STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

ILLINOIS COMMERCE COMMISSION, On Its Own Motion -vs.- 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 STAFF WITNESSES
OF THE ILLINOIS COMMERCE COMMISSION

PUBLIC VERSION

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STATE OF ILLINOIS
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The Staff Witnesses of the Illinois Commerce Commission (the "Staff"), by and through its counsel, and pursuant to Section 200.800 of the Commission's Rules of Practice (83 Ill. Adm. Code 200.800), respectfully submits its Initial Brief in the above-captioned matter.

I. Procedural History

On November 7, 2001, the Illinois Commerce Commission ("Commission"), on its own motion, entered an Order commencing this reconciliation proceeding in accordance with the requirements of Section 9-220 of the Public Utilities Act ("Act"), 220 ILCS 5/9-220. The Order directed Peoples Gas, Light and Coke ("Peoples Gas" or "Company"), among others, to present evidence at a public hearing depicting the reconciliation of its purchased gas adjustment ("PGA") clause revenues collected with the actual cost of such gas supplies prudently obtained for the 12 months ending on September 30, 2001

("2001 Reconciliation Period"). On November 16, 2002, Peoples Gas provided a list to the Chief Clerk's Office of municipalities to which it provides service. Peoples Gas' filed its direct testimony and exhibits in this proceeding on January 9, 2002, in accordance with the direction of the November 7th Order.

Pursuant to proper legal notice, a status hearing was held in this matter before a duly authorized Administrative Law Judge of the Commission at its offices in Chicago, Illinois on February 20, 2002. Appearances were filed by Peoples Gas, City of Chicago ("City") and Commission Staff ("Staff"). Thereafter, petitions to intervene were filed by Citizen's Utility Board ("CUB"), the Attorney General of the State of Illinois ("AG")[1], and Cook County States Attorneys Office ("Cook County"). An evidentiary hearing was held from April 18 - 22, 2005. On May 5, 2005, the record was marked "Heard and Taken."

At the evidentiary hearing in this matter, Peoples Gas provided testimony of five witnesses: Ms. Valerie Grace (Exs. A, D, J and Q), Mr. David Wear (Exs. B, C, F, L and O), Mr. Frank Graves (Exs. E, H, and R), Mr. Thomas Zack (Exs. G, K and P), Mr. Thomas Puracchio (Exs. I and M), and Mr. William Morrow (Ex. N).

CUB provided testimony of two witnesses: Mr. Brian Ross (Exs. 1 and 3), and Mr. David Mierzwa (Exs. 2 and 4). CUB and City provided joint testimony of a witness: Ms. Lindy Decker (Exs. 1 and 2). The AG provided testimony of a witness: Mr. David Efron (Ex. 1). The City provided the testimony of a witness: Mr. John Herbert (Exs. 1 and 2).

Staff provided the testimony of five witnesses: Mr. Steven Knepler (Exs. 1, 5 and 10), Mr. Dennis Anderson (Exs. 2, 6, and 11), Mr. David Rearden (Exs. 3, 7 and 12), Mr.

[1] The City of Chicago, Citizen's Utility Board and Attorney General of the State of Illinois will be jointly referred to as Government and Consumer Parties ("GCP").

Eric Lounsberry (Exs. 4, and 8), and Ms. Dianna Hathhorn (Exs. 9 and 13). In addition, Staff and Peoples provided a Group Exhibit 1, consisting of documents produced in discovery and portions of discovery depositions.

II. Summary of Position

Staff has proposed adjustments to the gas charge ("Gas Charge Adjustments") to recompense the ratepayer for the additional and imprudent costs caused by Peoples Gas' decisions in the 2001 Reconciliation Period. Staff also proposes eleven operational recommendations due to serious breakdowns in internal controls, an unusual amount of oral agreements and undocumented transactions impacting the Gas Charge. The Adjustments relate to natural gas transactions in which Peoples Gas was a party, for third-party customer natural gas transactions that used recoverable gas costs and for imprudent use of Manlove field.

The contract warranting the greatest scrutiny is the Gas Purchase and Agency Agreement ("GPAA"). The 2001 Reconciliation Period was the second year that the GPAA was in effect. The GPAA was a five-year agreement with Enron North America ("Enron") that provided the majority of natural gas that Peoples Gas' needed for the reconciliation year. At the same time, Peoples Gas and its holding company, Peoples Energy Corporation ("PEC"), were trying to expand their strategic partnership with the Enron corporate family. The stated goal of the strategic partnership was to market wholesale services in the greater Chicago metro area and the Midwest. The wholesale services included hub services and the marketing and transacting of parking, balancing and exchanging gas. In its testimony, Peoples Gas states that one purpose of the partnership was to capitalize on increased gas flow from western Canada into the

Chicago market. The apparent goal being the reaping of profits from the markets identified in the 1999 Letter of Intent between PEC and Enron. Such a market would be created by the difference in gas prices between western Canada and the eastern United States and the seasonal changes in gas prices. The potential financial windfall from increasing operations identified in the 1999 Letter of Intent was limited by Peoples Gas' physical assets – in particular, the storage capacity that Peoples Gas owned. Therefore, the goal of expanding hub services and marketing in the Chicagoland area and Midwestern region induced Peoples Gas to expand Manlove storage field. Such an expansion enabled Manlove field to be used to supply hub services to companies other than Peoples Gas and North Shore Gas. Peoples Gas increased the field's capacity by approximately one-third to accommodate its plans to provide storage services to third-party customers.

Peoples Gas' behavior was affected by the business relationship between PEC, its corporate parent, and Enron. As discussed in Staff's Adjustment section, this corporate business relationship affected almost every aspect of Peoples Gas' operations. It gave incentives for Peoples Gas to enter into transactions that were not in the best interests of ratepayers and that subsequently raised gas costs. Nearly all the adjustments that Staff proposes for this reconciliation period are directly or indirectly related to transactions with Enron. The way the strategic partners (*i.e.*, PEC and Enron) shared Hub revenues provided an incentive for Peoples Gas to allocate a significant percentage of the usage of the field to unregulated transactions. In effect, Peoples Gas allowed marketers and Enron to use a disproportionate amount of the capacity and gas in Manlove field for parties other than ratepayers, especially during peak periods.

The focus on developing the strategic partnership affected storage field operations. During the unusually cold winter of 2000-2001, when natural gas prices were spiking to unprecedented levels, Peoples Gas allowed third-party customers to withdraw more gas than they had injected into the field. Therefore, Peoples Gas was required to use natural gas purchased for its ratepayers to provide this additional natural gas to the third-party customers. The negative inventory balance for third-party customers from January until May 2001 is clear evidence of this fact. Moreover, during the period when gas prices were at their highest levels, third-party customers had a rate of withdrawal disproportionately greater than the withdrawals for ratepayers. This difference in withdrawal rates illustrates that Peoples Gas gave third party customers better access to Manlove field than ratepayers.

Another unfortunate result from PEC's rush to increase profits in the wholesale market is that numerous transactions and services were conducted pursuant to oral agreements, or understandings, and without written memorialization. As a result, Peoples Gas did not properly record or document the aforementioned gas transactions and operations of Manlove field, as well as their consequential impacts to its storage facilities and assets in this reconciliation period. Stated another way, Peoples Gas had serious breakdowns in internal controls and lacked documentation that clearly identifies the impact third-party operations had on ratepayers.

The strategic partnership included the GPAA between Peoples Gas and Enron, the creation of a joint venture named "enovate," and the sharing of profits between Enron MW, LLC ("Enron MW") and PEC. The profit sharing between PEC and Enron MW created an incentive for Peoples Gas to enter into transactions with Enron MW (either through asset optimization deals or gas trades). Evidence of this motivation is Peoples Gas acceptance of a price for gas or services sold that is too low, or purchasing gas or a service at too high a price.

Numerous times Staff requested of Peoples Gas an analysis of and justification for the GPAA. Until discovery was re-opened in February 2004, Peoples Gas' defense for the GPAA was not numerical, but merely an informal discussion of its goals for the GPAA and the manner in which the GPAA met them. Peoples Gas could not even document that the goals it proffered were an element in the GPAA's negotiation. In addition, it is not clear whether the GPAA was necessary to achieve the after-the-fact goals, or whether the GPAA was the optimal manner of meeting those goals.

After review of many documents, Staff has a total adjustment to the Gas Charge of approximately $92 million. This recompenses the ratepayer for the additional and imprudent costs caused by Peoples Gas' decisions. Some adjustments, such as those related to enovate, are not as precise as Staff normally provides, because Peoples Gas conducted numerous transactions without written contracts, and kept insufficient documentation of those transactions. The resulting consequence is the failure of Peoples Gas and PEC to maintain sufficient documentation and records on third-party operations that impacted the Gas Charge.

Staff's Appendix A Schedules 5.01 through 5.05 summarizes the fifteen cost and revenue adjustments to the Gas Charge. The Gas Charge Adjustments relate to the imprudent aspects of the Gas Purchase and Agency Agreement, Storage Optimization Contract ("SOC"), operations of the storage field, revenues generated from the use of ratepayer assets (*see* 83 Ill. Adm. Code 525.40(d)), imprudent individual transactions, and improper transactions involving affiliates.

Staff has also proposed eleven operational recommendations ("Recommendations"). Most of the Recommendations are in response to Staff's concern about the lack of sufficient records and documentation, as discussed above. Staff proposes that an internal audit of gas purchasing be performed by Peoples Gas, as well as a management audit of its gas purchasing practices, gas storage operations and storage activities to be performed by a third-party, independent auditor. Staff also proposes that Peoples Gas file a report explaining how it intends to comply with the Uniform System of Accounts for Gas Utilities (Part 505).

Staff has a number of recommendations related to maintenance gas which are agreed to by Peoples Gas. In addition, Staff proposes that Peoples Gas update their operating statements that have been on file with the Commission since 1969. Staff's final proposal is to re-open the 2000-2001 Reconciliation docket (Docket No. 00-0720), which was the first year of the GPAA, since many of the issues addressed in this proceeding with respect to the GPAA and third-party operations were not reviewed as extensively as they should have been in that docket.

III. Regulatory Framework for Adjustments to the PGA

Subsection 9-220(a) of the Act, 220 ILCS 5/9-220(a), provides the legal authority for the Commission to review, on an annual basis, the actual cost of gas purchased by an Illinois utility. Under that provision, the Commission may authorize the increase or decrease in rates and charges based upon changes in the cost of purchased gas through the application of a fuel adjustment clause or a PGA clause. During the annual reconciliation hearings, the Commission is to determine whether the gas purchases were prudent and, if not, to reconcile any amounts collected with the actual costs of gas prudently purchased. In such a proceeding, "the burden of proof shall be upon the utility to establish the prudence of its cost of . . . gas . . . purchases and costs." 220 ILCS 5/9-220(a). The Commission has defined prudence as the 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. *Illinois Commerce Commission v. Illinois Power Co., Reconciliation of FAC and PGA clauses,* Docket No. 02-0721, Order at 2 (July 21, 2004).

For gas purchases, the provisions of Section 9-220 of the Act, *supra*, are implemented in 83 Ill. Adm. Code 525 ("Part 525"), "Purchased Gas Adjustment Clause." Section 525.40 identifies gas costs which are recoverable through the PGA. Adjustments to gas costs through the Adjustment Factor are addressed in Section 525.50. The gas charge formula is contained in Section 525.60. Annual reconciliation procedures are described in Section 525.70.

Of particular relevance in this proceeding is Subsection 525.40(d), which has been thoroughly discussed in pre-trial memoranda filed in early March 2005. Section 525.30 of Part 525 states, in pertinent part and with emphasis supplied:

> The Gas Charge(s) shall represent the utility's estimate of *recoverable gas costs (as prescribed in Section 525.40*) to be incurred during the base period, with an adjustment to such costs through use of Adjustment Factors (as prescribed in Sections 525.50, 525.60 and 525.70).

Subsection 525.40(a) of Part 525 defines the costs recoverable through the Gas Charge, and those costs are to be offset by revenues meeting the criteria set forth in

Subsection 525.40(d). In order for Subsection 525.40(d) to apply, a transaction must meet the three essential conditions. First, the transaction must produce revenue per Subsection 525.40(d). Second, the revenue must not be derived from a transaction pursuant to an ICC tariff or a special contract approved by the ICC. Third, at least one of the associated cost(s) of the transaction must be recoverable gas costs as defined in Subsection 525.40(a).

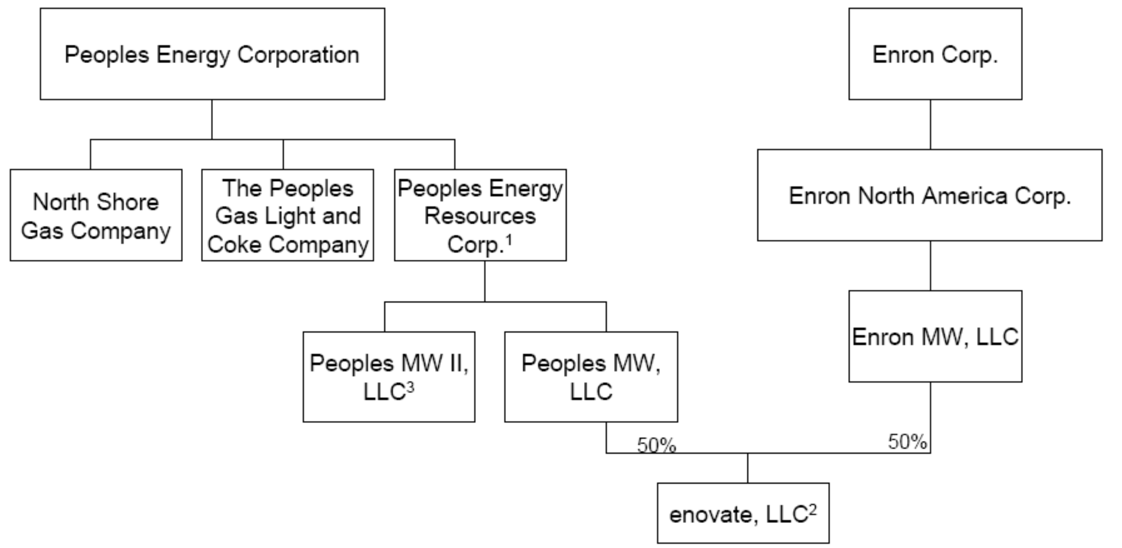
Subsection 525.40(d) is applicable to this case because Peoples Gas entered into two types of transactions that meet the conditions set forth above. Staff proposes two adjustments related to Part 525 (i.e., see Section V. A. 3. for Staff's discussion of its adjustments for revenues obtained through non-tariff service transactions).

IV. Background and Statement of Facts

A. Strategic Partnership with Enron

In the 2001 Reconciliation Period, Peoples Gas' and its affiliated companies had significant business relationships with Enron North America ("Enron" or "ENA") and its family of companies. Below is an organization chart, produced by Peoples Gas, which reflects the relationship of the entities involved in the issues of this case and for the North Shore case (Docket No. 01-0706):

Chart 1: PEC/Enron Organizations



[1] Now Peoples Energy Resources Company, LLC
[2] Formerly, Midwest Energy Hub, LLC
[3] Formed after Enron bankruptcy to purchase Enron MW's interest and preserve partnership tax treatment for enovate.

September 16, 1999, was a significant day in the partnership between the Peoples Energy and the Enron corporate families. On September 16, 1999, Peoples Gas signed a large, long-term gas supply agreement -- the GPAA. (Staff Ex. 2, Attach. 1 at 36). On that same day, PEC signed a Letter of Intent ("1999 LOI") that indicated its intent to enter into a joint venture with Enron. (Staff Ex. 7 at 7). The joint venture was first called Midwest Energy Hub ("MEH") and was subsequently renamed "enovate." Peoples Gas was an affiliate of enovate. (Staff Ex. 9 at 4). The Enron subsidiary, Enron MW, LLC ("Enron MW") was the managing partner of enovate. The GPAA and enovate were the foundation for the strategic partnership between PEC and Enron. (*Id.* at 5, n. 9).

The partnership, however, went beyond the GPAA and the creation of enovate, and included oral agreements to share Enron MW's profits with PEC (*Id.* at 7, 9-10; *see also* Staff Ex. 9 at 7), and to share Peoples' Hub revenues with Enron MW.[2] Some profit sharing arrangements were outlined in a draft letter of intent dated September 14, 2000. This letter of intent was never signed, but the partners seemed to have put into practice many of its terms. In particular, the 2000 Letter of Intent listed various forms of revenue sharing that appeared to have occurred. (Staff Ex. 7 at 7.)

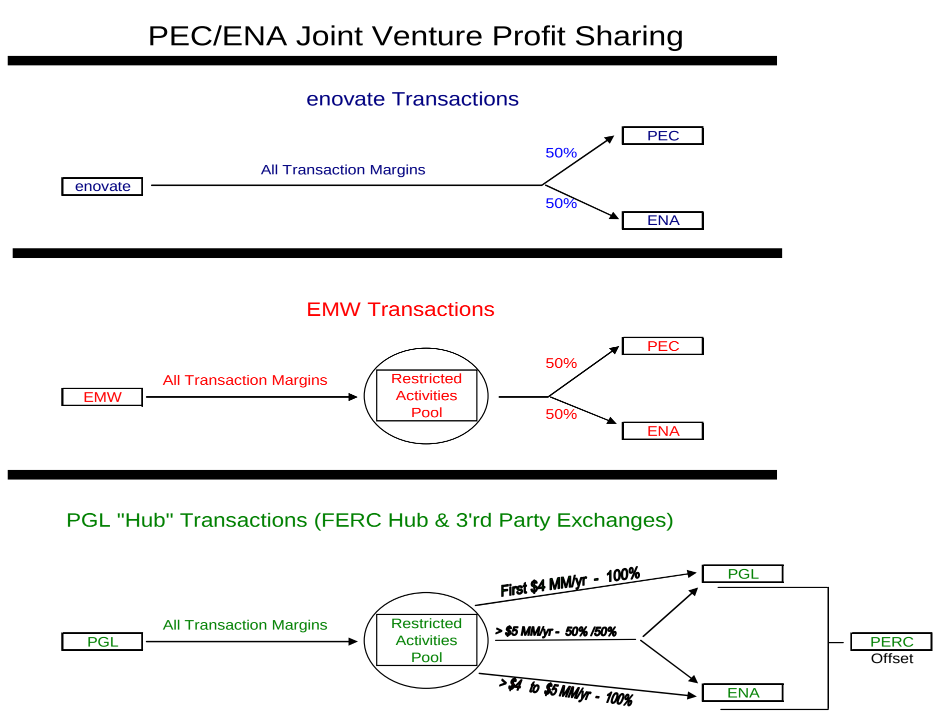
The sharing arrangements are depicted in the diagrams (provided by Peoples Gas during discovery) below. Figure 1 is split into three sections and is titled PEC/ENA Joint Venture Profit Sharing Diagram. (Staff Ex. 9, Attach. C. Figure 2 is titled "enovate Profit Sharing." *Id.*, Attach. D).

The chart in the top panel of Figure 1 refers to the written enovate Agreement. Under that agreement, PEC and ENA equally split enovate's profits from all transactions. (*Id.* at 7). The second panel of Figure 1, labeled "Enron MW Transactions" represents the oral revenue sharing agreement between Peoples Energy Resource Corporation ("PERC") and Enron MW. (*Id.* at 8). The arrow from Enron MW labeled "All Transaction Margins" represents the profits from Enron MW deals that were eventually split 50/50 between PEC and ENA, as depicted on the right side of the panel. The third panel of Figure 1, labeled "PGL Hub" Transactions (FERC Hub & 3'rd Party Exchanges)" diagrams the oral revenue sharing agreement between PERC and Enron

[2] According to Peoples Gas, the Hub refers to excess capabilities of storage and transmission assets of the utility (i.e. Manlove storage field and Mahomet pipeline) that are not needed by the ratepayers. (Staff Ex. 9 at 7).

MW for Peoples' Hub revenues. (*Id.*) The arrow from "PGL" labeled "All Transactions Margins" follows through to different parties, PGL or ENA, depending upon the threshold of margins (i.e., profits) generated by the Enron/Peoples partnership on "Hub" transactions. The top arrow shows 100% of profits going to Peoples Gas for the first $4 million per year earned in hub transactions. The bottom arrow represents the next $1 million profits, i.e. ">$4 to $5 MM/yr", of which 100% is to flow to Enron. The middle arrow details plans that the profits from hub transactions greater than $5 million were to be split 50/50 between Peoples Gas and Enron. It is unclear what the box "PERC Offset" means, although it may be related to the marketing of Peoples Gas' hub by PERC.

Figure 1: PEC/ENA Joint Venture Profit Sharing



<u>Figure 2: enovate Profit Sharing</u> <u>(Unredacted)</u>

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Figure 2 is a different diagram that illustrates some of the same relationships between enovate, Enron MW, PEC, and Peoples Gas, as well as the extensive nature of the interactions between the parties. (Staff Ex. 9 at 9; Group Ex. 1 at ST-PG 46-48). At the top of Figure 2 are the headings “PGL Share” and “Enron MW Share.” These headings describe the profit sharing terms of the Storage Optimization Contract (“SOC”). A flow-chart illustrating the profit sharing with respect to the SOC is below those headings. At the bottom of Figure 2 are the words “HUB Revenue.” The oral profit sharing agreements for revenues generated from Peoples Gas’ hub are described in the bottom panel of Figure 1. On the right side of Figure 2 is the heading “Profit Split.” This part of the flow-chart illustrates how enovate’s profits were to be shared between Enron MW and PEC. “Profit Split” is a heading that depicts the sharing of enovate’s profits between PEC and Enron MW. This part of Figure 2 is also represented in the top panel of Figure 1.

The strategic partnership with Enron fundamentally alters how Peoples Gas’ gas costs should be reviewed during a reconciliation proceeding. Over the 26 months, from October 1999 through November 2001, PEC and its subsidiaries entered into numerous transactions with Enron and Enron MW. The extent of the impact PEC’s profit sharing with Enron had on the gas costs is exhibited by Figures 1 and 2. Whenever Enron MW or enovate transaction generated profits, PEC received a portion of those profits. (Staff Ex. 9 at 15-16; and Staff Ex. 7 at 11). The transactions with Enron MW are a method to allocate value between the PEC and Enron corporate families. That value involved recoverable gas costs all of whose related revenues are to be flowed through the PGA for ratepayers’ benefit. (*Id.*)

The following excerpt from a draft of a data request response authored by Mr. Timothy Hermann, Director of Midstream Services for PERC. He stated provided some insight on the Enron-PEC relationships oral arrangements:

> [redacted]
>
> (emphasis added) (Group Ex. 1 at ST-PG 165. *See also* City-Cub Exhibits 1.32 through 1.34).

This draft response revealed each companies motives to generate revenue, yet this information was not provided in the response provided to Staff in discovery.

During discovery conducted in Spring 2004, it became clear that PEC employees did, in fact, conduct a numerical analysis of the GPAA. Staff located a document termed the “Aruba analysis.” (Staff Ex. 7 at 12). The employee who conducted the analysis was Roy Rodriguez. He worked for PEC in Risk Management and was part of the team evaluating the GPAA. (Group Exhibit 1 at ST-PG 102). Risk Management exists to track and analyze risk for the corporation so it can make reasoned business decisions. Mr. Rodriguez took it upon himself to do the analysis to show whether it was a good deal or not. (*Id.* at 103). Later, in April 2005, a second numerical analysis was located. It was a spreadsheet that evaluated the effect the GPAA would have had on Peoples Gas’ gas costs for the period 1995 through 1999. (Wear Cross Ex. #15). It was found in the electronic documents attributed to Peoples Gas’ Gas Supply Manager, Mr. David Wear. Neither study found the GPAA to be favorable for the ratepayers. (*Id.* and Staff Ex. 7 at 12-13).

Both of the numerical analyses conducted by PEC employees examined only one aspect of the GPAA (the field delivered price versus the citygate price), but failed to analyze other terms of the GPAA, which Staff analyzes herein. Some of those terms include the three re-pricing terms (the Baseload Pricing Adjustment, and Articles 4.2b and 4.2c) as well as the Summer Incremental Quantity (“SIQ”). These terms granted an option to Enron to change the price of the gas it sells to Peoples Gas. (Staff Ex. 7 at 14). Enron also had the ability to choose the quantity to be sold under the SIQ provision of the GPAA. The SIQ provided Enron the ability to choose the volumes it sold to Peoples Gas at the first of the month price in the Summer Period (April through November), and Articles 4.2b and 4.2c as well as the Baseload Pricing Adjustment gave

Enron the ability to unilaterally change the price for specified volumes from the monthly to the daily price during the Winter Period (December through March). (Staff Ex. 3 at 8-9).

The strategic partnership's other pillar, enovate, has a history that also impacts Peoples Gas' Gas Charge. Staff sought to understand the workings of enovate, the source of enovate's substantial profits, how it operated and how it interacted with the regulated utility. (Staff Ex. 9 at 20-23). It has been Peoples Gas' position throughout this proceeding that enovate's operations are outside the scope of this investigation.

The Trunkline deal is a good illustration of how enovate affected Peoples Gas' Gas Charge (Appendix A, Schedule 5.03, column O). In the Trunkline deal, enovate purchased gas from PERC and subsequently resold it to Peoples Gas, using Enron MW as an intermediary. (Staff Ex. 7 at 68-69). The mark-ups at each stage of the deal were substantial. (Staff Ex. 3 at 62; and Staff Ex. 3 at 13). In other words, the partnership constructed a deal, with healthy margins, that passed from a subsidiary of PEC (*i.e.*, PERC) through a subsidiary of both PEC and Enron -- enovate -- and then to a subsidiary of Enron (*i.e.*, Enron MW) and then to Peoples Gas, a regulated public utility. (Staff Ex. 7 at 68-69).

While enovate and the GPAA were the pillars of the strategic partnership, they were certainly not the only elements. Two other critical elements of the alliance, that were discussed *supra*, were sharing Peoples Gas' Hub revenues with Enron and the receipt of a portion of Enron MW's profits by PERC.

The Peoples Gas' hub offers transportation, storage and exchange services to third parties. Staff identifies these services as non-tariff services since they are not provided under an ICC jurisdictional tariff. (Staff Ex. 3 at 44-45). Some non-tariff services are provided under the FERC tariff called an Operating Statement, which governs the terms and conditions of services as well as the maximum rate that can be charged for them. (*Id.*) In addition, Peoples Gas provides other non-tariff services outside the Operating Statement. Peoples Gas identifies these services as third party storage exchanges. (*Id.* at 44-46).

Peoples Gas also expanded the capacity of Manlove field. (Staff Ex. 2 at 44-45). As it increased the amount of gas in the field, the amount of base gas increased. Base gas is gas that is injected into the field to support the field's use, but is not generally available to be withdrawn.[3] Since base gas is expensive (after all, it is gas that is injected but cannot be used), Peoples Gas accounted for 2% of injections into Manlove field as "maintenance gas" and recovered its cost in the PGA. (Staff Ex. 1.0 at 14-22; and Staff Ex. 2 at 48-50). Gas that becomes base gas is properly recovered through base rates. (*Id.*) Staff proposes an adjustment to reverse the maintenance gas charged to the Gas Charge (Appendix A, Schedule 5.03, column B). (*Id.*)

Peoples Gas allowed deals to be made (i.e. "38 Special", "Hub Blowout" and "Manlove Jumpstart") that involved Enron and other marketers to use a disproportionate amount of the capacity and gas in Manlove field for parties other than ratepayers, especially during peak periods[4] (Staff Ex. 3 at 49-51; Staff Ex. 7 at 49-50; and Staff Ex. 12 at 25; *also* Tr. 1300.). Moreover, third parties were loaned such a large volume of

[3] *Id.* Base gas is subdivided into recoverable and non-recoverable. Recoverable base gas can be withdrawn at the time the field is shut down, whereas non-recoverable base gas will never be physically recovered, even when the field is shut down.

[4] Peoples Gas only recently ceased the practice of allowing PERC to 'market' Hub services. (Group Ex. 1 at ST-PG 79-80)(City-Cub Exhibits 1.19 and 1.25)(See also Appendix A, Schedule 5.03, column I, for adjustment related to imprudent use of Manlove field).

gas during the reconciliation period that they withdrew five BCF more gas during early 2001 than they had injected into the field by the Fall of 2000. Staff Ex. 3 at 60. Such a withdrawal amounts to a loan, whose value is captured in Staff's Appendix A, Schedule 5.03, column H. (*Id.*)

To conduct hub services, Peoples Gas had to use gas held in its system facilities, that is, hub services had to be provided through displacement. Displacement is the movement of natural gas through a pipeline transportation system without the physical delivery of the same molecules of natural gas. (Staff Ex. 2 at 32). *Id.*(See Staff's displacement discussion below and both Staff Ex. 1 at 14-22; and Staff Ex. 4 at 10).

Staff also reviewed the Storage Optimization Contract ("SOC"). In Staff's review it found that Peoples Gas had received an offer from TPC, to provide services similar to the SOC, and Staff reviewed the terms of that offer. (Staff Ex. 7 at 64). Staff also found that the revenue Enron MW shared with PEC stemmed from the use of two storage contracts. Staff is proposing two adjustments related to the SOC. The first adjustment adds the Gas Charge revenues that PEC received, rather than Peoples Gas, due to PEC's sharing arrangement with Enron MW. (Appendix A, Schedule 5.03, column M; and Staff Ex. 9 at 14-16). Staff is proposing a second adjustment because it views the SOC as imprudent. Therefore, the Staff proposes that the PGA be adjusted by Enron MW's revenues received under the SOC. (Appendix A, Schedule 5.03, column N; and Staff Ex. 7 at 67).

Another deal that was reviewed by Staff was the RFG deal. (Appendix A, Schedule 5.03, column L). From October 1, 1995 until September 30, 1999, Peoples

Gas bought refinery fuel gas (“RFG”) from UNO-VEN (also known as “Citgo” and “PDVMR”), pursuant to a contract. While the contract with Citgo ended in September 1999, Peoples Gas agreed to continue purchasing RFG from Citgo under the same contract terms. This arrangement lasted until October 1, 2000, when PERC assumed Peoples Gas’ ability to purchase refinery fuel gas. (Group Ex. 1 at ST-PG 181-189). PERC assumed Peoples Gas’ ability to purchase refinery fuel gas at substantially the same terms and conditions and at the same price. (*Id.* and Staff Ex. 9 at 11-14). PERC then resold the gas to Enron MW, who in turn sold it to Peoples Gas for an additional profit. (*Id.*) Staff proposes to return to ratepayers the entire margins surrendered to PERC and Enron MW. (*Id.*)

Finally, Staff reviewed two off-system transactions with Enron MW -- Transactions 16/22 (Appendix A, Schedule 5.03, column D) and Transaction 103. In the former, Peoples Gas sold an option to Enron MW to buy gas at the first of the month price in November and December 2000. Peoples Gas was compensated with a demand payment. (Staff Ex. 3 at 38-39). A demand payment is a fixed, upfront payment. The transaction raised a host of ancillary issues related to the interactions between two alliance members, PEC and Enron, and about Peoples Gas’ internal controls – including documentation of transactions. (Staff Ex. 1 at 28-30; and Staff Ex. 3 at 40-41). Staff’s adjustment attempts to return the full cost of the transaction to the ratepayers. (Staff Ex. 3 at 39-40).

For Transaction 103 (Appendix A, Schedule 5.03, column K), Enron MW paid a pipeline penalty for Peoples Gas in return for the ability to purchase gas from Peoples

Gas in December 2000 at October 2000 first of the month prices. (Staff Ex. 7 at 41). Staff's adjustment calculates the value this decision had on ratepayers. (*Id.* at 42).

B. Contracts Impacting the Gas Charge.

There are a number of contracts impacting the Gas Charge, both written and oral, during the 2001 Reconciliation Period. The profit sharing section discusses the oral agreements, and herein is a brief summary of four written contracts: Gas Purchase and Agency Agreement, Storage Optimization Contract, Refinery Gas Purchase Agreement, and enovate LLC Agreement.

1. Gas Purchase and Agency Agreement

The GPAA was an agreement between Peoples Gas and Enron North America ("Enron"), entered into on September 16, 1999. (Staff Ex. 2, Attach. 1, cover page). The term of the GPAA was from October 1, 1999 through October 31, 2004. (*Id.* at 9). The contract provided more than half of the natural gas Peoples Gas would need during the five year period.[5] (PG Ex. C at 4). Under this contract Enron agreed to deliver to Peoples Gas a Baseload Quantity, a Summer Incremental Quantity, and a Daily Incremental Quantity of natural gas. The Baseload Quantity obligated Peoples Gas to take 100% of a specified quantity of gas each day. (PG Ex. C at 3, 11). The Baseload quantities changed from month-to-month. (*Id.* at 12). Baseload volumes were priced at [redacted] ("FOM") minus 3¢. (Staff Ex. 2, Attach. 1 – GPAA Agreement at 9 – Art. 4.1(a)).

[5] During the reconciliation period, the GPAA provided approximately [redacted]% of the Peoples Gas' total supply.

The SIQ was an amount of gas, within a range of [redacted], that Enron would deliver to Peoples Gas. (PG Ex. C at 14). Enron could choose the amount to be delivered. The SIQ was effective between April through November (defined as the "summer period"). (*Id.* at 11; and Staff Ex. 3 at 19). SIQ volumes were priced at [redacted] ("GD") minus 3¢. (Staff Ex. 2, Attach. 1 – GPAA Agreement at 9 – Art. 4.1(b); and Staff Ex. 3 at 8).

The DIQ was an amount of gas in addition to the Baseload and SIQ that Enron would to deliver to Peoples Gas at the utility's option. (PG Ex. C at 12). Peoples Gas states that it considered the DIQ a "swing contract." (Staff Ex. 7 at 19). The amount of gas available under the DIQ is the total capacity of the pipelines released to Enron less what is used to supply baseload and SIQ. There is no explicit demand charge or other premium for using a DIQ. (*Id.*) DIQ volumes were priced at Daily Midpoint Price for City Gate as published in Gas Daily. (Staff Ex. 2, Attach. 1— GPAA Agreement at 9 – Art. 4.1(c); and Staff Ex. 3 at 8).

In addition there are three re-pricing options within the contract – (1) baseload pricing adjustment ("BLPA"), and the Flexible Pricing Terms of (2) Article 4.2(b) and (3) Article 4.2(c). (Staff Ex. 7 at 18-19). The BLPA allowed Enron to change the price of a portion of Baseload volume from [redacted] (*Id.* at 18). The Flexible Pricing Terms (Articles 4.2(b) and (c)) allowed Enron to re-price volumes of gas during the Winter Period to GD. The volumes that apply to each re-pricing term are as follows: [redacted] for BLPA, [redacted] for Article 4.2(b) and [redacted] for Article 4.2(c) after January 1, 2000. (*Id.* at 19).

Finally, the GPAA gives Peoples Gas the right to re-sell natural gas back to Enron based upon the [redacted]. (Staff Ex. 2, Attach. 1— GPAA Agreement at 7 – Art. 2.4; Staff Ex. 7 at 32). The penalty varies between [redacted] and [redacted] based on the size of the resale and the time the resale was nominated for execution. (*Id.* at Art. 4.1(e)). The volumes that could be returned were up to [redacted]. (Staff Ex. 3 at 28).

2. Storage Optimization Contract

The SOC was an agreement between Peoples Gas and Enron MW, LLC, to optimize the unrestricted/unutilized storage capacity associated with two Peoples Gas' leased storage service contracts with Natural Gas Pipeline of America under Rate Schedule NSS ("NSS"). (PG Ex. L at 37; and SOC at 4). The total capacity that was to be used was approximately 19,200,000 MMBtus. (SOC AT 4). Enron MW was responsible for acquiring supplies and coordinating the dispatch of the [redacted] MMBtus and Peoples Gas was responsible for acquiring supplies and coordinating the dispatch of [redacted] MMBtus. (*Id.*)

The parties shared the revenue generated from the optimization. (*Id.* at 6). Enron MW received a share of the profits which increased as the gross margin increased, and Peoples Gas received the remainder of the profits (minus carrying cost, injection fuel costs and monthly management fee). The profit sharing is described in Profit Sharing, Figure 2, *above* under headings "Enron MW Share" and "PGL Share." Peoples Gas paid a monthly management fee for the optimization of each contract. (PG

Ex. L at 6). That fee totaled [redacted]. (Staff Ex. 9 at 15, and Sched. 9.02). The SOC resulted in $334,344 in credits that were accounted for in the Gas Charge. In addition to the SOC were oral agreements, which resulted in revenue earned under the SOC being shared with PERC -- $503,000 -- and PEC received [redacted] of the management fees paid by Peoples Gas -- [redacted].(Staff Ex. 15-16, and Sched. 9.02).

3. Refinery Gas Purchase Agreement

Prior to 2001, Peoples Gas had a contract ("RFG Agreement") to purchase refinery fuel gas ("RFG") from CITGO (formerly known as "UNO-VEN" or "PDVMR"). (*See* Group Exhibit 1 at ST-PG 212-236). The RFG Agreement was in effect from October 1, 1995 through September 30, 1999 (*Id.* at ST-PG 225-226), and Peoples Gas continued purchasing under the agreement until October 1, 2000 (*Id.* at ST-PG 182, and 188-189). Mr. Morrow, as Executive Vice-President of Peoples Gas and a witness in this case, signed the agreement on behalf of Peoples Gas.

There are four methods by which the price for RFG was to be determined. (*Id.* at ST-PG 215-216). One method was [redacted] times the Contract Price. (*Id.* at ST-PG 215 and 222). The Contract Price ("F") is defined as [redacted] ("E")). The costs of the purchase of RFG were accounted for in the Gas Charge prior to and during FY2001. (Staff Ex. 9 at 12).

On October 1, 2000, PERC began purchasing RFG from CITGO under the same terms as the RFG Agreement. (Group Exhibit 1 at ST-PG 188). No written contract was executed between CITGO and PERC. (*Id.*; and ICC Staff Ex. 9 at 12). In a letter from Mr. Morrow, President of PERC, to CITGO, [redacted]. (Group Exhibit 1 at ST-PG 188).

After the RFG Agreement ended, Peoples Gas still obtained RFG from CITGO, but only after it had passed through PERC and affiliates of Enron. PERC bought RFG from CITGO at 75% of the Average City Gate Price, then sold the RFG to Enron MW at 92.5% of Average City Gate Price. Enron MW then sold the RFG to Peoples Gas at 95% of Average City Gate Price. (Staff Ex. 9 at 12-13, Attach. B, and Sched. 9.01; see also Group Exhibit 1 ST-PG 181-189 (ENG 2.126)).

4. 1999 Letter of Intent and LLC Agreement Creating enovate

On September 16, 1999, PEC and Enron executed a letter of intent to form a business together.[6] The purpose of the joint venture was to primarily provide: (a) hub and marketing services to the Chicago wholesale marketplace; (b) risk management and structuring services in conjunction with transactions; (c) asset optimization services to PEC and its affiliates; (d) wholesale bundled services to Peoples Energy Services Corporation in power and gas; and (e) investment in and monetization of capital improvements to PEC's Chicago physical infrastructure. (Group Exhibit 1 at ST-PG 192). The parties anticipated the formation of a new business or other type of relationship which would operate for approximately five years. (*Id.*) Eventually they settled on a new business venture. On April 26, 2000, Enron MW and Peoples MW, LLC (a subsidiary of PEC) entered into a limited liability agreement for an entity named Midwest Energy Hub, LLC. Midwest Energy Hub's name was later changed to enovate, LLC.

Enron and PERC each formed a subsidiary for the purpose of owning enovate. Enron formed Enron MW and PERC formed Peoples MW, LLC. Profits and losses were

[6] Signed on behalf of PEC by Mr. William Morrow, who at the time was a Vice President of four companies -- Peoples Gas, North Shore, PERC, and PEC.

allocated between Enron MW and Peoples MW in accordance with their respective Membership Interests. (Staff Ex. 7 at 8). enovate's operations were intrinsically tied to Peoples Gas' PGA operations. A substantial number, if not all, of their transactions impacted the Gas Charge. Such transactions include the Trunkline deals and Transactions 16/22.

C. Storage Field Operations.

1. Negative Balance of Non-Tariff Natural Gas Inventory in Manlove Field

The non-tariff inventory balance in the Manlove storage field turned negative on January 5, 2001, and stayed negative until May 3, 2001. A "negative" inventory for non-tariff customers of the hub means that third parties had collectively withdrawn more natural gas from Manlove field than they had collectively injected. On February 28, 2001, the negative inventory balance reached its maximum -- 4,903,211 dekatherms ("Dth"). (Staff Ex. 2 at 37). During this five month period, from January to May, Peoples Gas continued to flow gas to third-party customers. Since third parties collectively did not have a positive storage balance to draw upon, the only supply source available to Peoples Gas for those services was the PGA system supply gas. (Staff Ex. 6 at 45).

2. Planned Injections and Withdrawals

Staff witness Anderson compared Peoples Gas' planned injections to its actual injections for the reconciliation period in support of Staff's adjustments related to imprudent operations of Manlove field and non-tariff service revenues. Table 1 reflects that comparison, and was included in Staff Ex. 6 at page 37. Table 1, *infra,* shows Peoples Gas' planned withdrawals and actual withdrawals of PGA gas for system supply and actual net withdrawals for non-tariff services for the winter of the 2001 Reconciliation Period at Manlove Field.

Table 1: Planned and Net Actual Withdrawals from Manlove

PGA Gas	November 2000	December 2000	January 2001	February 2001	March 2001	Total
Plan	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	
Actual	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Difference	+2.04 Bcf	-0.62 Bcf	-1.92 Bcf	+3.68 Bcf	+1.44 Bcf	
% of Total	8.1%	26.7%	28.1%	31.4%	5.7%	100%

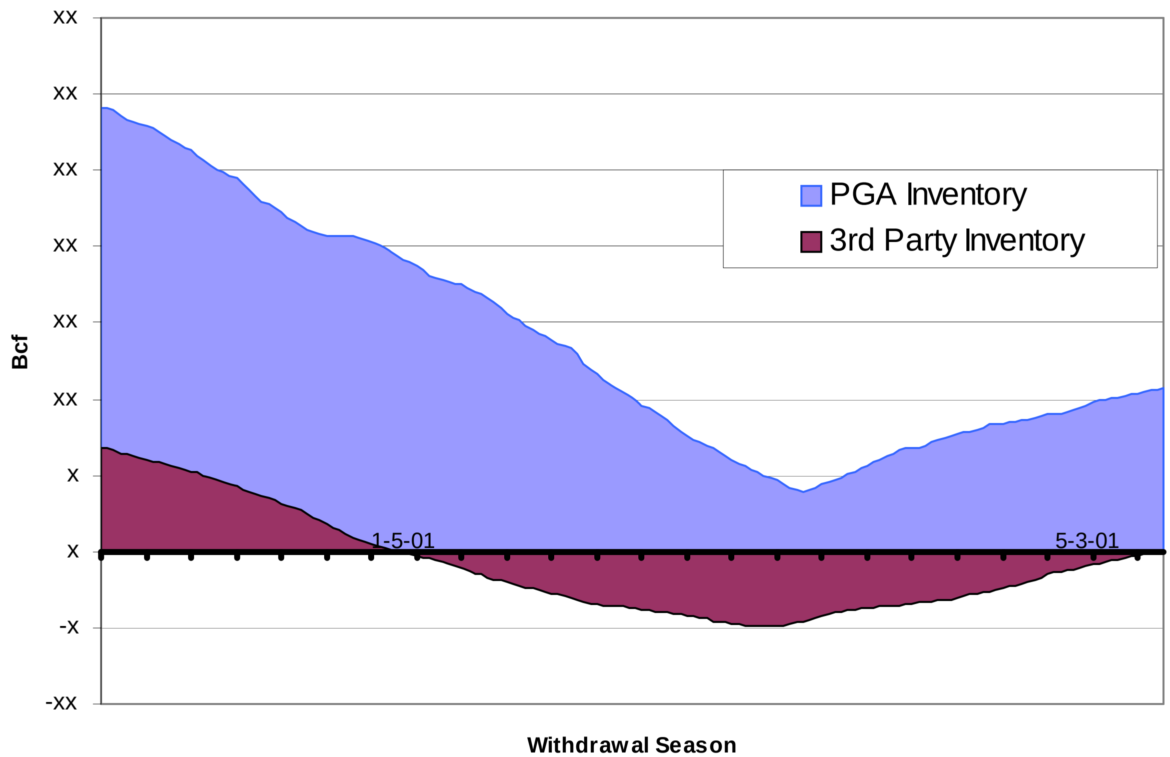
Non-Tariff	November 2000	December 2000	January 5 2001	Total
Actual	[redacted]	[redacted]	[redacted]	[redacted]
% of Total	21.6%	71.6%	6.8%	100%

(Source = Staff Exhibit 3.03 and Staff Data Request POL 2.74)

Table 1 reflects that Peoples Gas planned to withdraw [redacted] MMBtus from Manlove field for ratepayer use in December 2000, and [redacted] MMBtus in January 2001. Peoples Gas actually withdrew only [redacted] MMBTus in December 2000 and [redacted] MMBtus in January 2001, yet Peoples Gas was able to ensure that third party customers were able to withdraw the gas that they wanted. In fact, the cumulative percentage of inventory withdrawn for PGA customers from November 2000 through January 2001 was only [redacted]% of the total amount Peoples Gas stored in Manlove ([redacted]

[redacted]), while the cumulative inventory withdrawn for non-tariff customers for that same period was [redacted]% of their total injections ([redacted]). In his testimony, Staff witness Anderson determined that third party gas, which is gas used for non-tariff services, was totally depleted by January 2001, as is evident from Graph 1, *below* (Staff Ex. 6 at 38).

Graph 1: PGA and Third Party Gas Inventory in Manlove Field[7]



3. The Decline Curve

The decline curve is used to monitor withdrawals from the field to keep the field available to meet peak day conditions through a certain date (usually in late January). (PG Ex. F at 35-37). The decline curve, as it relates to Manlove field, represents the effect from the decrease in pressure in the field as inventory volumes are withdrawn

[7] Volume numbers are confidential on Graph 1.

through the winter. As the pressure (or amount of inventory maintained) at Manlove falls, so does the *peak day deliverability* of the field. In other words, as the field's pressure declines it is more difficult to withdraw a given volume of natural gas from the field.

4. "Park and Loan", and "Exchange" Transactions

When Peoples Gas performs a park and loan transaction, Peoples Gas can either loan natural gas to a customer on one date and is repaid at a later date, or it stores the customer's natural gas and returns the customer's gas later. From a physical supply standpoint, Peoples Gas could loan natural gas from its PGA system supply and replace it with gas from the other entity at a later date, or Peoples Gas could accept delivery of natural gas, from an entity, and store the natural gas until Peoples Gas returns the gas to the entity. Exchange transactions involve a similar loan or borrow of natural gas that is replaced or returned by the counterparty. (Staff Ex. 6 at 31-34). Again, the source for the natural gas used in these transactions can be either the natural gas in the Manlove storage field or flowing natural gas from Peoples Gas' PGA system supply assets, which includes purchased storage services. (Staff Ex. 11 at 11).

For example, in a loan and park transaction, Peoples Gas loans natural gas to an entity, and they agree to replace it at a later date. Unless the injections and withdrawals from storage match the details of the transaction, PGA system supply gas is used to support the transaction. There is simply no other natural gas supply available to Peoples Gas to complete this transaction. (Staff Ex. 6 at 31-34). This type of transaction occurred during the five months when the non-tariff natural gas inventory was negative.

Natural gas is parked when Peoples Gas receives natural gas in a non-tariff transaction. It must then either be injected into storage or consumed as system supply. In either case, the gas must be replaced or returned to the entity who delivered the natural gas to Peoples Gas, at a later date. The natural gas can be returned to the third party by either withdrawing it from storage or provisioning it from Peoples Gas's PGA system supply assets. In either case, PGA system supply gas, whose cost is recovered through the PGA, is the replacement gas. **(***Id.*)

D. Displacement.

Peoples Gas used displacement in executing non-tariff transactions. In reviewing non-tariff service operations, Staff witness Anderson analyzed the physical injections into Manlove field and the accounting records of injection and withdrawals. The meters at the field recorded Peoples Gas injecting 37,137,000 Dth into Manlove field and withdrawing 37,064,000 Dth. (Staff Ex. 2 at 36-37). However, the accounting records indicated total injection activity at Manlove of 45,643,000 Dth. This represents an additional 8,506,000 Dth (45,643,000 – 37, 137,000) of natural gas injections above the meter data, or 23% (8,506,000 / 37,137,000 = 22.9 %) margin of accounting injection volumes over the metered injection volumes at Manlove. There is a similar variance between withdrawals reported per the accounting records and the metered gas withdrawals. There is 9,237,000 Dth (46,301,000 – 37,064,000) more gas in the accounting data than the physically metered data. (Staff Ex. 2 at 33-37). This indicates that accounting withdrawal volumes are 25% (9,237,000 / 37,064,000 = 24.9%) more than the physical metered withdrawal volumes at Manlove.

Peoples Gas' used displacement to provide non-tariff services[8], relying upon system supply gas to provide said services. Displacement refers to the movement of natural gas through a pipeline transportation system without the physical delivery of the same molecules of natural gas. Since system supply gas costs are recovered through the PGA (a/k/a "recoverable gas costs" [9]) the revenues from non-tariff services should be recovered as an adjustment to the PGA. That displacement is used to provide non-tariff services is not in dispute. Rather, the issue regarding displacement is whether Peoples Gas can provide non-tariff services using <u>only</u> the rate-based assets of Manlove storage field and its own pipeline transmission system.[10] PG Ex. C at 32-35; (Staff Ex. 2, 6, 11 at 28). As will be discussed more fully in Section V – Argument, this clearly cannot be done.

Staff witness Dennis Anderson provided an example of displacement: assume Peoples Gas planned to inject 1,000 units of gas into its Manlove storage field during the pipeline day and on the same pipeline day, planned to fulfill a request for a non-tariff withdrawal of 10 units from the same storage field. Peoples Gas' accounts would show that 1,000 units were injected and 10 units withdrawn from storage. However, the utility could simply inject 990 units into storage and provide the remaining 10 units to the entity requesting gas from storage. (Staff Ex. 2.0 at 32). Thus the 10 units of gas would not be coming from the storage field at all, but be delivered to the third party from flowing gas in the system supply.

[8] Non-tariff service or transactions refer to those transactions that are performed under a FERC tariff or are agreements whose terms were not filed or approved by the ICC or the FERC.
[9] Recoverable Gas Costs are defined in 83 Illinois Administrative Code Part 525, Subsection 525.40(a) and include, among other things, the cost of transportation, purchased storage services, and the natural gas that flows through the PGA clause.
[10] Manlove field and the Mahomet pipeline are the two assets that make up the cost basis for the FERC Operating Statement.

Displacement is common in the gas industry and promotes economic efficiency., However, in the instant case, Peoples Gas did not identify the source of the natural gas used to perform such loans for non-tariff transactions during the reconciliation period. Further, Peoples Gas failed to refute Staff's conclusion that PGA system supply gas was used for the loans associated with the non-tariff transactions. (Staff Ex. 11 at 9).

When gas is provided to a third party customer to implement a non-tariff transaction, the gas being withdrawn does not originate from a specific source, such as from another hub customers' supply of gas, system supply working gas, transportation customer gas, or recoverable cushion gas. If the molecules could be color coded and their paths traced, it could be shown which of these sources the gas originated from. (PG Ex. L at 22-23). Since the non-tariff transactions rely, at least in part, upon gas being withdrawn from leased storage and/or gas flowing in on interstate pipelines, the gas being used is system supply. System supply gas costs are recovered through the PGA. (Staff Ex. 6 at 32-35).

V. Argument

Staff recommends fifteen adjustments to Peoples Gas' Gas Charge and makes eleven operational recommendations. The fifteen adjustments are reflected in Appendix A, Schedule 5.03 (i.e. Staff Ex. 5, Attach. 5.03). The adjustments, either agreed to by Staff and Peoples Gas, or as recalculated by Staff, collectively amounts to $91,987,033.

A. Gas Charge Adjustments.

1. Gas Purchase and Agency Agreement.

The record developed in both phases of the discovery process clearly indicates that Peoples Gas' decision to enter into the GPAA was not prudent and was not in the best interest of ratepayers.

a. Peoples Gas' Defense of the GPAA is Insufficient

Peoples Gas argues that the GPAA is prudent for two broad sets of reasons. However, neither reason stems from an economic analysis performed at the time the GPAA was signed. First, Peoples Gas argues that the GPAA is prudent because the Commission found it prudent in Docket No. 00-0720 (PG Ex. C at 28). Its second argument is that the GPAA meets five objectives that Peoples Gas argues are sufficient to prove prudency if said objectives are achieved (*Id.* at 10-11).

<u>(i). Commission decision in Docket No. 00-0720</u>

Peoples Gas incorrectly argues that the GPAA is prudent because the Commission found it prudent in Docket No. 00-0720. Peoples Gas' argument falters on a number of points. Even though the Commission had reconciled gas purchases under the GPAA for the previous year in that docket, the Commission is not bound to its previous decision because the decisions of the Commission do not have *res judicata* effect. *Mississippi River Fuel Corp. v. Illinois Commerce Commission,* 1 Ill. 2d 509, 513 (1953) (holding that the Commission may freely decide an issue irrespective of what is has done in previous cases) and *Governors Office of Consumer Services v. Illinois Commerce Commission,* 242 Ill. App. 3d 172, 189 (1st Dist., 1993) (Allowance of a cost item in the past does not mean that the item cannot be rejected upon investigation). Indeed, because these complicated transactions between affiliates within the PEC family and affiliates of the Enron family do not appear to have been meaningfully reviewed in Docket No. 00-0720, Staff recommends that the docket be reopened for a more thorough investigation.

Section 9-220 of the Act, 220 ILCS 5/9-220, requires the Commission to reconcile the costs of gas purchases with costs prudently incurred. The fact that Peoples Gas entered into a five-year contract does not alter the statutory requirement. *See Business and Professional People for the Public Interest v. Illinois Commerce Commission,* 136 Ill. 2d 192, 219-229 (1990) (holding that in general rate cases, a test-year must be used, thus the multi-year approach taken in the BPI cause was improper, barring an amendment of the Commission's rules). Thus, it is perfectly possible for the GPAA to be found prudent in one year and imprudent in the next. *Illinois Commerce Commission v. Illinois Power Co., Reconciliation of FAC and PGA clauses,* Docket No. 01-0701, Order at 4-7, 2004 Ill. PUC Lexis 101 at *13 and **16-17 (Feb. 19, 2004)(holding that a disallowance of a contract in one year does not require disallowance in the next year). Peoples Gas was not required to enter into a multi-year gas supply agreement and gains no immunity from annual reconciliation under Section 9-220 of the Act, 220 ILCS 5/ 9-220, by doing so.

An additional reason that militates against the foreclosing of examination of the GPAA in the present case because of the Commission's decision in Docket No. 00-0720 is the finding and review of new evidence related to the GPAA. Some of the evidence Staff found in the present cause that was not evaluated in Docket No. 00-0720 were two numerical analyses of the GPAA. One was developed by Mr. David Wear, Gas Supply Manager for Peoples Gas (Wear Cross Ex. 15), although Peoples Gas was unable to explain the document (Hearing April 22, 2005, Tr. 386-395). The other was developed by Mr. Roy Rodriguez while assigned to the team evaluating the GPAA (Staff Group Ex. 1 at ST-PG 050-074 "Aruba analysis" and at ST-PG 135-074 "Aruba Analysis: Economic Analysis Final.xls"). Both were prepared at or near the time the GPAA was signed. The Aruba analysis shows that the GPAA was likely to be a more costly alternative to Peoples Gas' then-current practice. And Wear Cross Ex. 15 also showed that the GPAA produced higher costs for ratepayers over the period it surveyed. Moreover, this evidence was in the control of Peoples Gas and was only produced after numerous data requests from Staff.

(ii) The 5 Negotiation Goals Are Not Sufficient to Demonstrate the Prudence of the GPAA, Even if They Were Met

Peoples Gas claims five goals for negotiations with Enron which the Company argues are sufficient to demonstrate prudency once they are achieved (PG Ex. C at 29).

The five goals were:

1. A contract that preserves transportation asset values in the face of a falling basis.
2. A contract that allows Peoples Gas to buy gas at market prices without demand or reservation charges.
3. A contract that provides Peoples Gas with flexible pricing terms.
4. Peoples Gas is granted flexibility to meet operational requirements by the contract.
5. The contract serves as a proxy for historical contracts.

Peoples Gas does not document that these goals were, in fact, Peoples Gas' goals at the time of the GPAA's negotiation (Staff Ex. 3 at 12-13). Peoples Gas cannot demonstrate that the GPAA was no worse at meeting the goals than other options available to it (*Id.* at 14-15). Finally, the goals are not sufficient to show that the GPAA was prudent within the meaning of 220 ILCS 5/ 9-220(a) (*Id.* at 11).

1. <u>A contract that preserves transportation asset values in the face of a falling basis.</u>

Peoples Gas did not demonstrate that the GPAA provided beneficial alternatives that preserved the value of transportation assets against a falling basis.[11] There are three main problems with Peoples Gas' position. First, signing the GPAA departed from historical Company practice of load shifting to preserve its transportation assets' value. Therefore, the GPAA was not Peoples Gas' only option. Second, in effect, the GPAA caused Peoples Gas to pay twice for transportation capacity. Third, given Peoples Gas' known view of the future, the bases do not fall fast enough in comparison to the discount in the GPAA in order to justify the contract.

Peoples Gas testified that it anticipated additional pipeline capacity would be entering the Chicago market and, as a consequence, the value of its transportation capacity would be reduced. The consequence of such a growth is that the basis between the field area price and the Chicago city-gate price would be reduced and that, in turn, lowers the value of Peoples Gas' leased transportation assets. Peoples Gas argues that this was a major factor in the process that led to it signing the GPAA (PG Ex. C, at 5-11). By purchasing gas at the citygate price, the GPAA allowed Peoples Gas to preserve the value of its transportation assets.

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[11] Basis is the difference in gas prices between two locations. In this brief, the focus is on the difference between the field area price (production region) and the [redacted].

While the GPAA does provide protection against an eroding basis, that fact alone does not justify the prudency of the contract. By entering the GPAA, Peoples Gas departed from its historical practice of load shifting. Distribution companies use the potential to shift load from one pipeline to another to negotiate transportation rates between pipelines. In particular, where multiple pipelines serve a particular market area, pipelines can and do negotiate rates below the maximum set by FERC when competing for business. Utilities use the potential to shift load between pipelines to negotiate lower transportation rates. This tactic was a viable alternative to preserve the value of transportation assets without signing the GPAA, but Peoples Gas provided no evidence of using that practice in conjunction with the GPAA (Staff Ex. 6 at 16-18).

Peoples Gas provided an exhibit that showed Peoples Gas' firm pipeline transportation portfolio changing over time (PG Ex. L, Exhibit 19). This exhibit indicated that Peoples Gas had historically used load shifting to obtain the best available transportation rates from its transportation suppliers. In addition, Peoples Gas admitted that it had substituted one piece of pipeline transportation for another in the past (PG Ex. 19). In spite of this, Peoples Gas still disputed its ability to shift loads between pipelines (PG Ex. L at 12-14). Peoples Gas denied that either shifting the load or signing shorter term transport contracts was a better response to market conditions that it faced at the time. However, Peoples Gas failed to provide any analysis of the available alternatives that Peoples Gas considered before it signed the GPAA (Staff Ex. 6 at 18).

Further, the potential for basis erosion during this time period should have been obvious. If there was excess capacity of firm transportation into a market area (such as

Chicago), then pipeline transportation costs should also decrease whenever the utility renegotiates its contract with the pipeline. Peoples Gas negotiated four new pipeline contracts in late 1998 and one in 1999 before signing the GPAA in fall 1999. Given the timing of these new pipeline contracts, the potential for basis erosion during this time period should have been easily demonstrable. Shorter-term agreements would have allowed contracts to be renegotiated more frequently in order to capture the benefits from a falling basis without resorting to signing the cumbersome and complex GPAA (Staff Ex. 6 at 18).

Peoples Gas stated that load shifting between pipelines and signing a shorter term transportation contracts was not necessarily a better response to market conditions in 1999 than signing the GPAA. But Staff merely pointed out the alternatives to the GPAA that Peoples Gas should have investigated prior to signing the GPAA. Peoples Gas nowhere indicated that it even considered any alternatives to signing the GPAA with Enron (*Id.*) This is not surprising given the strategic partnership between PEC, Enron, and their affiliates.

Moreover, no other Illinois gas utility dealt with the potential for eroding bases by entering into an agreement similar to the GPAA. Peoples Gas' actions in this regard were unique. In short, Peoples Gas failed to show that the GPAA uniquely benefited ratepayers by preserving the value of transportation asset basis relative to Peoples Gas' historical practice (Staff Ex. 2 at 17).

The GPAA also caused Peoples Gas to pay twice for its transportation capacity. Under the GPAA, Peoples Gas released its pipeline transportation capacity to Enron. Enron then paid the pipeline, but Peoples Gas reimburses Enron for all pipeline transportation costs (Staff Ex. 6 at 14-21). Enron used this released pipeline capacity to supply gas to Peoples Gas. However, capacity not needed to supply Peoples Gas can be used by Enron for its own business purposes without any further reimbursement to Peoples Gas (Staff Ex. 2 at 18-19).

Thus, Peoples Gas transferred the released pipeline capacity to Enron at no cost to Enron, while Peoples Gas shoulders the same transportation costs as it did before signing the GPAA. Further, Peoples Gas purchased gas at a citygate index price ("GD"), which implicitly includes transportation costs. In effect, the GPAA caused Peoples Gas to pay twice for transportation costs while surrendering its excess capacity to Enron for no compensation (*Id.* at 20).

As noted above in this section, in the discussion about the firm delivered price versus the GD, bases do not start at a low enough level and/or do not fall fast enough to justify the GPAA. In particular, the discount in the GPAA does not atone for the difference. To the extent that the bases do fall, they do not fall fast enough in comparison to the discount in the GPAA in order to justify the contract. In other words, the discount needs to be higher to protect the ratepayers against falling bases given what is known to be Peoples Gas' projections for bases (Staff Ex. 3 at 13-14).

2. A contract that allows Peoples Gas to buy gas at market prices without demand or reservation charges.

Peoples Gas averred that a GPAA benefit was that Peoples Gas could receive supply without any reservation or demand charges.[12] However, Peoples Gas continued to pay all pipeline demand charges under the GPAA. Therefore, Peoples Gas cannot

[12] Reservation or demand charges are fixed costs that reserve a supply source or space on a pipeline. They are incurred whether any gas is delivered or not.

support its claim that it does not incur any swing load demand charges under the GPAA. Peoples Gas proved unable to disaggregate the components in the GPAA contract in order to determine whether it includes demand or reservation charges to cover the swing capability of the GPAA (Staff Ex. 2 at 20).

3. A contract that provides Peoples Gas with flexible pricing terms

Peoples Gas claimed that the GPAA also benefited ratepayers through flexible pricing terms. Staff agrees that ratepayers are well served when a utility's gas supply portfolio provides pricing flexibility, and the GPAA does have Article 4.2(a) that enables Peoples Gas to alter pricing terms upon request. However, this pricing flexibility is not obviously superior to Peoples Gas' historical gas supply practices. If Peoples Gas had retained its historic approach and not entered into the GPAA, Peoples Gas would have retained sufficient pricing flexibility (Staff Ex. 2 at 25-26).

4. Peoples Gas is granted flexibility to meet operational requirements by the contract

Peoples Gas asserts that the GPAA gave it sufficient flexibility to meet its customer's varying demand requirements. Again, Peoples Gas did not demonstrate that the GPAA was superior or even equal to its previous behavior in meeting its customers' demands placed by varying weather conditions versus its previous manner of purchasing gas supplies. In fact, Peoples Gas did indicate that the GPAA was not superior to its previous procedures. A five-year agreement with a single vendor is not as flexible as multiple contracts for supply and transportation with multiple suppliers with varying expiration dates. The latter allows Peoples Gas to deal with changes in the market more quickly (*Id.* at 26).

5. The contract serves as a proxy for historical contracts

Peoples Gas claimed that the GPAA was a reasonable proxy for the historic gas supply contracts that GPAA had replaced. A five-year agreement with a single vendor is not equivalent to multiple contracts for supply and transportation with multiple suppliers with varying expiration dates. In fact, the GPAA contains several onerous contract provisions that are inferior to Peoples Gas' historic supply practices (*Id.* at 27). In particular, there are the re-pricing elements and the SIQ discussed earlier in this section of the Brief.

As discussed supra in Section IV.B.1., the terms of the GPAA were not a reasonably close proxy to Peoples Gas' past purchasing practices. The contract provided Peoples Gas a large percentage of its system supply through one contract. The GPAA had three pricing methods. As noted above, Enron could change the price for some quantities solely at its discretion and can choose volumes that are sold (Staff Ex. 3 at 42). All of these components indicate that the GPAA was a significant departure from its past practices and, as such, prudence requires that Peoples Gas perform some type of economic analysis or analyze a request for proposals in choosing such a contract. As Mr. Anderson testified, Peoples Gas provided neither a contemporaneous analysis of the GPAA (Staff Ex. 6 at 8-11), nor did it provide any information about entering negotiations with a written set of objectives that Peoples Gas wanted to meet in establishing the GPAA (*Id.* at 15-16).

Staff's investigation into the prudence of the GPAA shows that, in fact, the GPAA was demonstrably inferior to what Peoples Gas could have done. According to the basis projections provided by Peoples Gas in its additional direct testimony, it would not have been cheaper to buy natural gas at the citygate price than at the field delivered price and transport it to the citygate (PG Ex. C, Ex. 2; Staff Ex. 3 at 22-24 [Table 1]; and Staff Ex. 7 at 20-21). Therefore, the data provided in Mr. Wear's additional direct testimony indicated that the GPAA was more expensive than its previous practice. Thus, the GPAA was not a good proxy for previous supply contracts.

(iii). Baseload levels are not justified

Peoples Gas has not shown that the manner in which baseload quantities are established under the GPAA is prudent. The baseload quantity in the GPAA is the volume of natural gas Peoples Gas was required to purchase. The daily volume was established by month over the entire course of the contract.

Peoples Gas did not provide any studies, analyses, and methodologies used to establish baseload quantities. Instead, Peoples Gas provided at least four rationales for those quantities. It indicated that they were established in the GPAA negotiations. Peoples Gas also asserted that baseload quantities did not reflect baseload demand on Peoples Gas' system. Further, Peoples Gas also claimed that the baseload quantities in the GPAA were similar to baseload purchases by Peoples Gas before the GPAA. Peoples Gas also stated that baseload volumes were based upon normal weather, although daily or monthly decisions may be based on other scenarios. None of these rationales justify the specific baseload levels in the GPAA. (Staff Ex. 2 at 21-22).

When a utility establishes baseload purchases based upon normal weather conditions, a regulated utility's goal is to contract for natural gas supplies in an amount that just meets the estimated load requirements of its customers. Baseload requirements normally represent that portion of total customer demand that the utility estimates it can take no matter what conditions exists. When normal weather is used to set baseload, Peoples Gas is induced to purchase more baseload supply than it needs whenever temperatures were warmer than normal. An alternative approach used by other utilities is to size baseload purchases to meet warmer than normal conditions and to purchase swing supply to cover the balance of the load (*Id.* at 22-23).

Peoples Gas did not show that it considered any alternatives to the baseload quantities negotiated with Enron. Instead, Peoples Gas committed to baseload purchases without thoroughly studying the prudent level of baseload needed by its customers.

<u>(iv). The SIQ is operationally deficient</u>

The effect of the SIQ provision of the GPAA has not been shown to be prudent. This adverse effect includes operational concerns as well as the provision's effect on gas costs.

The SIQ provision allows the seller, Enron, to choose the amount of gas Enron delivers to Peoples Gas during the Summer Period. SIQ volumes are part of Peoples Gas' estimated gas supply requirements. Since Peoples Gas requires this quantity of gas supply, it is not appropriate for Peoples Gas to allow Enron to dictate these amounts. Whenever Enron declines to deliver some portion of the incremental SIQ volumes to Peoples Gas, Peoples Gas must purchase gas from another source (*Id.* at 23-24).

In the GPAA, the DIQ allows Peoples Gas to purchase additional volumes of gas as from Enron. However, the SIQ is priced at the Chicago [redacted] Index, while the DIQ is priced at a Daily Midpoint Price for City Gate as published in Gas Daily [redacted] price index (as would most other replacement sources). If the [redacted] price is above the Chicago [redacted] Index on a given day, Enron is unlikely to sell any incremental SIQ volumes to Peoples Gas. Peoples Gas is then forced to purchase its load requirements either through the DIQ or from another source at a price based upon the higher [redacted] index (*Id.* at 24-25).

Peoples Gas asserted that it is common practice to grant a seller the option of providing supply in exchange for a discount, especially when refilling storage (PG Ex. F at 30). However, the discount in the GPAA applies to the entire contract, not just the SIQ. Peoples Gas elsewhere describes the discount as a tradeoff for buying gas at the citygate price (Staff Ex. 6 at 22).

Peoples Gas notes that it did not purchase higher priced gas over 20 percent of the time during the reconciliation period, when Enron delivered only the minimum SIQ amount. Further, Peoples Gas stated that Enron was not always able to predict when the daily price index will exceed the first of the month index price.[13] Peoples Gas noted that, on 6 percent of the days that Enron was required to make a decision on the SIQ, Enron "guessed" wrong (PG Ex. L at 11).

In other words, about 80 percent of the time when Enron supplied Peoples Gas with the minimum amount of SIQ gas, Peoples Gas had to find volumes to replace the reduced SIQ volumes. Since the minimum SIQ was generally chosen when daily prices were higher, those replacements were necessarily higher priced. Further, Enron could predict when the daily price index would exceed the first of the month index price 94% (100% – 6%) of the time. Enron was able to very accurately determine when it was in its best interest (and conversely not in the ratepayers' best interests) to choose whether to deliver the maximum or minimum levels of SIQ {Staff Ex. 11 at 5-6}.

[13] If Enron wants to maximize its profits, it should choose the maximum SIQ whenever the daily price is less than the monthly price. Then Enron would sell to Peoples Gas only when Enron obtains a higher price than the current market price.

The SIQ is not operationally defensible, especially in light of the other terms of the contract.

b. The GPAA is Not Prudent

Peoples Gas entered into a five year, $ [redacted] million gas supply contract with Enron without performing *any* economic studies or analysis. It is Peoples Gas' burden to prove the prudency of entering into the GPAA for this Reconciliation Period. 220 ILCS 5/ 9-220(a). The prudency of its actions is to be measured at the time of entering the GPAA.

Staff finds the GPAA to be imprudent because Peoples Gas admits that it failed to conduct any economic analyses of the GPAA prior to signing the GPAA. In addition, Peoples Gas failed to consider two economic analyses of the GPAA that its employees or employees of PEC performed prior to the GPAA being signed. Peoples Gas did not consider any alternate gas-supply options to the GPAA. Finally, reviewing information known at the time Peoples Gas entered into the GPAA, the GPAA was imprudent because its projected cost was significantly and consistently higher than what Peoples Gas should have otherwise expected to pay for natural gas.

(i). Economic studies are required to demonstrate the GPAA's prudence.

Peoples Gas cannot demonstrate that the GPAA was prudent since it neither entered into a competitive bidding process nor did it consider any existing economic analyses at the time the GPAA was entered. A conclusion about the prudence of a decision to enter into the GPAA must be made on information and facts available at the time the utility made its decision, and hindsight review is impermissible. *Illinois Commerce Commission v. Commonwealth Edison Co., Reconciliation of FAC clause,* Docket No. 84-0395, Order at 17, 1987 Ill. PUC LEXIS 68 at *34 (Oct. 7, 1987). Peoples Gas has not provided a persuasive set of reasons why the decision was prudent.

Moreover, the Commission has previously defined prudence as the 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. *Illinois Commerce Commission v. Illinois Power Co., Reconciliation of FAC and PGA clauses,* Docket No. 01-0701, Order at 2, 2004 Ill. PUC Lexis 101 at *4-5 (Feb. 19, 2004). The GPAA was a dramatic change in Peoples Gas' gas purchasing practices. As such, prudent business practice warrants that, prior to making such a change, Peoples Gas should have taken steps to determine that entering into the GPAA was a prudent action. In its testimony, Peoples Gas failed to provide any analysis performed at the time the contract was entered into that demonstrates the GPAA was prudent (Staff Ex. 3 at 10-13).

The GPAA was a dramatic change in how the Peoples Gas buys gas (Staff Ex. 3 at 16, Staff Ex. 12 at 21, City-CUB Ex. 1 at 13-15, and City-CUB Ex. 2 at 11-12). Prior to signing the GPAA, Peoples Gas had purchased its own natural gas supplies and transported these supplies to its Chicago distribution system via its contracted interstate pipeline capacity. The GPAA was a major departure from that practice for a few reasons. First, Peoples Gas purchased gas at the citygate price and did not have to transport it to the citygate, whereas its previous method was to buy at the field price and transport the gas to the citygate. Second, the GPAA provided Peoples Gas with a significant portion of its gas during the reconciliation period -- [redacted]% of its system supply during the reconciliation period under the GPAA. The GPAA also committed Peoples Gas to spending a significant amount of revenue -- expending over $[redacted] million for gas supply under the GPAA during the reconciliation period. Moreover, this contract was not for a one- or two-year term, as was most contracts prior to this point – it was a five-year contract. Peoples Gas does not explain why its historic supply procedures were less preferable than the GPAA (Staff Ex. 6 at 16).

Peoples Gas argues that the GPAA did not alter its historical practices. It states that the GPAA merely integrates into one contract all the different previously used buying methods (PG Ex. C at 4). However, the GPAA uses several different and complex pricing schemes. The inherent complexity of the GPAA reinforces the idea that it is a definite change in purchasing methods (Staff Ex. 6 at 6). It has a longer term than most gas-supply contracts had during the period (City-CUB Ex. 1.0 at 12-13).

A change in purchasing method requires that the new method be evaluated. The purchasing method can be evaluated with a request for proposal ("RFP") and a careful evaluation of the responses. Peoples Gas did not conduct an RFP and does not appear to believe one was appropriate (Staff Ex. 3 at 11). However, Peoples Gas can also evaluate a change in practices with an economic analysis, but it did not do this either. Peoples Gas provided no contemporaneous economic studies in testimony or in discovery prior to the reopening for additional discovery (Staff Ex. 3 at 13-14; Staff Ex. 7 at 3). Absent competitive bidding and without economic studies, Peoples Gas has no quantitative benchmark to measure the GPAA's prudence.

(ii). Peoples Gas ignored the economic analyses of the GPAA that were performed prior to signing it.

In the additional discovery, Staff and Government and Consumer Parties obtained, two numerical analyses of the GPAA created by PEC employees were discovered. Staff located a document termed the "Aruba analysis" (Staff Group Ex. 1, at ST PG 050-074 and at ST-PG 135-161 "Aruba Analysis: Economic Analysis Final.xls"; and Staff Ex. 7 at 7-10). A second numerical analysis was located in the electronic documents attributed to Peoples Gas' Gas Supply Manager, Mr. David Wear. The existence of these studies contradicts previous data request responses and the sworn testimony of Peoples Gas (Staff Ex. 7 at 6-7). The Aruba Analysis indicates that the GPAA was expected to be more expensive than was prudent (*Id.* at 12-13).

Wear Cross Exhibit 15 appears to be a type of economic analysis that is backward-looking. Wear Cross Ex. #15. The document was an Excel spreadsheet, that examined how the GPAA would have operated if in effect from fiscal year 1996 through the first ten months of fiscal year 2000. The spreadsheet, identified as "ENAPGL.xls", appeared to show that the GPAA was cumulatively about $50 million more expensive than actual gas costs. Wear Cross Ex. #15. The likely author of the document, Mr. David Wear, does not recall it. Tr. 1024.

As discussed supra in Section IV.A., the Aruba analysis was a forward-looking economic analysis prepared by Mr. Roy Rodriguez of PEC (Staff Ex. 7 at 12-15). PEC constructed a data set that projected prices at different locations where it received gas into its leased interstate transportation (Staff Ex. 3 at 21-22).[14] The analysis concluded that gas costs would be higher as a result of the contract (Staff Ex. 7 at 12-13).

While the two studies modeled the single most important aspect of the comparison and were accessible to at least two people involved in the team analyzing the GPAA – Mr. Rodriguez and Mr. Wear – Peoples Gas appears to have ignored these studies and to have sought no other empirical studies of the GPAA. It is imprudent for a utility to have ignored such studies or to have performed no empirical studies in the first place when considering a new method of purchasing gas that is as important and significant as the GPAA (Staff Ex. 7 at 14-15).

(iii). Using data known to be possessed by Peoples Gas at the time the GPAA was signed, the GPAA was imprudent.

Staff has, in this cause, performed an *a priori* analysis of the GPAA – analyzing only the information known at the time Peoples Gas made the decision under the alternatives that Peoples Gas faced. The analysis clearly indicates that the GPAA's projected cost was significantly and consistently higher than what Peoples Gas should have otherwise expected to pay for natural gas (Staff Ex. 3 at 16-32).

Staff broke the GPAA into seven components and analyzed each component for its effect on gas costs. The components' values are totaled and then totals are summed over the term of the agreement. These components are (1) the discount, (2) field price plus variable transport cost versus the citygate price (Staff Ex. 7 at 19-20),[15] (3) foregone demand credits, (4) repricing options, (5) resale penalty, (6) avoided demand

[14] A more accurate description is that the data projected the price differentials from the Henry Hub to each location. Actual delivery point prices can be easily inferred from this data.

[15] In Staff Ex. 3 at 17-18, the comparison is equivalently framed as a comparison between variable transport cost and the basis from field locations to the citygate. The results are unaffected by which method is used.

charges, and (7) the SIQ option (Staff Ex. 3 at 31-32; Staff Ex. 7 at 34-35). These components will be taken *in seriatim.*

The discount is a savings that is passed on to ratepayers since it is a sale of gas from Enron to Peoples Gas at a price below the average market price. The discount applies to both baseload quantity purchases and SIQ purchases. Since baseload quantities are specified for the GPAA's entire term and Peoples Gas provides an estimate for SIQ volumes, it is relatively straightforward to estimate the value for this element over the term of the GPAA. The estimated value from the discount over the term of the GPAA is $[redacted] (Staff Ex. 3 at 17 discusses the issue. The calculations' results are presented in Staff Ex. 7.02).

The second component is the field delivered versus citygate comparison. This examines the difference between the cost of gas purchased at the field price and transported to the citygate versus the cost when gas is bought at the citygate price. This is the single biggest factor in the GPAA evaluation .

Peoples Gas released interstate transportation that it had under lease to Enron. For each delivery point in the transportation contracts released to Enron, Peoples Gas projected a basis from the Henry Hub to that point (as well as from the Henry Hub to Chicago) for each month over the GPAA's term. NYMEX futures contracts are used to project a Henry Hub price forward. These contracts, which have the Henry Hub as the delivery point, are sold at least three years forward. The field price for each location is calculated as the Henry Hub price, estimated by the NYMEX futures price, plus the projected basis for that location. The citygate price is similarly constructed as the Henry Hub price plus the Chicago basis. The field delivered price is the field price plus the variable transport charges to transport the gas from the field to the citygate. Variable transport costs are derived from the applicable pipeline tariffs. The estimated additional that the GPAA imposed upon Peoples Gas' ratepayers by buying gas at the citygate rather than in the field is estimated to be $[redacted] (See Staff Ex. 3 at 17-18 for the initial discussion. In Staff Ex. 7 at 20-22, the method is adjusted. The calculations that follow from these changes and corrections are presented in Graves at FCG-AR3, Column [3].).

The third component is the foregone demand credit. When Peoples Gas controls a transportation contract, it can derive revenues that are flowed through the PGA in two ways. Peoples Gas can release the capacity to third parties, or it can engage in demand credit transactions where it buys gas at one point on the pipeline and sells it at another. In this case, the margins on the sales cover some of the demand charges, thereby reducing PGA rates. When Peoples Gas released some of its interstate pipeline transportation contracts to Enron, it could no longer earn those revenues. That revenue loss raised gas costs. In addition, since at least part of the reason for signing the GPAA was to hedge the value of the pipeline contracts, it must follow that the transportation contracts have a value and that their surrender has a cost. The cost to ratepayers for this component of the GPAA is estimated to be $[redacted] (Staff Ex. 3 at 18 and 24-25, with the results presented in Staff Ex. 7.02).

The fourth component is the value that Peoples Gas surrendered to Enron via the re-pricing options. The GPAA contained three elements that Staff termed the 'repricing options.' Specifically, they are the Baseload Pricing Adjustment, Article 4.2b and 4.2c of the GPAA. All three allow Enron to unilaterally change the price, during the winter, of various quantities of gas from the base monthly price to a daily price. Although Peoples Gas stated that Enron never invoked the repricing terms during the reconciliation period, they were a part of the agreement as signed. As such, they must be evaluated to help determine the prudency of the contract. PGA costs were increased when Enron could choose the daily price whenever it was higher. Staff estimated that Enron would choose the daily price on half of the days during the winter months. Staff calculated the average difference between the daily price and the monthly price when the daily price was higher. Staff used historical data to calculate this average difference. Those calculations resulted in a higher cost to ratepayers of $ [redacted] (Staff Ex. 3 at 18-19 and 26-28. The results are presented in Staff Ex. 7.02.).

The fifth component is the resale penalty. The resale penalty increased gas costs for ratepayers. The resale term allowed Peoples Gas to resell gas back to Enron at the GD minus a penalty, depending on both when the resale was nominated and the amount resold back to Enron. Since the GPAA states that Peoples Gas cannot use the resale article to make a profit, it is almost guaranteed to lead to higher gas costs. The value of this component is estimated by assuming that a fixed percentage of incremental SIQ will be resold and multiplying that amount by an assumed penalty. The resulting estimate over the GPAA's term is $[redacted] (Staff Ex. 3 at 19 and 28-30. The results are presented in Staff Ex. 7.02.).

The sixth component is the value from avoiding demand charges by having the DIQ available. The DIQ is an amount of gas that is available for Peoples Gas to buy at its option. Since swing contracts typically have a demand charge and the DIQ does not, the avoided demand charges serve to lower gas costs for ratepayers. Staff estimates this effect using a value provided by Peoples Gas in this case. The figure provided by Peoples Gas was found by using the midpoint of demand charges that paid on Peoples Gas contracts. The estimate for the value of avoided demand charges is calculated by multiplying the unit estimate by available DIQ. This value is estimated as $[redacted] (Staff Ex. 3.0 at 19 and 30-31. Results are presented in Staff Ex. 7.02.).

The seventh component is the value of the SIQ term. The SIQ term is best described as a put option for Enron. Under this component, Enron can choose an amount to sell to Peoples Gas at its option. Enron optimizes the SIQ's value by opting for the maximum SIQ whenever the daily price exceeds the monthly price. Of course, when Peoples Gas grants this capability to Enron, it surrenders value to Enron, regardless of how that value is realized. Staff estimates this term as the probability for the daily price to exceed the monthly price times the average differential when that is true. Staff uses the 50% figure posited in Peoples Gas' testimony for the estimated probability, and the conditional expected differential is estimated using historical data. The value is estimated as $[redacted] (Ex. 3 at 19 and 31-32. The issue is further discussed in Staff Ex. 7.0 at 34-36. Results are presented in Staff Ex. 7.02.).

The value for each component is analyzed to derive an estimate by month over the GPAA's term. The components' values are totaled, and then the totals are calculated over the term of the agreement. The analysis clearly indicates that the GPAA's projected cost was significantly and consistently higher than what Peoples Gas should have otherwise expected to pay (Staff Ex. 3 at 17-32 and Staff Ex. 7 at 35-36). The estimated additional cost to ratepayers over the term of the contract totals $4,553,410.[16]

c. Peoples Gas' Reply to Staff's Analysis is not Persuasive

In one of its arguments, Peoples Gas asserts that Staff's method is flawed because the GPAA has benefits that are not quantifiable (PG Ex. 7-10). But the alleged unquantifiable benefits are supported only by vague generalizations. Peoples Gas offers no facts or concrete examples to demonstrate their allegations. On the other hand, the GPAA effects examined by Staff have direct results on ratepayers (Staff Ex. 7 at 17-19 and Staff Ex. 12 at 21-22). Peoples Gas did not respond to Staff's analysis with an alternative approach, but simply issued a summary rejection of Staff's analysis. Peoples Gas, however, attempts to inject an unsupported liquidity premium into the calculations (PG Ex. E at 18-19). The liquidity premium improves the estimated evaluation of the GPAA.

Peoples Gas also relies upon the studies performed by Cambridge Energy Research Associates ("CERA") and Public Interest Research Associates ("PIRA") to provide more favorable comparisons (PG Ex. H at 43-47). One flaw in relying upon these alternative basis projections is that Peoples Gas cannot document that it considered them prior to signing the contract (Staff Ex. 7 at 21-22; Staff Ex. 12 at 10-11). Moreover, neither Peoples Gas nor CERA assigned relative probabilities to the CERA scenarios (Staff Ex. 7 at 22).

In addition, the alternative basis projections are incompatible with the GPAA. For example, the CERA data are annual and use the calendar year, while the fact that the

[16] The updated, formal results are presented in Staff Ex. 7.02 (monthly data), 7.03 (by fiscal year) and 7.04 (by fiscal year per MMBtu).

data are monthly is important in evaluating the contract[17] and Peoples Gas' fiscal year goes from October through September. Since monthly variations matter, the calendar year bases necessarily differ from the fiscal year bases (Staff Ex. at 25-26).

Finally, as discussed on pages 16 and 17 of Staff's Exhibit 12, Dr. Rearden explains that the locations in the CERA data do not coincide with the locations in the transportation contracts released to Enron as part of the GPAA. Since the locations in the CERA data do not match the delivery points for the transportation contracts that were released to Enron in the GPAA comparisons, using this data to try to demonstrate that the GPAA was prudent is problematic (Staff Ex. 12 at 16-17). Perhaps most importantly, the Peoples Gas' witness Mr. Graves examines only variations in the Henry Hub-Chicago basis. Peoples Gas did not try to adjust for this fault (Staff Ex. 12 at 15-17).

A liquidity premium, in the context of the GPAA, is the additional amount that a buyer must pay at a given location when purchasing large gas supplies at that location. The theory is that the large demand by the utility at a given location drives up gas prices at that location. In this docket, the liquidity premium is the amount above the index price at a given location that the utility must pay to buy a large volume of gas at that location (PG Ex. E at 18-19). The liquidity premium is not supported by data or analysis and should be rejected (Staff Ex. 12 at 19).

While Peoples Gas did furnish alternative basis scenarios for the field delivered comparison, it did not offer alternatives to Staff's analysis of other aspects of the

[17] Many of the pricing terms depend on whether it is in the Summer Period or Winter Period. Also, the basis projections and baseload quantities in the GPAA are quite variable from month to month.

contract. Yet those other elements of the contract inarguably had an effect on gas costs (Staff Ex. 7 at 29-30 (repricing terms), 27 (foregone demand credit) and 35 (SIQ)).

d. Imprudently High Costs in the GPAA Should be Refunded

Peoples Gas should refund the additional costs imposed by the GPAA on ratepayers.

The disallowance proposed by Staff is calculated using the same framework as the test for prudence. The seven elements that formed the basis for estimating the GPAA's prospective value are used to calculate the additional cost to ratepayers caused by the GPAA (Staff Ex. 7.05). The material difference for the reconciliation period between the two calculations is that the data that are used in the disallowance calculation are the actual outcomes rather than the projections and estimations that are used in the contract evaluation (Staff Ex. 3 at 32-35 and Staff 7 at 36).[18]

(1) discount: this is calculated as volumes subject to the discount times the discount. The value of the discount to Peoples Gas ratepayers totals to $2,856,673 (Staff Ex. 3 at 33).

(2) field-delivered versus citygate comparison: the prices are taken from published data in *Natural Gas Intelligence.* Peoples Gas' various delivery points are matched as closely as possible to the published figures. The same formula as in the evaluation is used. This element totals $10,755,048 as a detriment to ratepayers (Staff Ex. 7 at 36).

(3) foregone demand credits: This element is calculated simply as the difference between demand credits in fiscal year 1999 and fiscal year 2001. This element raised ratepayers' costs $847,429 (Staff Ex. 3 at 34).

[18] All elements of the proposed adjustment are presented in Staff Ex. 7.05.

(4) repricing options: This term is set to zero, since Enron did not invoke its rights under either of the repricing options (Staff Ex. 3.0 at 34).

(5) resale penalty: This term is calculated by totaling the aggregate discounts below the [redacted] price that Peoples Gas resold to Enron. It comes to $86,681, (Staff Ex. 3 at 34).

(6) avoided demand charges: A rate identical to that chosen for the evaluation is used to calculate the disallowance. The rate is multiplied times the available DIQ to arrive at the value from avoiding demand charges. It is a benefit to Peoples Gas' ratepayers and amounts to $345,894 during fiscal year 2001 (Staff Ex. 3 at 35).

(7) SIQ option: This term is found by calculating the gas' arbitrage value on the days that Enron invokes the term, that is, it is the difference between the [redacted] price and the [redacted] price times incremental SIQ volumes. This added to ratepayers costs by $4,818,319 (Staff Ex. 3 at 35; Staff Ex. 7 at 34-35).

These elements total to a proposed disallowance of $13,304,910 (See Appendix A, Schedule 5.03, column B; see also Staff Ex. 7 at 36 and Staff Ex. 5, Schedule 5.03 column B).

2. Manlove Storage Field

a. Manlove Storage Field Operations were Imprudent

Peoples Gas' operation of Manlove field was imprudent because it over-allocated usage of the field to third party customers in a manner that raised gas costs to the ratepayers. Peoples Gas over-allocated usage of the field at a time when spot market prices were high (Staff Ex. 3 at 59), and Peoples Gas had to purchase gas on the spot market to support Manlove field's peak deliverability until it reached the third week of

January 2001 (Staff Ex. 7 at 40-41;see also PG Ex. L at lines 739-43). An additional factor that contributes to the finding of imprudence is that Peoples Gas had the ability to interrupt service (Staff Ex. 3 at 59; Staff ex. 6 at 43-44; Staff Ex. 7 at 48) so it would not have to purchase gas for ratepayers at high prices. Peoples Gas, however, continued loaning large volumes of gas to third party customers instead of interrupting service to third party customers. *See* Graph 1, *supra* at 12: PGA and Third Party Gas Inventory in Manlove Field. Based on this imprudence, Staff recommends two adjustments to the Gas Charge. The first adjustment is $32,548,812 and is attributed to the value of the gas Peoples Gas had to purchase to replace the gas it had loaned to third parties. (Appendix A, Schedule 5.03, line 18). The second adjustment is $10,268,181, and is attributed to the value of the gas Peoples Gas loaned to third parties. (*Id.* at column H).

In 1999, the PEC corporate family entered into a strategic partnership with Enron and its corporate family. (Supra §IV.A). By 2000 Peoples Gas had expanded Manlove field to improve its ability to conduct various hub transactions for third party customers. In November 2000, Peoples Gas decided to turn-over operations from injection to withdrawals. (Staff Ex. 7 at 45). November was an early start to withdrawals, in which Peoples Gas typically doesn't begin withdrawals until December. (*Id.*) At that time, Manlove field stored gas for North Shore, Peoples Gas and third party customers of hub services. Third party customers had injected approximately [redacted] BCF into Manlove at the time that withdrawals were initiated. (Staff Ex. 7 at 46). By January 5, 2001, the third party customers had withdrawn all of the gas they had injected and continued withdrawing gas through that month. (*See* Table 1 *supra* at 26: Planned and Net Actual Withdrawals from Manlove). Nonetheless, Peoples Gas allowed the third parties to continue withdrawing gas from Manlove field, although doing so caused Peoples Gas to have to purchase additional gas to maintain peak deliverability of the field. (Staff Ex. 6 at 37-39; and Staff Ex. 7 at 46-47). Since third party customers no longer had gas in the field, said customers were being loaned North Shore's and Peoples Gas' gas allocated to their ratepayers. Third party inventory stayed negative until May 3, 2001. (See Graph 1, attached).

Since Peoples Gas was loaning its gas to third parties for their use, there was less volume in the field for ratepayers and for the operation of the field. (Staff Ex. 3 at 59). To maintain the field at peak deliverability (*supra* §IV.C.3.), Peoples Gas had to purchase additional gas from the spot market. (Staff Ex. 7 at 46). During the winter period, particularly December 2000 and January 2001, prices in the spot market were high (Staff Ex. 12 at 29), which was consistent with the fact that the Chicagoland area was experiencing a colder than normal winter (PG. Ex. F at lines 775-77).

Peoples Gas' actions were imprudent, since it loaned ratepayer gas to third party customers rather than furnishing it to its ratepayer. (Staff Ex. 3 at 60). Since Peoples Gas had to retain Manlove field's peak deliverability until mid to late January, and it imprudently continued providing large volumes of gas to third parties, Peoples Gas was forced to purchase gas from the spot market to keep the field operating. Staff witness Rearden showed that Peoples Gas purchased spot market gas at a higher price than what it had purchased gas to fill the field prior to turning the field over in mid-November. (Staff Ex. 7 at 56, 58). Therefore, Peoples Gas was paying a higher rate for gas, and that rate was borne by the ratepayer.

Peoples Gas continued loaning large volumes of gas to third parties during the period with high spot market prices, despite having the ability to interrupt non-tariff services (Staff Ex. 3 at 59; Staff Ex. 7 at 48). Peoples Gas could have avoided the need to purchase as much additional gas as it did(*Id.*) Since Peoples Gas had the ability to interrupt its withdrawals for third parties, it could reduce the volume of gas being withdrawn. That, in turn, would have reduced the need to purchase gas at spot market prices. Peoples Gas, however, didn't exercise this option. (*see* Graph 1). Instead, Peoples Gas seized the opportunity instead to earn profits for its parent corporation using ratepayers' gas.

As Peoples Gas purchased gas in the withdrawal season to support its hub, its major suppliers were Enron and Enron MW. (Staff Ex. 3 at 59). As discussed in Section IV.A., the strategic partnership between the PEC corporate family and the Enron corporate family was established to earn profits for the partners, and hub services with third party customers is one way the partnership intended to do that. An example of this relationship and Peoples Gas imprudent operations of Manlove field are evident in the "Manlove Jumpstart" deal. (*See also* "Hub Blowout" in Staff Ex. 3 at 54-55 (describing the imprudence of operations related to the Hub Blowout" deal)).

Manlove Jumpstart began on the same day as the early withdrawals started at Manlove. Manlove Jumpstart was an exchange where Peoples Gas loaned 100,000 MMBtus per day from November 21-30, 2000. Enron MW initially planned to return the volumes in the April 2001. At almost the same time, Peoples Gas stopped purchasing DIQ from Enron, under the GPAA, and began buying 100,000 MMBtus per day from Enron MW at the same price as the DIQ. During this docket, Peoples Gas expressed concern with preserving peak deliverability, but in November 2000, it loaned gas to Enron MW which Enron MW sold back to Peoples Gas at the same price (for almost the same volumes) that Peoples Gas could have received under its GPAA with Enron. (Staff Ex. 3 at 55-56 and Staff Ex. 7 at 51 and 53-54). There are two reasons this was imprudent. First, as Dr. Rearden explained on page 56 of his direct testimony (Staff Ex. 3), comparing the November 13, 2000 futures prices for gas with the compensation Peoples Gas received on the deal, Peoples Gas was in line to receive less than one-eighth of the value of the gas in this transaction. (Staff Ex. 3 at 56). Second, Peoples Gas could have kept the gas involved in the Manlove Jumpstart deal in the field, approximately [redacted] MMBtus, and just purchased the additional gas for the same price under an existing contract -- the GPAA.

Thus it is clear that that the way Peoples Gas operated Manlove field during the winter of 2000-2001 was imprudent. Peoples Gas sought the opportunity to provide hub services to third party customers. It loaned ratepayer gas to third party customers when spot market prices were high, causing it to purchase gas for ratepayers at high spot market prices. It had the option of interrupting services and using gas for ratepayers that was purchased at prices lower than the spot market, however it chose not to. Consequently, ratepayer gas costs were increased because of such actions. Accordingly, Staff recommends that adjustments be made to the Gas Charge for both the value of the gas purchased to replace the gas Peoples Gas had loaned to third parties, and for the value of the gas Peoples Gas loaned to third parties.

b. Calculation of Adjustment for Gas Purchased by Peoples Gas

The adjustment for gas purchased by Peoples Gas, due to imprudent operations, is the extra cost from the gas that it purchased in the spot market between December 2000 and January 2001. The method used to calculate the increased cost proceeds in three steps.

First, the volumes of incremental spot market gas that Peoples Gas needed to buy to support its third party storage usage is calculated. It is the lower of either all spot market purchases or withdrawals from Manlove for third parties.[19] (Staff Ex. 7 at 56). The calculation method is presented in Staff Ex. 7.06.

Second, the individual spot market purchases to "reverse"[20] are selected. That is done by finding the spot market buys that have the highest price on a given day. The highest cost gas is reversed first because that represents the cost to ratepayers. Peoples Gas should have cut back on the most expensive gas first, all other things equal. (Staff Ex. 7 at 56-58). While the Company argues that it cannot know how the prices it pays compare to market outcomes, it does not demonstrate the specific constraints on its behavior that would justify using a different approach. (PG Ex. L at 33). This step proceeds until the volumes reversed equal the incremental spot market volumes determined in the previous step. (Staff Ex. 7 at 57-58). The cost for reversed purchases is summed and subtracted from PGA costs.

[19] Total incremental spot market purchases are the sum of four factors. One is storage usage. The other factors are three off-system sales that are supported by additional spot market purchases. Only the volumes that are appropriate for each adjustment are used in the calculations for that adjustment. However, the average for each day is applied to every adjustment for that day.

[20] To reverse means to subtract the cost from the PGA.

Third, the value of the incremental gas withdrawn from Manlove is calculated as volumes times the value per MMBtu of the last-in-first-out ("LIFO") layer for the reconciliation period. That value is added back into PGA costs. (Staff Ex. 7 at 58-59). The amount that should be credited to the PGA is $32,548,812. (Appendix A, Schedule 5.03, line 18). It is the additional cost imposed upon ratepayers when the Company supported its hub operations with PGA costs.

c. Calculation of Adjustment for Gas Loaned to Third Parties

The adjustment for gas loaned to third parties is the value of the gas loaned as part of providing hub services. That value is calculated in two steps. The first step is to compute the loan amount by day. The balance of hub services became negative on January 5, 2001, remained negative until May 3, 2001. For each day after the hub balance became negative, the loan amount is the net activity at the hub. The daily loan value is calculated as the daily loan amount times the daily price represented by the GD citygate price ("[redacted]"). (Staff Ex. 3 at 60).

The second step essentially continues the same process when third parties begin returning (on net) the gas back to the hub. The net injections are also valued at the GD price. This continues on all days until the balance returns to zero. The value of the loan is $10,268,171. (*Id.*; see also Appendix A, Schedule 5.03, column H).

3. Revenues from Non-Tariff Services

Staff proposes two adjustments to reduce Peoples Gas' recoverable PGA gas costs, pursuant to 83 Illinois Administrative Code §525.40(d), for revenues received for providing non-tariff services to third parties. Generally, non-tariff services relate to transporting, parking and loaning, or storing gas owned by third parties.

Staff's two proposed adjustments for non-tariff service revenue are:

- $4,378,486 for FERC Operating Statement Transactions (Appendix A, Schedule 5.03, column F) ; and
- $2,250,165 for Storage Exchange Transactions (Appendix A, Schedule 5.03, column G).

The nature of the non-tariff revenue transactions is further discussed in the direct and additional direct/rebuttal testimony of Staff witness Rearden (Staff Ex. 3.00 at 45-60 and Exhibit 7.00 at. 44-53).

a. Staff Adjustments to Gas Cost

Staff continues to support the arguments made in its Part 525.40(d) pretrial memo and will not repeat those in this initial brief. However, Staff would like to direct the Commission's attention to certain facts with respect to the applicability of Part 525.40(d) to the non-tariff revenue adjustments issue. The first fact is that gas utilities are permitted to recover, "dollar-for-dollar," their gas cost defined by Subsection 525.40(a). Additional requirements, stated at Subsection 525.40(d), require gas utilities to "offset" (or reduce) the amount of *recoverable gas cost* charged to PGA customers by the revenue earned on transactions except for two types not subject to the gas charge. The two exceptions are (1) revenue received from tariffs approved by the Commission, and (2) revenues derived from tariffs under the provisions of special contracts approved by the Commission.

In its pre-trial brief, Staff proposed the following questions in order to determine whether the recoverable gas cost is to be offset by the revenue obtained from a transaction, pursuant to Part 525.40(d):

1. Does a utility receive revenue from a transaction?
2. Are any of the costs associated with the revenue transaction (identified in 1 above) defined as recoverable gas cost in Section 525.40(a)?
3. If the answer to I and 2 above is "yes", then that revenue must offset the recoverable gas cost, unless one of the two exceptions noted above are met (i.e., revenue received under a tariff approved by the Commission or revenue from tariff pursuant to a special contract approved by the Commission).

Pre-trial Brief of the Staff Witnesses of the Illinois Commerce Commission on the Applicability of 83 Illinois Administrative Code 525.40(d), at 14.

In applying the above analysis to Peoples Gas, the revenue it received from transactions under its FERC Operating Agreement or its storage exchange transactions with third parties must be subtracted from the recoverable gas cost. Neither the FERC Operating Agreement nor its storage exchange transactions with third parties qualify as an exception, thus those revenues must be accounted for as a reduction to the recoverable gas cost.

b. Peoples' Argument

Peoples Gas opposes Staff's adjustments to reduce recoverable gas cost for its non-tariff revenues. In its *Brief of the Peoples Gas Light and Coke Company on the Applicability of 83 ILL. Admin. Code Section 525.40 to the Issues in this Proceeding,* Peoples Gas states that Section 525.40(d) applies to two types of transactions (*Id.* at 10):

1. off-system sales for resale; and
2. interstate storage, transportation and exchange services (i.e. "hub services").

Peoples Gas states that the revenue obtained from the first type of transactions (off-system sales for resale) properly flow through the Gas Charge. Staff agrees, and these transactions are not at issue. The second type of transactions, collectively identified by Peoples Gas as "hub" services relate to both of Staff's adjustments. Staff categorized the “hub” transactions into two adjustments because they are authorized under different types of FERC authority and it differentiates the nature of the transactions.

Peoples Gas argues that there are two criteria which must be met for hub service revenue to flow through the Gas Charge as an offset to recoverable gas costs. Peoples Gas states that the first criteria is that the transactions must not be at rates that are subject to the Gas Charge. (*Id.* at 13). Peoples Gas states that these transactions are not set at rates that are subject to the PGA gas charge. (*Id.*) The second criterion, according to Peoples Gas is whether any of the costs associated with the hub transactions are a recoverable gas cost. (*Id.* at 14). Peoples Gas further states that the only costs involved in the generation of hub service revenues are those related to the use of the Manlove Storage Field and the Mahomet Pipeline assets. Peoples Gas opines that it is the incremental capacity of its storage field that supports hub transactions. The costs related to the storage field and pipeline assets are recovered in base rates and are not recoverable gas costs as defined in Subsection 525.40(a). (*Id.* at 14). Finally, Peoples argues that the revenues from hub transactions satisfy only criterion 1, and are thus, not subject to the offset provisions of Subsection 525.40(d).

c. Displaced Gas is a Recoverable Gas Cost

In addition to the cost of the Mahomet Pipeline and the Manlove Storage Field, Staff believes that the hub transactions are only possible because Peoples Gas must use displacement gas. Peoples Gas acknowledges the definition of displacement gas, but does not believe it is an essential component of hub transactions. Sections IV.C. and IV.D. of this initial brief provide additional discussion on the necessity of displaced gas to Peoples Gas' operations. Staff's testimony extensively discuss the nature of displacement and why it is an essential component of non-tariff service transactions.[21]

Briefly, displaced gas allows Peoples Gas to enter into transactions that utilize natural gas facilities "without the physical delivery of the same molecules of natural gas" that were received (Staff Exhibit 2, at 32, lines 680-681). In other words, displaced gas molecules injected into Peoples Gas' system substitute for other gas molecules (that are presently in the system) in order to facilitate the movement of gas. Without using displaced gas molecules to accomplish these third party transactions, Peoples Gas would need to construct and operate duplicate systems for its distribution, transportation and storage. It is not in the public interest for Peoples Gas to duplicate its system and therefore, the displaced gas must be considered as an essential component of these non-tariff service transactions.

The fallacy of Peoples Gas' argument -- that displacement gas is not a cost component of hub transactions -- can best be illustrated with the following two points. First, on page 12 of its 525.40(d) brief, Peoples Gas states that the transfer of gas "may occur at different points in time and at different physical locations. However, all hub exchanges are transacted through the use of Peoples Gas system, i.e. they do not use pipeline services or gas purchased for end users." (*Id.* at 12).

As noted in *Staff's Part 525.40(d) Pre-Trial Memo*, the use or consumption of gas is not a requirement in determining whether to flow the revenues through the Gas Charge. The requirement is "(r)ecoverable gas costs shall be offset by revenues…*if any of the associated costs are recoverable gas costs* as prescribed by subsection (a)

[21] Also See, Staff Exhibit Staff Exhibit 2 at 38-40, and Staff Exhibit 6 at 26-46 (Anderson Direct and Additional Direct / Rebuttal Testimony).

of this Section." (83 Ill. Adm. Code 525.40(d), *emphasis added*). That means that, if any of the associated costs necessary to complete the transaction meet the definition of recoverable gas defined in Subsection 525.40(a), then the revenues from the transaction must be accounted for as an offset to recoverable gas costs. As established above, in this section, displaced gas qualifies as a recoverable gas cost under subsection 525.40(a) (see generally *Staff's Section 525.40(d) Pre-Trial Memo*) and is essential to accomplishing hub transactions. The fact that injections and withdrawals of gas occur at different physical locations and at different times is sufficient proof that the delivery process requires the use of displaced gas.

Second, under its FERC operating agreement, Peoples Gas enters into certain hub transactions that first require it to loan gas to a third party which is repaid in-kind at a later date. The question for the Commission is, where did Peoples find the gas to loan if it did not use displaced gas? The only answer is, Peoples Gas could not accomplish this transaction without the use of displacement gas present in its distribution system. The cost of natural gas is defined as a "recoverable gas cost" under Subsection 525.40(a)(1). Thus, Peoples Gas is required to include hub revenues in the determination of recoverable gas cost under the requirements of Subsection 525.40(d), and the Commission should enter an order requiring such.

d. NICOR Rate Order is Outdated and Did Not Consider the Requirements of Section 525.40(d)

Peoples Gas also states in its Section 525.40(d) brief that "the Commission has determined the hub service revenues are properly accounted for above the line and not in the Gas Charge." (*Id.* at 15). Peoples Gas' reliance on the *93-0320 Order*[22] is misplaced since the Commission did not consider Section 525.40(d) in its analysis. In addition, the issue of the treatment of Peoples Gas' hub revenues has not been addressed by the Commission since the inception of Subsection 525.40(d) in 1996. Although FERC has approved a blanket certificate for Peoples Gas to conduct hub transactions and approved Peoples Gas transportation rates in 1998, and approved Peoples Gas storage and parking and loan rates in 1999 (*Id.* at 12), the fact remains that the treatment of Peoples Gas' hub revenues for PGA purposes has never been before this Commission.

In its Part 525.40 brief, Peoples Gas relies upon a request for accounting treatment that Northern Illinois Gas Company ("Nicor") filed in 1993. The record in Docket No. 93-0320 was marked heard and taken on July 7, 1994, and the order was later issued on March 13, 1996. The central issue in that docket was revenue sharing, Nicor proposed a 50-50% sharing with ratepayers of its hub profits (*93-0320 Order*, at *3). The Commission rejected Nicor's proposal. The Commission ordered Nicor to include hub revenues above-the-line (i.e., included in utility operating income) and that such revenues would be offset to Nicor's expenses in its next rate case. *93-0320 Order*, at *14. The Commission sided with Staff in finding that "revenues derived from a utility asset reflected in rates are generally treated above-the-line." *93-0320 Order*, at *11. In reaching that decision the Commission found that the ratepayers were the ones who built the system therefore they are the ones who should be the beneficiary of the distribution system. (*Id*. at *13). The Commission never considered, and none of the

[22] *Northern Illinois Gas Company: Application for an order approving accounting treatment related to certain market area hub activities*, Docket No. 93-0320, 1996 Ill. PUC LEXIS 151 (March 13, 1996).

parties raised Subsection 525.40(d). Therefore, the *93-0320 Order* is inapplicable to the instant case. This position is supported by the fact that Subsection 525.40(d) wasn't put into effect until after the record was closed in Docket 93-0320.

At the same time the 93-0320 proceeding was being conducted, the Commission was in the process of revising the PGA rule (83 Ill. Adm. Code §525) in Docket No. 94-0403. This revision of Part 525 contained a new provision -- Subsection 525.40(d) – which was discussed previously. The Order in Docket No. 94-0403 was entered on August 3, 1995 with an effective date of November 1, 1995. Thus, the first monthly filings were made for rates to be in place during January 1996. Since hub operations were a new concept and furthermore the fact that Subsection 525.40(d) was recently enacted, it is conceivable that their combined impact was not fully considered in both dockets. In any event, the issue of the accounting treatment of Peoples Gas hub revenues has not been before the Commission for consideration.

Since Peoples Gas relies upon Nicor's accounting treatment, the Commission should be aware that Nicor recently filed a petition to open a rate case, Docket No. 04-0779. In Nicor's pre-trial memorandum in that case, it states:

> Nicor Gas and Staff witness Mr. David Borden have agreed that gross revenues from Hub services collected by Nicor Gas should be credited to customers through Rider 6 (Nicor's PGA tariff), and that the administration fees associated with these revenues, which have been forecasted at $1,079,000, should be recovered as operating expenses through base rates. (*Nicor Gas Pre-trial Memorandum*, Docket No. 04-0779, at 41, explanation of Rider 6 added).

Moreover, and contrary to the inferences of Peoples Gas, the *93-0320 Order* does not require the Commission to extend the same accounting treatment approved in that order to Peoples Gas. It is well established that an administrative agency is not bound to its previous decision because the decisions of the Commission do not have *res judicata* effect. *Mississippi River Fuel Corp. v. Illinois Commerce Commission,* 1 Ill. 2d 509, 513 (1953) (holding that the Commission may freely decide an issue irrespective of what is has done in previous cases); and *Governors Office of Consumer Services v. Illinois Commerce Commission,* 242 Ill. App. 3d 172, 189 (1st Dist., 1993) (Allowance of a cost item in the past does not mean that the item cannot be rejected upon investigation). More recently, the Commission did not hesitate to put Illinois Power on notice that it would pursue the proper course of action, even if it required it to reverse a finding from a prior order:

> Furthermore, the fact that the Commission allowed recovery of $230 in interest charges in Docket No. 99-0477 does not require the same outcome in this proceeding since nothing prevents the Commission from correcting a prior oversight of this nature on a prospective basis. (Illinois Commerce Commission, On Its Own Motion, vs. Illinois Power, Docket No. 01-0701, Order Date, February 19, 2004, at 27).

There are, however, rules and laws that the Commission is to follow. The first is the Commission's PGA rule and in particular the requirements of Subsection 525.40(d) which includes certain revenues in the computation of recoverable gas cost unless the revenue meets one of two exceptions. As noted previously, the second type of excluded transactions are "contracts entered into pursuant to such tariffs," such as the transportation agreements between Nicor Gas and North Shore approved in Docket Nos. 02-0779 and 03-0551. The second type of rule that the Commission is bound to follow in rendering decisions is Court Orders. One such court order providing direction to the Commission is the *BPI I Order*. At page 23 of that order it states:

> The Commission may alter or amend its past practice, but it must follow the procedures set forth in its rules and the Act. (*Business and Professional People for the Public Interest et. al.*, 136 Ill. 2nd 192, 226, 555 N.E. 2nd 693, 708 (1989)).

Therefore, for these reasons little weight should be given to that order and Peoples Gas reliance thereon.

e. Nicor – North Shore Gas Company Transportation Orders Aren't Applicable Because These Transactions Met the Section 525.40(d) Exception Criteria

In its Section 525.40(d) brief, Peoples Gas cites two Commission approved transportation agreements between Nicor Gas Company and North Shore Gas Company (Docket Nos. 02-0779 and 03-0551), *infra*. In those dockets, Nicor and North Shore, as joint petitioners, sought Commission approval that would allow North Shore access to storage services from the ANR pipeline over Nicor's transportation facilities. The orders state that without the transportation service from Nicor, North Shore would be required to purchase more costly service from Natural Gas Pipeline. (*Northern Illinois Gas Company d/b/a NICOR Gas Company and North Shore Gas Company Joint Petition for Consent to and Approval of a Firm Transportation Agreement Pursuant to Section 7-102, 9-102 and 9-201 of the Illinois Public Utilities Act and related relief*, Docket No. 03-0551, Order at 1 (Nov. 12, 2003) ; and *Northern Illinois Gas Company d/b/a Nicor Gas Company and North Shore Gas Company Joint Petition for Consent to an Approval of a Firm Transportation Agreement Pursuant to Section 7-102, 9-102 and 9-201 of the Illinois Public Utilities Act and Related Relief*, Docket No. 02-0779, Order at 2(Feb. 20, 2003).

The transportation orders are identical in all material respects to a firm transportation agreement except that the *03-0551 Order* extends the agreement from

March 31, 2003 to March 31, 2006. The accounting treatment provided in both orders is also identical. The *03-0551 Order* states;

> Under the Agreement, Nicor Gas would receive a monthly demand charge of $49,075 during the winter months (November through March), plus $0.01 MMBtu transported. The revenues from the service would allow Nicor Gas to recover its cost associated with providing the service and make a contribution to fixed cost recovery. As under the previous agreement, Nicor will record the revenues from this service as above-the-line utility revenue. As under the previous agreement, North Shore would recover the charges paid by North Shore for this service through its gas charge (PGA).
>
> (*Northern Illinois Gas Company, d/b/a Nicor Gas Company and North Shore Gas Company, Joint Petition for Consent to and Approval of a Firm Transportation Agreement*, Docket No. 03-0551, (Nov. 12, 2003).

The above transportation agreements between Nicor and North Shore Gas Company <u>do not support</u> Peoples Gas' position that hub revenues should be excluded from the provisions of the PGA clause because the assets used to provide the transportation service by Peoples Gas are in rate base and their related costs are recovered in base rates. Peoples Gas' rationale is flawed and simply wrong. The reason why it is proper for Nicor to exclude the transportation revenues from the PGA clause is because these revenues qualify for exclusion under one of the two exceptions (*see Staff's Section 525.40(d) Pre-Trial Memo*, at 8-9) provided in Subsection 525.40(d):

> 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 provided for in the tariffs. (Subsection 525.40(d), second sentence, *emphasis added*).

Thus, the Nicor transportation revenues, by way of the contracts approved by the Commission, are excluded from the PGA clause because Subsection 525.40(d) requires such. Furthermore, the fact that expenses related to a transportation system are recovered in base rates does not support Peoples Gas position. Nicor transportation revenues are exempted under the second exception contained in the second sentence of Subsection 525.40(d) cited above.

f. Conclusion

The Commission has never reviewed or determined how Peoples Gas' hub revenues are to be treated at anytime, and the Commission has not addressed the issue in light of Subsection 525.40(d).. Hub revenue transactions do not qualify as an exempt transaction under either of the exceptions provided for in the second sentence of Subsection 525.40(d). Furthermore, the Commission is not bound to follow prior orders, especially since the issue was not addressed. Finally, Peoples Gas could not complete its hub revenue transactions without the use of displaced gas – a recoverable gas cost as defined by Subsection 525.40(a). Therefore, it is appropriate that the Commission enter an order in this proceeding adopting Staff's non-tariff revenue adjustments (identified in columns (F) and (G) of Schedule 5.03 in Appendix A). It is further appropriate that the Commission direct Peoples Gas to comply with the provisions of Subsection 525.40(d) with respect to its hub revenues in future proceedings (See Staff Recommendation 4 in §VI - Conclusion).

4. enovate Profits

Peoples Gas' FY2001 PGA revenues should be adjusted by the amount of enovate's fiscal year 2001 income since Peoples Gas implicitly admitted that enovate's transactions impacted the Gas Charge by crediting certain enovate transactions to the Gas Charge. In addition, Peoples Gas has failed to clarify why the Gas Charge was credited or provide documentation, which it is required to maintain (*See* Part 505 – Uniform System of Accounts), showing they are properly accounting these transactions. In addition, Staff showed in its testimony that a) if it were not for Peoples Gas' gas distribution system and its position as a utility, enovate could not economically conduct business (Staff Ex. 9 at 20-23; Staff Ex. 7 at 52-53) and b) Peoples Gas cannot document or explain (other than to deny) the relationship between enovate's income and Peoples Gas' PGA (Staff Ex. 9 at 23-27). Accordingly, Staff recommends the entire amount of enovate's earnings -- $19,683640 -- be credited to the PGA.

The record clearly shows that transactions conducted by enovate could not have been conducted without the use of Peoples Gas' system supply. enovate was a trading entity that leveraged a utility's assets, in this case its affiliate, Peoples Gas, to provide its services – interstate transportation and leased storage. (Staff Ex. 7 at 71). Attachment H of Staff Exhibit 9 (*see* inserted Table 2: "enovate P&L"; see also City-Cub Exhibit 1.42) shows that a number of enovate deals in which enovate's profits were recovered through Peoples Gas' Gas Charge. The enovate deals that were credited to the PGA have dollar amounts in the far right column of the "enovate P&L." (*See also* Staff Ex. 9 at 25). Moreover, Peoples Gas did not refute this position in its rebuttal or surrebuttal to Staff's testimony.

Peoples Gas has not explained nor provided documents that explain the relationship between enovate's income and Peoples Gas' PGA, other than state that it did not have such documentation. (*Id.*) Staff's position is supported by Peoples Gas' responses to data request questions regarding "ANR Rolling Thunder" and "NSS Tidal Wave". (Staff Ex. 9, Attach H). In those responses Peoples Gas did not deny that credits for these, and other deals, affected its Gas Charge. (Staff Ex. 9 at 26).

Since documents, such as the "enovate P&L" demonstrate that Peoples Gas' Gas Charge was impacted by enovate operations, and People Gas does not possess complete documentation explaining the impacts the transactions had on its Gas Charge, Staff recommends that all of the profits earned by enovate be recovered through the Gas Charge.

The lack of documentation runs contrary to General Instructions #2 and #14 of 83 Illinois Administrative Code Part 505, which requires the following:

> A. *Each utility shall keep its books of account, and all other books, records, and memoranda which support the entries in such books of account so as to be able to furnish readily full information as to any item included in any account*. Each entry shall be supported by such detailed information as will permit ready identification, analysis, and verification of all facts relevant thereto.
>
> B. *The books and records referred to herein include* not only accounting records in a limited technical sense, but *all other records,* such as minute books, stock books, reports, correspondence, memoranda, etc. *which may be useful in developing the history of or facts regarding any transaction.* (emphasis added)

Table 2: enovate P & L

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In this case, Peoples Gas' inability to keep and or maintain proper documents regarding transactions it knew impacted the PGA was imprudent and improper.

Another document which supports both of Staff's contentions – that enovate could not economically conduct business without using Peoples Gas' gas distribution system, and Peoples Gas did not document or explain the relationship between enovate's income and Peoples Gas' PGA -- is a document regarding "annuities" (identified by bates numbers 01PGL046246 through 01PGL046249) that was included in the documents Peoples Gas provided to Staff. (*See* Staff Ex. 9, Attach. G). This document appears to list Enron MW and enovate deals, with varying amounts credited to Peoples Gas and/or PEC. Peoples Gas' responses to data requests (Group Ex. 1 at ST-PG 49) and depositions failed to explain or clarify the deals, the allocations of profit between the parties, and their effects on PGA costs. Peoples Gas has stated that the "annuities" document was produced by Enron, and therefore no further information is available. Therefore, Peoples Gas acknowledges that its Gas Charge was impacted by enovate operations, but does not possess complete documentation as to which transactions impact its Gas Charge.

Staff has split the entire enovate profits adjustment in to two adjustments. (Staff Ex. 9, Sched. 9.05). The first adjustment -- $9,052,823 -- is attributed to PEC's share of enovate's income, net of other Staff adjustments. (Appendix A, Schedule 5.03, column P). This adjustment is further explained on page 20 of Staff Exhibit 9, and in Schedule 9.05. The second adjustment -- $10,630,817 -- represents Enron MW's and Enron's share of enovate's income. (Appendix A, Schedule 5.03, column Q). This adjustment is further explained on page 23 of Staff Exhibit 9 and in Schedule 9.06.

5. Transaction 19

Transaction 19 is imprudent for three reasons. First, Peoples Gas does not justify the need to enter in to such a transaction. Second, Peoples Gas does not justify executing this transaction outside the resale provision of the GPAA. Third, Transaction 19 is contrary to Peoples Gas' expressed concern that it would have excess supply of gas during December 2000. Staff, therefore, recommends that the additional cost to replace the gas sold back to Enron-- $5,661,703 -- be credited to the Gas Charge.

Transaction 19 is the name for a transaction in which Peoples Gas sold 50,000 MMBtus of gas back to Enron at the first of the month price during December 2000. (Staff Ex. 3 at 36). Peoples Gas executed this transaction in November 2000, at the time it decided to initiate early withdrawals from Manlove field. (PG Ex. F at 49-50).

In justifying this transaction, Peoples Gas claims that it feared being "long" in gas. (PG Ex. F at 49). The term "long" in this context refers to an oversupply of gas. Specifically, People Gas' claims that it was worried that the weather would heat up and that baseload supplies would exceed its ratepayers' demand. (*Id.* at 50-51). In turn, Peoples Gas would be required to resell gas into a market in which prices were dramatically declining. Rather than use up its ability to resell to Enron under the GPAA resale terms, Peoples Gas' asserts that it opted to resell a fixed amount at the monthly price, avoiding the risk of daily price movements, preserving its rights to resell to Enron under the GPAA and retaining the discount. (Staff Ex. 3 at 36-37 and PG Ex. F at 49).

As stated above, there are several reasons why Transaction 19 was imprudent. First, Peoples Gas should not be shedding its gas supply coming into a heating season. While it is reasonable to consider all possible weather conditions when planning for gas supplies, it is not reasonable to focus on one potential outcome over others. Peoples

Gas' primary responsibility is to ensure that it provides sufficient supply for its customers. In the instant transaction, Peoples Gas traded the risk that it might suffer losses on excess supply if the weather turned much warmer for the risk of being short during a cold winter. This risk is identical to what it faces every year, and Peoples Gas has not shown that the risk in this reconciliation period was any greater than previous years. (Staff Ex. 7 at 38-39). Thus, Peoples Gas has not justified this trade. (Staff Ex. 3 at 37 and Staff Ex. 7 at 37-39).

Second, Peoples Gas did not justify the need to resell gas back to Enron outside of a GPAA provision that provided them such a right. (*Id.* at 37-38). The GPAA contains a resale provision, Article 2.4, that allows Peoples Gas to sell up to [redacted] MMBtus of gas back to Enron under a penalty of [redacted]¢ to [redacted]¢ per MMBtu. Transaction 19 was not pursuant to the GPAA resale provision. Peoples Gas justified the execution of this transaction outside of the resale provision of the GPAA by claiming that it needed to preserve its resale right in the face of a very cold winter. The rationale provided by Peoples Gas is contradictory to the first argument addressed above. Peoples Gas cannot conduct a prudent transaction, fearing that it would have too much gas, and at the same time not have enough gas. (Staff Ex. 7 at 38). Given the contradictory nature of these arguments, Staff finds this rationale falls short of justifying this trade.

Three, Transaction 19 is contrary to Peoples Gas' expressed concern that it would be long in gas during December 2000. There, Peoples Gas argues that it could not bring more gas out for ratepayers, because it was constrained by the decline curve. (*See supra*, §IV.C.3). In other words, Peoples Gas argues that it could not withdraw more gas from Manlove for ratepayers due to its concern that the field required adequate pressure to maintain peak deliverability until later in the heating season. However, if that is the case, then Transaction 19 is the exact opposite of a prudent action for Peoples Gas to take. One way to support the field is to have adequate supplies of flowing gas. Under such a course of action, there is less need for Peoples Gas to withdraw gas from Manlove or buy expensive spot gas. (Staff Ex. 7 at 38).

The increased cost to ratepayers from Transaction 19 is the additional cost to replace the volumes sold back to Enron. The adjustment is calculated in the same manner as the imprudent storage usage adjustment. The reversed spot market purchases are subtracted from recoverable gas costs, while the last-in-first-out ("LIFO") value of the replacement stored gas is added back in. The difference is the adjustment. (Staff Ex. 3 at 38). It totals to $5,661,703. (Appendix A, Schedule 5.03, column E). Staff Ex. 7.06 explains the details of the calculation.

6. Transaction 103

Transaction 103 is imprudent because the amount paid by Enron MW (i.e. the pipeline penalty) was not equivalent to the projected difference in gas price between October and December 2000. Staff, therefore, recommends that the increase cost to ratepayers from Transaction 103, which was the additional cost Peoples Gas paid to replace the gas it sold (below value) to Enron MW, be credited to the Gas Charge -- $1,411,031. (Appendix A, Schedule 5.03, column K).

Transaction 103 is the name for the transaction wherein Peoples Gas sold gas to Enron MW in December 2000 at the October 2000 first of the month price. This sale was in exchange for Enron MW paying a pipeline penalty that Peoples Gas had incurred. Peoples Gas decided to enter into this transaction on [redacted]. (Staff Ex. 7 at 41).

The transaction is imprudent because the amount of the penalty that Peoples Gas was supposed to pay was less than the projected difference in the price of gas between [redacted] and [redacted]. On the day Peoples Gas entered into the deal, the difference in futures prices between [redacted] and [redacted], according to the NYMEX futures prices, was $0.206 per MMBtu. However, the pipeline penalty average was $[redacted] per MMBtu. Allowing for some decrease in the Henry Hub to Chicago basis, from [redacted] to [redacted], the penalty amount does not adequately compensate Peoples Gas, especially since the basis usually increases in the winter. (*Id*. at 42).

There is nothing uniquely beneficial about paying a penalty. Paying the penalty retained Peoples Gas full access to the pipeline's storage services. Whether Peoples Gas pays the penalty or Enron MW does has the same effect on Peoples Gas' operations. The only question is whether the value transferred to Peoples Gas, in this case the penalty amount, covers the expected difference in prices. As explained in Dr. Rearden's testimony, the penalty was about [redacted] the value of the gas involved in this transaction. (Staff Ex. 12 at 41-42).

The increased cost to ratepayers from Transaction 103 is the additional cost to replace the volumes sold to Enron MW below value. The adjustment is calculated in the same manner as the imprudent storage usage adjustment. (*See* the discussion in §V.A.2). The reversed spot market purchases are subtracted from recoverable gas costs, while the last-in-first-out ("LIFO") value of the replacement gas is added back in to recoverable gas costs. The difference is the adjustment. (Staff Ex. 7 at 42). It totals to $1,411,031. (Appendix A, Schedule 5.03, column K); see Staff Ex. 7.06 for the calculation details).

7. Revenues from Trunkline deal

The ultimate parties in the Trunkline deal were enovate and Peoples Gas, and Enron MW was a conduit for the deal between two affiliates. (Staff Ex. 9 at 17-19). This is supported by the fact that prices and quantities of gas Peoples Gas purchased from Enron MW were the same that Enon MW purchased from enovate. (Staff Ex. 7 at 68-69). In addition, the revenue sharing agreement between PEC and Enron MW allowed PEC to profit from the Trunkline deal, while increasing gas costs to PGA ratepayers. Thus, Staff proposes to recover the revenues generated by the deal -- $372,000 -- through Peoples Gas' Gas Charge. (Staff Ex. 9.0, Sched. 9.04).

Understanding the Trunkline Deal requires assembling the puzzle pieces provided in discovery. First, Peoples Gas provided several documents to Staff that show "affiliate adjustments." One example is document 01PGL043249. In her deposition, Ms. Maria Divito, PEC Senior Accountant, explained that the adjustments reflected in the documents were necessary because Peoples Gas and PERC were affiliates and PERC receives half of enovate's income. (Group Ex. 1 at ST-PG 75-76; Staff Ex. 9 Attach. F). In response to Staff data request ACC-2.01 (Group Ex. 1 at ST-PG 17-19), PERC explained that there were three agreements that structured the affiliate relationships in the Trunkline deal:

1. Transaction Confirmation Pursuant to Master Natural Gas Contract by and between The Peoples Gas Light and Coke Company and Enron MW, LLC;

2. Agreement to purchase and sell gas between Midwest Energy Hub, LLC ("MEH") (later, enovate, LLC) and Enron MW, LLC;

3. Rate Schedule EFT transportation agreement between Trunkline Gas Company ("Trunkline") and Midwest Energy Hub, LLC (later, enovate, LLC).

These three agreements are shown in the Table 3 below:

Table 3: Agreements and Companies Involved in Trunkline Deal

Agreement No.	Parties to Agreement	
1	Peoples Gas	Enron MW
2	Enron MW	Enovate
3	Enovate	Trunkline

Mr. Tim Hermann, Director of Midstream Services for PERC during the 2001 Reconciliation Period, confirmed the above information, when he explained in his deposition that enovate held the pipeline contract for Trunkline's firm transportation capacity. (Group Ex. 1 at ST-PG 82).

Two different sets of documentation suggest that enovate conducted transactions with Peoples Gas via the Trunkline deal. The first set of documents is the accounting description of the affiliate adjustment by Ms. Divito (Staff Ex. 9.0 at 17 and Attachment F to Staff Ex. 9). These documents track the money trail in the Trunkline deal, showing "PGL paying enovate", "enovate paying Trunkline", and "PERC's [redacted] which Ms. Divito confirmed was PERC's [redacted] of the revenue that accrued to enovate due to the Trunkline deal. (Group Ex. 1 at ST-PG 76-77). The fact that Enron MW's contractual obligation is not reflected in Attachment F of Staff Exhibit 9 supports Staff's position that Enron MW was nothing more than a buffer between Peoples Gas and enovate. If Enron MW was not a buffer, but had actually negotiated arms-length transactions with Peoples

Gas and enovate, then Enron MW's contractual obligations would have been reflected in the accounting description of the affiliate adjustment by Ms. Divito and Attachment F. Since they are not reflected Attachment F, then the contractual arrangements with Enron MW were not arms-length transactions and should be considered imprudent.

The second set of documents supporting Staff's conclusion is a series of executed deal tickets, identified by bates numbers 01 PGL 043883 through 01PGL 043886. (Group Ex. 1 at ST-PG 262-65). The deal tickets show that enovate (then known as "MEH") purchased transportation from Trunkline and commodity gas from PERC and a third party, then delivered the gas to [redacted] as a call option. The tickets also show that [redacted] sells that same call option at the citygate to Peoples Gas at the exact same price. [redacted] did nothing more than re-sell the call option from enovate to Peoples Gas. While the written deal was explained in Table 3 above, in practice the deal was:

Trunkline sells to ⟶ enovate, sells to ⟶ Peoples Gas

Thus, the record shows that [redacted] was used as an intermediary so as to facilitate transactions between Peoples Gas and enovate and to shield the transactions from Commission scrutiny. (Staff Ex. 9 at 17-19). [redacted] is needed as an intermediary between enovate and Peoples Gas to avoid Commission approval of the transactions as affiliate transactions under Section 7-101 of the Public Utilities Act (220 ILCS 5/7-101). (PG Ex. N at 3; *see also* City-Cub Exhibit 1.31). The Commission should find this deal to be imprudent, so as to discourage other gas utilities from establishing similar arrangements in an attempt to end run the Act. Accordingly, Staff recommends that the $372,000 Peoples Gas paid enovate be recovered through the Gas Charge. (Appendix A, Schedule 5.03, column O).

8. Refinery Fuel Gas deal

This adjustment relates to the Refinery Fuel Gas ("RFG") deal described above in Section IV.B.3, whereby Peoples Gas purchased RFG from its affiliate PERC at a marked-up price, rather than directly from the supplier at the discounted price Peoples Gas had received prior to the 2001 Reconciliation Period. It was imprudent for Peoples Gas to terminate the RFG contract when its alternative was to purchase the RFG from Enron MW at a higher price and pass the additional costs onto ratepayers through the PGA. Staff proposes that the revenues -- $2,232,490 -- earned by the mark-up imposed by Enron MW be recovered through Peoples Gas' Gas Charge. (Staff Ex. 9. Sched. 9.01).

The RFG deal is similar to the Trunkline Deal, because Enron MW was used as an intermediary. In effect, Peoples Gas used Enron MW to avoid statutory regulation of affiliate transactions. The RFG deal, however, had an added twist. This arrangement increased the cost to ratepayers, and then directed part of that increased rate to Peoples Gas' parent -- PEC. (*See supra* §IV.A (describing Enron MW's profit sharing between PEC and Enron)). Therefore, this transaction benefits two affiliates of Peoples Gas, and to the detriment of the ratepayers. To understand this deal we will first describe the transaction, and then discuss the imprudence of Peoples Gas' actions and their financial impacts on the ratepayers.

Prior to 2001, Peoples Gas had a contract with Citgo ("RFG Agreement") to receive RFG at [redacted]% of the citygate price. In a letter dated March 13, 2002, Mr. William

Morrow explained that Peoples Gas received RFG from Citgo until September 30, 2000, and subsequent to October 1, 2000, PERC purchased RFG from Citgo under the terms of the RFG Agreement. (Group Ex. 1, ST-PG 188-89). Attachment B of Staff Exhibit 9 is a flowchart depicting the arrangement of this transaction. First, PERC bought RFG from PDVMR, *i.e*. Citgo, at 75% of the average city gate price. PERC then sold the RFG to Enron MW for 92.5% of the average city gate price. Finally, Peoples Gas bought the RFG from Enron MW for 95% of the average city gate price. These terms were confirmed by Peoples Gas in its response to Staff data request ENG 2.126 and from Staff's review of the deal tickets listed on page 2 of Schedule 9.01. All of these arrangements were oral commitments rather than written contracts. (Staff Ex. 9 at 13).

The primary problem with the RFG deal is the unsupported substitution of PERC for Peoples Gas as the buyer of RFG <u>at the same price and nearly the same terms and conditions</u> that Peoples Gas used to purchase RFG from Citgo -- at [redacted]% of the average city gate price. (Staff Ex. 9 at 12). Enron MW was then inserted as an intermediary between PERC and Peoples Gas and profited from the markup on RFG by reselling it to Peoples Gas at 95% of the average city gate price. Given that this change in procurement procedure resulted in an increase in the purchase price of RFG, Peoples Gas has not provided an adequate business purpose for this change.

As discussed in the Profit Sharing section above, Enron MW participated in an oral revenue sharing agreement with PEC, however that had no impact in this adjustment. Staff was unable to determine whether PEC received half of that markup, as implied by the description of the revenue sharing arrangements by the Peoples in Staff DR POL-16.15(b) because Peoples Gas did not properly document the RFG deal.

Therefore, Staff's adjustment does not include PEC revenue sharing with Enron MW on RFG purchases.

Staff recommends that the increased cost Peoples Gas paid for the RFG be recovered through the Gas Charge -- $2,232,490. (Appendix A, Schedule 5.03, column L). It was imprudent for Peoples Gas' to buy the RFG without a written contract, and Peoples Gas did not show why it was prudent to change procurement procedures given that such action simply raised costs above what it had been paying under the RFG Agreement for the same gas supply.

9. Storage Optimization Contract

The Storage Optimization Contract ("SOC") is imprudent, and Staff is proposing that the adjustment be split into two. The first adjustment is attributed to the revenues earned by Enron MW under the SOC, since Peoples Gas has not demonstrated the SOC to be prudent. (Staff Ex. 7 at 48-50). The second adjustment is for revenues received by PEC (Group Ex. 1 at ST-PG 237-61), rather than Peoples Gas, as a result of PEC's improper oral revenue sharing agreement with Enron MW (Staff Ex. 9 at 15-16). The respective amounts of the two adjustments are $717,455 (Staff Ex. 9, Sched. 9.03) and $623,000 (*Id.*, Sched. 9,02).

Staff's first adjustment is attributed to Peoples Gas failure to prove that the SOC was a prudent choice. The SOC, as described supra, §IV.B.2., was an arrangement with Enron MW wherein Enron MW "optimized" the excess leased storage capacity of Peoples Gas. Peoples Gas never explained why it needed Enron MW to optimize its leased storage. (Staff Ex. 7 at 49). Evidence shows that Peoples Gas had an alternative to Enron MW -- a different company ("TPC") was interested in optimizing

Peoples Gas' storage. *Id.* at 46-47. As Staff's testimony shows, the terms offered by TPC appear to be a more favorable revenue split for the ratepayers. Therefore, Peoples Gas' choice of the SOC was imprudent. The most obvious explanation for Peoples Gas' choice of Enron MW over the other vendor is the profit sharing arrangements Enron MW had with PEC. (*Id.* at 47-49).

Staff's second adjustment relates to the profits Enron MW earned under the SOC and shared with PEC. Peoples claims that "All NSS storage costs and all net revenues received from the Storage Optimization Contract flowed through the PGA to the benefit of ratepayers." (*Id.* at 48). The record, however, shows that the only benefit to ratepayers in 2001 through the SOC was $334,344 of revenues credited to the PGA (*see* Group Ex. 1 at ST-PG 20-30). Schedule 9.02 shows that of the [redacted] management fee paid by Peoples Gas to Enron MW, [redacted] of that amount was directed to or shared with Peoples Gas' parent PEC, through PERC, as a result of its oral revenue sharing agreement with Enron MW. This is blatant cross-subsidization, moving monies from the utility to its parent for no other reason than to increase the earnings of the parent. Further, PERC also received approximately $503,000 of revenues shared with Enron MW from the SOC (Staff Ex. 9 at15), which represented [redacted] of Enron MW's or enovate's revenues obtained from the SOC with Peoples Gas. Peoples Gas gives no explanation for granting profits to its corporate parent while denying ratepayers the full benefits of the SOC

Accordingly, Staff proposes two revenue adjustments be credited to the Gas Charge as a result of the SOC. The first adjustment is for revenues received by PEC -- $623,000. (Appendix A, Schedule 5.03, column M). The second adjustment is for revenues earned by Enron MW -- $717,455. (Appendix A, Schedule 5.03, column N; Staff Ex. 9, Scheds. 9.03 and 9.02 (for each respective adjustment)).

10. Maintenance Gas

Staff testified that it was improper for Peoples Gas to request recovery of gas costs associated with the Manlove field's "maintenance gas" through the PGA clause as lost and unaccounted for gas during the reconciliation period. Instead, Staff noted that the appropriate classification for the maintenance gas in question was for Peoples Gas to designate the maintenance gas as recoverable base and non-recoverable base gas. (Staff Ex. 1 at 13-28; and Staff Ex. 2 at 48-50). This designation is consistent with the manner that Peoples Gas had historically classified the maintenance gas until 1999. The impact of removing the cost associated with maintenance gas from the PGA would result in a reduction in gas costs of approximately $4,628,000 during the instant reconciliation period.

Peoples Gas does not contest Staff's position that it was inappropriate to treat maintenance gas as lost and unaccounted for gas. Peoples Gas accepted Staff's position and the disallowance of $4,628,267. (PG Exhibit F, at 55; see also Appendix A, Schedule 5.03, column B) Further Peoples Gas agreed to account for maintenance gas in the manner described by Staff (*see* §V.B.5 through 9).

11. Transaction 16/22

Transaction 16/22 refers to a ten-day call option that Enron MW purchased from Peoples Gas. Nowhere in its testimony does Peoples Gas demonstrate that the revenues it received from Enron MW was adequate compensation for its costs or the value of the gas. (Staff Ex. 3 at 38-40). The transaction is quite troubling because it illustrates Peoples Gas' problem with maintaining records of its actions. It also supports the Staff's call for a management audit. The adjustment is calculated in the same way as the imprudent storage usage adjustment. (*Id.* at 40). Peoples Gas has agreed to an adjustment of $535,554. (Appendix A, Schedule 5.03, column D). See Staff Ex. 7.06 for the details of the calculations.

B. Recommendations

Staff proposes the following eleven operational recommendations to remedy issues impacting Staff's ability to review gas purchases as well as non-compliance with the Public Utility Act or Illinois Administrative Rules. The first argument encompasses the Staff's first two recommendations and the fifth argument summarizes Staff Recommendations 6 through 10.

1. An annual internal audit should be Performed by Peoples Gas and a Management Audit should be Performed by an Outside Consultant

Due to the nature of the Gas Charge Adjustments, discussed above, Staff recommends that an internal audit be performed by Peoples Gas, and that an independent auditor perform a management audit of Peoples Gas. (Staff Ex. 5 at 22). Two audits are necessary because each audit investigates different issues uncovered in this proceeding, and thus have different outcomes.

An external management audit provides a forward looking evaluation of the internal control requirements needed to ensure that ratepayers are protected when Peoples Gas makes gas purchasing and storage decisions. The gas purchasing and storage decisions that the management audit evaluates should include, but not be limited to, the awarding of gas supply contracts, the allocation of company owned storage between ratepayers and the hub users, the decisions to lease storage capacity, and storage injection and withdrawal activities.

An annual internal audit evaluates completed transactions in terms of whether they comply with internal controls established by a management audit. The annual internal audits are a necessary follow-up to the management audit, which ensure Staff recommendations are implemented according to the Commission order. The audits are needed because Peoples Gas improperly accounted for maintenance gas. (Staff Ex. 1 at 14-22). Peoples Gas also lacked documentation that detailed the reasons for entering into certain gas transactions. (*Id.* at 28). Further, Peoples Gas' internal controls broke down in Transactions 16 and 22. (*Id.*) A management audit combined with internal audits will help fix the aforementioned improper accounting procedures. It will also provide information about Peoples Gas' transactions and practices that will be useful in future PGA reconciliation cases.

Finally, in addition to the internal control problems discussed above, Staff has discovered serious breakdowns in the internal controls regarding undocumented transactions (Staff Ex. 9 at 24-27), oral agreements (*Id.* at 7-8 and Group Ex. 1 ST-PG 185), revenue sharing (Staff Ex. 9 at 7-10, 15-16, and 17-20), and third party storage usage (Staff Ex. 6.0 at 34-48). These internal control breakdowns are supported, in part, by findings in Peoples Gas' own internal audit of enovate's operations. (Staff Ex. 9.0. at 10 and Attach. E).

Therefore, Staff's recommendation of two audits, first to establish a series of internal control procedures (management audit) and secondly to evaluate them on an annual basis (internal audit), is a logical approach to the issues discovered in this proceeding. The internal audit of Peoples Gas' gas purchasing should be performed annually by Peoples Gas. A copy of the audit report should be submitted to the Manager of the Commission's Accounting Department by May 1 of the year following the audit. This should occur until the Commission finds that an internal audit is no longer necessary after a formal request by Peoples Gas.

The management audit of Peoples Gas' gas purchasing practices, gas storage operations and storage activities should be performed by an outside consultant engaged by Peoples Gas. The firm selected to perform the management audit should be independent of Peoples Gas, Staff and Intervenors to Docket Nos. 01-0706 and 01-0707, and be approved by the Commission. The management audit should be managed by the independent directors of Peoples Energy Corporation's audit committee. Until the management audit report has been submitted, a monthly report of the management audit's progress should be submitted to the Bureau Chief of the Commission's Public Utilities Bureau, with a copy to the Manager of the Commission's Accounting Department. Upon completion of the management audit, which should occur no later than 12 months after the date a final order is entered in this proceeding, copies of the management audit report should be submitted to the Public Utilities Bureau Chief and the Manager of the Accounting Department.

2. Peoples Gas should prepare and file a report explaining how it intends to comply with 83 Illinois Administrative Code § 505 – Uniform System of Accounts for Gas Utilities

Staff recommends that Peoples Gas' file a report explaining the way it intends to comply with §505, because Peoples Gas' supporting documentation for the 2001 fiscal year is insufficient. Documents were frequently absent, its analysis of credits to the

PGA from enovate is nonexistent, and its personnel are usually unable to explain and justify Peoples Gas's decisions with respect to Gas Charges.

Accounts for Gas Utilities ("USOA").[23] General Instruction #2 from the USOA states:

> *2. Records*.
>
> A. Each utility shall keep its books of account, and all other books, records, and memoranda which support the entries in such books of account so as to be able to furnish readily full information as to any item included in any account. Each entry shall be supported by such detailed information as will permit ready identification, analysis, and verification of all facts relevant thereto.
>
> B. <u>The books and records referred to herein include</u> not only accounting records in a limited technical sense, but <u>all other records</u>, such as minute books, stock books, reports, correspondence, memoranda, etc., <u>which may be useful in developing the history of or facts regarding any transaction.</u>
>
> C. No utility shall destroy any such books or records unless the destruction thereof is permitted by rules and regulations of the Commission.

Further, General Instruction #14 states:

> 14. *Transactions with associated companies*. Each utility shall keep its accounts and records so as to be able to furnish <u>accurately and expeditiously</u> statements of <u>all transactions with associated companies.</u> The statements may be required to show the general nature of the transactions, the amounts involved therein and the amounts included in each account prescribed herein with respect to such transactions. Transactions with associated companies shall be recorded in the appropriate accounts for transactions of the same nature. Nothing herein contained, however, shall be construed as restraining the utility from subdividing accounts for the purpose of recording separately transactions with associated companies. (emphasis added)
>
> (Staff Ex. 9 at 23-24).

[23] 83 Ill. Adm. Code §505.10

The most significant instance supporting Staff's recommendation is an as-yet unexplained document entitled "enovate P&L." (*See* Staff Ex. 9, Attach. H and "enovate" Gas Charge Adjustment discussion above). The responses provided by Peoples Gas with respect to this document lead Staff to conclude that Peoples Gas requires a management audit and follow-up annual gas purchasing audits.

For example, in its response to Staff data request ACC-1.07 (*See* Group Ex. 1 at ST-PG 4-13), Peoples Gas confirmed that the PGA was credited [redacted] in the 2001 Reconciliation Period due to a storage exchange transaction with Enron MW referred to as "ANR Rolling Thunder." "ANR Rolling Thunder" was one of many deals listed on "enovate P&L". However, Peoples did not document how this credit amount was determined.

In addition, Peoples Gas acknowledged that it failed to maintain workpapers or documents regarding numerous transactions that impacted the Gas Charge. In response to Staff's data request ACC 4.01, Peoples Gas stated: "Respondent does not have <u>*any*</u> workpapers or contracts to describe how the PGA credit was calculated." (emphasis added). (Staff Ex. 9.0 at 26). Similarly, for an exchange deal known as "NSS Tidal Wave", also identified in the "enovate P&L", Peoples Gas cannot explain nor document the methodology behind [redacted] in FY2001 PGA credits, responding: "Respondent does not have <u>*any*</u> workpapers or contracts to determine how the PGA credit was calculated." (emphasis added). (*Id.*) Another deal listed on the "enovate P&L" document was "38 Special." Although Peoples confirmed the PGA was credited [redacted] for this deal, again it can only state:

> The [redacted] credit to the Gas Charge was an amount mutually agreed to by Respondent and Enron North America ("ENA"). <u>There</u>

> are no workpapers or calculations which support the [redacted] Gas Charge credit. (emphasis added)
>
> (*Id. See also* City-Cub Exhibit 1.26).

Peoples Gas will argue that the enovate transactions are outside the scope of this proceeding. enovate's transactions are not outside the scope of this proceeding. As explained above and in § V.A.4. *supra*, the record clearly indicates a relationship exists between enovate deals and Peoples Gas' PGA gas costs and revenues for FY2001. According to the Public Utility Act and Commission rules, Peoples Gas has the burden of proof to explain and document how it calculates PGA credits. 220 ILCS 5/9-220(a). This case is a testament to Peoples Gas' failure to have sufficient documentation; it is reflected in Peoples Gas' responses to data requests from Staff and the Government and Consumer Parties and in the depositions of its employees. The USOA requires this information be maintained so that Peoples Gas' actions can be justified to ratepayers.

"enovate P&L" is not the only document that illustrates Peoples Gas' incomplete explanations for and documentation of its actions that affected gas costs. Staff attempted to validate the $334,344 of revenues credited to the PGA for the SOC, as discussed above. The only documentation Peoples Gas provided was one e-mail from an Enron employee stating the deal's gross margin, carrying costs, fuel expense, net value before sharing, and actual net payment to Peoples Gas. The SOC was a complex transaction that had multiple levels of sharing. Managing the contract was complicated, but the contract included terms granting Peoples Gas the ability to track the activity that occurred under it. Peoples Gas' continues to maintain that "Respondent has no additional documents which show how these amounts were derived" from ACC-5.02. (Staff Ex. 9 at 27).

Therefore, even if the revenue sharing arrangements with Enron MW (excluding the revenue sharing between Enron MW and PEC) are temporarily ignored, Peoples Gas cannot independently verify that the PGA was credited with the proper amount, even though the SOC expressly grants this ability to Peoples Gas. This indicates Peoples Gas lacked controls in the accounting for gas transactions affecting the PGA.

Thus, the record supports Staff's recommendation that the Commission order Peoples Gas to report how it intends to come into compliance with the USOA. This report should be filed with the Chief Clerk of the Commission, with a copy to the Manager of the Accounting Department, within 60 days of the order date in this proceeding. (*Id.*)

3. Peoples Gas must comply with 83 Illinois Administrative Code § 525.40(d)

The adjustments for Revenues from Non-Tariff Services (*supra* §V.A.3.) result from Peoples Gas' failure to properly account for its Hub[24] revenues. Staff thoroughly explained this adjustment in its *Pre-Trial Brief of the Staff Witnesses of the Illinois Commerce Commission on the Applicability of 83 Illinois Administrative Code 525.40(d)*, which was filed on March 7, 2005. In addition to accepting the 2001 Reconciliation Period adjustments proposed by Staff, the Commission should order Peoples Gas to record its revenues from non-tariff services in compliance with 83 Illinois Administrative Code 525.40(d).

[24] Hub transactions are transportation, storage and exchange services to third parties. Staff identifies these services as non-tariff services ("NTS") since they are not provided under an ICC jurisdictional tariff.

4. Docket No. 00-0720 should be reopened

Staff has reviewed the GPAA for the 2001 Reconciliation Period and found that the GPAA was imprudent; for the reasons set forth in Section V.A.1 *supra*. Since the first year the GPAA was in effect was the 2000 Reconciliation Period, the Commission should re-open Docket No. 00-0720 to consider the impact of the GPAA on the 2000 Reconciliation Period. (Staff Ex. 5.0 at 18). Further, the "enovate P&L" is evidence of unexplained PGA credits for 2000 Reconciliation Period transactions involving enovate, such as the above discussed "38 Special" deal, "NSS Tidal Wave", and "ANR Rolling Thunder."

5. Peoples Should Properly Account for Third Parties Use of Maintenance Gas.

In its direct testimony, Staff discussed the problems encountered with Peoples Gas' accounting for maintenance gas at length and made the following recommendations as a result.

- #6: Peoples should account for all gas physically injected into the Manlove Storage Field by including the cost associated with maintenance gas in the amount transferred from purchased gas expense to the gas stored underground account (Account 164.1);
- #7: Peoples should account for the portion of gas injected into the Manlove Storage Field in order to maintain pressure (*i.e.*, maintenance gas) as credits from Account 164.1, Gas Stored Underground and as charges to Account 117, Gas Stored Underground (for the recoverable portion of cushion gas) or to Account 101, Gas Plant (for the non-recoverable portion of cushion gas);
- #8: Peoples should revise its maintenance gas accounting procedures related to gas injected for the benefit of the North Shore Gas Company and third parties to require those entities to bear the cost of maintenance gas;
- #9: Peoples should submit its revised maintenance gas accounting procedures to the Commission's Chief Clerk with a copy to the Manager of the Accounting Department within 30 days after the date a final order is entered in this proceeding; and
- #10: Peoples should submit quarterly reports reflecting its use of journal entries regarding maintenance gas to the Manager of the Commission's Accounting

> Department within 45 days of the end of each quarter after the date a final order is entered in this proceeding through the quarter ending September 30, 2007.

(Staff Ex. 1.0 at 13-28 and Staff Ex. 2.0 at 48-50).

Peoples Gas stated it would not oppose Staff's Recommendations (listed above) and would account for maintenance gas in the manner recommended by Staff. PG Ex. F at 55).

6. Peoples Gas' Operating Agreements should be updated

Due to various concerns raised *inter alia*, the enovate audit, the PERC/Enron MW Consulting Contract (Staff Ex. 9 at 4-6 and Attach. A-1), and Peoples Gas' Hub operations, Staff recommends that Peoples Gas be ordered to update its operating agreement that was approved by the Commission in Docket No. 55071. The operating agreement governs how Peoples Gas conducts transactions with its affiliates. (Staff Exs. 1.0 at 33 and 9.0 at 6). Peoples Gas agreed to the update (PG Ex. K at 13), but no timetable was discussed. Staff recommends the Commission order Peoples Gas to file its update within six months of the final order date in this proceeding.

VI. Conclusion.

Accordingly, Staff recommends that all fifteen of Staff's adjustments discussed above and reflected in Appendix A (Staff Ex. 5, Attach. 5.03) be accepted. The amounts, either agreed to by Staff and Peoples Gas or as recalculated by Staff, collectively amounts to $91,987,033 in the period of this reconciliation case.

In addition, Staff proposes the following eleven operational recommendations to remedy issues impacting Staff's ability to review gas purchases as well as non-compliance with the Public Utility Act or Illinois Administrative Rules:

Recommendation 1: The Commission should direct Peoples Gas to perform an annual internal audit of gas purchasing and submit a copy of the audit report to the Manager of the Commission's Accounting Department by May 1 of the year following the audit, and that such an audit should continue until the Commission finds that an internal audit in no longer necessary upon a formal request by Peoples Gas;

Recommendation 2: The Commission should direct Peoples Gas to perform a management audit of its gas purchasing practices, gas storage operations and storage activities. The Commission should direct Peoples Gas to engage outside consultants. The outside consultant(s) that is selected should be independent of Peoples Gas, Staff and Interveners to Docket Nos. 01-0706 and 01-0707, and approved by the Commission. The management audit should be managed by the independent directors of Peoples Energy Corporation's audit committee. Monthly reporting of the progress of the conduct of the management audit should be submitted to the Bureau Chief of the Commission's Public Utilities Bureau, with a copy to the Manager of the Commission's Accounting Department, until the management audit report has been submitted. Upon completion, which shall occur no later than 12 months after the date a final order is entered in this proceeding, copies of the management audit report are to be submitted to the Public Utilities Bureau Chief and the Manager of the Accounting Department;

Recommendation 3: The Commission order Peoples Gas to report how it intends to come into compliance with the USOA. This report should be filed with the Chief Clerk of the Commission, with a copy to the Manager of the Accounting Department, within 60 days of the order date in this proceeding;

Recommendation 4: In all future reconciliation proceedings Peoples Gas should offset recoverable gas costs by revenues received from transactions not subject to the PGA gas charge when any of the costs associated with these transactions are recoverable gas costs, as required in §525.40(d). This recommendation is implicit within Staff's testimony and reflects Staff Adjustments 5, 6, and 9 (Staff Exhibit 5.00, lines 94-104 and 120-130);

Recommendation 5: The Commission should find that Docket No. 00-0720, Peoples Gas' PGA 2000 reconciliation, should be reopened, and direct Staff to file a Staff report recommending such an opening;

Recommendation 6: The Commission should direct Peoples to account for all gas physically injected into the Manlove Storage Field by including the cost associated with maintenance gas in the amount transferred from purchased gas expense to the gas stored underground account (Account 164.1);

Recommendation 7: The Commission should direct Peoples Gas to account for the portion of gas injected into the Manlove Storage Field used to maintain pressure (i.e., maintenance gas) and recorded as credits in Account 164.1, Gas Stored Underground and as charges to Account 117, Gas Stored Underground (for the recoverable portion of cushion gas) or to Account 101, Gas Plant (for the non-recoverable portion of cushion gas);

Recommendation 8: The Commission should direct Peoples Gas to revise its maintenance gas accounting procedures related to gas Peoples Gas injects into Manlove Storage Field for the benefit of North Shore Gas Company and for the benefit of third parties, so Staff can determine whether those entities should bear the cost of maintenance gas;

Recommendation 9: The Commission should direct Peoples Gas to submit its revised maintenance gas accounting procedures to the Commission's Chief Clerk with a copy to the Manager of the Accounting Department within 30 days after the date a final order is entered in this proceeding;

Recommendation 10: The Commission should direct Peoples Gas to submit quarterly reports reflecting a summary of its' journal entries regarding maintenance gas. Such reports should be sent to the Manager of the Commission's Accounting Department within 45 days of the end of each quarter after the date a final order is entered in this proceeding through the quarter ending September 30, 2007;

Recommendation 11:. Peoples Gas should immediately update its operating agreement approved by the Commission in Docket No. 55071.

WHEREFORE, the Staff of the Illinois Commerce Commission respectfully requests that its recommendations be adopted in their entirety consistent with the arguments set forth herein.

Respectfully Submitted,

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312 / 793-2877

June 30, 2005

Counsel for the Staff Witnesses of the Illinois Commerce Commission

INITIAL BRIEF OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

APPENDIX A

Schedules 5.01 through 5.03

(The attached schedules were previously admitted as part of ICC Staff Exhibit 5.00 and are attached to this Initial Brief for the convenience of the parties. These schedules along with the text of this brief represents Staff's position.)

APPENDIX B

Acronyms and Terms used in Staff's Initial Brief

Bcf: billion cubic feet

Bcf/d: billion cubic feet per day

CERA: Cambridge Energy Research Associates

DIQ: daily incremental quantity

Dth: dekatherm

Enron MW: Enron MW, LLC

Enron: Enron North America Corporation

FERC: Federal Energy Regulatory Commission

FOM: first of month

FY: fiscal year

FY01: fiscal year 2001, the reconciliation period in this proceeding, which is the twelve-month period October 1, 2000 to September 30, 2001

GD: [redacted]

GPAA: Gas Purchase and Agency Agreement

LIFO: last in, first out (the method by which Respondent accounts for storage activity)

LOI: Letter of Intent

Mcf: one thousand cubic feet

MDth: one thousand dekatherms

MMBtu: one million British thermal units

MMcf/d: one million cubic feet per day

MMDth: one million dekatherms

NGPL: Natural Gas Pipeline Company of America

NOI: Notice of Inquiry

NSS contracts: means the storage service offered by Natural Gas Pipeline Co. of America ("Natural") pursuant to Rate Schedule NSS of Natural's FERC Gas Tariff

PGA: purchased gas adjustment

SIQ: summer incremental quantity

SOC: Storage Optimization Contract