000 related to those or any other costs, and the Commission found that Respondent's gas costs were prudently incurred. Resp. Ex. G, p. 21.

The Commission's order and Staff testimony indicates that in the fiscal year 2000 case the GPAA was reviewed thoroughly. For example, the Commission's Order stated: "Staff witness Steven Cianfarini, a Senior Energy Engineer in the Engineering Department of the Energy Division, testified as to the Commission's definition of 'prudence.' He then stated that, after reviewing the Company's testimony and responses to extensive data requests, he did not find that the respondent made any imprudent purchases." Peoples Gas Fiscal Year 2000 Order at *4. *See also* Resp. Ex. G, p. 20.

In the Commission Analysis and Conclusions section, the Commission concluded that:

> All parties were afforded the opportunity to conduct discovery, cross-examine all witnesses, and present any evidence with respect to any issue in this proceeding. … Respondent presented detailed evidence in support of the prudence of the gas costs that it recovered through its PGA during the reconciliation period. In evaluating this evidence, ***Staff used the appropriate standards adopted by the Commission to review prudence, and found no evidence of imprudence***.

Peoples Gas Fiscal Year 2000 Order at *10 (emphasis supplied). S*ee also* Resp. Ex. G, p. 20. Moreover, the Commission further stated: "[D]uring the reconciliation period there was no evidence to indicate that Respondent had not acted reasonably and prudently in its purchases of natural gas." Peoples Gas Fiscal Year 2000 Order at *21. *See also* Resp. Ex. G, p. 20.

To conclude that Respondent prudently entered into the GPAA in fiscal year 2000, yet find that entering into the same contract in fiscal year 2001 was imprudent, would be unreasonable. Moreover, when dealing with a multi-year contract such as the GPAA, such a conclusion improperly would stand the Commission's prudence standard on its head. Resp. Ex. G, p. 19.

As Mr. Graves observed, to disallow contract costs in certain years and allow customers to enjoy the benefits of the contract in other years with no credit to Peoples Gas would be unfair. Such an asymmetric process would cause a utility to refuse to enter into multi-year contract unless it was certain that costs would be lower than alternatives in every year. Resp. Ex. E, p. 8. Here, where Staff and the Commission, after thorough review, found that costs incurred under the GPAA were prudent in fiscal year 2000, the only reasonable conclusion is that the GPAA and related costs for fiscal year 2001 likewise were prudent.

B. The GPAA Embodied Prudent Business Decisions That Achieved Five Important Company Objectives

Peoples Gas' Manager of Gas Supply Administration, David Wear, testified that Respondent sought to achieve five objectives through the GPAA. Those objectives were: (1) market-based commodity pricing with no reservation or demand charges, (2) flexible pricing options, (3) preservation of the value of Respondent's transportation capacity, (4) sufficient flexibility to assist Respondent in meeting different weather conditions, and (5) a reasonable proxy for Respondent's gas supply contracts in prior years. The GPAA met each of these five objectives. Resp. Ex. C, pp. 10-11.

1. Through the GPAA, Respondent Achieved Market-based Commodity Pricing With No Reservation or Demand Charges

The GPAA specified market based pricing for all gas. All three quantity components in the GPAA -- baseload, SIQ and DIQ -- were priced based upon a published, Chicago citygate index.[35] There was no demand or reservation charge for any quantity. Instead, there was a three-cent credit for the baseload quantity and SIQ, which in fiscal year 2001 reduced costs below the market indices by $2.7 million.[36] The GPAA therefore satisfied Respondent's goal of obtaining market-based commodity pricing with no reservation or demand charges.

The GPAA's market-based commodity pricing terms with no reservation or demand charges was a benefit to Respondent. These pricing terms also were atypical for a swing service such as the DIQ, which normally includes a demand charge as compensation for the supplier

[35] In fiscal year 1999, the year before the GPAA took effect, Respondent had six contracts where pricing was based upon the Natural Gas Intelligence Weekly Gas Price Index ("NGI") and thirty-six contracts where pricing was based upon Inside F.E.R.C.'s Gas Market Report, both of which are readily available, widely used sources for setting a market price in gas contracts; these contracts were a mix of first of month, daily pricing and weekly pricing. Resp. Ex. C., p. 19. Under the GPAA, the price for the first of month pricing, applicable to the baseload and SIQ, was based upon NGI, which during the reconciliation period was comparable to Inside F.E.R.C.'s Gas Market Report. Under the GPAA, the price for the daily pricing, applicable to the DIQ, was based on Gas Daily, the most commonly used index for purposes of daily priced contracts and, like NGI, Gas Daily, is a readily available, widely used source for setting a market price in gas contracts. Resp. Ex. C, p. 18.

[36] Resp. Ex. C, pp. 15-19; Sec. 4.1 of the GPAA, ICC Staff Ex. 2.00, Attach. 1.

standing prepared to meet the buyer's requirements on short notice, without assurance that the buyer will nominate supply. Prior to the GPAA, Respondent paid demand charges for such service ranging from $0.0067 to $0.023 per MMBtu of the daily contract quantity. Resp. Ex. C, pp. 15-18.

In contrast to Respondent's prior contracts, the GPAA specified market based commodity pricing for all gas, with no reservation or demand charges, thereby satisfying one of Respondent's goals when entering into the GPAA.

2. Through the GPAA, Respondent Achieved Flexible Pricing Options

Under the GPAA, the parties could agree to alternative pricing, such as locking in prices instead of the otherwise applicable index price. Beginning in May 2001, Respondent locked in the price of certain baseload quantities under the GPAA. Therefore, instead of the first of month price, the fixed price would apply to the purchase of these quantities and Respondent continued to receive a three-cent credit on these quantities. Approximately 15% of the purchases during the May - September 2001 period were at these locked in prices. Resp. Ex. C, pp. 19-20.[37] Through the GPAA, therefore, Respondent achieved its goal of flexible pricing options**.**

3. Through the GPAA, Respondent Preserved the Value of Its Transportation Capacity

Respondent negotiated contract provisions that preserved the value of its pipeline transportation in response to declining basis expectations. These expectations largely were based upon evidence of upcoming increased capacity. As a simple matter of supply and demand, increased capacity would depress the value of pipeline capacity, given that, at the time of the

[37] This locked-in pricing was part of Respondent's implementation of its gas price protection program. See Section I, *supra*, at pp. 32-33 n. 20.

contract negotiations, the Chicago market already was well-served by several pipelines. Resp. Ex. C, p. 6.[38]

When Respondent was negotiating the GPAA, available information, such as analyses by the Cambridge Energy Research Associates ("CERA") reviewing trends and projections for the 1996-2001 period, showed that basis likely would be declining. Respondent's review of projections for the GPAA period (1999-2004) showed a similar trend. Resp. Ex. C, pp. 7-8; Resp. Exs. 2, 3.

A declining Chicago basis is the same as a decline in the value of transportation. As a result, a citygate gas purchase agreement that included some assurances about recovery of the value of Respondent's underlying transportation contracts would counter declining basis. Resp. Ex. C, p. 21.

There was considerable support for the prospect of declining basis. At the time when Peoples Gas was entering into the final stages of GPAA negotiations, the Northern Border and Alliance projected represented 2.0 Bcf per day of new capacity into the Chicago market area on top of the roughly 8.0 Bcf per day of existing capacity on four other pipelines, an increase of 25%. While the new capacity coming into Chicago was quite certain, the status of new projects to move gas away from Chicago was highly uncertain.

For example, two projects -- Independence and Millennium -- were strongly opposed.[39] The only takeaway project that was advancing through the regulatory process was the 1.0 Bcf per day Vector pipeline, which was approved by Canada's National Energy Board in March 1999

[38]Local distribution companies like Peoples Gas generally contracted for pipeline transportation under long term (one year or longer) firm agreements and the price is within a cost-based range in the pipeline's tariff. While the basis is a proxy for the value of pipeline transportation, the price that shippers pay for transportation typically does not change from day-to-day. The changing value of transportation appears in changing commodity prices. Resp. Ex. C, p. 7.

[39] In March 1999, FERC indicated it would not issue preliminary determinations for either pipeline. In September 1999, FERC convened a public conference to discuss the market need for these projects.

and FERC in May 1999. However, there were claims in early 1999 that Vector's markets had not been established and its fate was still somewhat uncertain at the time the GPAA was being finalized.

In sum, 2.0 Bcf per day of new capacity was being built to Chicago. Only 1.0 Bcf per day of new capacity leaving Chicago seemed likely, and that project was not as advanced as the incoming pipelines. On net, it appeared there would be at least a 1.0 Bcf per day increase in a market that already had concerns about excess capacity. Resp. Ex. H, p. 42.

Under these circumstance, by moving a large portion of Respondent's purchased gas to the citygate from the field, the GPAA allowed Peoples Gas to achieve its goal of preserving the value of its transportation capacity.

4. Through the GPAA, Respondent Achieved Flexibility Sufficient to Assist Meeting Load Requirements

Respondent's load is weather sensitive and day-to-day requirements can fluctuate substantially. The GPAA provided flexibility that helped Respondent meet these requirements.

First, as discussed above, the negotiation of the baseload, SIQ and DIQ quantities resulted in flexibility.[40] Second, the GPAA included a valuable sellback provision that provided a firm market when an oversupply situation existed. Under that provision, on any day ENA had to accept up to 150,000 MMBtu of gas and move it away from the citygate. By establishing a contractual right to resell gas to ENA, Respondent substantially eliminated the uncertainty associated with finding a market for excess gas, often on short notice, when required to alleviate an oversupply situation. Resp. Ex. C, p. 23.

[40] For example, while most of Respondent's pre-GPAA contracts required long term baseload quantities, the GPAA baseload (*i.e.*, the quantity that Respondent was required to take) varied from month-to-month, allowing the baseload quantity to be tailored to each month's requirements. Resp. Ex. C, p. 14; Resp. Ex. L, pp. 15-16.

The sellback provision was valuable because the need to resell gas is substantially affected by variables over which Respondent has little or no control -- weather, customer usage and transportation customers' deliveries. Weather, of course, has a major effect on Respondent's sendout in the winter months. Even small variations from forecast weather can produce significant sendout changes.[41] Similarly, while Respondent uses customer usage forecasts for planning purposes, usage that deviates from the forecast for non-weather related reasons must be accommodated. Regarding transportation customer deliveries, approximately 40% of Respondent's annual throughput is for such customers, but their daily deliveries show considerable variability.[42]

The GPAA's sellback provision further was valuable because an oversupply situation creates significant and serious business issues. Operationally, an oversupply must be managed from a safety perspective to avoid overpressure situations on Respondent's system.

Economically, an oversupply can cause pipeline imbalances that give rise to substantial penalties. For example, Respondent's no-notice storage contracts provide a defined level of no-notice swing down rights to which penalties apply if these rights are exceeded.[43] Accordingly, it is cost-effective to use off-system sales, such as the GPAA's sellback provision, to address certain oversupply situations. Resp. Ex. C, pp. 26-27.

[41] During the reconciliation period, one heating degree day in December and January would equate to roughly 22,400 MMBtu of demand on Respondent's system. Resp. Ex. L, p. 26.

[42] Four recent years of data showed that the daily deliveries from large volume customers ranged from a low of 20% of system sendout to a high of 124% of system sendout. Respondent's Choices For You® transportation program, Riders SVT and AGG of Respondent's Schedule of Rates for Gas Service, gives it some control over deliveries, but the bulk of transportation deliveries are under programs under which customers have more flexibility. Resp. Ex. C, pp. 25-26.

[43] For example, the unauthorized overrun charge under Natural Gas Pipeline Company of America's tariff is $10 per MMBtu and there are tiered imbalance charges, increasing with the amount of the imbalance, based on commodity prices. On the other hand, no-notice services are costly and carry fixed charges that are payable regardless of whether the service is used.

The GPAA's sellback pricing terms did not lose their value because they were tied to daily market indices (specifically, the Gas Daily midpoint[44]) with a slight discount to the index. This slight discount was not a penalty, as incorrectly labeled by Staff witness Dr. Rearden. ICC Staff Ex. 3.00, p. 28. It would not be unusual for Peoples Gas to transact sales at prices where the weighted average was less than that of the midpoint. Even if Respondent only wished to enter into index-based transactions, it is not always possible to receive bids at the Gas Daily midpoint. Sellers who are physically long the commodity often have to adjust their Gas Daily offers with a discount from the midpoint to attract buyers. The GPAA pricing takes this phenomenon into account. Resp. Ex. F, p. 17.

Disposing of or moving to an alternate market up to 150,000 MMBtu of gas on a day when the market is oversupplied is a formidable task. The GPAA transferred that burden from Respondent to ENA. Resp. Ex. C, p. 24. The GPAA therefore achieved Respondent's goal of obtaining sufficient flexibility to meet its varying load requirements.

5. The GPAA Was a Reasonable Proxy for Respondent's Gas Supply Contracts in Prior Years

The commercial terms and conditions of the GPAA were comparable to Respondent's pre-GPAA contracts. As described above, the quantity provisions (a mix of baseload and swing) and index-based pricing were the same as the contracting approach used by Respondent prior to the GPAA. Index based pricing inherently produces market responsive results. The GPAA was a single contract for a larger total quantity, including the valuable sellback provision that often was not included in pre-GPAA contracts.

[44] The Gas Daily midpoint is the average of a range of prices that are reported to the publisher. These ranges reflect the spectrum of prices at which transactions being reported to Gas Daily are occurring. Gas Daily publishes what it calls a "Common" range and an "Absolute" range of prices. The midpoint of these ranges is the midpoint of the "Common" range.

Respondent's Exhibit 8 showed that the GPAA was a reasonable proxy for Respondent's prior contracts. Specifically, that exhibit compared Respondent's actual monthly gas costs for the two fiscal years prior to the GPAA (1998 and 1999) to the same monthly gas purchase volumes priced using the citygate indices used in the GPAA.

Notably, Respondent's Exhibit 8 does not reflect the benefit of the GPAA's 3¢ credit on baseload and SIQ volumes. Even without this benefit, Respondent's actual total gas purchases cost an average of $0.0327 per MMBtu more than a comparable Chicago citygate index weighted with 35% of purchases priced at a daily index and 65% priced at a first of month index. In other words, the costs in the two years prior to the GPAA could be viewed as a Chicago citygate delivered contract with an index plus $0.0327 per MMBtu overall price. While changing market conditions may dictate a more forward looking approach to negotiations, Respondent's Exhibit 8 shows that the GPAA allowed Respondent to achieve its goal of obtaining a reasonable proxy for its prior supply contracts. Resp. Ex. C, p. 28; Resp. Ex. 8.

The reasonableness of the GPAA's pricing likewise is demonstrated by other evidence. First, Respondent's Exhibit 9 showed actual GPAA purchases during the reconciliation period and simulated the costs associated with those purchases at the default index prices. Respondent exercised flexible pricing on some of its baseload and SIQ purchases. Resp. Ex. 9 substituted the appropriate default index price in the GPAA to determine the purchase costs associated with the core structure of the agreement. It then compared those costs to the hypothetical costs generated by purchasing that same amount of supplies with 65% priced at the applicable first of month price and 35% at an average daily price. On a per MMBtu basis, these two scenarios are less than 0.25% apart. Resp. Ex. F, pp. 15-16; Resp. Ex. 9.

Indeed, during the hearing, Respondent had requested that administrative notice be taken of gas charges from several other Illinois utilities. While this request was denied at the time it was made, this information would show that the results of Respondent's gas charges under the GPAA reasonably were in line with costs incurred by other utilities during the reconciliation year, further supporting the prudence of Respondent's gas costs at issue.

Second, Respondent's Exhibit 10 took these same volumes and costs associated with the GPAA and compared them to the volumes and costs associated with all of Respondent's non-GPAA purchases. For the reconciliation period, the GPAA outperformed all other purchases by over 14%. Resp. Ex. F, p. 16; Resp. Ex. 10.

Third, the Commission, in Docket No. 99-0127, approved a gas cost performance based rate for Northern Illinois Gas Company. Northern Illinois Gas Company d/b/a NICOR Gas Company, Order dated November 23, 1999, in Docket No. 99-0127 (1999 Ill. PUC LEXIS 921). The benchmark melded first of month and daily pricing. The approved benchmark was a Chicago citygate index with a 1.68¢ per MMBtu commodity adjustment above the index. Northern Illinois Gas Company d/b/a NICOR Gas Company, Order dated November 23, 1999, in Docket No. 99-0127 (1999 Ill. PUC LEXIS 921 at *70-71). By contrast, the GPAA pricing was at or below Chicago citygate indices.

In sum, there is substantial evidence, both forward looking and retrospective in nature, that shows the reasonableness of the GPAA pricing and the resulting gas costs recovered from customers. In particular, this evidence shows that the GPAA pricing was comparable to or better than pricing achieved by Respondent in prior years and from other suppliers during the reconciliation year and to a price benchmark approved by the Commission for another large utility serving the Chicago area. As such, through the GPAA Respondent achieved its goal of obtaining a reasonable proxy for Respondent's prior gas supply contracts.

* * * * * *

Notwithstanding the size and apparent complexity of the GPAA, it essentially was an aggregation of the types of market-based contracts that the Commission previously has found to produce prudent gas costs. Respondent historically purchased a great deal of its gas supply at index prices under contracts with terms ranging from four months to five years. These purchases included supply to meet winter requirements and to fill purchased and Company-owned storage both of which the GPAA included. Additionally, like prior agreements, under the GPAA Respondent continued to purchase some of its gas supply from other suppliers.[45]

Resales for operational reasons historically have been transacted through contacts with counterparties or through specific resale rights included in a supply agreement. In sum, the GPAA mirrored the types of services that Respondent previously purchased under multiple contracts.[46] As such, through the GPAA, Respondent achieved its goal of obtaining a reasonable proxy for its previous gas supply contracts.

C. The GPAA Was Prudent Based Upon Benefits That Are Not Easily Quantifiable

The GPAA's prudence further is demonstrated by benefits that, while substantial, may be hard to quantify. First, a large contract with a single supplier allowed Respondent's discretionary daily purchase activity to remain hidden from the larger market. Without direct knowledge of Respondent's purchase plans, daily prices might tend to rise less dramatically than

[45] Daily swing purchases historically have been made under different types of agreements. For example, some firm contracts for winter or year-round supply included swing rights, so that the amount purchased on any day could vary. Other daily swing requirements have been met through spot contracts, which have been priced at an index or at a fixed price agreed upon at the time of purchase.
[46] Resp. Ex. F, pp. 11-12; Resp. Ex. C, pp. 27-28.

if Respondent were out in the open market soliciting offers from dozens of counterparties. Resp. Ex. F, p. 8. This can produce significant cost savings. Second (and related), is that under the GPAA, Respondent could turn to a single supplier for daily sales activity that may be required for operational reasons, *i.e.*, the sellback provision discussed above. Resp. Ex. F, p. 8. Third, the GPAA preserved the reliability of Respondent's supply. When Respondent was negotiating the GPAA, ENA was the dominant gas trader in the country, with both a national presence and a regional presence in the Chicago market. Resp. Ex. F, p. 9. Fourth, while not part of the GPAA, by contracting with ENA Respondent and its customers received other benefits, in the form of increased efficiency and information. This would not have been available with a portfolio of smaller contracts with a variety of vendors.[47] The Staff and intervenor analyses fail to account for these more intangible benefits.

D. Staff and Intervenor Criticisms Did Not Establish that the GPAA Was Imprudent and Their Recommendations for Cost Disallowances Were Flawed.

While Staff and intervenor witnesses claimed that the GPAA and a portion of the costs incurred under it in the reconciliation year were imprudent, their analyses cannot withstand scrutiny. Further, the Staff's and intervenors' recommendations for cost disallowance, based on several different theories and ranging from $2.8 million to $37.5 million,[48] show the variety of approaches, including Respondent's, by which the GPAA may be analyzed. The variety of these approaches, in and of themselves, demonstrate that the GPAA's economic impact is incapable of mathematical precision. As a result, neither Staff nor the intervenors have provided a basis for finding the GPAA imprudent or for imposing cost disallowances.

[47] For example, ENA provided technical support to facilitate efficient operations under the GPAA. This included ENA's construction of a secure web page that allowed Respondent and ENA to exchange information about daily activity under the GPAA. ENA also developed a data base for Respondent's gas controllers to use that retrieved historical system sendouts based on weather inputs. Resp. Ex. F, p. 9.
[48] *See* ICC Staff Ex. 5.00, p. 4; AG Ex. 1.0, p. 18; CUB Ex. 4.0, p. 3; City-CUB Ex. 1.0, p. 7.

Illinois law recognizes that honest differences of opinion are not necessarily evidence of imprudence. ("Imprudence cannot be sustained by substituting one's judgment for that of another. The prudence standard recognizes that reasonable persons can have honest differences of opinion without one or the other necessarily being 'imprudent'.") Commonwealth Edison Company, Order dated October 7, 1987, in Docket No. 84-0395, (1987 Ill. PUC LEXIS 68 at *34); *also see* Commonwealth Edison Company, Order dated November 5, 1998, in Docket No. 95-0119 (1998 Ill. PUC LEXIS 1018 at *13)).

Here, there was a wide range of recommended disallowances for the GPAA based upon different theories: $2.8 million from CUB witness Mierzwa, $8.1 million from AG witness Effron, $8.9 million from Staff witness Dr. Rearden's first analysis, $13.3 million from Staff witness Dr. Rearden's second analysis and $37.5 million from CUB/City witness Decker. These differences of opinion by the parties contesting the GPAA's prudence show that how prudence should be evaluated or alleged imprudence quantified is subject to a variety of opinions. As a result, it would be unreasonable to conclude that because Staff and the intervenors viewed the GPAA differently from Respondent, the GPAA was imprudent.

Moreover, the Staff's and intervenors' recommendations in the present case are inconsistent with the Commission's prior treatment of GPAA costs and revenues during Respondent's fiscal year 2000 reconciliation case. An unexplained and unsupported departure from past practice and policy is contrary to Commission policy and Illinois case law. *See, e.g.*, Illinois Power, 339 Ill. App. 3d 425, 439 (5th Dist. 2003); Business & Professional People for the Public Interest v. Illinois Commerce Commission, 136 Ill. 2d 192, 228 (1989) (Commission decisions "are entitled to less deference when it [the Commission] drastically departs from past practice"). In Illinois Power, which involved the retirement of a propane plant, the Commission concluded that the utility was imprudent in retiring a propane plant without conducting what the Commission called a present value revenue requirement ("PVRR") analysis. In reversing, the court noted: (1) the utility had retired four propane plants in the preceding six years without being required to use a PVRR analysis prior to making such a determination, (2) "the prior Commission decisions and other experience would have lead one to conclude that a PVRR analysis was not necessary," and (3) "the Commission did not point to any prior decision or any other sources of a 'standard of care' that should have led a reasonable person to conclude that a PVRR analysis was a necessary component of prudent decision-making." Id., at 438-39.

Here, as in Illinois Power, the Staff's and intervenors' purported claims of imprudence and their various cost disallowance recommendations were based upon analyses of the GPAA in direct conflict to the conclusion in the fiscal year 2000 case that the GPAA was prudent. Accordingly, the Staff's and intervenors' claims that the GPAA was imprudent and their cost allowance recommendations should be rejected.

1. Staff's Criticisms Did Not Establish the GPAA's Imprudence Nor an Appropriate Basis for Cost Disallowance

Staff witnesses Dr. Rearden and Anderson criticized Respondent for not using a request for proposal ("RFP") process in connection with the GPAA and not relying upon a written, quantitative analysis. *See e.g.,* ICC Staff Ex. 2.00, pp. 9-10; ICC Staff Ex. 3.00, pp. 16-17. Additionally, Dr. Rearden performed an analysis, which he later revised and corrected, from which he concluded that the GPAA was imprudent. ICC Staff Ex. 3.00, pp. 33-36; ICC Staff Ex. 7.00, p. 36. Neither the call for an RFP or a written, quantitative analysis nor Dr. Rearden's analysis showed that the GPAA was imprudent.

Indeed, to the extent that Staff's approach was based upon requiring Peoples Gas to perform a specific type of analysis that the Commission has not previously articulated or required, that was improper. *See* Illinois Power at 438-39, 440 (the Commission cannot "create[] *after the fact* the standard of care a reasonable person should have followed … ." (emphasis in original)).

Moreover, Staff's analysis unrealistically considered a single set of assumptions and inputs, rather than considering a range of realistic scenarios and outcomes. Resp. Ex. E, pp. 15-16. Reducing the GPAA to a specific dollar value, rather than, for example, a range of costs and benefits, and then recommending a relatively small disallowance, treats prudence as a mathematical exercise. There is no one right answer to the question of what constitutes a prudent contract. Resp. Ex. P, p. 7. As Staff witness Anderson acknowledged, there are many different prudent ways to purchase gas. R. 866.

~~a.~~a. *The GPAA was not conducive to an RFP and that Respondent did not use one was not determinative of prudence*

While RFPs can be useful tools for evaluating gas supply contracts and have been used by Respondent,[49] they are most useful for relatively narrow, standard services that can be judged almost entirely on price. To that end, RFPs sometimes are used because price transparency is desired.

RFPs take time to issue and evaluate and, even when standardization is an explicit goal or constraint of the process, they frequently result in customized (*i.e.*, non-standardized) bids. Bidders often offer customized features to show their unique qualifications to provide service. The larger and more complex the services being sought by RFP, the more likely that bidders will submit non-conforming responses.

Here, the GPAA was not conducive to an RFP. For example, it involved the transfer of several supply and transportation contracts. Bidders likely would have picked and chosen the

[49] *See* R. 941-942.

contracts and service features that were most beneficial to their particular situation. Resp. Ex. H, p. 49; Resp. Ex. C, p. 4. Under these circumstances, the decision not to use an RFP process is not determinative of prudence.

b. ***That Respondent did not utilize a written, quantitative analysis is not determinative of prudence***

As Mr. Graves testified, the absence of a written, quantitative analysis is not determinative of the GPAA's prudence. The basic thrust of the GPAA was to achieve citygate-based pricing under terms that would prove advantageous if pipeline supply imbalances were to shift towards Chicago. These possibilities were sufficient and potentially large enough to indicate that the GPAA would reduce Respondent's gas costs. Even if Respondent had undertaken a written, quantitative analysis, it presumably would have shown, as have Mr. Graves' and Dr. Rearden's reconstructions, a fair amount of uncertainty. Resp. Ex. H, p. 49. As a result, the single most important factor underlying Respondent's decision to enter into the GPAA was, and necessarily would have been, management judgment that, as demonstrated throughout this brief, was entirely reasonable.

Further, it appears that the week before entering into the GPAA, Peoples Gas employee David Wear may have looked at the economics of the GPAA. *See* Wear Cross Examination Exhibit No. 15. While Mr. Wear did not recall that document, it seemed to suggest that Mr. Wear conducted an analysis of how a supply agreement like the GPAA would have affected customers had it been in effect in the four-year period prior to the GPAA. Mr. Wear was unable to testify about the substance of the analysis contained in Wear Exhibit No. 15 or with whom at Peoples Gas he may have discussed the analysis. On its face, however, the document showed that an agreement with the characteristics of the GPAA was increasingly favorable over the four-year period. Specifically, analysis in Wear Exhibit No. 15 showed directionally improving results under the GPAA leading up to 1999; GPAA losses from the earliest years of the analysis decreased and turned into gas cost savings over prior purchasing practices as it approached 1999. It appears that Peoples Gas' expectations about declining basis and the effect on traditional purchasing strategies was borne out by the simple comparison of actual costs relative to costs under an agreement like the GPAA. Moreover, Respondent Exhibit No. 8, a more sophisticated analysis for the two fiscal years immediately prior to the GPAA, showed that the GPAA, in fact, would be economically beneficial to Peoples Gas' customers relative to historical practices.[50]

c. *Staff Witness Dr. Rearden's analysis of cost disallowance was flawed*

Staff witness Dr. Rearden initially proposed a GPAA cost disallowance of $8.9 million (ICC Staff Ex. 1.00, pp. 2-3), which he subsequently revised to $13.3 million (ICC Staff Ex. 5.00, p. 4). Mr. Graves concluded that Dr. Rearden's analysis was flawed because it was based upon a single, not very extreme, scenario.

Mr. Graves testified that while the GPAA's benefit to Peoples Gas' customers could not have been a certainty, there was considerable evidence, well-known to industry practitioners, suggesting the plausibility, if not likelihood, of a steep decline in Chicago-area basis. As a result, to pass judgment on the GPAA's merits at the time it was negotiated and executed using only Dr. Rearden's single scenario would be unreasonable. A view of other, equally plausible,

[50] The "Aruba" analysis prepared by Roy Rodriguez of PEC likewise was not considered or relied upon by Peoples Gas in making its decision to enter into the GPAA. *See* Resp. Ex. L, p. 5. However, this analysis was ~~is~~ consistent with the analysis of Peoples Gas' expert, Frank Graves, in showing that over a range of possible assumptions, entry into the GPAA was reasonable in light of the potential outcomes in terms of obtaining value for the Company's transportation capacity. Id.

scenarios would show that the GPAA's payoffs potentially were significantly beneficial.[51]

Dr. Rearden's analysis was very sensitive to the assumptions of future basis projections. Based upon the range of future basis projections giving rise to a variety of potential outcomes, Dr. Rearden's disallowance calculation, which relied upon a single snapshot, was too precise to be meaningful. In the absence of other scenarios covering a range of possible outcomes, Dr. Rearden's analysis does not rebut Peoples Gas' showing of prudence, as demonstrated, in part, by Mr. Graves' analyses, which considered a range of outcomes and demonstrated the reasonableness of Respondent's decision.

2. CUB/City Witness Decker's Proposed Cost Disallowance Was Statistically Flawed

CUB/City witness Decker's proposed cost disallowance of $37.5 million[52] was statistically flawed. In addition, her analysis was improper because it wholly was the product of hindsight review.

Specifically, Ms. Decker examined the ratio of the prices paid by Peoples Gas' customers to daily spot market prices at the Chicago city-gate, the Katy Hub and the Henry Hub during four time periods: (1) January 1, 1995, to September 30, 1999 ("pre-GPAA period"), (2) October 1, 1999, to December 31, 2001 ("GPAA to Enron bankruptcy period"), (3) October 1, 2000, to September 30, 2001 ("reconciliation period") and (4) January 1, 2002, to June 30, 2004 ("post-Enron GPAA period"). By comparing the level of the Chicago citygate ratio during the pre-

[51] Mr. Graves used the framework of Dr. Rearden's analysis to show that the Staff methodology can produce significantly different results depending on the basis projections used. In particular, Mr. Graves evaluated Dr. Rearden's analysis using scenarios developed by CERA. The scenario most comparable to Dr. Rearden's, the "Integrated Growth" scenario, showed five-year GPAA costs ($5.9 million) that were much lower those Dr. Rearden calculated. The other three of the four scenarios produced savings. On average, the CERA scenarios suggest the GPAA was forecast to have net savings with respect to the basis-variable transportation cost component. Resp. Ex. H, pp. 45-46; Resp. Exs. FCG-6, FCG-7.

[52] City-CUB Ex. 1.0, p. 7.

GPAA period to the ratio during the reconciliation period, Ms. Decker calculated a disallowance recommendation of $37.5 million. City-CUB Ex. 1.0, pp. 21-27.

Ms. Decker's approach was inappropriate for determining the prudence of Respondent's decision to sign the GPAA because it relied on hindsight information (specifically, realized spot gas prices). Further, her analysis incorrectly presumed that unattractive costs arising from an alternative supply strategy represent imprudence as opposed to uncontrollable or unexpected circumstances. Ms. Decker's approach also is faulty and should be rejected because: (a) her metric for measuring reasonableness (the ratio of prices paid to Chicago city-gate prices) was unstable, and (b) the time period used to calculate this ratio for the pre-GPAA period was arbitrary. These flaws inappropriately inflated Ms. Decker's disallowance proposal. Resp. Ex. E, pp. 5-6. Moreover, Ms. Decker's performance metric is far too coarse to explain whether the GPAA was prudent. Resp. Ex. E, pp. 6-7. [53]

Significantly, Ms. Decker's analysis can be interpreted to demonstrate that the GPAA saved customers money in certain years. As shown in Respondent's Exhibits FCG-AR1 and FCG-AR2, when Ms. Decker's ratios are calculated as a combined 5-year GPAA period, they actually decline relative to her 5-year pre-GPAA period ratio.[54] As a result, even taking the

[53] For example, Ms. Decker's test compares a 5-year average cost ratio (prior to the GPAA) with the same ratio(s) in shorter periods since then, including the 1-year reconciliation period. However, as shown in Respondent's Exhibits FCG-AR1 and FCG-AR2, Ms. Decker's pre-GPAA cost ratio had huge changes from year-to-year when calculated on an annual basis. Specifically, the annual ratios fluctuated from a high of 75.67% (for Peoples Gas' costs over Chicago city-gate) to a low of -7.59%. Part of the reason for this internal contradiction is that Ms. Decker committed the statistical error of comparing a multi-period average of a volatile number to its value in a shorter period. Valid comparisons must be for ratios calculated over the same horizon and must address whether the two periods are otherwise comparable. The extreme year-to-year variability in Ms. Decker's gas index ratios during the benchmark period indicates that something much more complicated than whether the GPAA was in place was affecting gas prices.

[54] For example, Exhibit FCG-AR1 shows that the Chicago city-gate ratio actually fell from 17.72% in the pre-GPAA period to 16.41% in the full five-year period the GPAA was in effect. Likewise Exhibit FCG-AR2 shows that the Henry Hub ratio actually fell from 24.55% in the pre-GPAA period to 18.08% over the full five-year period the GPAA was in effect.

intrinsic flaws of Ms. Decker's analysis into account, she corroborated the GPAA's reasonableness relative to Peoples Gas' historical purchasing practices. Resp. Ex. E, pp. 8-9.

3. AG Witness Effron's Proposed Cost Disallowance Was Flawed

AG witness Effron purported to compare quantified "costs" with quantified "benefits" to produce a recommended $8.1 million disallowance. AG Ex. 1.0, p. 18. Mr. Effron's proposed GPAA adjustment relied upon his conjecture that an off-system transaction known as Transaction No. 19 was a "surrogate" for the baseload price adjustment included in the GPAA. AG Ex. 1.0, p. 15. The only apparent purpose of Mr. Effron's claim was to make his GPAA cost/benefit analysis produce a larger result that can be attributed to the GPAA.

Mr. Effron presented no evidence of a tie between the pricing mechanism, which ENA did not exercise during the reconciliation period, and the off-system transaction. Resp. Ex. F, pp. 53-54. Based upon the prudence of the GPAA, as well as the prudence of Transaction No. 19, Mr. Effron's analysis should not be a basis to determine the GPAA's prudence nor the appropriateness of a cost disallowance.

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In sum, no criticism by Staff or the intervenors rebutted Peoples Gas' position that the GPAA was the result of reasonable management decision making. Indeed, this was the very position implicitly taken by the Commission, Staff and intervenors during the fiscal year 2000 reconciliation case. Moreover, the gas costs charged to Peoples Gas' customers under the GPAA were no higher, and in some cases lower, than those charged by Peoples Gas in prior years and by other suppliers during the reconciliation year and were consistent with a price benchmark approved by the Commission for another large utility serving the Chicago area. Under these circumstances, as was the case for fiscal year 2000, the GPAA should be deemed prudent not subject to cost disallowance.

III. Peoples Gas' Provision of Hub Services Did Not Raise Gas Costs and Its Accounting of Hub Revenues Was Proper

Pursuant to authority granted by the FERC, Peoples Gas provides hub services -- interstate transportation, storage and exchange services.[55] While neither CUB nor the Staff questioned the propriety of offering hub services,[56] both seek various disallowances based on claims that the provision of hub services prevented Peoples Gas from using its storage capacity for the benefit of end users or caused Peoples Gas to purchase more expensive gas for end users. Staff further argued that the revenues generated from hub services should have been flowed through the Gas Charge. An examination of the record, however, demonstrates that there is no evidence hub services increased gas costs or prevented storage gas from being used for end users. Indeed, Peoples Gas presented evidence that providing hub services improves the operation of Manlove Field, which benefits end users. Furthermore, Peoples Gas' accounting treatment of hub revenues is consistent with Commission regulation and precedent.

A. Hub Transactions Did Not Increase Gas Costs

CUB witness Mierzwa claimed that Respondent used 12 Bcf of stored gas to support hub services during the 2000-2001 winter. He testified that this gas should have been used for end users. Based on this conclusion, he recommended a disallowance of approximately $51.2 million.[57] Staff witness Dr. Rearden also proposed a disallowance related to loans of gas to third parties that purchased hub services from Peoples Gas. He reviewed third party storage activity and found that on 59 days gas was loaned to third parties when the balance for third party storage

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[55] For a full description of the authority under which hub services are provided and what those services entail, see the Statement of Facts, *supra*, at p. 23.
[56] CUB Ex. 2.0, p. 7; ICC Staff Ex. 7.00, p. 45.
[57] CUB Ex. 2.0, pp. 6-7; CUB Ex. 4.0, pp. 5-7.

activity was negative. The $10.3 million disallowance sought by the Staff was based on the assumption that Peoples Gas bought gas on the daily market to make up for the amount of gas loaned to the third parties on those 59 days. ICC Staff Ex. 3.00, pp. 59-60. (CUB witness Mierzwa's adjustment also addressed these loans. CUB Ex. 4.0, pp. 8-9.)

Staff's and CUB's claims, however, are not supported by the evidence or the law. Rather, the evidence demonstrated that Peoples Gas' decisions as to how to use Manlove Field for end users were prudent and the provision of hub services neither interfered with the use of Manlove Field for end users nor raised their gas costs. Moreover, hub services provided operational benefits that ultimately benefit end users.

1. The Provision of Hub Services Did Not Affect the Amount of Gas Stored in Manlove Field Available for End-Users

In planning for fiscal year 2001, Peoples Gas planned to use approximately 25.5 Bcf of Manlove storage for its end users. This plan was the same as in prior years and, in prior reconciliation years, had not been challenged as imprudent. Also as in prior years, Peoples Gas provided hub services pursuant to its FERC authority. Resp. Ex. F, pp. 38-39, 45.

The key fact is that, contrary to Staff's and CUB's assumptions, the amount of Manlove Field storage capacity used for end users was established independently from and not influenced by the provision of hub services. As Respondent's witnesses testified, even if Peoples Gas did not offer hub services, no additional amount of Manlove Field storage would have been used to store gas for end users and no additional volume of gas would have been in its inventory to provide for end users during the 2000-2001 heating season.[58]

[58] Resp. Ex. L, p.21; Resp. Ex. F, pp. 38, 43-44.

Moreover, the evidence showed that the provision of hub services did not limit or otherwise impact the amount of gas available from Manlove Field for end users at any time during the reconciliation period. As Mr. Wear, Respondent's witness, testified:

> Hub transactions only utilized seasonal capacity in excess of that which had been established as appropriate for Respondent's end users. Hub transactions only utilized daily capacity if Respondent's normal daily dispatch indicated that they would not otherwise be used to meet end user's requirements. ***At no time were Respondent's end use customers denied the use of Manlove capacity because services were being provided to hub customers instead.*** Respondent's end use customers received the exact same access to daily and seasonal Manlove capacity as they would have had the Company not offered hub services at all.

Resp. Ex. L, p.21, emphasis added.

As Peoples Gas established, there are important operational reasons why the amount of Manlove Field storage used for end users is set at approximately 25.5 Bcf every year. The basic reason is the necessity of cycling the working inventory of the Manlove reservoir. Not cycling all working gas can have deleterious effects on the future performance of the field. Experience has shown that approximately 25.5 Bcf of aquifer storage is the amount that fits Respondent's load profile. Any amount greater than this could not be withdrawn under warmer than normal scenarios or would reduce or replace the need for baseload purchases throughout the year. Baseload purchases are necessary to achieve a mix of first of month and daily prices in the supply portfolio. Without baseload purchases, Respondent would increase its exposure to daily price volatility. Resp. Ex. F, pp. 38-39.

Displacing purchased storage services with additional gas from Manlove Field is not feasible. Only marginal tweaking is possible between these two types of storage. Each storage service performs a unique function to meet load requirements on an hourly, daily and seasonal basis. For example, Respondent receives two different storage services from Natural that are used mainly for no-notice balancing, *i.e.*, to serve hourly load variations and load changes due to weather forecast errors. Firm storage from ANR Pipeline Company ("ANR") serves swing loads, especially in the fringe months of October, November, March and April when Manlove Field is generally unavailable for withdrawals. During the reconciliation period, Respondent also received no-notice service from ANR. The 25.5 Bcf of Manlove Field inventory, which comprises approximately 50% of Respondent's storage portfolio, does not have a no-notice feature to it. Manlove Field is the single largest component of the resources used to meet heating load from December through February. Therefore, in addition to the difficulty in cycling additional Manlove inventories during warmer than normal conditions and the effects on baseload purchases, Respondent's storage portfolio must maintain diversity for operational and reliability concerns. Resp. Ex. F, pp. 39-40.

2. Peoples Gas Cannot Confiscate Third Party Gas

The suggestion by CUB witness Mierzwa that Respondent should have used gas stored at Manlove Field for end users in excess of the 25.5 Bcf of gas Peoples Gas had bought and injected into Manlove Field to provide to end users is meritless. It would have required Peoples Gas to breach contractual commitments and/or violate the law by essentially "stealing" gas that belonged to third parties.

As explained in the preceding section, Peoples Gas plans on using about 25.5 Bcf of gas from Manlove Field to serve its end users. Accordingly, it injects only this amount into the field. During the reconciliation period, Respondent fully used the gas it injected for its customers. To the extent intervenor recommendations are predicated on Peoples Gas using more gas from Manlove Field, this was not possible during the reconciliation period. Having prudently planned to use 25.5 Bcf, Respondent cannot change those plans in the midst of the withdrawal season.

Gas in Manlove Field in excess of this amount was gas subject to third party contractual commitments. Any such gas delivered by customers is either subject to an obligation of Respondent to return the gas at some future point in time or it represents the return of gas previously loaned to the customer. Confiscation of such gas by Respondent to use as it sees fit would be contrary to its contractual commitments and, for transactions subject to its FERC Operating Statement, its tariff obligations. Resp. Ex. F, p. 40.

3. Hub Loan Activity Actually Decreased Gas Costs

Staff and CUB witnesses reviewed Peoples Gas' hub activity and claimed that on some days the total quantity of gas loaned by Peoples Gas to hub customers exceeded the total quantity of gas that Peoples Gas received from these customers and this created a negative hub balance, requiring Peoples Gas to make daily gas purchases to serve its end users, which increased gas costs by $10.3 million.[59] Essential to this theory was that Peoples Gas made incremental daily gas purchases to support the loans. Specifically, as Staff witness Dr. Rearden's claimed, the loan of gas to third parties caused the Company to make incremental purchases on each day of the loan period in an amount equal to that day's loan volume and, conversely, the Company avoided incremental purchases on each day that the payback was received. If the total cost of incremental purchases was greater than the total avoided cost, then gas costs would be increased. Resp. Ex. F, p. 46. This theory however was incorrect; Peoples Gas did not make incremental purchases to support hub activity and, in fact, did not make the purchases that Dr. Rearden

[59] CUB Ex. 2.0, pp. 6-7; ICC Staff Ex. 3.00, pp. 59-60.

alleged.[60] Indeed, examining the facts concerning the loans and gas purchases that actually were made using the Staff's own methodology demonstrates that this activity ***reduced*** gas costs.

There is no dispute that Respondent entered into hub loan transactions during the 2000-2001 winter period. Resp. Ex. F, p. 45. The dispute is the effect of those loans on the Gas Charge. Respondent showed that customers were not adversely affected and, in fact, using Staff's analytical approach, the loans provided end users a slight cost benefit. Resp. Ex. F, p. 47; Resp. Exs. 14, 15.

The hub services offered by Peoples Gas are intended to be supported by its storage field. Peoples Gas made almost no incremental purchases beyond its baseload purchase commitments and those that were made were to meet minimal purchase needs or for optimization. Respondent's Exhibit 14 showed that Peoples Gas' made incremental purchases to meet system supply requirements for the period in which third party storage inventories were negative. Such purchases were made on only seven days. This shows that transactions that caused the net third party activity to go negative had little effect on the Company's gas costs. Instead of calculating a disallowance based on 4,914,182 Dth of loan activity (and $36,397,452 of purchase costs), Respondent, at most, made only 352,342 Dth of incremental purchases. Resp. Ex. F, pp. 46-47.

[60] The theories alleged by Staff and intervenors misapprehend how Peoples Gas serves its customers and draw artificial accounting distinctions. Respondent serves all its customers using the resources available to it. Manlove Field is a single storage facility that Peoples Gas owns and operates. R. 677. While the Company uses Manlove Field to provide service to its various customers -- end use sales customers, end use transportation customers, North Shore, and hub customers – ***none*** of these customers has a "right" as to any portion of Manlove Field. Instead, each of these groups of customers purchases services from the Company. They do not acquire title to specific molecules of gas, nor do they have a right to demand service from Manlove Field or any other specific resource. What these customers have is a right -- established by contract or through a Commission or FERC-approved tariff – to deliver certain quantities of gas and/or receive certain quantities of gas. Resp. Ex. L, p. 23.

Tracking how much gas each customer delivers and receives from the Company is a necessary accounting exercise, but it has no operational relevance. It allows the Company to bill customers and ensure that customers stay within their tariff and contract rights. There is only a single inventory in Manlove Field -- not individual inventories for different classes of customers -- (R. 677) and at no time during the withdrawal period was inventory in Manlove Field negative. Staff and intervenors are elevating accounting distinctions over operational decisions. What is proper and necessary for accounting reasons has no bearing on the day-to-day operational considerations affecting use of the field. Resp. Ex. L, p. 24.

When loaned gas was paid back, Peoples Gas simply returned that gas to storage. It avoided no purchases. This activity, as with all hub activity, did not affect Peoples Gas' purchase requirements. However, assuming that Respondent avoided certain purchases, as Staff's analysis assumes, the volume that did not need to be repurchased was only 352,342 Dth. Assuming that the avoided purchases occurred as the hub balance numbers became less negative, as Dr. Rearden did, to calculate the avoided cost, the avoided purchase costs were $1,932,230 (*see* Resp. Ex. 15), with a net gain of $21,633. In other words, the Company's gas costs, as determined using Staff's methodology, actually were reduced by the loan transactions.[61]

4. Hub Transactions Provided Operational Benefits

By providing hub services, Peoples Gas was able to expand Manlove Field that, for several reasons, has been operationally beneficial to the field. First, Peoples Gas has experienced less gas becoming trapped as compared to the top gas volume. Resp. Ex. I, pp. 9-10. Second, the field decline point, which is the point at which the peaking performance of Manlove Field begins to decline has been extended.[62] Prior to expanding the working gas of Manlove Field to accommodate gas for hub services, the field decline point was at a cumulative withdrawal volume of 18 Bcf. After the expansion, the field decline point was at a cumulative withdrawal point of 27 Bcf. Accordingly, increasing the size of the field by 8 Bcf has resulted in a 9 Bcf increase in the field decline point. This increase in the amount of working gas to accommodate hub services has allowed Peoples Gas to call on the full withdrawal capabilities of Manlove Field for an additional 1 Bcf of cumulative withdrawal. Resp. Ex. I, pp. 7-8.

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[61] Resp. Ex. F, p. 47, Resp. Exs. 14, 15.

[62] Respondent's witness Thomas Puracchio, Gas Storage Manager, explained on cross-examination:

Q. What is a deliverability decline curve calculation?

A. The deliverability decline curve calculation is used to determine the point in the season at which -- after a certain level of cumulative withdrawals has occurred, the field can no longer be expected to meet its rated maximum daily capacity. R at 679.

Third, the field performance, as measured by the water-gas ratio, has improved. The water-gas ratio is the ratio of total seasonal withdrawn water to total seasonal withdrawn gas. Lower water gas ratios are important measures of improved field performance in two ways: (1) lower ratios indicate higher gas saturations and the more efficient use of storage space; and (2) lower ratios require less pressure to remove water which can extend well life. Resp. Ex. I, pp. 8-9.

B. Hub Revenues Were Properly Treated

Additionally, Staff witnesses proposed a disallowance of $6.6 million on the theory that the revenues Peoples Gas earned from its hub services in fiscal year 2001 should have been flowed through the Gas Charge to offset gas costs. ICC Staff Ex. 5.00, p. 5. This theory is contrary to the Commission's Gas Charge rules. The Commission consistently has ruled that hub revenues are properly accounted for "above-the-line" and not in the Gas Charge. Accordingly, this proposed disallowance should be rejected.

1. The Commission's Gas Charge Rules Do Not Require that Hub Revenues Be Flowed through the Gas Charge

The determination of whether revenues, such as those generated by hub services should be flowed through the Gas Charge is governed by Section 525.40(d) of the Commission's rules, which provide:

> Recoverable gas costs shall be offset by the revenues derived from transactions at rates that are not subject to the Gas Charge(s) if any of the associated costs are recoverable gas costs as prescribed by subsection (a) of this Section. This subsection 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. . . .

83 Ill. Admin. Code Sec. 525.40(d).

Respondent agrees that hub revenues are "derived from transactions at rates that are not subject to the Gas Charge(s)." However, none of "the associated costs" of the hub transactions "are recoverable gas costs." Section 525.40(d) therefore does not require hub revenues to be flowed through the Gas Charge.

Peoples Gas' hub transactions are fully supported through the use of assets, such as Manlove Field and the Company's transmission pipeline, for which costs are recovered in Peoples Gas' base rates and not through the Gas Charge. Costs recovered in base rates are not recoverable gas costs.[63]

Here, Staff has testified that hub transactions occur by "displacement," which Staff described as a way to permit natural gas to move through a transportation system without the physical movement of molecules. ICC Staff Ex. 6.00, n 1.[64] Peoples Gas agrees with this description and agrees that displacement occurs on its system. For efficiency, Peoples Gas elects to physically perform on the net daily activity for all groups of customers, rather than, for example, schedule simultaneous injections and withdrawals. Resp. Ex. F, p. 41. Moreover, it is not possible to identify specific molecules of gas that are used for hub transactions *versus* molecules that are used to supply end users. It is impossible, from an operational perspective, to state that a transaction did or did not have any recoverable gas costs associated with it. Resp. Ex. L, pp. 22-23; *also see* R 870-871 (Staff witness Anderson stated that he was not aware of any transaction under which a customer would receive the same gas that the customer put in the system and it was not even possible to know if the gas is the same). Trying to interpret the rule against such an operational standard would render it a nullity.

[63] Resp. Ex. C, pp. 32-34; Resp. Ex. F, p. 41; *also see* ICC Staff Ex. 3.00, p. 45.

[64] For example, if both storage injection (10 units) and withdrawal activity (1,000 units) are scheduled on the same day, performing the transaction by displacement means that the injection and withdrawal activity is netted and only that physical activity is performed (990 units of withdrawal). ICC Staff Ex. 2.00, pp. 32-33.

However, whether hub transactions are physically performed through displacement is not determinative of the accounting treatment of hub revenues. Resp. Ex. L, pp. 23-24. The issue is not whether the Commission can mechanically trace molecules from the wellhead to the customer, but whether a hub transaction (*i.e.*, a transaction performed on a utility's transmission and distribution system) is one for which costs and revenues flow through the Gas Charge. As discussed below (Section II.B.2), in previously addressing this question, the Commission has not indulged in the theoretical exercise of whether it can associate specific molecules with specific transactions. It is Peoples Gas' physical assets, such as Manlove Field, that allow Peoples Gas to offer hub services. Resp. Ex. F, p. 41. The storage field has capacity to support services in addition to what is required for end user service. It is this incremental capacity that supports hub services.

2. The Commission Has Ruled that Hub Revenues Are Properly Accounted for in Setting Base Rates

The Commission already has ruled that hub service revenues properly are accounted for above-the-line and not in the Gas Charge. This ruling disposes of Staff's argument regarding the accounting treatment to be accorded hub service. A departure from the Commission's practice is unwarranted.

In 1993, Northern Illinois Gas Company ("Nicor Gas") requested an accounting treatment under which it would retain a portion of revenues generated by its hub services. Docket No. 93-0320. The Commission rejected Nicor Gas' request; instead, the Commission directed Nicor Gas to account for such revenues above-the-line. In other words, Nicor Gas had to account for revenues generated by its hub services in way that would allow these revenues to be considered in setting base rates in Nicor Gas' next rate case. The Commission stated that "[r]evenues from the operation of the Chicago Hub should be treated above-the-line. The

Commission agrees with Staff that revenues derived from a utility asset reflected in rates are generally treated above-the-line." Northern Illinois Gas Company, Docket No. 93-0320, Order dated March 13, 1996, 1996 Ill PUC LEXIS 151 at 11.[65]

Furthermore, the Commission twice has ruled on the appropriate cost and revenue treatment for transportation services provided by Nicor Gas to North Shore that is analogous to hub services. Docket Nos. 02-0779 and 03-0551. Nicor Gas provides a firm transportation service to North Shore. Transportation services are comparable to hub services in that they use company-owned assets to move gas from one point to another. In Docket No. 02-0779, the Commission found Nicor Gas' accounting treatment (above-the-line and not through the gas charge) and North Shore's treatment of costs (through the Gas Charge) acceptable. Northern Illinois Gas Company d/b/a Nicor Gas Company and North Shore Gas Company, Docket No. 02-0779, Order dated February 20, 2003, 2003 Ill. PUC LEXIS 201 at *4. Similarly, in Docket No. 03-0551, the Commission stated that this revenue accounting treatment was proper and that the customer (North Shore) would recover costs through its gas charge: "It is proper for Nicor Gas to account for the revenues it receives above-the-line, rather than flowing them through the PGA. It is also proper for North Shore to treat the charges for the service as recoverable gas costs that are accounted for in its PGA, subject to the annual reconciliation of costs and revenues." Northern Illinois Gas Company d/b/a Nicor Gas Company and North Shore Gas Company, Docket No. 03-0551, Order dated November 12, 2003, 2003 Ill. PUC LEXIS 956 at *4.

[65] In 1995, Nicor Gas filed its first rate case since its request for a hub revenue accounting ruling. In that case (Docket No. 95-0219), projected hub revenue was an adjustment to operating income in setting Nicor Gas' rates, thus lowering base rates. Northern Illinois Gas Company, Docket No. 95-0219, Order dated April 3, 1996, in Docket 95-0219 (1996 Ill. PUC LEXIS 204 at *33-35). This was consistent with the Commission's prior ruling that hub service revenues should not be flowed through the Gas Charge.

Consistent with these decisions, it was proper for Peoples Gas to account for its hub revenues above-the-line and not through the Gas Charge. In Peoples Gas' next base rate case, these revenues would be taken into consideration in establishing cost-based base rates.

IV. Peoples Gas Prudently Used Manlove Field for End Users

Peoples Gas met part of its end users' requirements during the 2000-2001 winter through withdrawals from Manlove Field. It began withdrawing gas in late November 2000 and continued withdrawals through early March 2001. The commencement of withdrawals was somewhat earlier than usual. Resp. Ex. I, p. 7.

Staff witnesses argued that Peoples Gas' use of Manlove Field during December 2000 and January 2001 was imprudent. Specifically, Staff asserted that Peoples Gas should have used as much gas from Manlove Field as possible in December and January for ratepayers, thereby reducing later season withdrawals, and relied upon daily purchases in February and March. ICC Staff Ex. 7.00, pp. 58-60. The recommended disallowance associated with this theory is $25.9 million.[66] ICC Staff Ex. 5.00, p. 5.

The Staff's claim is incorrect. Not only does it ignore the reasonable and legitimate operational concerns of Peoples Gas that drove how it used Manlove Field for end users in connection with its entire portfolio of gas sources, but it was based on hindsight review that is inappropriate under the Commission's prudence standard and represents unacceptable micromanagement.

[66] CUB witness Mierzwa also questioned Peoples Gas' use of Manlove Field, particularly in the context of hub services. To the extent Staff or intervenors claim that Peoples Gas misused or underused Manlove Field for end users in December and January of the reconciliation period, those claims are addressed in Section III, *supra*, in which the independence of Peoples Gas' use of Manlove Field for its end users from the provision of hub services and the fact that the amount of gas available from Manlove Field would be the same with or without hub services is discussed in detail.

A. Manlove Field Withdrawals During the Reconciliation Period Were Driven by Operational Factors

Staff is correct that actual withdrawals from Manlove Field in December 2000 and January 2001 were less than the levels included in Respondent's planning documents. However, the conclusions that the Staff draws from that fact are wrong. Resp. Ex. L, p. 25.

Under design day conditions, Manlove Field would meet 39.5% of Peoples Gas' supplies. Therefore, preserving the peaking capabilities of the field is critical. Peak deliverability only can be maintained until a certain amount of inventory is removed. This describes the phenomenon called the "decline curve," which means that when inventory is reduced to a particular level, the amount that can be withdrawn on a day begins to decline. *See* note 62, *supra*, at p. 70. A second factor that affects deliverability is "cycling," which is the degree to which working gas is removed and replaced each year. Resp. Ex. F, pp. 33-34.

Manlove Field withdrawals were less than planned in December 2000 primarily because the actual sendout to end users on certain days was significantly less than forecast. The purchased gas nominations could not be changed for those days, so the unexpected decrease in demand was accommodated by a reduction in storage withdrawals. Without this disparity between forecast and actual sendout, Manlove withdrawals would have been closer to what originally was planned. In January 2001, the weather was warmer than normal, so monthly sendout was about 5,000,000 MMBtu less than that forecast for normal weather. Respondent's purchased storage services absorbed a portion of the deficit as did Manlove Field. Resp. Ex. L, p. 25. Storage necessarily is used to accommodate such situations. Resp. Ex. L, p. 27.

The standard "gas day" in the industry is the 24-hour period beginning at 9:00 a.m. Industry standards require that the supplies that flow during that period must be acquired and scheduled for delivery no later than 11:30 a.m. on the day prior to flow. Therefore, Respondent's planning and purchasing activities must take place well ahead of the time that the supplies are actually needed. Once Respondent has committed to a daily purchase, it cannot change its mind in the middle of the gas day and renege on its purchase commitment. This situation is exacerbated over weekends and holidays when, for example, Respondent must purchase and schedule the supplies (generally for the same amount each day) that are needed for Saturday, Sunday, Monday and Tuesday, on the Friday morning before a three-day weekend. Resp. Ex. L, p. 26.

Respondent relies on weather forecasts to estimate the amount of demand that it will need to meet. In December and January, forecasts for the next day have an absolute average error of 6.5º F, using two standard deviations. Forecasts for days farther out get worse with each additional day. During the reconciliation period, one heating degree day in December and January would equate to about 22,400 MMBtu of demand on Respondent's system. Unsurprisingly, Respondent's load is difficult to predict. Whenever the actual weather conditions for a given day differ from the available forecast, Respondent must use storage to accommodate these differences. Often, Manlove Field is the only suitable storage service. Resp. Ex. L, pp. 26-27.

In addition, Respondent must deal with imperfect knowledge of transportation customer deliveries. Customers constantly change their deliveries, which causes the actual amount delivered to Respondent to differ from the estimated amount. These customers submit their nominations to Respondent at the same time that Respondent is scheduling gas with the interstate pipelines. Resp. Ex. L, p. 27.

Moreover, even with perfect knowledge of weather and transportation customer deliveries, other factors can cause system consumption to differ from that which is estimated at the time supplies are acquired. These include changing industrial demand due to customers canceling or adding production activity, heating customers changing their thermostats or the interruption of firm services on the upstream pipelines due to *force majeure* events. Storage is the only means to accommodate these events. Resp. Ex. L, p. 27.

Respondent maintains storage inventories to protect against cold weather. Under normal conditions, Respondent expects approximately 33% of its demand in December through February to be met by storage withdrawals and, during the reconciliation year, it reasonably expected cold weather to occur during January and February, which normally are the coldest of these months. This did not occur. January 2001 and February 2001 had only one day that averaged below 10º F. In contrast, in the 42 prior years of O'Hare data for January through March periods, there were 384 days with average temperatures of 10º F or colder, which is about 9 per year. In early December 2000, Respondent, of course, could not and did not know that it could pull more storage to reduce daily purchases instead of saving the gas for anticipated colder January and February days.[67] Staff's critique of the Company's use of storage ignores these facts. Resp. Ex. L, pp. 27-28.

B. Staff's Recommendation Is Wholly Based on Hindsight and Disregards the Essential Operational Function of Manlove Field

The Staff's recommendation is not based on the conclusion that Respondent's use of Manlove Field was imprudent; rather, this recommendation is the result of its arithmetic exercise

[67] Staff also alleged that gas from Manlove Field was underused during "peak times" (due to hub services). Respondent does not know when the "peak times" during the heating season are occurring. Respondent experienced cold days throughout December 2000. It also experienced cold days in November, January and February, notwithstanding that January and February were, on average, warmer. There is no way to know what period will be the "peak time." Resp. Ex. L, p. 29. Staff witness Anderson agreed that what he called the "peak winter period" does not occur at the same time each year. R. 873. This is, necessarily, known after-the-fact. Respondent's peak day, *i.e.*, the day with the highest sendout, for the reconciliation period was December 21, 2000. In addition to this day, Respondent experienced 24 other days in which the sendout for those days was at least 75% of that peak day sendout. Thirteen of these days occurred before the peak, the earliest being November 20, 2000, and eleven of them occurred after the peak, the latest being February 17, 2001. Resp. Ex. L, p. 29.

under which Staff calculated that, given perfect knowledge about winter requirements and prices, Respondent's gas costs would have been lower had it used Manlove Field differently. As noted above, hindsight review is impermissible under Section 9-220 of the Act. Staff's recommendation here is a particularly egregious example of hindsight review. Indeed, the crux of Staff's proposal is that "Peoples Gas should have *foreseen* that gas prices were likely to be lower in February and March than they actually were during December and January." ICC Staff Ex. 7.00, p. 61, emphasis added.

Further, by engaging in an arithmetical exercise, Staff's recommendation ignored the critical operational function of Manlove Field. Resp. Ex. L, p. 34. Setting aside the operational problems with frontloading withdrawals and treating Manlove activity as an economic exercise, a disallowance cannot be based upon the presumption that "Peoples Gas should have foreseen" future prices. Apparently, Staff witness Dr. Rearden based this claim on his review of NYMEX data. R. at 1303. The unqualified weight he gave this data was unwarranted. NYMEX information shows the prices at which buyers and sellers are willing to transact at any given moment, not what the price of the commodity will "likely" be.

In fact, NYMEX prices tend to be a very poor indicator of prices. The delivery point for the NYMEX futures contract is the Henry Hub in Louisiana. Therefore, if NYMEX futures prices were indicative of gas prices, they should be most representative of physical gas prices at the Henry Hub. During the reconciliation period, however, the average of December NYMEX settlement prices during October 2000 was 14% lower than December's actual Henry Hub first of month index. The average of November's published December NYMEX settlement prices during November 2000 was 5% lower than the actual December Henry Hub first of month index price. Of course, these are only the average of each day's settlement price, which prices would change minute by minute throughout the month. NYMEX data for January through March 2001 would not show that prices during that time were going to be lower than in December 2000. Resp. Ex L, p. 31.

Furthermore, the months selected by Staff for the rearrangement of storage activity are based on Respondent's LIFO price. In fact, Dr. Rearden stated that "[t]his price is the reason that December 2000 and January 2001 are the only months that figure in the disallowance calculations." ICC Staff Ex. 7.00, p. 58. Until the end of the fiscal year, however, the LIFO price is unknown and therefore not a tool that Respondent could have used when it was making daily withdrawal decisions to fine tune storage withdrawals for the biggest economic benefit. Moreover, if comparison of the cost of purchases versus the LIFO rate is a decision making criterion, such that anytime a purchase greater than the LIFO rate is called into question, Respondent could not function.

Even with such an unworkable premise, Dr. Rearden's adjustment presupposes that when making decisions in December and January, Respondent would know the LIFO price. This is untrue. Respondent's LIFO price of $6.23 was unknown until after the end of the fiscal year (September 30, 2001) when its books closed. In December 2000, Respondent's estimate for LIFO rate was $7.22 per MMBtu. In January 2001, this estimate was $6.80 per MMBtu. Without knowledge of future events, neither Dr. Rearden nor anyone else could know that substituting storage for purchases would have produced any savings. Resp. Ex. L, p. 34.

Moreover, putting aside that decisions cannot be made on the basis of unknown information, Staff's recommended disallowances were based on a false belief that the only purpose of storage is to provide a price arbitrage. The proposed dispatch of Manlove Field makes no accommodation for operational restrictions, peak day protection, balancing needs, the possibility that summer prices could exceed winter prices or how Respondent would be expected to respond to these circumstances. Resp. Ex. L, p. 34. Respondent must be flexible and use storage to accommodate the inevitable discrepancies between planned and actual conditions. Accordingly, the use of Manlove Field for end users was reasonable and consistent with the circumstances encountered by Peoples Gas during the 2000-2001 winter. Resp. Ex. L, p. 49.

V. The Storage Optimization Contract ("SOC") Was a Prudent Means of Generating Revenue and Preserving the Peaking Capacity of Respondent's Purchased NSS Storage Service

Staff questioned the prudence of the Storage Optimization Contract ("SOC") that Peoples Gas entered into with Enron MW, LLC ("EMW"). ICC Staff Ex. 7.00, pp. 62-68. Contrary to Staff's suggestions, the SOC did not increase Respondent's gas costs. In fact, it decreased total gas costs and, consistent with its operational purpose, preserved needed storage flexibility.

Under the SOC, Respondent contracted with EMW to optimize excess storage capacity associated with a storage service purchased by Respondent from Natural Gas Pipeline Company of America ("Natural") under Natural's Rate Schedule NSS ("NSS"). When coupled with the NB ("no-notice balancing") option under Natural's Rate Schedule Firm Transportation Service ("FTS"), NSS can provide the no-notice balancing function that is critical to Respondent's operations (i.e., ability to inject or withdraw gas from this storage without advance notice).

As it had done in prior years, Peoples Gas contracted with a third party to manage the unneeded capacity. Resp. Ex. F, p. 55. The Commission's Gas Charge rules contemplate such arrangements and permit the recovery of costs. 83 Ill. Admin. Code §525.40(a)(4). (The definition of recoverable gas costs includes "other out-of-pocket direct non-commodity costs, related to hydrocarbon procurement, transportation, <u>supply</u> <u>management</u>, or price management, net of any associated proceeds, … .") (emphasis added).

NSS is a 75-day storage service. This means that, for each MMBtu of peak withdrawal capability that a shipper wants, the shipper also must acquire 75 times that amount in storage capacity. Here, Respondent wanted additional no-notice rights in its portfolio, but it did not need 75 days of peaking capability. Through the associated discounted, firm transportation agreements with Natural and the SOC with EMW, Respondent converted its two 75-day NSS contracts (total storage capacity of 19,218,750 MMBtu) into a 10-day storage service (90,000 MMBtu per day for a total of 900,000 MMBtu) and a 20-day storage service (85,000 MMBtu per day for a total of 1,700,000 MMBtu). The capacity not needed or used by Respondent was optimized by EMW (i.e., used to support revenue generating transactions) under the SOC.[68] Resp. Ex. L, p. 37.

One important reason why Peoples Gas needed its NSS contracts was to provide for no-notice withdrawal capability to ensure service on peak days. Under Natural's NSS tariff, however, if storage inventory fell below 50% of total capacity, the NSS withdrawal rights were reduced. Thus, if Respondent only filled NSS with the 2,600,000 MMBtu that it needed in its portfolio, it would have had only 134,531 MMBtu per day of peak day withdrawal capability instead of 175,000 MMBtu per day. The SOC avoided this problem.

Under the SOC, EMW used the NSS storage capacity in excess of the 2,600,000 MMBtu needed by Peoples Gas so that gas acquired by EMW could be used to meet the 50% requirement of Natural's NSS tariff for keeping full withdrawal rights. <u>See</u> Resp. Ex. L, p. 38. The SOC, therefore, served the important function of allowing Peoples Gas to use NSS for peak day service without having to pay the cost of filling 50% of the storage space itself. In addition, under the

[68] Of the 19,218,750 MMBtu of total NSS storage capacity, Respondent retained firm rights to 2,600,000 MMBtu – which the SOC referred to as "Restricted Capacity." Respondent was responsible for acquiring the gas supplies to fill this "Restricted Capacity" and had sole rights to its use. EMW was responsible for acquiring the supplies and coordinating with Respondent for the dispatch of those supplies for the purpose of optimizing the remaining "Unrestricted Capacity." Resp. Ex. L, p. 38.

SOC, Peoples Gas received a share of the revenues generated by EMW's optimization activities -- $334,344 in demand credits during the reconciliation period -- that were flowed through the Gas Charge to the benefit of end users. Resp. Ex. L, pp. 37-38.

While Staff questioned why Respondent did not optimize the additional capacity on its own, ICC Staff. Ex. 7.00, p. 66, the expertise required to do so made it reasonable for Respondent to hire a third party to perform the optimization service. The primary manner in which EMW generated storage revenues was through the use of "spread trades." Additional value would be extracted from rolling in and out of those positions.

The value of storage constantly changes as the NYMEX price levels of future months change. To maximize the value of storage, positions must be monitored in real time whenever the NYMEX is open for trading. Although Respondent understood the methods used to optimize capacity, it lacked sufficient tools and resources to perform the kind of trading activity required to monitor and track storage positions. Third parties already in this trading business ideally are suited to perform the task of managing an additional 17,000,000 MMBtu of storage capacity. Resp. Ex. L, p. 39.

Also, CUB/City witness Decker opined – without any support -- that the "most logical reason" for Respondent to enter into two NSS contracts was to transmit a greater quantity of Manlove Field gas to EMW. City-CUB Ex. 1.0, p. 51. Ms. Decker appears to be preoccupied with Article V.1 of the SOC that calls for Respondent to transfer title of an equivalent amount of Manlove Field capacity as that which is injected into NSS for the purpose of optimizing the unutilized capacity. City-CUB Ex. 1.0, p. 51. Federal policy necessitated this transfer in title.

Specifically, the FERC requires the shipper, *i.e.*, the party to the contract with the pipeline (Peoples Gas, in this case), to hold title to all gas being transported or stored using the shipper's contracts. Consequently, when EMW purchased gas to optimize the "Unrestricted Capacity," it sold this gas to Respondent which injected the gas into the NSS account. To offset this acquisition of gas, Respondent sold a like quantity of gas to EMW for which title was accounted in Manlove. The price of the purchase and sale was equal, the transaction netted to zero, and there was no effect on Peoples Gas' Gas Charge. *See* Art. V.1 of the SOC, City-CUB Ex. 1.24. When gas originally purchased by EMW for optimization purposes was withdrawn from the NSS accounts, the purchase and sale process was reversed. Again, the price of the purchase and sale was equal, that transaction netted to zero, and there was no effect on Peoples Gas' Gas Charge. *See* Art. V.2 of the SOC, City-CUB Ex. 1.24. Through this accounting exercise, EMW acquired no control over Manlove Field, and none of the gas purchased by Respondent for use by its end users was transferred to EMW. *See* Art. XI.1 of the SOC, City-CUB Ex. 1.24 ("Such classification shall confer no rights or obligations on EMW, nor shall it alter the Delivery Point under this Contract.") Respondent had two NSS agreements as part of the SOC for the operational reasons described above; furthermore, the second NSS agreement was acquired to replace a different 30-day storage service that was not renewed. Resp. Ex. L, p. 41.

In sum, the SOC was a prudent way for Respondent to acquire a valuable storage service and tailor it to its specific peak day and seasonal no-notice needs. In addition to allowing Respondent to maximize the rights available under the SOC, Respondent received a share of revenues generated under the SOC and flowed the full amount of these revenues through the Gas Charge to the benefit of end users.

VI. enovate's Activities Did Not Cause Peoples Gas' Customers to Pay More For Gas

Staff and CUB/City witnesses recommended a disallowance in an amount equal to the fiscal year 2001 profits earned by PEC and Enron through enovate.[69] For any disallowance based upon enovate's activities in connection with PEC to be valid, Staff, CUB and the City had to establish that these activities caused Peoples Gas' customers during the reconciliation period to pay more for their gas. Neither Staff nor CUB/City even attempted to make, let alone prove, such a connection – because there was none. Indeed, the record establishes that enovate's transactions were proper and lawful. Moreover, the evidence showed that the enovate transactions did not affect Peoples Gas' Gas Charge, which was reasonable whether viewed prospectively, retrospectively or in comparison with other Illinois utilities. As a result, any cost disallowance based upon enovate's earnings is unwarranted.

A. enovate Did Not Engage in Any Improper Affiliate Transactions

Given that PMW, a wholly owned subsidiary of PERC, which is a wholly owned subsidiary of PEC, was a 50% owner of enovate, enovate was an "affiliated interest" of Peoples Gas. 220 ILCS 5/7-101. Section 7-101 of the Act requires prior Commission approval for certain transactions with affiliated interests. 220 ILCS 5/7-101. Not all affiliate transactions however require prior Commission approval. For example, affiliates can purchase services from Peoples Gas at the regulated rates included in Peoples Gas' Operating Statement on file with the FERC and Peoples Gas can enter into transactions with affiliates in the ordinary course of business at prevailing market prices. 220 ILCS 5/7-101; 83 Ill. Admin. Code Part 310.

Here, enovate purchased hub services from Respondent pursuant to its FERC Operating Statement at cost-based rates approved by the FERC under that Operating Statement. Resp. Ex. N, p. 5. During the reconciliation period, neither enovate nor any other affiliate sold gas to or

[69] ICC Staff Ex. 5.00, pp. 6-7; City-CUB Ex. 1.0, p. 8.

purchased gas from Peoples Gas. Resp. Ex. C, pp. 37-38. enovate's costs and revenues did not flow through the Gas Charge. enovate did not manage Respondent's hub. Resp. Ex. L, pp. 20-21. enovate did not administer the GPAA. Resp. Ex. O, p. 2. As a result, enovate did not engage in any transaction that under the Act required prior Commission approval.

B. enovate's Profits Had No Relationship to Peoples Gas' Gas Charge

Staff and CUB/City witnesses claimed that enovate's profits solely were the product of its use of Peoples Gas' assets and were achieved through enovate's association with Peoples Gas.[70] To support that claim, Staff witness Dr. Rearden said that enovate did not own any assets. ICC Staff Ex. 7.00, p. 70. Dr. Rearden's analysis was incorrect. While enovate may not have had physical assets, it had many tools at its disposal to generate profits. Indeed, Staff witnesses Hathhorn (R. 1125) and Dr. Rearden (R. 1306-1307) agreed that physical assets are not a prerequisite to a company's ability to earn a profit.

enovate had a variety of assets, even if these assets were not physical. For example, enovate had contractual assets such as firm pipeline transportation with Trunkline Gas Company, interruptible services that it purchased from interstate pipelines and local distribution companies and physical gas supply agreements with several counterparties. enovate also had financial assurances, in the form of parent guaranties from PEC and Enron, to support its purchases of services and gas. And Enron and PEC made capital available to enovate to cover trading risk associated with its activities.

In addition to their capital contributions, enovate's members made substantial non-cash contributions to the company. Through enovate's back office functions, provided by Enron at Enron's cost, enovate had access to sophisticated tracking and trading systems without the need for capital to support these systems. Further, enovate received the services of PERC and Enron

[70] ICC Staff Ex. 7.00, pp. 71-72; ICC Staff Ex. 9.00, pp. 20-21; City-CUB Ex. 1.0, p. 7.

personnel, paid for by those companies, who had considerable expertise in physical and financial sales of gas.

Also, prior to the Enron bankruptcy, Enron leased office space in Chicago, a portion of which was used for enovate operations. The offices were separate from the offices of PEC and its subsidiaries. enovate was staffed by PERC and Enron employees paid for by PERC and Enron. Consequently, enovate did not need capital to make a payroll.

In other words, in addition to what Ms. Decker called the modest capital contribution from the enovate members,[71] the members made other, valuable contributions to enovate. They provided labor and services and access to capital and parent guaranties. This meant that enovate did not need to have capital on hand or provide letters of credit or make pre-payments to address creditworthiness issues. Under these circumstances, enovate's lack of physical assets was of no consequence to its ability to operate its business. And that it lacked physical assets did not mean that its relationship with Peoples Gas was in any way untoward.

Likewise, Staff witnesses' and CUB/City witness Decker's speculation that enovate earned its revenue entirely through the "use" of Peoples Gas' system was wrong. As a result, these witnesses' recommended disallowances based upon enovate's fiscal year 2001 income, including ENA's 50% share, were unwarranted.[72] Specifically, Respondent's witnesses Morrow and Zack[73] rebutted Staff's disallowance recommendation of $19,683,626 (ICC Staff Ex. 5.00, pp. 6-7) and the CUB/City disallowance recommendation of $20,652,322 (City-CUB Ex. 1.0, p. 8).

enovate's "use" of Peoples Gas' system provides no basis for a cost disallowance. While what "use" means to Staff or City/CUB is unclear, that any company, including enovate, profits

[71] *See* City-CUB Ex. 1.0, p. 65.
[72] *See* City-CUB Ex. 1.0, p. 7; ICC Staff Ex. 7.00, pp. 70-72; ICC Staff Ex. 9.00, pp. 20-21.
[73] *See* Resp. Ex. N, *passim*; Resp. Ex. K, pp. 11-13.

as a result of transactions that occur on Respondent's system or through association with Respondent has no bearing on Respondent's gas costs. Presumably, any "for profit" entity doing business with Respondent has the goal of making money. Respondent, a large buyer and seller of gas located in Chicago, a major market hub, does business with many marketers who can profit by selling Respondent gas or services. These marketers also can profit by buying gas or services from Respondent for use to support transactions with other companies.

Properly analyzed, every company doing business with Respondent presumably hopes to profit from the "use" of Respondent's system or its association with Respondent. This does not mean that enovate's profits were tainted or, more importantly, adversely affected Respondent's gas costs. As a result, the "use" of Respondent's system or association with Respondent does not support Staff's and the City/CUB recommendations that an amount of gas costs equal to enovate's profits be refunded to Respondent's customers. Resp. Ex. K, pp. 12-13.

Rather, the purpose of this proceeding, as prescribed by Section 9-220(a) of the Act, is to determine whether Peoples Gas' gas purchases and the attendant costs were prudent. Staff and CUB/City have not tried, let alone succeeded, in showing any nexus between enovate's profits and Peoples Gas' gas costs recovered from customers pursuant to its Gas Charge. Without such a nexus, Respondent's gas costs should not be subject to disallowance.

VII. CUB/City's Analysis of Gas Lost and Unaccounted For ("GLU") Is Flawed and Does Not Support a Disallowance.

Staff did not sponsor testimony recommending a cost disallowance based upon GLU. CUB/City witness Decker recommended a disallowance of $38.1 million based first on a theory of an alleged increase in GLU above a purported "industry norm" and then on a theory that the increase exceeded Peoples Gas' recent experience.[74] Both of Ms. Decker's theories are flawed.

[74] City-CUB Ex. 1.0, pp. 28-41; City-CUB Ex. 2.0, pp. 25-35.

Her first theory used erroneous numbers and an unsupported "industry norm" for no apparent reason other than to inflate the recommended disallowance. Resp. Ex. K, pp. 3-11. The second theory, advanced after Respondent pointed out the flaws in her first theory, was based upon another flawed benchmark. Resp. Ex. P, pp. 2-5. Both theories are in the record, however, so this brief will address both.

A. Ms. Decker's First Analysis Relied on Incorrect Data and an Unsupportable "Industry Norm"

Ms. Decker's first GLU analysis erroneously used a line item from Peoples Energy's 10-K report (9,972 MDth) rather than the amount Peoples Gas reported for GLU in its responses to data requests (8,331 MDth).[75] The line item used from the 10-K report, however, was an aggregate of several items other than GLU. Ms. Decker's use of the wrong number inflated her first analysis. Compounding this error, CUB/City's first analysis improperly used total purchases (129,737 MDth) as opposed to sendout (221,454 MDth) to calculate the percentage of GLU. Using the correct figures, the percentage of GLU for fiscal year 2001 was 3.76%, not 8% as claimed by Ms. Decker. Resp. Ex. K, pp. 8-9. Furthermore, Ms. Decker's analysis excluded customer-owned gas, which is inconsistent with the methodology set forth by the Commission for determining GLU. Id. at 9-10.

Ms. Decker then attempted to compare her inflated GLU figure to a purported "industry norm" of 0% to 3%. Ms. Decker however, created this claimed "industry norm" by examining a single entity from the midstream industry (an interstate pipeline), not a representative sample of LDCs such as Peoples Gas. Resp. Ex. K, pp. 4-5. Ms. Decker did not (and cannot) provide any support or explanation as to how the experience of this pipeline (or any other interstate pipeline)

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[75] The 10-K line item improperly characterized by Ms. Decker as GLU is labeled as a quantity comprised of several items: purchased storage compressor fuel, Company use, franchise requirements and unaccounted for gas. Ms. Decker's claim that Respondent's SEC filing is inconsistent with a data response clearly labeled as including only GLU data is nonsense. Resp. Ex. K, p. 8.

could represent an industry standard relevant to an LDC such as Peoples Gas. In fact, no industry standard appears to exist for GLU. Id. at 5.

B. Ms. Decker's Second Analysis Relied on a Similarly Arbitrary Benchmark

In CUB/City's rebuttal testimony, Ms. Decker replaced her unsupportable "industry norm" benchmark with a 1% benchmark based solely on Peoples Gas' GLU from two prior years (fiscal years 1999 and 2000). The selection of that benchmark was similarly arbitrary. Resp. Ex. P, p. 3. Additionally, Ms. Decker made much of the percentage increase in GLU ("the Company's GLU in FY 2001 *increased almost 400%* over FY 2000, from 0.84% to 3.76%"). City-CUB Ex. 2.0, p. 33, emphasis in original. To take these percentages, which Ms. Decker admitted (City-CUB Ex. 1.0, p. 28) can vary from period to period, and use a one year change as a basis for a disallowance is irresponsible. Doing so penalizes Peoples Gas for being below what she called "industry norms" in prior periods.

Furthermore, the calculation itself -- percentage changes in percentages -- is unfair. Determining a percentage change from two percentages that are volatile for many reasons and that hover around 0% is a flawed analytical approach because the resulting percentage changes can be quite large. Surely, if Peoples Gas' GLU had increased from 0.1% to 0.5%, this 500% increase would not represent imprudence, nor would the percentage increase be particularly useful in determining the reasonableness of GLU. As examples, Central Illinois Public Service Company experienced a 1,137% increase when its GLU percentage increased from 0.46% in 2000 to 5.69% in 2001 and Illinois Power Company experienced a 526% increase when its GLU percentage increased from 0.39% in 2001 to 2.44% in 2002. Neither of these increases, which Ms. Decker apparently would consider substantial, were found imprudent. Resp. Ex. P, pp. 3-4.

C. Peoples Gas' Fiscal Year 2001 GLU Was In Line With Other Illinois Utilities

Further, a review of the GLU percentages reported by other major Illinois gas utilities for calendar years 1999-2003 (from ICC Form 21, Annual Reports) showed that Peoples Gas' fiscal year 2001 GLU percentage was not excessive and was well within the range experienced by comparable Illinois companies. Per ICC Form 21, Annual Reports for Calendar 1999 through 2003, Respondent and other major Illinois gas utilities reported GLU percentages as follows:

Calendar Year	Average	Range	Respondent
1999	1.67%	-.81% to 3.97%	-.45%
2000	1.62%	.46% to 3.94%	1.77%
2001	1.78%	.97% to 5.69%	2.84%
2002	1.51%	1.28% to 3.60%	3.57%
2003	1.77%	-.77% to 2.15%	1.51%
5 Year Avg.	1.67%	N/A	1.77%

In all of these years, Respondent's GLU fell within the range of its Illinois peers. Furthermore, the five-year average of 1.77% is very close to the average of other major Illinois gas utilities and even Ms. Decker's 0% to 3% range. Resp. Ex. K, pp. 6-7.

D. CUB/City's Analysis Failed To Consider the Maintenance Gas Adjustment

Finally, CUB/City failed to take into account Peoples Gas' decision not to contest the maintenance gas adjustment, which further reduces Peoples Gas' unaccounted for in fiscal year 2001. Had the Company been accounting for this gas in 2001, as it has now agreed to do, sendout and the GLU would have been reduced by 742,900 Dth. The impact on the GLU percentage would be a decrease from 3.76% to 3.44%. Resp. Ex. K, p. 9.

* * *

In sum, there is no "industry norm" for GLU and CUB/City witness Decker's effort to create one by comparing Peoples Gas to a single interstate pipeline and then to two of its own recent years' experience is unpersuasive. If there is industry data that would be reasonable for the Commission to consider, it is the data reported by Illinois utilities. Respondent's fiscal year 2001 GLU was in line with its and other Illinois utilities' historical experience. It is undisputed that GLU fluctuates from year to year, and the increase in the reconciliation year was not imprudent.

VIII. Off-System Transaction Nos. 19 and 103 Were Prudent and Should Not Be <u>the Basis for Any Cost Disallowances</u>

Of the 103 off-system sales during the reconciliation year, Staff has questioned four of the transactions. Respondent has opted not to contest a recommended disallowance associated with two of these transactions.[76]

A. Transaction No. 19 Was Prudent

1. Transaction No. 19 Was a Reasonable Business Decision Based Upon the Conditions Existing at the Time

Transaction No. 19 was a prudent response to the potential "long" situation created by the turnaround of Manlove Field.[77] After consideration of the relevant operational and economic ramifications, Respondent concluded that an off-system sale was a reasonable way to address possible oversupply situations identified by its planning model.

Staff claimed that Transaction No. 19 was imprudent as an early emptying of Manlove Field to benefit the hub that allowed Peoples Gas to earn unregulated profits and sought a $5.7

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[76] *See* pp. 103-104, *infra*.

[77] In response to oversupply situations, the Company can either reduce its baseload purchase requirements and potentially be exposed to higher levels of daily purchases, or it can sell volumes on days as needed to balance the system. Gas sales during such oversupply conditions commonly result in negative margins when the daily sale price is less than the first of month purchase price. This can be avoided if the baseload purchases are at the same daily price as the daily sales. The Company could have made such a pricing change for a portion of its baseload purchases, but the exposure to daily price increases is the same as reducing baseload purchases by that amount. Resp. Ex. F, pp. 50-51.

million disallowance.[78] More specifically, Staff claimed that Transaction No. 19 was imprudent because it (1) decreased the Company's flexibility to respond to weather conditions different than warmer than normal weather, and (2) the explanation that the Company was planning for warmer than normal conditions was implausible because there was no indication that Peoples Gas had better or different information that changed its forecast gas needs. ICC Staff Ex. 3.00, pp. 37-38.

Staff's criticisms of Transaction No. 19 are baseless. Regarding Respondent's decision to enter into the transaction, Mr. Wear explained that to meet higher than normal demand for an extended period of time, Respondent had been purchasing large quantities of spot gas in November 2000. A significant portion of those purchases was supporting the final stages of Respondent's injection plan. Those purchases were at unprecedented price levels. Based upon these circumstances, Mr. Wear discussed with his immediate supervisor the merits of an early turnaround of Manlove Field, which would reduce Respondent's daily purchases by approximately 450,000 MMBtu per day (the absolute difference between the amount of planned injections and the amount of expected withdrawals).

At the time of Mr. Wear's discussions, the price of spot gas purchases in Chicago was roughly $6.00 per MMBtu. An early onset of withdrawals therefore would reduce gas purchases by nearly $3,000,000 for each day of foregone injections. On the other hand, an early onset for withdrawals would mean entering the heating season with less storage inventories than planned, as well as the increased likelihood of a weather-related oversupply situation. Ultimately, Mr. Wear and his supervisor recommended that the Company proceed ahead with the early turnaround; management agreed. Resp. Ex. L, pp. 19-20. Only impermissible after-the-fact

[78] *See* ICC Staff Ex. 5.00, pp. 4-5; ICC Staff Ex. 7.00, p. 38.

analysis, with full knowledge of weather, requirements and prices, could reveal that not entering the transaction could have reduced gas costs.

Moreover, by challenging the propriety of Transaction No. 19, Staff sought to impose upon Respondent the obligation to perform a specific type of study or analysis to make decisions about off-system transactions that never had been adopted, required or suggested by the Commission. Specifically, Staff opined that Peoples Gas should have estimated relative probabilities for different weather outcomes to assess the need for reducing December 2000 baseload. ICC Staff Ex. 3.00, p. 38.

Significantly, Peoples Gas made hundreds of off-system transactions over the years, yet never had been directed to perform such an analysis. Nor were those transactions reviewed under the standard Staff proposed. As a result, nothing in Peoples Gas' experience would have led it to conclude that such an analysis was a prerequisite to entering into an off-system transaction.

2. While No Disallowance is Warranted Based Upon Transaction No. 19, Staff's Calculation of Its Proposed Disallowance Is Flawed

While no disallowance for Transaction No. 19 is warranted, Staff's calculation for such a disallowance erroneously used inflationary assumptions. First, in its calculation of incremental costs, Staff improperly selected Respondent's highest priced purchases on each of the days in December 2000. Respondent does not purchase gas this way. Rather, Respondent makes incremental purchases as necessary to satisfy the entire system's requirements. No particular purchases go to meet a particular portion of that need. As a result, no particular purchases could have been avoided had some portion of total system requirements not been present. The proper calculation should have used a weighted average cost of purchases made on that day. Resp. Ex. F, pp. 51-52.

Second, Dr. Rearden made his computation on a daily purchase volume of 50,000 Dth even though there were days during the month when Respondent actually purchased less than that amount. Resp. Ex. F, p. 52. Third, Dr. Rearden's December 12, 2000 worksheet contains an error. When calculating his adjustment, Dr. Rearden's did not off-set the daily purchase cost by the daily sales revenue. In subsequent testimony, Dr. Rearden corrected this error. Resp. Ex. F, p. 52.

Correcting these errors reduces Staff's proposed disallowance by $1,299,706 (Resp. Ex. F, p. 52) from $6,357,688 (ICC Staff Ex. 1.00, p. 3) to $5,057,982. Of course, based upon the foregoing, any claim of disallowance based upon Transaction No. 19 should be rejected.

B. Transaction No. 103 Was Prudent And Does Not Warrant a Cost Disallowance

Transaction No. 103 was a reasonable business decision designed to avoid Peoples Gas' payment of a pipeline cycling charge. In April 2000, Respondent's inventory levels in its Rate Schedule DSS (Delivered Storage Service) that it purchases from Natural were such that, in the absence of paying a cycling charge to the pipeline, Respondent would face reduced injection rights in the coming injection period. To preserve its injection rights, Respondent could have paid that charge to the pipeline. As an alternative, EMW offered to pay the entire charge in exchange for Transaction No. 103. In addition to obtaining the much desired balancing flexibility during the 2000 injection season, Respondent had the opportunity to receive additional gas charge commodity credits through the off-system transaction. Respondent made use of all or a portion of the additional injection rights 69 times. Peoples Gas sold a baseload quantity of gas to EMW in December 2000 for which EMW paid based upon the October 2000 first of month index. Resp. Ex. L, pp. 44-45.

Dr. Rearden claimed that based on NYMEX pricing, Peoples Gas received from Transaction No. 103 about one-half of the value that it should have received. As a result, Staff sought a $1.4 million disallowance. ICC Staff Ex. 5.00, p. 5; ICC Staff Ex. 7.00, pp. 40-42. EMW paid a fair price for the gas. No disallowance is merited.

Assuming, *arguendo*, that a disallowance was appropriate (which is not the case), Staff's theory regarding its proposed disallowance is erroneous. Specifically, Dr. Rearden based the disallowance upon the theory that this purely was a financial spread transaction that Respondent should have undertaken and assumed that Respondent could have hedged the October to December NYMEX spreads and locked in the entire value of the transaction. Dr. Rearden was wrong for two reasons. First, the injections to support the sale to EMW, presumed to take place from May through October, 2000, were expected on a no-notice basis. This meant that there could not be a baseload hedge on any portion of those volumes. Second, October 2000, when the transaction was entered into, was the highest priced month of the May through October NYMEX strip. Resp. Ex. L, p. 45. As a result, even with a hedge, Peoples Gas could not have achieved the economic benefit that Dr. Rearden speculated was possible. Accordingly, there should be no disallowance based upon Transaction No. 103.

IX. The Trunkline Transaction Was Prudent

Peoples Gas entered into a gas purchase transaction with EMW under which it had the firm right to purchase supplies year-round on a 100% swing basis, with the exception of ten days out of every winter period. In addition to swing purchase rights, Peoples Gas had the right to divert supplies away from its citygate as a means to balance its system. Resp. Ex. L, p. 42.

Staff called this the "Trunkline deal" and recommended a disallowance. Staff stated that enovate held Trunkline transportation and sold gas to EMW, which, in turn, sold that gas, at no mark up, to Peoples Gas. Staff opined that EMW appeared to be merely an intermediary to facilitate the enovate/Peoples Gas transaction and because the profits from this deal depended on Peoples Gas' participation in the transaction and the use of utility assets to support the transaction, those profits should flow through the Gas Charge. Staff is seeking a disallowance of $372,000, which is supposed to represent profits from this transaction that did not flow through the Gas Charge. ICC Staff Ex. 7.00, pp. 68-70; ICC Staff Ex. 9.00, pp. 17-19.

Staff's recommendation is wrong for two reasons. First, the "Trunkline deal" was an ordinary gas purchase transaction. The price, terms and conditions were not at all unusual, and customers received market-priced gas. Resp. Ex. L, p. 42. The transaction was a prudent way to purchase supply. Second, the proposed disallowance has no relationship to gas costs. As with enovate, Staff seeks to have Peoples Gas disgorge the profits that it claims another company earned (although it makes no effort to show that the transaction was imprudent) and then to tie the amount of the disallowance to the extent to which gas costs recovered by Peoples Gas were imprudent.

As described above, Peoples Gas purchased gas at its citygate and had the right to divert gas away from the citygate; this provided a balancing function. Although Peoples Gas took delivery in the market area, under certain circumstances the commodity price paid was tied to a Texas field index. On other occasions the commodity price paid was tied to a market area index. In this case, the reservation charge was in consideration not only for the firm rights for swing delivery, but for the implied cost of transportation from the field zone to the citygate. Resp. Ex. L, p. 42.

The transaction was a useful part of the portfolio as it provided a significant amount of supply flexibility. From a maximum purchase quantity of 50,000 MMBtu per day to a maximum balancing quantity of 42,500 MMBtu per day, Respondent could alter its deliveries by 92,500 MMBtu from one day to the next during the winter. These types of load swings are not uncommon,[79] and the contract filled a valuable niche even though it was not part of the Company's peak day supplies. Resp. Ex. L, p. 43.

The basis of the disallowance sought for the Trunkline transaction is factually incorrect and legally flawed. No utility assets were used in the transaction, which was simply a purchase of gas. The demand charge was a reasonable proxy for transportation costs and costs that flowed through the Gas Charge were based on market prices. Resp. Ex. L, p. 42. If Respondent had held the firm transportation capacity, itself, and contracted separately for swing supply and balancing, the costs would have been identical. Resp. Ex. L, p. 43.

The proposed disallowance has no relationship to Respondent's gas costs or the prudence of these gas costs. The purpose of this proceeding is to review the prudence of the gas costs that Respondent recovered during the reconciliation period. Staff's recommendation neither shows that the transaction was imprudent, nor that the costs it proposes to disallow were imprudently incurred.

X. Respondent's Decisions Concerning Refinery Fuel Gas ("RFG") Were Prudent

Prior to fiscal year 2001, Peoples Gas purchased refinery fuel gas ("RFG") from Citgo at 75% of a Chicago first of month price ("FOM"). During fiscal year 2001, the Citgo agreement terminated and Peoples Gas instead purchased gas, much of it likely RFG, from EMW at 95% of FOM. Staff recommends a disallowance of $2.2 million for the difference between purchases at 75% of FOM and 95% of FOM. ICC Staff Ex. 9.00, pp. 11-14.

[79] As stated above, one heating degree day in December and January would equate to about 22,400 MMBtu of demand on Respondent's system. Resp. Ex. L, p. 26.

As a result of this discount price arrangement, Peoples Gas saved ratepayers approximately $558,000 over full-FOM pricing. Resp. Ex. L, pp. 46-47.

XI. The Fiscal Year 2000 Proceeding Should Not Be Re-Opened

A. Staff's Proposal

Staff proposed re-opening Peoples Gas' fiscal year 2000 gas charge reconciliation proceeding. Initially, Staff cited only the GPAA as a basis for its proposal. ICC Staff Ex. 5.00, p. 18. In later testimony, Staff suggested other issues from the instant proceeding also led it to recommend re-opening the older case. ICC Staff Ex. 10.00, p. 6.

B. Peoples Gas' Response

The fiscal year 2000 case is the subject of a final, non-appealable order from the Commission. As discussed above in connection with the GPAA and financial hedging, the case was fully litigated. If the situation were reversed -- the Company wished to re-open a case to recover gas costs that had not been recovered -- it would face considerable opposition from Staff. (*See* Staff's April 17, 2003 Response to Illinois Power motion to re-open the record in 01-0701[80]) Gas costs are the Company's largest cost component and exceed the Company's income by several times. The investment community looks to Commission orders to provide some certainty for utilities. Casting uncertainty on gas cost recovery by making completed cases subject to after-the-fact attack would have damaging implications for the Company and Illinois utilities generally. Resp. Ex. K, pp. 15-16.

Section 200.900 of the Commission's Rules of Practice states that:

[80] Illinois Power Company requested that the record in a case be re-opened to allow it to address an accounting error. The case was in the post-hearing briefing stage. That is, this was simply a case that had been marked "heard and taken" and not a case that was already the subject of a final- non-appealable order. In opposing the request, the Staff stated: "IP has not demonstrated that its new evidence is due to a significant and material change. In fact, no change has occurred. If IP's assertions are correct, the facts surrounding the accounting error have always existed; IP simply missed them. The new evidence is the result of an IP employee detecting a potential error in accounting. Staff believes that IP should bear the brunt of its accounting error, not IP's gas customers who would be positioned to pay for the error."

> After issuance of an order by the Commission, the Commission may, on its own motion, reopen any proceeding when it has reason to believe that conditions of fact or law have so changed as to require, or that the public interest requires, such reopening. No party may petition the Commission to reopen on its own motion until after the time to petition for rehearing has expired.

83 Ill. Admin. Code Sec. 200.900. Staff has not met the requirements of this section.

Staff witness Knepler argued that "[t]he Commission should reopen Docket No. 00-0720 because Staff has reviewed the GPAA for FY 2001 and found it imprudent. The first year the GPAA was in effect was the 2000 reconciliation year. In order for the Commission to consider the impact of the GPAA on the FY 2000 reconciliation year it would be appropriate to reopen Docket No. 00-0720." ICC Staff Ex. 5.00, p. 18. In the next round of testimony, Staff witness Knepler argued that there were reasons in addition to the GPAA that warranted re-opening. However, he does not explain what novel facts or law warrant re-opening. ICC Staff Ex. 10.00, p. 6. First, for the reasons stated above, the GPAA was not imprudent. Second, no facts about the GPAA have changed. The contract in effect in fiscal year 2000 was substantially identical to the contract in effect in fiscal year 2001. Third, the law has not changed. Finally, for the reasons stated above, it is not in the public interest to re-open cases.

Staff has not satisfied the requirements of the Commission's rules to re-open a case that is the subject of a final, non-appealable order.

XII. Management Audit

Staff made two different audit proposals. First, it proposed that the Commission require Peoples Gas to conduct an annual internal audit and submit the audit to Staff May 1 each year until the Commission directs it to stop. Second, Staff proposed that the Commission order Respondent to engage an outside consultant to perform management audit of gas supply/storage functions and submit to Staff no later than twelve months after a final order is entered. ICC Staff Ex. 5.00, p. 22.

Staff's proposals for internal and external management audits are based on its incorrect interpretation of some transactions. However, Peoples Gas continually strives to improve its processes and has made changes that enhance its already sound supply management. While the audit recommendations are unnecessary and burdensome, Peoples Gas proposed, as an alternative, to submit a report to Staff detailing actions it has taken to enhance its procedures and specifically explain how it addresses the concerns raised by the Staff. Peoples Gas' proposal allows Staff and, if necessary, the Commission to determine if a proceeding is warranted. Resp. Ex. G, pp. 24-25.

An audit should consider circumstances as they exist at the time of the audit and make forward looking recommendations. Respondent has made improvements to its processes that obviate the need for an audit even if Staff's allegations are accepted. Since fiscal year 2001, the Company has taken, or is in the process of taking, steps to improve its internal controls. Resp. Ex. G, p. 26; Resp. Ex. K, pp. 14-15. In particular,

<u>Policies and Procedures</u>

- Restrictions have been tightened as to which personnel are authorized to make gas supply deals.
- In late 2001, the Company began investigating a voice recording system for use in the daily gas supply purchasing activity. In June 2002 the Gas Supply area began using such a system. These recordings are also used on an as needed basis if differences of opinion are being discussed with suppliers or pipelines.

- Currently, documentation gaps are being identified and Gas Supply procedures are either being reviewed or developed. Processes that have not yet been documented are scheduled to be completed within the next six months.

Staffing Changes

- In February 2003 a new position was created in Gas Supply Administration to add emphasis on controls and analysis. The job consists of identifying gas supply needs, providing analysis to support the decision-making process, assisting in contract negotiations, and ensuring that contracts are executed in a timely manner. In addition, the job entails developing and maintaining policies and procedures for documenting and recording gas supply transactions and ensuring that all executed deals conform to these guidelines as well as to the terms and conditions of the contract.
- The Gas Supply area has recently filled two positions with personnel having accounting backgrounds. The Company believes this will help strengthen the documentation and internal controls in the area.

New Software - Monaco System

- The Company is in the process of installing new software that will improve the tracking and documenting of gas supply activity and transactions. The software called "Monaco" is provided by Woodlands Technology, LLC. The software provides for capturing comprehensive transaction information, contract administration, audit functionality and management reporting.

Sarbanes-Oxley

The Sarbanes-Oxley Act of 2002 requires companies to document and test the business processes used to create their financial statements. Beginning in 2004, when a company files its annual report, it must guarantee that its internal controls have been written down and tested by outside auditors. The gas supply procurement process is included in this review. The Company has assembled a project team to assure that the Company meets these requirements. Resp. Ex. G, pp. 26-28.

Given the scope of the Sarbanes-Oxley project, the Company believes that a second audit by the Commission may unnecessarily duplicate and add costs to the work being done for Sarbanes-Oxley compliance. Therefore, the Company proposes to submit to Staff a report that addresses Staff's concerns one year from the date of an order in this proceeding; that time frame allows for the above activities to be completed. Resp. Ex. G, p. 28.

UNCONTESTED ISSUES

I. Maintenance Gas

Maintenance gas refers to certain gas injected into Respondent's Manlove Field. The purpose of maintenance gas is to maintain deliverability from the field. Peoples Gas recovered the costs of maintenance gas as unaccounted for gas in the Gas Charge. Staff disputed this accounting treatment and proposed both a disallowance and a different accounting treatment that does not provide for Gas Charge recovery of costs associated with this gas. Peoples Gas is not contesting these recommendations. Resp. Ex. F, p. 55. The Staff's proposed disallowance is $4,628,267.[81] ICC Staff Ex. 5.00, p. 4.

II. Off-System Transaction Nos. 16/22

Transaction Nos. 16/22 refers to an off-system sale for resale transaction entered into by Respondent. Staff recommended a cost disallowance for this transaction. Peoples Gas is not

[81] CUB witness Mierzwa also proposed a disallowance. CUB Ex. 2.0, p. 3. Based on Peoples Gas' testimony that it would not contest the Staff disallowance, Mr. Mierzwa testified that his adjustment was moot. CUB Ex. 4.0, pp. 2-3.

contesting this recommended disallowance. Resp. Ex. F, p. 54. The Staff's proposed disallowance is $535,554.[82] ICC Staff Ex. 5.0, p. 4.

III. Intercompany Services Agreement

Peoples Energy Corporation has what it calls an intercompany services agreement (Staff calls it an operating agreement) under which it and certain subsidiaries provide and receive services from other parties to the agreement and allocate costs appropriately. Peoples Gas is one of the parties to the agreement. Staff recommended that Peoples Gas file a revised agreement. ICC Staff Ex. 5.0, p. 21. Peoples Gas agreed to do so. Resp. Ex. K, pp. 13-14. There is no recommended disallowance associated with this recommendation.

CONCLUSION

For the foregoing reasons and the reasons set forth in Respondent's testimony, Respondent The Peoples Gas Light and Coke Company respectfully requests that, except for those issues identified in this proceeding as uncontested, the Staff's and intervenors' suggested disallowances be rejected and that its fiscal year 2001 gas costs be found to have been prudent.

WHEREFORE, The Peoples Gas Light and Coke Company respectfully submits this Initial Post-Hearing Brief.

Dated at Chicago, Illinois this 30th day of June, 2005.

Respectfully submitted,

The Peoples Gas Light and Coke Company

By: _____/S/ MICHAEL A. FICARO_______
Michael A. Ficaro
An Attorney for
The Peoples Gas Light and Coke Company

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[82] Mr. Mierzwa also proposed a disallowance. CUB Ex. 2.0, p. 3. Based on Peoples Gas' testimony that it would not contest the Staff disallowance, Mr. Mierzwa testified that his adjustment was moot. CUB Ex. 4.0, pp. 2-3.

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