STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

ILLINOIS COMMERCE COMMISSION, On Its Own Motion -vs.- NORTH SHORE GAS COMPANY Reconciliation of revenues collected under gas adjustment charges with actual costs prudently incurred.	))))))))))	DOCKET NO. 01- 0706

INITIAL BRIEF OF THE STAFF WITNESSES OF THE ILLINOIS COMMERCE COMMISSION (public)

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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. Statement of Facts

On November 7, 2001, the Illinois Commerce Commission ("Commission"), on its own motion, entered an Order commencing this and other reconciliation proceedings in accordance with the requirements of Section 9-220 of the Public Utilities Act ("Act") 220 ILCS 5/9-220. The Order directed North Shore Gas Company ("North Shore" or “Company”) to present evidence at a public hearing reconciling the purchased gas adjustment ("PGA") clause revenues that the Company had 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, North Shore provided a list to the Chief Clerk’s Office of municipalities to which it provides service. North Shore 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 North Shore 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, North Shore provided testimony of four witnesses: Ms. Valerie Grace (Ex. A), Mr. David Wear (Exs. B, C, D, H and I), Mr. Frank Graves (Exs. F, K and J), and Mr. Thomas Zack (Exs. E, and G).

CUB provided testimony of one witness: Mr. Brian Ross (Exs. 1 and 2).

Staff provided the testimony of four witnesses: Mr. Steven Knepler (Exs. 1, 5 and 9), Mr. Dennis Anderson (Exs. 2, 6, and 10), Dr. David Rearden (Exs. 3, 7 and 11), and Mr. Eric Lounsberry (Exs. 4, and 8). In addition, Staff – North Shore Group Exhibit 1 was admitted into evidence, consisting of documents produced in discovery and portions of discovery depositions.

[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.

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 North Shore's decisions regarding natural gas transactions in which it was a party. North Shore's 2001 Reconciliation Period was October 1, 2000 to September 30, 2001.

The 2001 Reconciliation Period was the second year that the Gas Purchase and Agency Agreement ("GPAA") was in effect. It was a gas supply agreement between North Shore and Enron North America. The GPAA was a five-year agreement with Enron North America that provided the majority of natural gas North Shore's needed for the reconciliation year. At the same time, North Shore's holding company, Peoples Energy Corporation ("PEC"), was trying to expand its strategic partnership with the Enron corporate family. The strategic partnership's stated goal was to market wholesale services in the greater Chicago metro area and the Midwest. However, there is no evidence that facilities owned by North Shore were used directly by the strategic partnership.

The GPAA was a significant departure from North Shore's historical gas purchase methods, both because North Shore was buying more of its natural gas from one provider (approximately [redacted]% of its requirements) over a longer period of time than its usual historical practice, and because the GPAA's pricing structure and complexity represents a significant change from the historical. Through this contract, North Shore bought a majority of its annual natural gas needs for the term of the contract. The GPAA, however, is imprudent because, at the time the GPAA was entered into, the terms of the contract were likely to increase gas costs.

Due to the GPAA's sheer size and term, it was a significant commitment of resources on the ratepayer's behalf. Despite the contract's importance, and knowing that it is subject to Commission review in gas reconciliation cases, North Shore failed to maintain documentation of their decision-making process, and either did not perform an economic analysis prior to signing the GPAA or chose to ignore the economic analyses that were performed. In either case, North Shore failed to justify and support the prudency of its decision to enter into the GPAA. In addition, North Shore suffers from the same problem recordkeeping and documentation problems as its sister utility, Peoples Gas Light and Coke Co., which is not unexpected given that they share the same management team. The bottomline is that North Shore did not properly record or document their evaluation of the GPAA and did not prudently use its leased storage capacity in this reconciliation period.

To make the ratepayers whole, Staff is proposing two Gas Charge Adjustments requiring refunds of $3,962,969. Staff's Appendix A (attached), Schedule 5.03 summarizes the two cost adjustments to the Gas Charge. The Gas Charge Adjustments relate to the imprudent aspects of the Gas Purchase and Agency Agreement ("GPAA") and the imprudent use of the storage field by North Shore.

Staff has also proposed five operational recommendations ("Recommendations") (Staff Ex 9 at 5-6). Most of the Recommendations arise from 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 North Shore, as well as a management audit of its gas purchasing practices be performed by an independent third party consultant. In addition to the foregoing Recommendations, Staff proposes that North Shore 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. 00-0719), since many of the issues addressed in this proceeding with respect to the GPAA were not reviewed as extensively in that docket.

III. Regulatory Framework for Purchase Gas Adjustments

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,* Ill.C.C. Docket No. 02-0721, Order of July 21, 2004, at 2.

For gas purchases, the provisions of Section 9-220 of the Act, *supra*, are implemented in 83 III. 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. The two adjustments recommended by Staff are directly related to the prudency of gas purchases made by North Shore.

IV. Background

A. The Strategic Partnership

North Shore's behavior in purchasing gas in the 2001 Reconciliation Period was affected by the business relationship between Peoples Energy Corporation ("PEC"), its corporate parent, and Enron North America ("Enron"). The corporate business relationship affected many of North Shore's operations. It gave incentives for North Shore to conduct itself in ways that raised ratepayers' gas costs. The two adjustments that Staff proposes in this docket are directly (GPAA imprudence) or indirectly (storage usage) related to the PEC's dealings with Enron.

On September 16, 1999, North Shore signed a large, long-term gas supply agreement called the Gas Purchase and Agency Agreement ("GPAA") (ICC Staff Ex. 2.0, 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 (ICC Staff Ex. 7.0 at 10). The partnership, however, went beyond the GPAA and the joint venture. It also involved oral agreements to share Enron MW, LLC's ("EMW's")[2] profits with PEC (*Id*. at 5-7).

PEC's strategic partnership with Enron fundamentally alters how North Shore' gas costs should be reviewed during a reconciliation proceeding. Staff pressed the Company numerous times for its analysis of and justification for the GPAA (ICC Staff Ex. 3.0 at 10-14. Also see ICC Staff Ex. 2.0 at 5). Until discovery was re-opened in February 2004, the Company's defense for the GPAA was merely an informal discussion of its goals for the GPAA and the manner in which the GPAA met them (ICC Staff Ex. 2.0 at 12-27 and ICC Staff Ex. 3.0 at 13). It could not even document that the goals that it proffered were an element in the GPAA's negotiation. In addition, it was not clear that the GPAA was either necessary to achieve the after-the-fact goals or whether the GPAA was the optimal manner of meeting those goals (ICC Staff Ex. 2.0 at 12-27 and ICC Staff Ex. 3.0 at 14-15).

After discovery was reopened in Spring 2004, 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 NS 001-025 and at ST-NS 056-082 "Aruba Analysis: Economic Analysis Final.xls"; and ICC Staff

[2] Enron MW, LLC, was a subsidiary owned solely by Enron North America.

Ex. 7.0 at 7-10). The employee who prepared the analysis name is Roy Rodriguez, and he worked for PEC in Risk Management. Risk Management exists to track and analyze risk for the corporation so it can make reasoned business decisions (*Id*. at 7). In this study, the comparison was not favorable to the GPAA (ICC Staff Ex. 7.0 at 7-8).

Later, in April 2005, a second numerical analysis was located in the electronic discovery. It was a spreadsheet that evaluated the effect the GPAA would have had on gas costs for the period 1995 through 1999 (Staff's North Shore Cross Ex. 1).[3] The analysis was found in the electronic documents attributed to North Shore's Gas Supply Manager, Mr. David Wear. Mr. Wear was unable to provide any testimony explaining why this economic analysis was created or where the numbers shown came from, although the analysis appears to be a backcast of potential gas purchases under the GPAA with actual, historical gas purchases (Hearing April 22, 2005, Tr. 386-395). In this cause, Staff's North Shore Cross Ex. 1 was admitted for purposes of showing that economic analysis were done by PEC employees prior to the entering the GPAA.

Both of the studies conducted by PEC employees examined only one aspect of the GPAA [redacted] The other terms of the GPAA that were also largely unfavorable to the ratepayers were not analyzed. This latter category includes the two repricing terms, Articles 4.2b and 4.2c of the GPAA, as well as the Summer Incremental Quantity ("SIQ") provision. These terms all drove gas costs higher since they all granted an

[3] This is identical to what is usually referred to as Wear Cross Ex. 15 in Ill.C.C. Docket No. 01-0707.

option to Enron (ICC Staff Ex. 7 at 14). Enron could choose either the price (as in Article 4.2b and 4.2c) or the quantity (as in the SIQ), whenever it was in Enron's interest. The SIQ provided Enron the ability to choose the volumes it sold to North Shore at [redacted] in the Summer Period (April through November), and Articles 4.2b and 4.2c gave Enron the ability to unilaterally change the price for specified volumes from [redacted] during the Winter Period (December through March) (ICC Staff Ex. 3.0 at 8-9).

B. The GPAA.

The main contract impacting North Shore's Gas Charge during the 2001 Reconciliation Period is the Gas Purchase and Agency Agreement ("GPAA").

The GPAA was an agreement between North Shore and Enron, entered into on September 16, 1999 (ICC Staff Ex. 2, Attachment 1). The term of the GPAA was from October 1, 1999 through October 31, 2004 (*Id.* at p. 8). The contract provided more than [redacted] of the natural gas North Shore would need during the five-year period (PG Ex. C at 2 and 4). Under this contract, Enron agreed to deliver to North Shore a Baseload Quantity, a Summer Incremental Quantity, and a Daily Incremental Quantity of natural gas. The Baseload Quantity obligated North Shore to take 100% of a specified quantity of gas each day (PG Ex. C at 10). The Baseload quantities changed from month-to-month (*Id*. at 11). Baseload volumes were priced at [redacted] (ICC Staff Ex. 2, Attachment 1 (GPAA Agreement) at 9, Art. 4.1(a)).

The Summer Incremental Quantity ("SIQ") was an amount of gas, within a range of [redacted] MMBtus and [redacted] MMBtus per day, which Enron could deliver to North Shore (*Id.* at p. 6, Art. 1.46). Enron could choose the amount to be delivered. The SIQ was effective between April through November (defined as the "Summer Period") (*Id.* at p. 11; ICC Staff Ex. 3 at 25). SIQ volumes were priced at [redacted] (ICC Staff Ex. 2, Attachment 1 (GPAA Agreement) at 9, Art. 4.1(b)).

The Daily Incremental Quantity ("DIQ") was an amount of gas, in addition to the Baseload and SIQ, that Enron stood ready to deliver to North Shore (PG Ex. C at 11). A DIQ transaction was considered a "swing contract" (Staff Ex. 7 at 19). There is no explicit demand charge or other premium for using a DIQ (*Id.*). DIQ volumes were priced at [redacted] as published in [redacted] (ICC Staff Ex. 2, Attachment 1 (GPAA Agreement) at 3 and 9, Art. 4.1(c); and ICC Staff Ex. 3 at 6).

In addition, there are two re-pricing options within the contract – Article 4.2(b) and Article 4.2(c) (Staff Ex. 7 at 15). The repricing options allowed Enron to change the price of a portion of Baseload volume from [redacted] to the [redacted] during the Winter Period without notice or limit (*Id.* at 18). The volumes that apply to each re-pricing term are as follows: [redacted] MMBtus per day for Article 4.2(b) and [redacted] MMBtus for Article 4.2(c) after January 1, 2000. (*Id*. at 19).

Finally, the GPAA gives North Shore the right to re-sell natural gas back to Enron based upon the [redacted]

[redacted] (ICC Staff Ex. 2, Attachment 1 (GPAA Agreement) at 7, Art. 2.4; and ICC Staff Ex. 7 at 22). 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 in the range of [redacted] (ICC Staff Ex. 3 at 22).

C. Manlove Field Operations for North Shore.

Staff found the Company imprudent in its use of Manlove leased storage services in December 2000. The Company failed to withdraw its planned volume from its Manlove leased storage service during December 2000 and, in fact, increased the volume of gas in its Manlove storage by injecting natural gas into Manlove during that month. December 2000 was a month that saw record cold temperatures and record high gas prices. Prudent operation of the Company's Manlove leased storage service called for withdrawals to provide supply during record cold weather and, since the stored gas was cheaper than the spot market gas, those withdrawals would have offset record high gas prices charged to ratepayer through the PGA clause. The Company has provided no reasonable explanation for failing to withdraw its planned storage volumes from its Manlove leased storage service in December 2000.

The Manlove storage field is located in Fisher, Illinois, and is an aquifer storage field operated by Peoples Gas Light and Coke Co. ("Peoples Gas"). North Shore has a leased storage agreement with Peoples Gas for a portion of the capacity of the Manlove Storage field. This agreement grants North Shore the right to use Manlove field for storage (PG Ex. H at 19). Illinois aquifer storage fields are normally operated so that gas is withdrawn from the field during December (Staff Ex. 6 at 6). During December 2000, there was even more reason than normal to withdraw gas from storage due to record cold temperatures and high natural gas prices. In particular, gas prices exceeded $15/Dth at times, while North Shore's gas inventory at Manlove had an average annual value of approximately $[redacted]/Dth (*Id*. at 5-6).

The additional discovery provided in this case resulted in information that PEC and its affiliates and Enron and its affiliates had formed a strategic partnership that included profit-sharing agreements (Staff Ex. 7 at 1-5 and 10). Staff believes these profit-sharing agreements caused North Shore's actual withdrawals to fall short of planned withdrawals for December 2000. North Shore thereby allowed Peoples Gas to use the gas in Manlove field for lucrative, non-tariffed third-party transactions that generated non-regulated profits for PEC.

V. Argument.

The record developed in both phases of the discovery process clearly indicates that the Company's decision to enter into the GPAA was not prudent and was not in the best interest of ratepayers. The record also shows that North Shore's actions in relation to its use of leased storage in Manlove Field were imprudent in December 2000. In addition, Staff makes five recommendations which are not reconciliations of the Gas Charge (Staff Ex. 9.0, at 5-6).

A. Gas Charge Adjustments due to the imprudence of the GPAA

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

1. North Shore's defense of the GPAA is insufficient.

North Shore 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, North Shore argues that the GPAA is prudent because the Commission found it prudent in Docket No. 00-0719 (PG Ex. C at 28). Its second argument is that the GPAA meets five objectives that North Shore argues are sufficient to prove prudency if said objectives are achieved (Staff Ex. 3 at 11).

a. Commission decision in Docket No. 00-0719

North Shore incorrectly argues that the GPAA is prudent because the Commission found it prudent in Docket No. 00-0719. North Shore's 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) [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 (1^{st} 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 Ill.C.C. Docket No. 00-0719, 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 North Shore 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) [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,* Ill.C.C. Docket No. 01-0701, Order of February 19, 2004, at 4-7, 2004 Ill. PUC Lexis 101 at *13 and **16-17 (disallowance of a contract in one year does not require disallowance in the next year). North Shore 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. 00-0719 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. 00-0719 were two numerical analyses of the GPAA. One was developed by Mr. David Wear, Gas Supply Manager for North Shore (Staff's North Shore Cross Ex. 1), although North Shore 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-NS 001-025 "Aruba analysis" and at ST-NS 056-082 "Aruba Analysis: Economic Analysis Final.xls"). Both were prepared at or near the time the GPAA was signed, and the Aruba analysis shows that the GPAA was likely to be a more costly alternative to North Shore's then-current practice. (Staff's North Shore Cross Ex. 1 was not admitted into the evidence of this case, except for the purposes of impeachment.) Moreover, this evidence was in the control of North Shore and was only produced after numerous data requests from Staff.

b. The 5 negotiation goals are not sufficient to demonstrate the prudence of the GPAA even if met

North Shore claims five goals for negotiations with Enron which the Company argues are sufficient to demonstrate prudency once they are achieved (Staff Ex. 3.0 at 11).

The five goals were:

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

North Shore does not document that these goals were, in fact, the Company's goals at the time of the GPAA's negotiation (Staff Ex. 3.0 at 11). North Shore cannot demonstrate that the GPAA was no worse at meeting the goals than other options available to it (Staff Ex. 3.0 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) (Staff Ex. 6 at 14).

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

The Company did not demonstrate that the GPAA provided beneficial alternatives that preserved the value of transportation assets against a falling basis.[4] There are three main problems with North Shore's position. First, signing the GPAA departed from historical Company practice of load shifting to preserve its transportation assets' value. Therefore, the GPAA was not North Shore's only option. Second, in effect, the GPAA caused North Shore to pay twice for transportation capacity. Third, given the Company's 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.

North Shore 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 North Shore's leased transportation assets. North Shore argues that this was a major factor in the

[4] Basis is the difference in gas prices between two locations. In this brief, the focus is on the difference between the [redacted]

process that led to it signing the GPAA (NS Ex. C, at 5-11). By purchasing gas [redacted], the GPAA allowed the Company to preserve the value of its transportation assets.

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, North Shore 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 (Staff Ex. 6 at 22). 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, however North Shore provided no evidence of using that practice in conjunction with the GPAA (Staff Ex. 6 at 22).

The Company provided an exhibit that showed the Company's firm pipeline transportation portfolio changing over time. This exhibit indicated that the Company used load shifting to obtain the best available transportation rates from its transportation suppliers (Staff Ex. 10 at 6). In addition, the Company admitted that it had substituted one piece of pipeline transportation for another in the past (NS Ex. L at 12-14). In spite of this, the Company still disputed its ability to shift loads between pipelines (NS Ex. L at 12-14). North Shore 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, North Shore failed to provide any analysis of the available alternatives that the Company considered before it signed the GPAA (Staff Ex. 2 at 21-22).

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. The Company negotiated four new pipeline contracts in late 1998 and one in 1999 before signing the GPAA in fall 1999 (Staff Ex. 2 at 17). 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 (*Id.*).

The Company 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 (Staff Ex. 10 at 6). But Staff merely pointed out the alternatives to the GPAA that the Company should have investigated prior to signing the GPAA. The Company nowhere indicated that it even considered shorter term contracts as an alternative to signing the GPAA with Enron (Staff Ex. 6 at 22-23). This is not surprising given the strategic partnership between PEC, Enron, and their affiliates.

No other Illinois gas utility dealt with the potential for eroding bases by entering into an agreement similar to the GPAA. The Company's actions in this regard were unique. In short, the Company failed to show that the GPAA uniquely benefited ratepayers by preserving the value of transportation asset basis relative to the Company's historical practice.

The GPAA also caused the Company to pay twice for its transportation capacity. Under the GPAA, the Company released its pipeline transportation capacity to Enron. Enron then paid the pipeline, but North Shore reimburses Enron for all pipeline transportation costs. Enron used this released pipeline capacity to supply gas to the Company. However, capacity not needed to supply North Shore can be used by Enron for its own business purposes without any further reimbursement to North Shore (Staff Ex. 2 at 19-20).

Thus, the Company transferred the released pipeline capacity to Enron at no cost to Enron, while North Shore shoulders the same transportation costs as it did before signing the GPAA. Further, North Shore purchased gas at a [redacted] which implicitly <u>includes</u> transportation costs. In effect, the GPAA caused North Shore to pay twice for transportation costs while surrendering its excess capacity to Enron for no compensation (*Id.*).

As noted above in this section, in the discussion about the [redacted], 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 the Company's projections for bases.

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

North Shore averred that a GPAA benefit was that North Shore could receive supply without any reservation or demand charges.[5] However, North Shore continued to pay all pipeline demand charges under the GPAA. The Company cannot support its claim that it does not incur any swing load demand charges.[6] North Shore 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 North Shore with flexible pricing terms

The Company 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 the Company to alter pricing terms upon request. However, this pricing flexibility is not obviously superior to the Company's historical gas supply practices. If North Shore had retained its historic approach and not entered into the GPAA, North Shore would have retained sufficient pricing flexibility (Staff Ex. 2 at 25).

[5] 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.
[6] Swing load is load above baseload purchases.

4. North Shore is granted flexibility to meet operational requirements by the contract.

The Company asserts that the GPAA gave it sufficient flexibility to meet its customer's varying demand requirements. Again, the Company 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, the Company did indicate that the GPAA was not superior to its previous procedures (Staff Ex. 6 at 27). 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 the Company to deal with changes in the market more quickly.

5. The contract serves as a proxy for historical contracts

The Company 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 the Company's historic supply practices (*Id*. at 28-29). In particular, there are the repricing elements and the SIQ discussed in this Brief at pages 8-10, 24-26 and 33-34.

The terms of the GPAA were not a reasonably close proxy to North Shore's past purchasing practices (this Brief, pp. 26-29). The contract provided North Shore approximately [redacted] of its system supply through one contract.

The GPAA had three pricing methods. As noted earlier, 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 North Shore perform some type of economic analysis or analyze a request for proposals in choosing such a contract. As Mr. Anderson testified, North Shore 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 North Shore 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 the Company could have done. According to the basis projections provided by the Company in its additional direct testimony, it would not have been cheaper to buy natural gas at the [redacted] and transport it to [redacted] Ex. 2, attached to PG Ex. C; Staff Ex. 3.0 at 19-20 [Table 1]; and Staff Ex. 7.0 at 7-8 and 14). Therefore, the data provided in Mr. Wear's additional direct testimony indicated that the GPAA was more expensive than its previous practice (Ex. 3 at 19-20). Thus, the GPAA was not a good proxy for previous supply contracts.

c. Baseload levels are not justified

The level of baseload quantities that are established under the GPAA has not been shown to be prudent. The baseload quantity in the GPAA is the volume of natural gas North Shore is required to purchase. The daily volume is determined by month over the entire course of the contract.

North Shore did not provide any studies, analyses, and methodologies used to establish baseload quantities. Instead, the Company provided at least four rationales for those quantities. It indicated that they were established in the GPAA negotiations. The Company also asserted that baseload quantities did not reflect baseload demand on the Company's system. Further, the Company also claimed that the baseload quantities in the GPAA were similar to baseload purchases by the Company before the GPAA (Staff Ex. 2 at 21-22). North Shore also stated that baseload volumes were based upon normal weather, although daily or monthly decisions may be based on other scenarios (Staff Ex. 6 at 25). None of these rationales justify the specific baseload levels in the GPAA.

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, the Company 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. (Staff Ex. 6at 26).

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

d. The SIQ is operationally deficient

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 the Company during the Summer Period. SIQ volumes are part of the Company's estimated gas supply requirements (Staff Ex. 2 at 23). Since the Company requires this quantity of gas supply, it is not appropriate for North Shore to allow Enron to dictate these amounts. Whenever Enron declines to deliver some portion of the incremental SIQ volumes to the Company, North Shore must purchase gas from another source (*Id.*).

In the GPAA, the DIQ allows the Company to purchase additional volumes of gas as from Enron. However, the SIQ is priced at the [redacted] Index, while the DIQ is priced at a [redacted] price index (as would most other replacement sources). If the [redacted] price is above the [redacted] Index on a given day, Enron is unlikely to sell any incremental SIQ volumes to North Shore. The Company is then forced to purchase its load requirements either through the DIQ or from another source at a price based upon the higher [redacted]

The Company asserted that it is common practice to grant a seller the option of providing supply in exchange for a discount, especially when refilling storage (NS Ex. F at 30). However, the discount in the GPAA applies to the entire contract, not just the SIQ. The Company elsewhere describes the discount as a tradeoff for buying gas at [redacted] (Staff Ex. 3 at 11-12).

The Company notes that it did not purchase higher priced gas over 4% of the time during the reconciliation period, when Enron delivered only the minimum SIQ amount (Staff Ex. 10 at 4-5). Further, the Company stated that Enron was not always able to predict when the [redacted] will exceed the [redacted].[7] The Company noted that, on 6 percent of the days that Enron was required to make a decision on the SIQ, Enron "guessed" wrong (NS Ex. L at 11).

In other words, about 96% of the time when Enron supplied the Company with the minimum amount of SIQ gas, the Company had to find volumes to replace the reduced SIQ volumes. Since the minimum SIQ was generally chosen when [redacted] were higher, those replacements were necessarily higher priced. Further, Enron could predict when the [redacted] 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. 10 at 4-5).

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[7] If Enron wants to maximize its profits, it should choose the maximum SIQ whenever the [redacted] is less than the [redacted] Then Enron would sell to North Shore 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.

2. The GPAA is not prudent.

North Shore entered into a five year, approximately $500 million gas supply contract with Enron without performing **any** economic studies or analysis. It is North Shore's 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 North Shore admits that it failed to conduct any economic analyses of the GPAA prior to signing the GPAA. In addition, North Shore failed to consider two economic analyses of the GPAA that its employees or employees of PEC performed prior to the GPAA being signed. North Shore did not consider any alternate gas-supply options to the GPAA. Finally, reviewing information known at the time North Shore entered into the GPAA, the GPAA was imprudent because its projected cost was significantly and consistently higher than what the Company should have otherwise expected to pay for natural gas.

a. Economic studies are required to demonstrate the GPAA's prudence

North Shore 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,* Ill.C.C. Docket No. 84-0395, Order of October 7, 1987, at 17, 1987 Ill. PUC LEXIS 68 at *34. North Shore has not sufficiently demonstrated the prudence of its decision to sign the GPAA.

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,* Ill.C.C. Docket No. 01-0701, Order of February 19, 2004, at 2, 2004 Ill. PUC Lexis 101 at *4-5. 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, North Shore should have taken steps to determine that entering into the GPAA was a prudent action. In its testimony, North Shore failed to provide any analysis performed at the time the contract was entered into that demonstrates the GPAA was prudent (Staff Ex. 3 at 8-9).

The GPAA was a dramatic change in how the North Shore buys gas (ICC Staff Ex. 3 at 16, ICC 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, North Shore 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, the Company purchased gas at [redacted] and did not have to [redacted], whereas its previous method was to buy at [redacted] Second, the GPAA provided North Shore with a significant portion of its gas during the reconciliation period -- approximately [redacted] of its system supply during the reconciliation period under the GPAA. The GPAA also committed North Shore to spending a significant amount of revenue -- expending over $99 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. North Shore does not explain why its historic supply procedures were less preferable than the GPAA (Staff Ex. 6 at 29).

North Shore 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. However, the GPAA uses several different and complex pricing schemes {see Section IV.B. of this Brief, *supra*}. The GPAA's very complexity reinforces the idea that the GPAA is a definite change in purchasing methods (Staff Exs. 6 at 16-17). 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. The Company did not conduct an RFP and does not appear to believe one was appropriate (PG Ex. C at 4). However, North Shore can also evaluate a change in practices with an economic analysis, but it did not do this either. The Company provided no contemporaneous economic studies in testimony or in discovery prior to the reopening for additional discovery (ICC Staff Ex. 3.0 at 12-13; and ICC Staff Ex. 7.0 at 3). Absent competitive bidding and without economic studies, the Company has no quantitative benchmark to measure the GPAA's prudence.

b. North Shore 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 NS 001-025 and at ST-NS 056-082 "Aruba Analysis: Economic Analysis Final.xls"; and ICC Staff Ex. 7.0 at 7-10). A second numerical analysis was located in the electronic documents attributed to North Shore' Gas Supply Manager, Mr. David Wear. The existence of these studies contradicts previous data request responses and the sworn testimony of the Company (ICC Staff Ex. 7.0 at 6). The Aruba Analysis indicates that the GPAA was expected to be more expensive than was prudent (*Id.* at 7-8).

As discussed supra in Section IV.A. of this Brief, the Aruba analysis was a forward-looking economic analysis prepared by Mr. Roy Rodriguez of PEC (Staff Ex. 7 at 6). The Aruba analysis constructed a data set that projected prices at different locations where it received gas into its leased interstate transportation

{ICC Staff Ex. 3.0 at 21}.[8] The analysis concluded that gas costs would be higher as a result of the contract (Staff Ex. 7 at 7-8).

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 – North Shore 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 (ICC Staff Ex. 7.0 at 9 and ICC Staff Ex. 12.0 at 12).

c. Using data known to be possessed by North Shore 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 North Shore made the decision under the alternatives that North Shore faced (ICC Staff Ex. 3 at 13). The analysis clearly indicates that the GPAA's projected cost was significantly and consistently higher than what the Company should have otherwise expected to pay for natural gas.

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) [redacted] versus the [redacted]

[8] 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.

[redacted] (Staff Ex. 7 at 13-14),[9] (3) foregone demand credits, (4) repricing options, (5) resale penalty, (6) avoided demand charges, and (7) the SIQ option (ICC Staff Ex. 3.0 at 17-19). 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 North Shore 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 North Shore 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].[10]

The second component is the [redacted] versus [redacted] comparison. This examines the difference between the cost of gas purchased at the [redacted] versus the cost when gas is bought at the [redacted]. This is the single biggest factor in the GPAA evaluation.

North Shore released interstate transportation that it had under lease to Enron. For each delivery point in the transportation contracts released to Enron, the Company 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

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[9] In Staff Ex. 3 at 14-15, the comparison is equivalently framed as a comparison [redacted] The results are unaffected by which method is used.

[10] ICC Staff Ex. 3 at 17-20 discusses the estimation process. The calculations' results are presented in Staff Ex. 7.01.

price, estimated by the NYMEX futures price, plus the projected basis for that location. The [redacted] is similarly constructed as the Henry Hub price plus the Chicago basis. The [redacted] to transport the gas [redacted]. Variable transport costs are derived from the applicable pipeline tariffs. The estimated additional cost from the GPAA for [redacted]X is $[redacted].[11]

The third component is the foregone demand credit. When North Shore controls a transportation contract, it can derive revenues that are flowed through the PGA in two ways. North Shore 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 North Shore 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 zero, because the data do not obviously indicate any large changes in the demand credits' value after the GPAA was signed (Staff Ex. 3 at 20-21).

[11] *See* ICC Staff Ex. 3 at 14-15 for the initial discussion. In ICC Staff Ex. 7.0 at 15-16, the method is adjusted. The calculations that follow from these changes are presented in ICC Staff Ex. 7.01.

The fourth component is the value that North Shore surrendered to Enron via the re-pricing options. The GPAA contained two elements that Staff termed the 'repricing options.' Specifically, they are Article 4.2b and 4.2c of the GPAA. Both allow Enron to unilaterally change the price, during the winter, of various quantities of gas from the [redacted] to a [redacted]. Although North Shore 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 [redacted] whenever it was higher. Staff estimated that Enron would choose the [redacted] on half of the days during the winter months. Staff calculated the average difference between the [redacted] when the [redacted] was higher. Staff used historical data to calculate this average difference. Those calculations resulted in a higher cost to ratepayers of $[redacted].[12]

The fifth component is the resale penalty. The resale penalty increased gas costs for ratepayers. The resale term allowed North Shore to resell gas back to Enron at [redacted], depending on both when the resale was nominated and the amount resold back to Enron. Since the GPAA states that North Shore 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

[12] ICC Staff Ex. 7 at 24. The results are presented in ICC Staff Ex. 7.01.

and multiplying that amount by [redacted]. The resulting estimate over the GPAA's term is $[redacted].[13]

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 North Shore 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 Docket 01-0707. The figure provided by North Shore was ten times the value used by Peoples Gas. Peoples Gas arrived at its figure by using the midpoint of demand charges that were 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].[14]

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 North Shore at its option. Enron optimizes the SIQ's value by opting for the maximum SIQ whenever the [redacted] exceeds the [redacted]. Of course, when North Shore grants this capability to Enron, it surrenders value to Enron, regardless of how that value is realized. Staff estimates this term as the [redacted] times the average differential when that is true. Staff uses the 50% figure posited in North Shore's testimony for the estimated probability, and the

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[13] Staff Ex. 3 at 15 and 22-24 The results are presented in Staff Ex. 7.01.
[14] Staff Ex. 3.at 16 and 24-25. Results are presented in Staff Ex. 7.01.

conditional expected differential is estimated using historical data. The value is estimated as $[redacted].[15]

The value for each component is analyzed to derive an estimate by month over the GPAA's term.[16] 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 the Company should have otherwise expected to pay (Staff Ex. 3 at 20-32 and Staff Ex. 7 at 28-29). The estimated additional cost to ratepayers over the term of the contract totals $[redacted].[17]

3. North Shore's reply to Staff's analysis is not persuasive.

In one of its arguments, North Shore asserts that Staff's method is flawed because the GPAA has benefits that are not quantifiable (PG Ex. D at 7-8), but the alleged unquantifiable benefits are supported only by vague generalizations. North Shore 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. 7.0 at 11-13 and Staff Ex. 12.0 at 21-22). North Shore did not respond to Staff's analysis with an alternative approach, but simply issued a summary rejection of Staff's analysis. North Shore, however, attempts to inject an unsupported liquidity premium into the calculations. The liquidity premium improves the estimated evaluation of the GPAA (Staff Ex. 11 at 8-10).

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[15] Staff Ex. 3 at 15 and 20-21. The issue is further discussed in Staff Ex. 7 at 27-29. Results are presented in Staff Ex. 7.01.
[16] The value of foregone demand credits is set to zero for the entire contract term.
[17] The updated, formal results are presented in ICC Staff Ex. 7.01 (monthly data), 7.02 (by fiscal year) and 7.03 (by fiscal year per MMBtu).

North Shore also relies upon the studies performed by Cambridge Energy Research Associates ("CERA") and Public Interest Research Associates ("PIRA") to provide more favorable comparisons (Resp. Ex. F (FCG-RT) at 38-41). One flaw in relying upon these alternative basis projections is that North Shore cannot document that it considered them prior to signing the contract (Staff Ex. 7 at 15-16;Staff Ex. 12.0 at 14). Moreover, neither North Shore nor CERA assigned relative probabilities to the CERA scenarios (Staff Ex. 7.0 at 15-16).

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 data is monthly is important in evaluating the contract[18] and North Shore's fiscal year goes from October through September. Since monthly variations matter, the calendar year bases necessarily differ from the fiscal year bases (*Id.* at 19-20).

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. 12.0 at 16-17). Perhaps most importantly, the North Shore's witness Mr. Graves examines only variations in the Henry Hub-Chicago basis. The Company did not try to adjust for this fault (Staff Ex. 7.0 at 25-26).

[18] 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.

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 (FCG-ART at 7-8). The liquidity premium is not supported by data or analysis and should be rejected (Staff Ex.11 at 9).

While the Company did furnish alternative basis scenarios for the field delivered comparison, it did not offer alternatives to Staff's analysis of other aspects of the contract. Those other elements of the contract inarguably had an effect on gas costs (Staff Ex. 7 at 20-21, 23 and 28).

4. Imprudently high costs in the GPAA should be refunded.

North Shore 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. 7.04). 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. 3.0 at 26-29 and Staff 7.0 at 13-30).[19]

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[19] All elements of the proposed adjustment are presented in Staff Ex. 7.04.

(1) discount: this is calculated as volumes subject to the discount times the discount. The value of the discount to North Shore ratepayers totals to $270,959 (Staff Ex. 3 at 27).

(2) [redacted] comparison: the prices are taken from published data in *Natural Gas Intelligence.* North Shore's 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 $1,519,090 as a detriment to ratepayers (Staff Ex. 7 at 16-20**).**

(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 $250,823 (Staff Ex. 3 at 28).

(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 at 28).

(5) resale penalty: This term is also set to zero, since North Shore did not resell any gas to Enron under the GPAA (Staff Ex. 3 at 28).

(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 North Shore's ratepayers and amounts to $87,594 during fiscal year 2001 (Staff Ex. 3 at 28).

(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] times the volume of the incremental SIQ. This added to ratepayers costs by $302,360 (Staff Ex. 7 at 27-29).

These elements total to a proposed disallowance of $1,713,720. (*See* Appendix A, Sched. 5.03, column B, attached to this Brief ?; see also Staff Ex. 7 at 30 and Staff Ex. 5, Sched. 5.03 column B).

B. Gas Charge Adjustments due to the imprudent use of storage in December 2000.

As noted above in the Background Section, North Shore planned to withdraw [redacted] MDth of natural gas from Manlove field during December 2000 for ratepayers by withdrawing [redacted] Dth per day.[20] North Shore's actual withdrawals during the month fell far short of its planned withdrawals, despite the fact that this shortfall occurred in the midst of a severe winter. North Shore did not use, to its planned capacity, an important resource for supplying its ratepayers with gas (Staff Ex. 3 at 30-31; Staff Ex. 7 at 30).

The Company injected gas instead of withdrawing it from Manlove in December 2000. According to the Company, it injected about [redacted] MDth of working inventory into Manlove by November 2000, and planned to withdraw [redacted] MDth of natural gas in December 2000. Contrary to this plan, North Shore instead injected a net [redacted] MDth in December.[21] By purchasing spot gas at high prices rather than relying upon gas it stored in Manlove, North Shore required its customers to pay excessive gas costs (Staff Ex. 3 at 31; Ex. 7 at 30-31).

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[20] A Dth is approximately 1,000 cubic feet and a MDth =1,000 Dth.
[21] This means that North Shore withdrew gas from Manlove field on some days and injected on others. Over the course of the month the Company injected more than it withdrew.

The Company's planned withdrawal volume for December represents its expected withdrawal requirements for the month. In the face of record cold temperatures during December, inexplicably North Shore instead had net injections into Manlove field for the month. Company witness Wear simply states that forecasting errors and unexpected decreases in demand caused North Shore's December withdrawals from Manlove storage to be less than planned (Ex. H at 15 to 17). However, these difficulties are faced by all Illinois gas utilities and represent normally expected difficulties in operating a gas system. In the end, Mr. Wear does not explain why the Company did not have net withdrawals from Manlove during a record cold December with record high gas prices (Staff Ex. 6 at 6).

It is Staff's position that, under the circumstances, prudence required that North Shore withdraw at least the amounts it planned to withdraw from Manlove if, for no other reason, to reduce gas costs to its customers. One of main purposes for storing gas in Manlove field is to limit price spikes experienced by North Shore customers during winter. In addition, the failure of North Shore to take its expected withdrawals from Manlove field, and indeed adding to the volume of gas in Manlove in December, aided the strategic partnership of Enron, PEC and their affiliates to use the gas in Manlove field for lucrative, non-tariffed third-party transactions that generated non-regulated profits for PEC.

The cost to the North Shore ratepayer is calculated in four steps. First, the amounts that the Company injected into Manlove field on days that it injected gas are calculated.[22] Second, the cost for those volumes is calculated by locating the highest price gas among non-GPAA purchases and summing their cost. Third, an offset is calculated by multiplying those volumes times the annual LIFO layer's cost. Finally, the adjustment is calculated by netting the offset from the cost of the additional gas {Staff Ex. 7.0 at 30-33}. Staff recommends that $2,249,249 be flowed through the PGA in favor of the ratepayers. (Staff Ex. 5.0, Schedule 5.03, column (C).

C. Recommendations.

There are five recommendations from Staff, four of which are not reconciliations of the Gas Charge (Staff Ex. 9.0, at 4-5). Only one item has been agreed to by North Shore (NS Ex. G at 9, lines 29-31 and Staff Ex. 9.0 at 5).

1. An independent consultant should perform a management audit of North Shore.

Due to many factors discussed herein, Staff recommends that both an internal audit be performed by North Shore and an independent consultant should perform a management audit of North Shore (Staff Ex. 5.0 at 6-7 and 9). Two audits are necessary because each audit investigates different issues uncovered in this proceeding and, thus, has different outcomes.

An external management audit provides a forward-looking evaluation of the internal control requirements needed to ensure that ratepayers are protected when North Shore makes gas purchasing and storage decisions. The gas purchasing and storage decisions that the management audit evaluates should

[22] The Company did not inject on every day of December 2000.

include, but not be limited to, the awarding of gas supply contracts, the allocation of company owned storage between ratepayers and the hub customers, 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, thereby ensuring that the audit recommendations are implemented according to Commission order. The Company also lacked documentation that detailed the reasons for entering into the GPAA and for purchases of high-cost gas when lower-cost gas was available from storage (Staff Ex. 9.0 at 2). A management audit combined with internal audits will help fix the aforementioned improper accounting procedures. It will also provide information about North Shore's transactions and practices that will be useful in future PGA reconciliation cases.

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.

For the management audit, North Shore should engage outside consultants to audit its gas purchasing practices, gas storage operations and storage activities. The firm selected to perform the management audit should be independent of the Company, 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, 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 should be submitted to the Public Utilities Bureau Chief and the Manager of the Accounting Department.

2. An annual internal audit should be performed by North Shore.

See immediately preceding section of this Brief, Section V.C.1. North Shore should perform an annual internal audit of its 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. This should occur until the Commission finds that an internal audit is no longer necessary after a formal request by the Company.

3. Docket No. 00-0719 should be re-opened.

Staff has reviewed the GPAA for the 2001 Reconciliation Period and found that the GPAA was imprudent. Since the first year the GPAA was in effect was the 2000 Reconciliation Period for North Shore, the Commission should re-open Docket No. 00-0719 for a fuller reexamination in view of the recently uncovered information. In addition, because North Shore and Peoples Gas are affiliates and share purchasing and storage functions, the reopening of Peoples Gas' 2000

PGA reconciliation (Docket No. 00-0720) as recommended in the companion reconciliation for Peoples Gas, Docket No. 01-0707, would make reopening of North Shore's 2000 PGA reconciliation case appropriate (Staff Ex. 9 at 4-6).

4. North Shore's operating agreements should be updated.

Due to various concerns raised in the companion reconciliation case (Docket No, 01-0707), *e.g.,*, the enovate audit, the PERC/EMW Consulting Contract, and the People Gas' Hub operations (Staff Ex. 7.0 at 5-7, Ex. 11.0 at 1-2, and Group Ex. 1 at ST-NS 26-29 and 84-86), Staff recommends that the Company be ordered to update its operating agreement that was approved between North Shore and Peoples Gas by the Commission in Docket No. 55071. The operating agreement governs how the Company conducts transactions with its affiliates (Staff Ex. 1 at 6-7 and Ex. 5 at 7). The Company agreed to the update (NS Ex. G at 9, lines 29-31), but no timetable was discussed. Staff recommends the Commission order the Company to file its update within six months of the final order date in this proceeding.[23]

VI. Conclusion.

Staff recommends that the Commission adopt Staff's proposed PGA reconciliation as reflected on ICC Staff Exhibit 5.00, Schedule 5.01. Staff's reconciliation shows that $3,962,969 is to be refunded to North Shore Gas' PGA customers via the Commodity Gas Charge (CGC) through an Ordered

[23] See *Illinois-American Water Co.,* Docket No. 02-0690,Order of August 12, 2003, at 28, wherein the Commission ordered such an operating agreement update to be completed within six months of the order date.

Reconciliation Factor (Factor O) to be reflected in the Company's first monthly PGA filing submitted after the date a final order is entered in this proceeding.

In addition, North Shore should be ordered to update its Operating Statement, engage an independent, external consultant for a management audit, and conduct annual internal audits to meet the requirements of the management audit. The Commission should reopen Ill.C.C. Docket No. 00-0719 to investigate the effects of the alliance between Enron and its affiliates and PEC and its affiliates, including Peoples Gas and North Shore, on gas costs.

Respectfully submitted,

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