

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

ILLINOIS COMMERCE COMMISSION, On its own Motion)	Docket No. 01-0706
)	
v.)	
)	
NORTH SHORE GAS COMPANY)	
)	
Reconciliation of revenues collected under gas adjustment with actual costs prudently incurred)	

REPLY BRIEF OF THE STAFF WITNESSES
of the ILLINOIS COMMERCE COMMISSION

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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 Reply Brief in the above-captioned matter.

In response to the Administrative Law Judge's Notice of July 12, 2005, Staff will [a] address the pre-existing numbers relevant to this reconciliation, including interest calculations, and any uncontested matters (Section I(A)(2) of this Reply Brief, "Any Determination of Interest is Made After Order Issued By Commission," *infra*); [b] explain the method it used to calculate its adjustments (Section II of this Reply Brief, "Calculation Methodologies," *infra*); and [c] address the burden of proof in terms of the applicable standard regarding the weight of the evidence (Section I(A))(1) of this Reply Brief, "Standard of Proof," *infra*).

I. ARGUMENT

A. Response to July 12th Order

1. Standard of Proof

Subsection 9-220(a) of the Public Utilities Act (“Act”), 220 ILCS 5/ 9-220(a), squarely places the burden of proof on the utility “to establish the prudence of its cost of fuel, power, gas, or coal transportation purchases and costs.” The Act, however, does not establish a standard of proof. Section 10-15 of the Illinois Administrative Procedure Act (“APA”), 5 ILCS 100/ 10-15, provides that “[u]nless otherwise provided by law or stated in the agency's rules, the standard of proof in any contested case hearing conducted under this Act by an agency shall be the preponderance of the evidence.” The Commission has observed that the APA standard appears to be “the appropriate standard in all contested cases[.]” *Illinois Commerce Commission on its Own Motion: Amendment of 83 Ill. Admin. Code Part 200*, Docket No. 92-0024, Order at 4, 1992 Ill. PUC LEXIS 200, *4 (April 29, 1992).¹ Consequently, the burden of proof in this case is upon North Shore Gas Company (“North Shore”) to show by a preponderance of the evidence that its gas purchases were prudent. Only after North Shore has made such a showing, then the burden of producing evidence shifts to Staff or GCI to show that it was not prudent.

The burden of proof places the burden upon the plaintiff to *produce* evidence and to *persuade* the trier of fact that certain facts are true. *Ambrose v. Thornton Twp. School Trustees*, 274 Ill. App. 3d 676, 680 (1st Dist. 1995). The burden of persuasion is to be distinguished from the burden of production, also called the burden of going

¹ It is worthy of note that the Chicago Bar Association, which rarely participates in Commission proceedings, filed comments in Docket No. 92-0024 supporting the preponderance standard. Docket No. 92-0024, April 29th Order at 1-2, 1992 Ill. PUC LEXIS 200, *1.

forward. *Board of Trade of The City of Chicago v. Dow Jones & Co., Inc.*, 108 Ill. App. 3d 681, 686 (1st Dist. 1982). The burden of production is satisfied when the plaintiff presents sufficient evidence on each element of the cause of action to establish a prima facie case. *Ambrose, supra*, 274 Ill. App. 3d at 680. Once a prima facie case is established, the burden of production shifts to the opponent. *Id.*; *Board of Trade of The City of Chicago, supra*, 108 Ill. App. 3d at 686. The opponent then has the burden of going forward to present contrary evidence. *Ambrose, supra*, 274 Ill. App. 3d at 680. The burden of persuasion, however, never shifts during the course of the trial. *Business & Professional People for Public Interest v. Illinois Commerce Commission*, 146 Ill. 2d 175, 196 (1991); *Ambrose, supra*, 274 Ill. App. 3d at 680; and *Board of Trade of The City of Chicago, supra*, 108 Ill. App. 3d at 686.

As these principles apply to the instant case, the Act establishes that the burden of proof is upon the utility. 220 ILCS 5/ 9-220(a). The burden of persuasion and production, in this case, is upon North Shore to show by a preponderance of the evidence that its purchases were prudent. The burden of production shifts to Staff or GCI only after North Shore presents sufficient evidence on each element of the cause of action to establish that the cost of gas purchases were prudent.

A preponderance of the evidence is that amount of evidence that leads a trier of fact to find that the fact at issue is more probable than not. *In re K.O.*, 336 Ill. App. 3d 98, 107 (1st Dist. 2002). A party need not establish a case or defense to an absolute certainty, See *Teter v. Spooner*, 305 Ill. 198, 211 (1922) (finding that it was error to give an instruction that imposes a burden upon the defendant that is greater than the standard, such as to convince the jury, or to satisfy the jury, or prove to the satisfaction

of the jury). In determining the preponderance of the evidence, the testimony of a single, credible witness is sufficient to sustain a finding even though the testimony is contradicted. *In Interest of Johnson*, 48 Ill. App. 3d 370 (1st Dist. 1977). By the same token, the Commission is not required to accept evidence as true, even if that evidence is unrebutted. *City of Chicago v. Illinois Commerce Commission*, 15 Ill. 2d 11, 16 (1958).

Applying the standard to the instant case, North Shore has failed to show that its entering into the GPAA (ICC Staff Ex. 2.0, Attach. 1) and its decision to purchase and inject gas rather than withdraw the planned amount of gas in December of 2000 were prudent in the first place. North Shore has not presented evidence of contemporary factors leading North Shore to the prudence of entering into this novel, long-term, and major gas purchase contract. North Shore has merely claimed some *post hoc* considerations for gas purchase contracts generally without a single bit of evidence that any of these considerations actually went into the negotiations for the GPAA (Staff Ex. 3.0 at 11-15; Staff Initial Brief pp. 15-22). North Shore has provided no reasonable explanation for their extraordinary purchase of high-cost gas in December 2000.

Nonetheless, Staff has presented evidence of the imprudence of the GPAA and these December 2000 gas purchases. Staff must demonstrate that its adjustments have a nexus to gas costs, as Staff has done, and, since Subsection 9-220(a) of the Act, *supra*, imposes the burden of proof upon the utility, North Shore ultimately bears the burden of producing evidence demonstrating, by a preponderance of the evidence, that Staff's contentions are incorrect.

In addition, as to the GPAA, North Shore failed to provide evidence within its control in response to Staff's data requests. Only upon reopening and extensive searching of electronic files by Staff and GCI, did any contemporaneous economic studies of the GPAA come to light. In those instances, a presumption arises in favor of Staff, because North Shore's failure to produce evidence "strengthens the probative force of the evidence given to establish such claimed fact." *Belding v. Belding*, 358 Ill. 216, 220-21, 192 N.E. 917 (1934).

North Shore's GPAA is imprudent. Purchasing and injecting additional gas instead of taking North Shore's planned withdrawal in December 2000 were imprudent. Both adjustments are supported by the preponderance of the evidence.

2. Any Determination of Interest is Made After Order Issued By Commission

Interest impacts the determination of the Gas Charge but is not determined until after a final adjustment – Factor O – is determined. Since 83 Illinois Administrative Code 525 ("Part 525") already addresses the issue of interest calculations on Factor O, as will be discussed below, there is no need for the order in this proceeding to address the issue.

Subsection 525.60(b) of Part 525 sets forth the formula for the Gas Charge -- estimated recoverable gas costs + prior year adjustments + (Commission ordered over or under recovery / estimated applicable therms) x 100. Interest is a component of the Commission ordered "over- or under-recovery," known also as Factor O. The 'over- or under-recovery' proposed by Staff is identified in Staff IB, Appendix A, Schedule 5.01, line 14, and this amount does not include the interest. Interest rate will be established

by the Commission under 83 Ill. Adm. Code 280.70(e)(1)² from the end of the reconciliation year to the order date in the reconciliation proceeding.

The interest rate is applied to Factor O using the simple interest method at the Commission approved rate for each applicable year. Additional interest shall be charged, in the same manner as that prescribed in Subsection 525.50(b) of Part 525, if Factor O is amortized. At the present time North Shore has not requested that the 'over- or under-recovery' determined in this docket be amortized.

The payment of interest will commence with the first monthly filing after the issuance of the order by the Commission, and the interest calculations will be prepared at the time of that first monthly filing. Therefore, there is no need to perform any interest related calculations at this time.

B. ADJUSTMENTS

1. Enron's Business Dealing and Accounting Procedures do not Absolve North Shore of Imprudent and Inappropriate Business Dealings

North Shore emphasizes that "Enron's fraudulent business dealings and accounting procedures should not taint North Shore's activities at a time when Enron's misdeeds not only were unknown but it was well-respected company and the largest natural gas marketer in the United States." (NS IB at 3). North Shore goes on to state that that their decision to enter the Gas Purchase and Agency Agreement ("GPAA") with Enron North America Corporation ("Enron") was based on Enron's pedigree -- "Enron had proven capabilities, superior deal structuring ability, trading skills and logistic

² Interest shall be paid on all deposits held by the utility. The rate of interest will be the same as the rate existing for the average one-year yield on U.S. Treasury securities for the last full week in November. The interest rate will be rounded to the nearest .5%. In December of each year the Commission shall announce the rate of interest that shall be paid on all deposits held during all or part of the subsequent year. 83 Ill. Adm. Code 280.70(e)(1).

support, as well as excellent credit rating and a strong record of providing reliable supplies.” (NS IB at 4). Enron’s image did not affect Staff’s review of the prudence of a contract or transaction, and it should not be determinative in the Commission’s decision.

Staff’s review has never focused on Enron’s misdeeds. It has always focused on North Shore’s imprudent decisions as it relates to contracts and transactions. The facts show, however, that Enron and its affiliates that were involved with North Shore did not act contrary to Enron’s current public image. The two Staff adjustments during the 2001 reconciliation period impact North Shore’s gas charge directly and relate to dealings with Enron or its affiliates. Each of Staff’s adjustments relates to an imprudent decision by North Shore – GPAA (Staff IB at 3-4 and 6-11) and Manlove Field operations in December 2000. Manlove Field contained gas for both North Shore and Peoples Gas. The imprudent purchase of gas by North Shore in December 2000 in part was a result of Enron MW, LLC’s (“Enron MW’s”) transactions with Peoples Gas, and it is Staff’s position that Enron MW’s involvement in transactions are part and parcel of the strategic partnership between Peoples Energy corporate family and the Enron corporate family. (Staff IB at 11-12).

Moreover, this strategic partnership was more than just the GPAA and enovate, as North Shore states in its brief. It included profit sharing between Peoples Energy and Enron affiliates (Staff Ex. 7 at 3-5). Therefore, the strategic partnership impacted, to one extent or another, the decisions of North Shore to enter into the GPAA without any quantitative analysis on gas costs and to inject rather than withdraw gas as planned, on a net basis, during the cold December 2000.

Each of Staff's recommended adjustments is based on the facts and not Enron's image. North Shore's argument that Enron was well respected in the gas industry at the time and, therefore, North Shore's decisions involving Enron were prudent is not persuasive (NS IB at 3). In its testimony and briefs, Staff explains why each transaction is imprudent, and each adjustment is based on North Shore performing unorthodox business practices that were imprudent. None of Staff's arguments even raise the point that Enron has a tainted image in the public eye. Staff's analysis of the facts surrounding each individual deal, contract and transaction support the finding of North Shore's imprudent decisions.

2. Gas Purchase and Agency Agreement

North Shore did not meet its burden of proving that that the GPAA was prudent. Any determination concerning the GPAA in Docket No. 00-0719 cannot be given a presumptive effect in view of the annual reconciliation requirement of Subsection 9-220 (a) of the Act, *supra*. In addition, North Shore's reliance on the Commission's decision in Docket No. 00-0719 is misplaced because there is evidence in this case shedding new light on the GPAA that was not produced by North Shore in 00-0719.

North Shore also argues that Staff failed to account for non-quantifiable benefits in the GPAA. However, the existence of such benefits, for which Staff believes North Shore did not meet its burden to show that such benefits existed, does not outweigh the need for an economic analysis. North Shore also attacks Staff's calculation of the cost of disallowance by relying upon Mr. Graves' testimony. Mr. Graves' testimony and his use of CERA and PIRA studies, however, only cast doubt upon the data said studies produced and relied upon and fails to prove what North Shore claims the studies do.

North Shore has claimed that no economic analysis was made of the GPAA prior to entering into the agreement. This claim is not surprising (Staff-North Shore Group Ex. 1, ST-NS 029-032). Staff suspects that anyone at North Shore with knowledge either knew or, at least, suspected that the GPAA was not a good deal for North Shore's ratepayers.³ There was no point in producing such an analysis since an agreement with ENRON was a foregone conclusion. Even North Shore admits that there was no other gas supplier that they were interested in reaching such a long-term and large-quantity contract in mid-1999 (NS Ex. C, pp. 2 (lines 25-30), 6 (lines 107-115), and p. 9 (lines 183-205)), no matter how many other suppliers were contacted concerning North Shore's earlier fixed gas proposal (*Id.*, p.3).

Peoples Energy wanted an alliance with ENRON and, as more fully shown in the companion docket with Peoples Gas, was to share profits with ENRON from various gas transactions involving various affiliates (S-NS Group Ex. 1, ST-NS 039-055 and 084-086). North Shore and Peoples Gas through their GPAA's were to provide the incentive to ENRON to enter into this alliance with Peoples Energy (*Id.*, ST-NS 026, 030-032, and 035-037). The prudence of the GPAA in a Section 9-220 of the Act, *supra*, sense was not a consideration in its signing. As shown in Staff's testimony, the GPAA was not prudent (Staff's Initial Brief, pp. 6-37 generally).

(a) North Shore Fundamentally Changed its Gas Supply Procurement Method

North Shore has failed to meet its burden of proof. North Shore attempts to prove the GPAA is prudent by asserting that it meets five objectives (See NS IB at 31-

³ This is borne out by the two economic studies done by Peoples Energy or North Shore personnel prior to the signing of the GPAA (S-NS Group Ex. 1, ST-NS 001-025 and 056-083, and Wear Cross # 1) for unknown reasons (S-NS Group Ex. 1, ST-NS 030 and 037-038). See *Belding v. Belding*, 358 Ill. 216, 220-21, 192 N.E. 917 (1934).

40). However, it fails to carry its burden, because a reasonable person would have performed an economic analysis of a contract of this type. Further, it was imprudent for North Shore personnel involved in negotiating the GPAA to disregard economic analyses performed at the time of the negotiations that indicated that the GPAA would raise gas costs to ratepayers.

Moreover, North Shore's five claimed objectives, as well as the CERA studies, fail to demonstrate that the GPAA was prudent. North Shore presented no documentation that showed that their personnel considered these matters at the time they negotiated the GPAA. (As discussed *later in this Brief*, pp. 15-21 and 25-27, respectively, explaining the failure of North Shore's after-the-fact reliance on these factors as proof.) Thus, North Shore has not met its burden of proving the GPAA is prudent.

If the Commission, however, finds that North Shore has met its initial burden of evidentiary production, the Commission should still find the contract was imprudent based on the preponderance of the evidence, especially Staff's economic analysis. Staff's economic analysis evaluates seven factors that determine the value of the GPAA. This analysis shows that North Shore would spend more money purchasing gas under the GPAA than they would have spent purchasing gas from the field and transporting it to Chicago (Staff IB at 30-35).

A number of factors warrants that a contract like the GPAA should be subject to a quantitative economic review. A reasonable person would note that the contract was: complex, unique, included three significant pricing structures in one contract, long-term (*i.e.* 5 years), and for a substantial (66%) amount of ratepayer gas from one source.

Given the atypical nature and novelty of this contract, analysis beyond a cursory business experience was merited.

North Shore argues that the contract was not a significant departure from past practices (NS IB at 37). Although the GPAA enables North Shore to purchase gas, the fact is that the GPAA is much more than just a purchase contract.⁴ In addition, its various elements, e.g., the volume being purchased from a single supplier and its long term, involved a substantial risk in a novel endeavor. As a novel endeavor, a reasonable person, acting on ratepayers' behalf, would give such a contract close scrutiny.

The signing of the GPAA is similar to a person failing to diversify his stock portfolio. A reasonable person knows that, when a portfolio places all funds in one stock, it runs a higher risk of significant losses than with a diversified portfolio. Similarly, buying 2/3 of the gas needed for ratepayers from one company ran a substantial risk that the contract terms would lead to higher costs. A reasonable person would have performed an economic analysis to understand that risk. In addition, the contract had terms that were beneficial (2¢ discount/credit and avoiding demand charges for swing purchases (DIQ)) as well as detrimental (i.e., the field-delivered price v. citygate price, SIQ pricing, re-pricing terms, and giving up transportation which led to loss of demand credits (or buy-sell transactions)), and North Shore could not have *a priori* known that the contract, in aggregate, would be prudent without performing an economic analysis. The central question of the GPAA is how would North Shore know that the citygate price was a good price without comparing it to the price of gas as it typically had been

⁴ The full title of the contract is Gas Purchase and Agency Agreement (ICC Staff Ex. 2.0, Attach. 1). The agency part of it refers at least to North Shore releasing some of its transportation capacity to Enron.

purchased by North Shore in the past. Staff did such an analysis, comparing the field-delivered price v. citygate price (See Staff IB at 30-37). Therefore, the GPAA is not amenable to the sort of business experience rationale provided by North Shore. A reasonable person would have looked at his cost option by performing some quantitative, mathematical analysis (such as were done in the Aruba analysis and North Shore Wear Cross Exhibit #1).

In addition, Subsection 9-220(a) of the Act, *supra*, gives North Shore notice that it must prove that entering into the GPAA was a prudent decision. Such a requirement, in conjunction with the unique characteristics of the contract discussed above, would have led a reasonable person to perform an economic analysis to understand the potential downside the GPAA could have to itself and the harm it could cause to ratepayers.

Another reason why the GPAA is imprudent is that a reasonable person would not have overlooked two economic analyses that were performed by personnel involved in the negotiation team (Staff IB at 7-10). Moreover, failure to rely upon, and produce such documents during discovery, such existing economic analyses to support the beneficial nature of the GPAA raises a presumption that, if analyses had been considered, the analyses are not favorable to the prudence in signing the GPAA.

Two employees -- Roy Rodriguez and David Wear – created or were in possession of economic analyses of the GPAA. Mr. Rodriguez acknowledged that he created the Aruba Analysis (Staff Ex. 7 at 6). Likewise, Mr. Wear was part of the negotiation team (Group Exhibit 1 at ST-NS 35-36; Hearing, April 22, 2005, Tr. 358) and was found to have an economic analysis that contained terms from the GPAA (North Shore Wear Cross Ex. # 1 (“Wear Cross # 1”)). Although North Shore argues that the

economic analysis contained on Mr. Wear's computer (Wear Cross # 1) shows that the contract was increasingly favorable over the four year period (NS IB at 44), North Shore failed to produce either document after repeated requests by Staff for economic analyses of the GPAA (Staff Ex. 7 at 3-4). Further, Mr. Wear expressly stated in testimony that the negotiation team did not perform an economic analysis similar to the one Dr. Rearden had performed (NS Ex. D at 11) and did not know of an economic analysis despite having received the Aruba Analysis in a contemporaneous email from Mr. Rodriguez. (Staff-North Shore Grp. Ex. 1, ST-NS 083) Moreover, Wear Cross # 1 (a) was stored on Mr. Wear's computer, which only he had access to; (b) identified him as the author, and (c) was created by within two weeks of the signing of the GPAA (April 20, 2005, Hearing in Docket 01-0707, Tr. 1021 and 1024). His denial of these two documents, in light of these facts, cannot be believed.

The economic analyses discussed above were created at or before the time in which the GPAA was signed and contain terms related to the GPAA. Therefore, these economic analyses should have received close consideration by North Shore instead of none. The failure to consider them was imprudent. Because North Shore chose not to rely upon them to demonstrate the GPAA's prudence, the presumption is raised that the documents do not show that the GPAA was prudent (*Belding v. Belding*, 358 Ill. 216, 220-21, 192 N.E. 917 (1934) (holding that the failure to present evidence that is chiefly, if not entirely, in control of the adverse party, tends to strengthen the probative force of the evidence given to establish such claimed fact, and a presumption arises in favor of the adversary's claim of fact)). To the extent there is a factual dispute of whether or not the Aruba analysis supports a finding of imprudence in the GPAA, Staff and GCI's

testimony is entitled to the greater weight, since the study was uncovered by Staff and GCI in 2004 (*Belding, supra*, 358 Ill. at 220-21).

Moreover, the five objectives, as well as the CERA and PIRA studies, are after-the-fact information and are without weight. *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) [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]. *Cf. Coney v. Rockford Life Insurance Co.*, 67 Ill. App. 2d 395, 400 (3rd Dist. 1966) [In contract construction, it is the contemporaneous construction which is entitled to great weight]. Thus, North Shore has not met its burden to prove that its decision to enter into the GPAA was prudent. A more thorough response on this point is provided *later in this Brief*, pp. 15-27.

If the Commission, however, finds that North Shore' arguments persuasively support their initial burden of proof, the Commission should still find the decision to enter into the contract was imprudent based on Staff's economic analysis. Staff's economic analysis evaluates seven factors that constitute the GPAA's value relative to its alternatives. It shows that North Shore spent more money purchasing gas under the GPAA than it would have spent purchasing gas from the field and transporting it to Chicago (Staff IB at 30-35).

(b) The Commission's Finding of the GPAA's Prudence in Docket No. 00-0719 can be Revisited

On pages 8 and 30-1 of its Initial Brief, North Shore argues that Staff's and GCI's conclusion that the GPAA is imprudent is inconsistent with the review performed in

Docket No. 00-0719. The Commission is not prohibited from reconsidering a prior decision. As Illinois Courts have held

A prior determination by an administrative body is not *res judicata* in subsequent proceedings before it. An administrative body has the power to deal freely with each situation as it comes before it, regardless of how it may have dealt with a similar or even the same situation in a previous proceeding.

Monat v. County of Cook, 322 Ill. App. 3d 499, 506 (1ST Dist. 2001); Hazelton v. Zoning Board of Appeals, 48 Ill. App. 3d 348, 351-52, 363 N.E.2d 44, 6 Ill. Dec. 515 (1977).

Subsection 9-220(a) of the Act, 220 ILCS 5/ 9-220(a), calls for annual reconciliation. A multi-year agreement cannot be given immunity from a prudence review for each year by presuming its prudence, or else the intent of Subsection 9-220 (a) of the Act, *supra*, will be defeated. The law is clear that the Commission can reexamine an issue no matter how often or how differently it has decided an issue in the past. *Mississippi River Fuel Corp. v. Illinois Commerce Commission*, 1 Ill. 2d 509, 513 (1953). The annual reconciliations under Subsection 9-220 (a) of the Act, *supra*, are quite similar to the annual determination to tax liabilities. *Cf. Rockford Life Insurance Co. v. Department of Revenue*, 112 Ill. 2d 174, 185-6 (1986) [except in the cases of fraud or injustice, a public body will not be estopped from reexamining an issue and coming to do a different conclusion]. A multi-year agreement cannot and should not be given a presumption of prudence under the statute, merely because it has been previously reviewed in an annual gas reconciliation case. *Cf. BPI v. Illinois Commerce Commission*, 136 Ill. 2d 192, 219-226 (1989) [Commission rules establishing a test year could not be avoided by allowing a multiple year approach]. Unlike the Commission's rules in the *BPI* case, *supra*, the Commission has no authority to alter the statute. *Illini Coach Co. v. Illinois Greyhound Lines Co.*, 403 Ill. 21, 29-30 (1949) [the Commission

has no authority to alter statutory timelimits]. Instead, the utility has the statutory burden to reprove the agreement's prudence for each year it is in effect.

In addition, North Shore' reliance on the Commission's decision in Docket No. 00-0719 is misplaced because evidence was presented in this case that was not produced by North Shore or considered by the Commission in Docket No. 00-0719. Such new evidence is significant enough to change the Commission's findings and orders in Docket No. 00-0719 regarding the prudence of North Shore's decision to enter into the GPAA.

The most significant evidence admitted in the instant docket, but was not produced by North Shore in Docket No. 00-0719, is the Aruba analysis and the GPAA analysis contained in Wear Cross #1. Neither document was made available to Staff in Docket No. 00-0719, despite the request for all analyses used to select each new or renegotiated firm supply contracts entered into in a reconciliation period (which would have included the GPAA agreement). The request was part of in Staff's generic data request in 00-0719 (Staff Ex. 8 at 5). Another fact that was not known in the 00-0719 proceeding, and that also has a high potential for impacting the review of North Shore's decision, was the strategic partnership between the Enron corporate family and the Peoples Energy corporate family. The strategic partnership between the Peoples Energy and Enron corporate families provides a reason why North Shore placed little reliance on either of the two economic analyses⁵ of the GPAA that were performed prior to signing. The strategic partnership was entered into as part of a profit making venture for the two companies, and it appears that the GPAA was a key part of that partnership. Given the two families desire to have a strategic partnership, it is easy to conclude that

⁵ The Aruba analysis and North Shore Wear Cross Exhibit #1.

little consideration was given to the impact the GPAA would have on ratepayers. This partnership existed during the 2000 reconciliation period and is discussed extensively in Staff's Initial Brief at pages 3-9 and need not be discussed further here.

(c) Collectively, North Shore's Evaluation of the GPAA Fails to Demonstrate its Prudence

i. The Five Objectives

The primary method, by which North Shore attempts to demonstrate that its decision to enter into the GPAA was prudent, is the claim that the GPAA met five objectives (NS IB at 31-32). Staff extensively discussed these in its Initial Brief at pages 15-22, and will reply below only to specific arguments in North Shore's Initial Brief.

a. Market-Based Pricing Without Demand Charges

At page 32 of its Initial Brief, North Shore argues that "The GPAA's market-based commodity pricing terms with no reservation or demand charges was a benefit to Respondent." Reducing or avoiding demand charges reduces costs and, in fact, it is one factor considered in Staff's GPAA analysis (Staff Ex. 3 at 16 and 24-25). However, it is only one factor. By itself, this objective is not informative about the total cost of the contract. More importantly, North Shore misstates (NS IB at 32) that it has no reservation or demand charges under the GPAA because North Shore continued to pay the pipeline demand charges. North Shore paid citygate prices for gas, while it also surrendered control of some of its pipeline capacity. Further, North Shore also never broke down the GPAA's components in way that allows the Commission to determine that North Shore is not paying a demand charge. Therefore, those transportation demand charges are a "reservation or demand" charge under the GPAA (Staff Ex. 2 at 20).

b. Flexible Pricing

At page 33, North Shore's IB notes that "Under the GPAA, parties could agree to alternative pricing... instead of the otherwise applicable index price." Article 4.2a of the GPAA allowed North Shore to negotiate prices at other than those specified elsewhere in the contract. However, North Shore did not show that this represented a benefit beyond what it would have had in the absence of the GPAA, that is, this does not demonstrate that this contract term provided any more flexibility than smaller volume and shorter term contracts (Staff IB at 20). Further, the likelihood that this contract term provided benefits to North Shore is limited by the fact that any change in pricing required agreement from Enron.⁶ It is not reasonable to expect Enron to agree to any change that did not improve Enron's expected revenues or provide it more price protection (Staff Ex. 3 at 12-13). Therefore, North Shore did not receive the benefit it claims to have received under this objective.

c. Operational Flexibility

North Shore argues that the GPAA provided flexibility to meet changes in weather and fluctuations in day-to-day requirements. North Shore supports this statement by discussing the flexibility provided by baseload, DIQ, SIQ, and the sellback provision.

⁶ See Article 4.2a stating that "...Buyer may, at any time and from time to time in accordance with the provision entitled "Flexible Pricing" in the Master Agreement, request different pricing for all or any portion of the quantities set forth in Section 2.1" (ICC Staff Ex. 2.0, Attach. 1 at 9). Under the heading "Flexible Pricing" in Appendix f, it states "The price for all Gas for which a Flexible Price has not been agreed by the Parties shall be the original Contract Price applicable to the Transaction." (*Id.*, at App. 1, p. "1"-3; p. 53 of the pdf copy).

At page 35 of its Initial Brief, North Shore states that the combination of baseload, SIQ, and DIQ gave it sufficient operational flexibility to North Shore. Staff reiterates its position, expressed at page 21 of its Initial Brief, that North Shore fails to demonstrate that the alleged flexibility of the GPAA reached the level North Shore had previous to the GPAA (or could have had absent the contract). Previous to the GPAA, North Shore entered into multiple contracts with multiple vendors for various types of supply and transportation to obtain gas at the citygate. While the GPAA provided three ways to purchase gas, and other different pricing arrangements, but the bottom line is that North Shore was buying from only one source – Enron.

North Shore also offers the sellback term as an example of flexibility. At page 35-37, North Shore offers three reasons why sellbacks provide substantial benefits. First, resales are “...substantially affected by variables over which Respondent has little or no control.” North Shore includes weather, customer usage and transport customers’ deliveries among these factors. The second reason is that an “...oversupply situation creates significant and serious business issues.” These include pipeline penalties. Third, “...an oversupply must be managed...to avoid overpressure situations...” and that “Disposing of or moving to an alternate market up to 10,000 MMBtu of gas on a day when the market is oversupplied is a formidable task” (NS IB at 37).”

Staff, however, noted that GPAA (particularly the SIQ term) forced North Shore to dispose of excess gas on the open market. North Shore nowhere demonstrated that (or even examined whether) self marketing was expected to be inferior to the resale term (Staff Ex. 3 at 23 and Staff Ex. 7 at 25-27). That means that the re-sale term only

has value because of other terms in the GPAA. The resale term is not independently valuable.

At page 36 of its Initial Brief, North Shore defends the price structure for the sellbacks by noting that a "...slight discount [to the daily market indices] was not a penalty..." However, this statement is unsupported and is inconsistent with the pricing for the DIQ (*i.e.*, purchasing gas at the daily market index). North Shore agreed to pay the full daily market index price, without a discount, when it purchases according to the DIQ, while simultaneously arguing that the discount reflects the lower value it would receive by selling the gas on short notice. See Staff Ex. 2, Attach. 1 – GPAA Agreement at 9 – Art. 4.1(c).

d. Preserve Value of Transportation

On pages 33-35 of its Initial Brief, North Shore argues that the GPAA met its objective to preserve the value of its transport capacity. In other words, North Shore asserts that the GPAA served as a hedge against a falling basis. First, as is true with all of its claimed objectives, it is not apparent that it really was pursuing this objective at the time of negotiations (Staff Ex. 3 at 11). Second, its initial attempt to support this objective showed that it was not accomplished (Staff Ex. 3 at 17-20).⁷ Third, North Shore relies upon the CERA data, but it cannot substantiate that the CERA data was reviewed by North Shore personnel or played a part in the GPAA negotiations (Staff Ex. 7 at 15-16 and 18-20). Fourth, even if the GPAA did "preserve the value of its transportation," this objective does not address, by itself, all the effects that the GPAA had on gas costs. These include the effects of the SIQ and the re-pricing terms, as well

⁷ Revised calculations are presented in Exhibit 7.04 and a mathematical error admitted in Staff Ex. 11 at 10-11. The error does not change the results.

as the lost revenue due to the release of pipeline capacity to Enron (Staff Ex. 3 at 14-16).

North Shore asserts that "...available information, such as analyses by the Cambridge Energy Research Associates ("CERA") ...showed that basis likely would be declining." (NS IB at 33-34). The statement reads as if North Shore had relied upon the CERA studies at the time the GPAA was negotiated. That is not the case. Based on a data request response, Dr. Rearden drew the conclusion that "it appears the CERA report played no part in the negotiations with Enron." (Staff Ex. 7 at 19). North Shore did not respond to the testimony, thereby raising a presumption in Staff's favor (*Belding v. Belding*, 358 Ill. 216, 220-21, 192 N.E. 917 (1934)). Further, if it did not rely upon the CERA data at the time, then North Shore has failed to prove that it reviewed any data demonstrating that it evaluated the probability of the basis differential dropping over the term of the GPAA. As such, no weight should be accorded North Shore's hindsight reliance on the CERA studies.

There are three reasons to accord little to no weight to the CERA study. First, in attempting to show that the basis differential for the GPAA was dropping, North Shore only looks at the projected basis differential at the citygate and fails to look at what was happening to the projected basis differentials for the locations that supply Chicago. Second, the locations analyzed by North Shore do not conform to the field locations applicable to the GPAA (Staff Ex. 11 at 7 and 11-13). Third, little weight should be accorded the CERA data because it looks at basis differentials in regions and not at delivery points that are comparable to those used by North Shore. These three flaws will be addressed in turn.

North Shore fails to look at what was happening to the projected basis differentials for the locations that supply Chicago. In its testimony, North Shore examined the scenarios in the CERA study (Staff Ex. 11 at 11-12). The scenarios charted the basis differentials between the Regional Markets (*i.e.*, Alberta, Rocky Mountain, and Midcontinent, as they are identified in "At the Crossroads of Competition: A Future of Midwest Gas and Power Markets") and Chicago (NS Ex. F at 38-41). Based on its analysis of the CERA study, North Shore claims that the basis differential between Henry Hub⁸ and Chicago was known to be falling.

The flaw in North Shore analysis is that it failed to look at its alternative to the GPAA – purchasing gas in the field and transporting it to Chicago. To determine the benefit of its decision, North Shore must compare the GPAA to the manner in which North Shore has historically purchased gas – purchasing it from the field through a number of contracts. When looking at the CERA scenarios, Mr. Graves analysis fails to evaluate their different effects on the costs to purchase gas in the field. He simply uses the Aruba Analysis data for the field prices for all the scenarios (Staff Ex. 11 at 6-7). To use each scenario correctly, North Shore has to look at the projected basis differential at all locations where it could, would or has purchased gas if it was going to purchase gas in the field in each scenario. The CERA study contains information that might allow North Shore to perform such an analysis but North Shore failed to do the additional mathematical analysis to make the comparison apt. North Shore used only the price differential for Henry Hub to Chicago but did not analyze alternative regions from which North Shore could receive gas, such as the price differential between Alberta (Canada)

⁸ Henry Hub is located in Louisiana. NS Ex. C, Ex. #2.

and Chicago, or Midcontinent (Iowa) and Chicago⁹ (Staff Ex. 11 at 11-13). Thus, North Shore's analysis presented a skewed view of the CERA study data and, consequently, a skewed view of the likelihood that the basis differentials between Chicago and other supply basins would sharply decline (*Id.*).

In addition, North Shore uses the CERA study as a counter to Staff's analysis of the GPAA. Staff's analysis compares the citygate price to the price of purchasing gas in the field to determine the prudence of entering into the GPAA (Staff IB at 22 and 30-32; Staff Ex. 3 at 17-20; Staff Ex. 7 at 12-15). For the CERA study to properly respond, or be comparable to Staff's analysis of the GPAA, it should compare the citygate price to the price of purchasing gas in the field. North Shore failed to make such a comparison and should be accorded less weight, if not disregarded for the flaws discussed herein.

The second and third flaws relate to the actual data that were used. The scenarios contained in the CERA study were not delivery points, but were regional markets. Dr. Rearden explains that, since the locations are broad regions and not individual delivery points, the CERA model needed to be developed further to have any probative value (Staff Ex. 11 at 12-13). Specifically, North Shore needed to either modify the scenarios to match field locations that apply to the GPAA, or to develop a relationship between the regional market and a delivery point on North Shore's leased interstate pipeline service (*Id.*) In addition, the GPAA pre-determined the baseload quantity over the course of the contract at the beginning, and those volumes varied by month. However, the CERA data were annual and could not contribute important

⁹ Staff did not analyze these other regions because, as noted in the following paragraph, Staff does not believe the CERA study data is compatible with the parameters of the GPAA since it needs to be manipulated to create a relationship between regional markets and individual delivery points.

information about gas costs (Staff Ex. 7 at 19). Thus, the CERA study data are not sufficient, without additional analysis well beyond what North Shore has performed, for a reasonable person to conclude that basis differentials would fall enough over the term of the GPAA to make the GPAA a prudent decision.

In discussing how likely that the “basis differential” to Chicago would precipitously fall, North Shore states that “On net, it appeared there would be at least 1.0 Bcf per day increase in a market that already had concerns about excess capacity.” (NS IB at 34-35). Even if one assumes that the effects that this excess capacity has on markets is what North Shore claims for it, it does not follow that North Shore demonstrated that its response was prudent. The presentation that North Shore has made simply did not consider its alternatives to the GPAA. In particular, Staff offered the idea that it could have entered into shorter term transport contracts to take advantage of transportation’s falling value. Indeed, Staff witness Anderson meticulously detailed the alternatives open to North Shore to respond to a declining basis (Staff Ex. 2 at 16-20). North Shore did not address them in its testimony. It cannot claim it has demonstrated prudence for the GPAA when it did not consider alternatives to the GPAA to address its “objectives” (Staff Ex. 2 at 9).

ii. North Shore Cannot Support its Premise That the Discount or Credit is Sufficient to Make the GPAA Prudent

At the end of the first paragraph on page 17 of its Initial Brief, North Shore states that the 2¢ discount (or credit) “...guaranteed value for its transportation assets and offset the expected decline in basis.” However, Staff showed that the credit was too low, all other things equal, since it determined that the GPAA raised gas costs, *i.e.*, only a higher credit could keep gas costs from rising (Staff Ex. 3 at 16-26 and Staff Ex. 7 at

11-29, see also NS Ex. E at 9). Again, Staff strongly emphasizes that a discussion about whether the discount (or credit) is large enough to make the GPAA prudent only makes sense when the all contract terms are aggregated and analyzed simultaneously (Staff Ex. 3 at 13-16). Staff's analysis of the seven factors comprising the GPAA was a review of the contract in the aggregate and was based on the contract terms as they were written. This analysis showed that the GPAA led to an increase in gas costs (Staff Ex. 3 at 16-27 and Staff Ex. 7 at 16-29). A higher credit, all else being held constant, could have changed this equation.

iii North Shore's Criticisms of Staff's Analysis are Baseless

The evidence North Shore offers to show that its decision to enter into the GPAA was prudent fails to look at the whole contract. Staff accounted for all factors in the relative value of the GPAA. Not only did North Shore not evaluate all factors, but also it did not even propose a competing value to all of Staff's values. In particular, the factors not empirically evaluated by North Shore are the SIQ, the re-pricing terms, and the transportation capacity that was released to Enron. North Shore only seriously treats with the field delivered price versus the citygate price comparison. Mr. Graves proposed an alternative view of this comparison. In his comparison, North Shore could legitimately suggest that there was potential for the field delivered price to fall below the Daily Midpoint Price for Citygate.¹⁰ North Shore, however, cannot hold this projection out as an evaluation of the contract as a whole, since it never estimated the effect other factors of the contract would have on gas costs.

¹⁰ Staff, of course, believes that the data that North Shore originally provided in this docket do not support that this is true. Staff also believes that the second attempt of North Shore to address the issue (the CERA data analyzed by Mr. Graves) had enough problems to undermine its conclusions there as well.

North Shore attempts to undermine Staff's analysis in two ways. First, it tries to inject uncertainty about Staff's specific estimates for the value of individual contract elements. Second, North Shore tries to also sow uncertainty about the whole process that Staff used in estimating specific values and aggregating them to evaluate the contract as a whole. This Brief will take these two points *in seriatim*.

a. North Shore' has not proven that Benefits that are Non-Quantifiable Support the Prudence of the GPAA

With respect to the latter strategy, North Shore makes a series of arguments in which it contends that the GPAA provides benefits that Staff's analysis did not address nor could be addressed (NS IB at 40-41). Staff confronted these alleged non-quantifiable benefits in its Initial Brief and responds to North Shore's argument below. In most instances, the benefits North Shore identifies do not possess characteristics that are easily quantified.

North Shore' makes the following series of arguments -- (1) that the contract with Enron allowed "...discretionary daily purchase activity to remain hidden from the larger market" (NS IB at 40-41); (2) that the sellback provision allows North Shore to ". . . turn to a single supplier for daily sales activity that may be required for operational reasons. . . ." (*Id.*); (3) that the GPAA ". . . preserved reliability of Respondent's supply. . ." (*id.*); and (4) that the GPAA ". . . increased efficiency and information" (*Id.*). For various reasons, it is difficult to place a value upon these items. Therefore, the Commission could value these items for purposes of this case as zero. Since market participants have not previously, and profitably, developed methods to deal with factors as nebulous as these, this lack of precedence might mean that markets assign small value to the factor. Similarly, North Shore has not determined that these factors have any specific monetary

benefit, such that they offset the very real and direct gas costs stemming from the GPAA (Staff Ex. 7 at 11-13) which is North Shore's statutory burden. Accordingly, these factors should be given no weight in determining the benefits of the GPAA.

Whatever the claimed anomalous benefits, such benefits do not overcome the detriment to the ratepayers which arose from the gas purchases under the GPAA. The Commission could even find that, by striving for anomalous benefits, the GPAA is shown to be imprudent in the matters that are subject to this annual reconciliation of gas purchases. Although the GPAA has to be examined as a whole for purposes of this case, not every matter in the GPAA has an effect on the prudence of gas purchases.

b. North Shore' Critique of Dr. Rearden's Analysis of Cost Disallowance Casts Doubt Upon its own Data

In its attempt to show that Dr. Rearden's analysis was flawed, North Shore tries to identify studies, other than an economic analysis, that would support its decision to enter into the GPAA, highlights that Dr. Rearden's analysis is a single scenario, and claims that the Aruba Analysis supports its position. As discussed below, the other studies North Shore relies upon are not applicable to the GPAA, Dr. Rearden's analysis is based on data from North Shore, and North Shore's interpretation of the Aruba Analysis misrepresents its results.

On page 45 of its Initial Brief, North Shore states that "Mr. Graves testified that while the GPAA's benefit to North Shore's customers could not have been a certainty, there was considerable evidence...suggesting the plausibility...of a steep decline in Chicago-area basis."¹¹ While the Company produced documents that might lead some individuals to conclude that a fall in basis differential was possible, North Shore cannot

¹¹ Resulting from Mr. Graves' analysis of CERA and PIRA studies.

document that it viewed the likelihood for such a fall to be sufficiently likely to warrant a contract, such as the GPAA, over some other strategy (Staff Ex. 7 at 15-19). Further, it is telling that North Shore did not present the data upon which Mr. Graves relies in its direct testimony, but only provided it in rebuttal to Dr. Rearden's analysis in his Exhibit 3. As discussed *earlier in this Brief*, pp. 19-20, if North Shore did not rely upon the Graves' CERA data at the time it negotiated the GPAA, then such testimony is merely a hindsight opinion, and North Shore has failed to prove that it reviewed any data demonstrating a meaningful evaluation of the probability of the dropping of the basis differential over the term of the GPAA. As such, no weight can be accorded North Shore's reliance on the CERA and PIRA studies.

North Shore further argues that "...to pass judgment on the GPAA's merits at the time it was negotiated and executed using only Dr. Rearden's single scenario would be unreasonable." (NS IB at 45). This statement ignores two important points. First, the scenario was developed by North Shore and presented to the Commission in discovery responses and testimony as a demonstration of the prudence of the GPAA, even though the data in fact shows the imprudence of the GPAA (Staff Ex. 7 at 8). North Shore documented this scenario by developing the data especially to evaluate the GPAA. (NS Ex. C at 7-8). North Shore cannot now claim that this data set is neither relevant to this issue nor part of its thinking at the time.

In footnote 44, on page 45 of its Initial Brief, North Shore represents that it did not consider the Aruba Analysis in making its decision to enter the GPAA, but that the results of the Aruba Analysis are consistent with North Shore witness Graves' analysis. This is a gross misrepresentation of the record evidence. The Aruba Analysis shows

the GPAA to raise gas costs to ratepayers, according to its author, Roy Rodriguez. He stated in his deposition that “It appears by looking at this based on a low case, it was showing that the proposed Chicago index minus three cents versus the straight weighted average delivered price -- ... -- it’s coming up as a higher cost.” (Staff Ex. 7 at 7-8, quoting the Deposition of Roy Rodriguez at 56). Again, this part of the Aruba Analysis does not even account for the deleterious effects of the SIQ and repricing terms.

In addressing the Company’s rebuttal to Staff’s testimony, North Shore claims that “Dr. Rearden’s analysis was very sensitive to assumptions of future basis projections.” (NS IB at 45). As explained numerous times by Staff, Dr. Rearden’s analysis simply used the only applicable data set known to have been considered by North Shore before it signed the GPAA, and it was the data set used by Mr. Rodriguez. This same criticism could have been leveled at North Shore before it signed the GPAA. Further, not only did the Aruba analysis rely upon a single scenario, but North Shore ignored any discovered numerical analysis of the future effects of the GPAA. It is the prudence of North Shore in entering the GPAA, and not the prudence of Staff’s quantitative analysis which is at issue in this cause.

iv. North Shore’s Reliance on Illinois Power is Misplaced

On pages 41 and 42 of its Initial Brief, North Shore states that Staff’s and GCI’s claims of imprudence of the GPAA and consequential cost disallowances are in direct conflict to the Commission’s decision in Docket No. 00-0719 and is an unsupported departure from past practices. In making this argument, North Shore relies upon the *Illinois Power v. ICC*, 339 Ill. App. 3d 425 (5th Dist. 2003). Of course, there are no past

practices related to annual reconciliation of multi-year gas purchase contracts at this Commission. The GPAA is itself a change in policy.

Similarly, North Shore incorrectly states the holding of the *Illinois Power Company v. Illinois Commerce Commission* (“*Illinois Power*”), 339 Ill. App. 3d 425 (5th Dist. 2003) to be that “the Commission cannot create a new standard and apply it retroactively in assessing the prudence of a utility’s gas purchases.” NS IB at 19. A closer review of the *Illinois Power* decision finds that the court held that the Commission’s “finding that a PVRR analysis was required in the instant case was not supported by substantial evidence.” *Illinois Power*, 339 Ill. App. 3d at 440.

The *Illinois Power* case involved the denial of the costs of replacement gas in the PGA case because the retirement of the Freeburg propane plant was not shown to be prudent. In its review the Commission held that Illinois Power should have performed a present-value-of-future-revenue-requirements (“PVRR”) analysis “comparing the costs . . . of continuing to operate the Freeburg plant versus the costs . . . of retiring the facility and replacing its capacity with alternative sources” in determining whether to retire the plant. *Illinois Power, supra*, 339 Ill. App. 3d at 433. The crux of the Court’s decision was that

“Section 9-220(a) of the Act does not set forth any specific type of analysis that a utility must perform to show its costs are prudent . . . that the Commission did not point to any prior decisions or any other sources of a ‘standard of care’ that should have led a reasonable person to conclude that a PVRR analysis was a necessary component of prudent decision-making . . . and that Illinois Power had not performed a PVRR analysis for the previous four propane plants it had retired.”
Illinois Power, 339 Ill. App. 3d at 439.

Other factors the *Illinois Power* Court considered were other orders in which the Commission had found a utility's actions prudent while not requiring an economic analysis be performed (*Illinois Power*, 339 Ill. App. 3d at 435-37), that the Commission had previously approved the retirement of four propane plants by Illinois Power without requiring an economic analysis (at 439), that Staff failed to show what relevant differences in circumstances existed between the first four propane plants and the Freeburg propane plant that necessitated an economic analysis be performed for the Freeburg plant (at 438), and that the Commission had committed an error in its review of other factors presented by Illinois Power to demonstrate the prudence of retiring the Freeport plant (at 440 (finding that the Commission had looked at the other factors in isolation rather than collectively)). Based on these factors, the *Illinois Power* Court concluded that the Commission had not previously required a utility, acting as a reasonable person, to perform a PVRR analysis in evaluating whether to retire a plant, and the change to requiring a PVRR analysis was not supported by substantial evidence. In comparing the *Illinois Power* Court's decision to the instant case, it is evident that North Shore has misconstrued the finding of the *Illinois Power* decision.

The enormous difference between the present cause and the *Illinois Power* case is evident. Propane plants have been around for many decades, and issues concerning their retirement had been examined before as the Court found in reversing the Commission. The multi-year GPAA is a novelty which North Shore negotiated over the summer of 1999 and signed on September 16, 1999.¹² There are no claims that North Shore's historical methods of purchasing gas were unsafe, obsolescent, or imprudent. North Shore ignores that the prudence of its decision to enter into the GPAA arises for

¹² June to September 1999 (NS Ex. C, pp.6-10); novelty (*Id.*, p.3, lines 38-39).

annual examination under Section 9-220 of the Act, *supra*, and that it bears the burden of proof for every year. *Cf. Rockford Life Insurance Co. v. Department of Revenue*, 112 Ill. 2d 174, 185-6 (1986) [except in the cases of fraud or injustice, a public body will not be estopped from reexamining an issue and coming to a different conclusion].

North Shore seeks to turn *Illinois Power* on its head. *Illinois Power* forbade the requirement of a specific method of economic study. *Illinois Power* did not bar the use of all economic studies in PGA cases. Staff's position is that a prudent utility would have examined the economics of such a long-term, complicated contract in some rigorous way before entering into such an agreement (assuming the prudence of the agreement in a Section 9-220 of the Act, *supra*, sense was a consideration in negotiating the GPAA at all). Despite the late discovery of two contemporary economic studies by Peoples Energy or North Shore, North Shore according to its own testimony did not examine the economic prudence of the GPAA before entering into the agreement. There is no presumption in Section 9-220 reconciliation cases that any action taken by a public utility is prudent necessarily. Yet North Shore argues as if the GPAA is presumed prudent.

Moreover, North Shore's interpretation of the *Illinois Power* decision seeks to limit the manner in which Staff experts can analyze an issue to only those methods it has performed in the past. The statute imposes no such limitation. If North Shore's interpretation is accepted, it would directly conflict with Illinois caselaw, which allows an expert to "offer knowledge and the application of science beyond the ken of the average juror." *Hiscott v. Peters*, 324 Ill. App. 3d 114 (2nd Dist. 2001). Taking North Shore's interpretation to its logical conclusion, a utility could argue that the Commission has only

performed X type of economic analysis in previous cases and prevent Staff from using Z type of economic analysis, even if economic analysis Z is generally accepted in the field.

Such an argument is also fails to account for the fact that each expert will have a different approach to analyzing an issue. Experts are used for a reason, and their opinions are not always the same or based on similar analysis. When opinions of expert witnesses are in disagreement, the judge determines which is of greater weight by considering “the reasons given for the conclusion and the factual details marshaled to support it.” *Mullen v. General Motors Corp.*, 32 Ill. App. 3d 122 (1st Dist. 1975). In weighing the testimony, the witnesses qualifications, the quality of their testimony, and their credibility are to be considered. *Hall v. National Freight, Inc.*, 264 Ill. App. 3d 412 (1st Dist. 1994); and *Rural Electric Convenience Cooperative Co. v. ICC*, 109 Ill. App. 3d 243 (4th Dist. 1982). Therefore, the variety of the approaches is not determinative of whether the GPAA can be mathematically analyzed. If anything, the variety of mathematical approaches only confirms that the GPAA can be analyzed mathematically, and the only question that remains is which opinion or study is accorded greater weight.

3. Gas Charge Adjustments due to the Imprudent use of Storage in December 2000

(a) North Shore has presented no specific evidence to justify its actions

In its Initial Brief, North Shore makes two primary arguments supporting its position that it prudently used Manlove field. First, North Shore argues that its use was driven by operational factors (NS IB at 47-48). Second, North Shore argues that Staff’s analysis was a hindsight review (*Id.* at 48-50). Both arguments are incorrect.

North Shore has failed to explain how its net injection of gas into Manlove in December 2000 was prudent for ratepayers from either a supply standpoint or an economic standpoint. Staff has shown that this decision by North Shore could have resulted from the need by Peoples Gas to offset the large withdrawal volumes by third party customers. North Shore argues that Staff fails to account for four operational factors: (1) North Shore must purchase and schedule supplies over three-day weekends (NS IB at 47); (2) whenever weather conditions varied from the forecast, Respondent would have to use storage from Manlove (*id.* at 48); (3) customers change their deliveries (*id.*); and (4) industrial customers' demands change (*id.*). The failure in analysis is not one of Staff's; it is North Shore's. North Shore failed to support its claims with any evidence for the existence of these operational factors during the reconciliation period. These are hindsight arguments without factual support for these particular transactions in December 2000.

Not only does North Shore have the burden of proof to demonstrate that their decisions to use Manlove Field was prudent, but they also control the information needed to support their decisions. In other words, North Shore has all the information to prove their theories concerning their operations. North Shore, however, has failed to provide specific instances when these operational factors occurred. Moreover, even assuming that any of the claims are valid, North Shore failed to quantify the extent to which the operational factors reduced their planned withdrawals. Finally, North Shore, as a gas utility, must regularly plan around these operational factors. Other Illinois gas utilities satisfactorily resolved these same issues without experiencing the problems

faced by North Shore (Staff. Ex. 10 at 8-9). North Shore has given no evidence as to why its situation was unique, although its actions were.

The record clearly establishes that North Shore planned to withdraw gas in December 2000. However, the Company actually injected gas into Manlove during December 2000 (Staff Ex. 6.0, p. 5). This activity is counter to logic given that December 2000 was a period of record cold temperatures and record high gas prices (Staff Ex. 10.0, p. 8). Finally, Staff indicated that injections into storage in December is not normal and that a utility would even have less reason for injecting gas into storage given the circumstances facing it in December 2000 (Staff Ex. 6.0, p. 6). North Shore's actions were not reasonable. North Shore failed to provide any specific, evidentiary support for its excuses.¹³ Therefore, Staff argues that North Shore's actions in December 2000 were imprudent.

(b) North Shore has inserted extraneous material into its Initial Brief

North Shore accuses Staff of using hindsight review to reach its conclusions. (*Id.* at 48-50). In particular, the Initial Brief quotes from Dr. Rearden's Additional Direct and Rebuttal Testimony in the **Peoples Gas docket**. Dr. Rearden neither gave such testimony nor made a similar statement in the **North Shore docket**.

Further, Staff does not use hindsight, since the crux of Staff's position is that North Shore planned to withdraw a certain amount from Manlove to supply ratepayers during December 2000, but instead, during a period of record cold, injected into Manlove on a net basis. North Shore's action implies that it had to support those injections with gas from the gas market. Under the conditions at the time (very high

¹³ North Shore's behavior does make sense by noting that North Shore's parent profited from the non-tariff transactions.

spot prices), those additional purchases cost more than the gas in the field owned by North Shore. Neither operational considerations nor economic considerations show the prudence of North Shore's behavior.

North Shore criticizes Staff's adjustment by charging that Staff was "...treating Manlove activity as an economic exercise..." (NS IB at 49) This is not true. Staff argued that North Shore withdrew less than it planned when very cold temperatures hit. The proposed adjustment is simply the way Staff believes is the best method to assess the additional costs imposed by North Shore's clearly imprudent behavior. Staff chose the highest price because there was no evidence that North Shore could not identify purchases likely to be highest price on a given day. Staff's method measures the actual harm to consumers caused by North Shore's imprudent actions.

At page 49-50 of its Brief, North Shore raises its argument that Staff seeks to impose a LIFO rule on storage usage. However, Staff did not and does not seek to impose such a rule. LIFO is just the way that Staff valued the gas in storage that should have been delivered to ratepayers during December 2000 but was not. In other words, it was not part of an operational recommendation to identify the imprudence, but part of the adjustment calculation of the damage caused by the imprudence.¹⁴

The adjustment is calculated by subtracting the costs for the market purchases that supported North Shore's injections into Manlove Field during December 2000. The value of the gas that would have been withdrawn is added back into the PGA. That gas is valued at the LIFO price. The difference is the adjustment.

¹⁴ In Dr. Rearden's additional direct and rebuttal testimony, he inadvertently quoted the Peoples Gas LIFO price. However, in the actual calculations, the North Shore figure was used. See Staff Ex. 7.05.

In all adjustments, Staff followed a two-step process. First, prudence is assessed. Second, given imprudence, the higher cost imposed upon ratepayers is calculated. In the case of the imprudent storage usage adjustment, the cost to purchase the spot market gas that supports the imprudent storage usage is subtracted from PGA costs. But the value of the stored gas needs to be returned to the PGA to complete the adjustment. The value that Staff attached to it was LIFO. In spite of the imprudence of the usage, no additional economic harm can be calculated when spot prices fall below LIFO. But nowhere in this docket, has Staff advocated a mechanistic rule to govern storage withdrawals that depends upon LIFO (Staff Ex. 11 at 21-23).

C. RECOMMENDATIONS

1. Docket No. 00-0719 Should be Reopened Because Numerous Adjustments Proposed in the Instant Docket Were Not Considered

North Shore argues that Docket No. 00-0719 cannot be reopened because Staff has not met the requirements of Section 200.900 of the Commission's Rules of Practice (NS IB at 51). There is an overwhelming amount of information in the record impacting adjustments to the Gas Charge that were never part of the record in Docket No. 00-0719: facts that impact adjustments related to the GPAA and storage field operations. These adjustments are related to transactions or operations that were also in effect in the 2000 reconciliation period. The underlying facts, however, were never provided to Staff in Docket No. 00-0719, despite data requests seeking such documents, and were discovered during the review of numerous documents produced in Docket No. 01-0707 after the reopening of these dockets.

The requirement for reopening a docket is set forth in Section 200.900, which states:

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

(83 Illinois Administrative Code 200.900).

There are several new facts that were not provided or considered in Docket No. 00-0719 that would change the results of that docket. Indeed, the majority of the discovery information discussed in the instant proceeding, which was not available for consideration in Docket No. 00-0719, could result in a finding that the Company did not purchase gas supplies prudently in that proceeding.

Here is a review of the most significant facts that came to light in the instant proceeding through the massive production of documents in Docket No. 01-0707 (*i.e.*, 106,000+ paper documents and 75 GB of electronic documents), most of which were not disclosed in Docket No. 00-0719. There is the Aruba analysis and the GPAA analysis contained in Wear Cross #1. Both documents were spreadsheets developed by employees of either Peoples Energy or North Shore that analyzed the GPAA agreement. Neither document were previously available to Staff, despite the request in Staff's generic data request in 00-0719 for all analyses used to select each new or renegotiated firm supply contracts entered into the reconciliation period (which would have included the GPAA agreement in Docket No. 00-0719) (Staff Ex. 8 at 5).

Another fact that was not known during the 00-0719 proceeding, which also has a high potential for impacting the adjustment in that case, was the strategic partnership

between the Enron corporate family and the Peoples Energy corporate family. This partnership, which also existed during the 2000 reconciliation period, is discussed extensively in Staff's Initial Brief, pages 3 through 5 and 6 through 9, and need not be discussed further here. Suffice it to say, the overall strategic partnership not only impacted Peoples Gas, but also impacted North Shore, since North Shore also entered into a GPAA with Enron NA and was impacted by imprudent operations of Manlove field.

Finally, it is important to note that North Shore witness Wear provided the Company's testimony in Docket No. 00-0719 regarding the gas supply and capacity procurement procedures, as he did for the instant proceeding (*Commission v. North Shore Gas Co.*, Docket No. 00-0719, Order of Jan. 24, 2002 at 2). The instant proceeding, however, shows that Mr. Wear is not a credible witness (see AG IB at 34-39). The loss of credibility of the Company's primary witness in the instant proceeding also calls into question the validity of his testimony and any discovery responses he provided or sponsored in Docket No. 00-0719, and also any other testimony he has provided before the Commission, especially in view of the Peoples Energy-ENRON alliance. Staff considers the credibility of North Shore's primary witness and any related discovery as a relevant change in fact that supports the reopening of Docket No. 00-0719.

Accordingly, the above recitation of highly relevant facts, that were unknown at the time the proceeding in Docket No. 00-0719 was being conducted and ruled upon by the Commission, provides a sufficient basis to reopen Docket No. 00-0719, pursuant to 83 Ill. Adm. Code 200.900. The conditions of fact have changed from the reconciliation

period in Docket No. 00-0719. Thus, both the changed condition of facts as well as the public interest require, in Staff's Opinion, the reopening of Docket No. 00-0719.

2. North Shore's Alternative to Staff's Recommended Internal and Management Audits Does Not Sufficiently Address the Concerns Raised in the Instant Proceeding

North Shore proposes an alternative to Staff's recommendation of an internal audit and a management audit. This proposal is unacceptable to Staff, for the reasons stated below. Staff will also respond to North Shore's assertions that it has made improvements that obviate the need for an audit (NS IB at 52-54) and that the audits may unnecessarily duplicate and add costs to work being done for compliance with Sarbanes-Oxley (NS IB at 54).

North Shore addresses these two audits as if they are one recommendation. Staff wants to make clear that they are not. These are separate audits, performing separate functions that complement each other. The management audit establishes a series of internal control procedures. The internal audit evaluate those procedures on an annual basis until the Commission finds that it is no longer necessary (See Staff IB at 41-43).

Although it is unclear, it appears that North Shore proposes, as an alternative to both the internal and management audit, that it submit a report to Staff detailing actions it has taken to enhance its procedures and specifically explain how it addresses the concerns raised by Staff (NS IB at 52). Further, North Shore opines that such a proposal will allow Staff and the Commission determine if a proceeding is warranted (*Id.*).

North Shore' proposal is unsatisfactory. Based on the lack of documentation of transactions that occurred in the 2001 reconciliation period and North Shore's actions in said period, close monitoring by the Commission is warranted. There has not been a more egregious set of circumstances demonstrating both poor documentation of actions and a misuse of ratepayer assets than what has occurred here (See Staff IB, generally). Proper and sufficient recordkeeping is one of the basic methods by which the Act protects the public. 220 ILCS 5/ 4-101, 5-101 through 5-109 and 9-250. Without proper recordkeeping, it is difficult to see how any of the provisions of the Act could be exercised with any efficiency, reliability or equity. 220 ILCS 5/ 1-102. Nearly all of Staff's adjustments relate to management decisions by North Shore. A management audit and an internal audit are the most prudent actions the Commission can take to be assured, and to assure the public, that in the future North Shore will be operating prudently and as required by Illinois law.

North Shore states that it has made improvements to its processes that obviate the need for an audit even if Staff's allegations are accepted (NS IB at 52). As discussed above, in Staff's expert opinion, North Shore has lost the credibility that is needed for a utility to self-report on its own actions. Moreover, North Shore witness Zack, in his Additional Rebuttal testimony, admitted that Staff's internal audit recommendation is not unreasonable (NS Ex. G at 3). However, that internal audit needs the outside management audit to help direct the areas to be audited.

Finally, North Shore states that a management audit may unnecessarily duplicate and add costs to the work being done for Sarbanes-Oxley compliance (NS IB at 54). Although Staff is particularly concerned about weaknesses in the internal controls of

Peoples Gas' operations, a management audit goal would establish internal control procedures to prevent such occurrences at North Shore (Staff Ex. 5 at 7). If a Sarbanes-Oxley compliance audit includes an analysis of the internal controls in the Company's gas purchasing practices and gas storage activities, the only extra effort and cost to be incurred would be associated with the special report to the Commission (Staff Ex. 5 at 7).

A potential problem with the Company's offer is that the Sarbanes-Oxley Act ("S-O Act") requires financial reporting and certification for any end of year financial statements filed after November 15, 2004 (see www.sarbanes-oxley-forum.com/). Since the FY 2000 through FY 2004 reconciliation periods occurred prior to the effective date of the Sarbanes-Oxley legislation, neither the internal control weaknesses addressed by Staff during the instant proceeding nor the internal controls that North Shore put into place prior to the effective date of the S-O Act (which includes North Shore FY 2002 and FY 2003 open PGA reconciliations) will be addressed in a S-O Act mandated financial report.

Since North Shore's S-O Act offer does not provide information related to Staff's concern about internal controls, Staff's recommendation for a management audit and an annual internal audit should be approved by the Commission. In any event, if North Shore has successfully implemented the additional policies, procedures, staffing changes, and software that it discusses in its initial brief, complying with a management audit will not be a burden for North Shore.

II. CALCULATION METHODOLOGIES

On July 12, 2005, the ALJ issued a Notice requesting, in part, that each party explain “any number asserted in a party’s attached schedule.” The amount of each of Staff’s adjustments (Factor O in the Gas Charge Formula of Subsection 725.50) are identified in columns B through G in its Initial Brief, Attachment A, Schedule 5.03. The method Staff used to calculate each adjustment is the explained below.

A. Gas Purchase and Agency Agreement

Staff’s calculation methodology for the adjustment attributed to the GPAA is set forth in Appendix A (revised) attached to Staff Ex. 7.0. How the dollar value of the adjustment is decomposed is shown in Staff Ex, 7.04. The proposed adjustment is \$1,713,720 and is reflected in Appendix A, Schedule 5.03, column B, which was attached to Staff’s Initial Brief. Staff described its calculation methodology in its Initial Brief Section V.A.4 at pages 37-39.

B. Manlove Storage Field

Staff’s calculation methodology for this part of the Manlove Storage Field is set forth in Staff Ex. 7.05. The proposed adjustment is \$2,249,249 and is reflected in Appendix A, Schedule 5.03, column C, which was attached to Staff’s Initial Brief. Staff described its calculation methodology in its Initial Brief Section V.B. at pages 39-41.

III. CONCLUSION

WHEREFORE, the Staff Witnesses of the Illinois Commerce Commission respectfully requests that its adjustments and recommendations contained in its Initial Brief be adopted in their entirety, consistent with the arguments set forth above.

Respectfully Submitted,

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