STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

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| Illinois Commerce Commission<br>On Its Own Motion | )<br>)<br>) | |
| v. | )<br>) | 01-0707 |
| The Peoples Gas Light and<br>Coke Company | )<br>)<br>)<br>) | |
| Reconciliation of revenues<br>collected under fuel and gas<br>adjustment charges with actual costs. | )<br>)<br>) | |

**REPLY BRIEF**

**OF**

**THE PEOPLES GAS LIGHT AND COKE COMPANY**

**[REVISED PER ALJ'S 9/16/05 ORDER]**


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**REPLY BRIEF**
**OF**
**THE PEOPLES GAS LIGHT AND COKE COMPANY**

Pursuant to Section 200.800 of the Illinois Commerce Commission's ("Commission") Rules of Practice (83 Ill. Admin. Code Sec. 200.800) and the schedule established by the Administrative Law Judge ("ALJ") on May 5, 2005, and the ALJ's Notice dated July 12, 2005, Respondent, The Peoples Gas Light and Coke Company (the "Company" or "Peoples Gas") hereby submits its Reply Brief in the above-captioned proceeding.

This Reply Brief is in response to the initial brief of the Commission Staff Witnesses ("Staff In. Br.") and the joint initial brief of the City of Chicago, Citizens Utility Board and People of the State of Illinois, collectively the Governmental and Consumer Intervenors or "GCI" ("GCI In. Br."). Peoples Gas' Initial Brief showed the prudence of the gas costs it recovered from customers during the reconciliation year and refuted anticipated criticisms of Staff and GCI. Accordingly, this Reply Brief is limited

to responding to: (1) allegations from Staff and GCI that Peoples Gas' gas costs were tainted by lawful business transactions between non-utility subsidiaries of Peoples Energy Corporation ("Peoples Energy") and Enron North America Corporation ("ENA") and (2) specific factual statements that are unsupported by or contrary to the record.

## INTRODUCTION

In its Initial Brief, the Staff for the first time expressly advocates that this proceeding be expanded "fundamentally" beyond the scope of a Section 9-220 reconciliation to examine the business transactions of entities over which this Commission lacks jurisdiction. Indeed, as Staff stated in its Initial Brief (at p. 14): Peoples Energy's "strategic partnership with Enron *fundamentally alters* how Peoples Gas' gas costs should be reviewed during a reconciliation proceeding" (emphasis added). According to Staff, this "fundamental alteration" includes finding lawful transactions involving affiliates and third-parties imprudent to discourage utilities from, in Staff's words, attempting to "end run the Act."[1] Likewise, although previously having hinted at their desire to review such transactions as well, GCI's Initial Brief confirms that they, too, are asking for such an unprecedented review of lawful affiliate and third-party transactions.

Staff's and GCI's view of this proceeding's scope would require the Commission to expand the Public Utilities Act (the "Act") - something that the Illinois Supreme Court consistently has held is improper.[2] Moreover, the legislature has demonstrated that it knows how to prohibit transactions by regulated entities and their affiliates that are

[1] *See*, *e.g.*, Staff In. Br. at p. 84.
[2] *See*, *e.g.*, Business and Professional People for the Public Interest v. Illinois Commerce Commission, 136 Ill. 2d 192, 201 (1989); Chicago v. Illinois Commerce Com., 79 Ill. 2d 213, 217-218 (1980) (citing People ex rel. Illinois Highway Transportation Co. v. Biggs, 402 Ill. 401, 409 (1949)).

designed to evade scope of regulatory review.[3] Significantly, in the Act the legislature did not prohibit such transactions.

Rather than seeking a recommended disallowance based upon the prudence of the gas costs incurred under the GPAA, as the Act requires, Staff and GCI claim that Peoples Gas' decision to enter into the GPAA was influenced by its parent's (Peoples Energy's) interest in unrelated deals with ENA that were not subject to Commission review. In essence, Staff and GCI argue that the lawful business transactions between Peoples Energy and certain of its other non-utility subsidiaries, and ENA and certain of its subsidiaries, in and of themselves, caused the GPAA between Peoples Gas and ENA to be imprudent. Staff and GCI make this claim even though they have no direct evidence that these lawful transactions in any way influenced Peoples Gas' decision to enter into the GPAA. Significantly, without such evidence, the GPAA was nothing more than an arms-length supply agreement between the parties.

Staff's and GCI's theories are not record evidence. Nor do these theories comprise the substantial evidence that is required to uphold a Commission finding of imprudence. Further, Staff and GCI have not shown a connection between those lawful transactions and Peoples Gas' gas costs. As a result, Staff's and GCI's attempt in this reconciliation proceeding to subject these lawful transactions between Peoples Energy, ENA, and their non-utility subsidiaries, to Commission review is improper.

Staff's and GCI's emphasis upon the Enron entities ignores that most of GCI's recommended disallowance and nearly half of Staff's recommended disallowance are unrelated or questionably related to Enron. Moreover, the Staff's and GCI's claims are

[3] *See, e.g.*, Illinois Insurance Code, 215 ILCS 5/126.5(C) ("An insurer shall not, directly or indirectly . . . [e]ngage on its own behalf or through one or more affiliates in a transaction or series of transactions *designed to evade the prohibitions of this Article*.") (emphasis added).

undermined by the factual inaccuracies and statements with no support in the record, with which their Initial Briefs are replete. Finally, the attack upon the credibility of Peoples Gas' witness David Wear because he could not recall having seen or created a one-page document (Wear Cross Exhibit 15) purportedly nearly six-years old, with which he was confronted for the first time on cross-examination, is unwarranted. This particularly is the case because, as explained in Peoples Gas' Initial Brief, Wear Cross Exhibit 15 directionally supports the prudence of entering into the GPAA. In sum, as described herein and in its Initial Brief, Staff and GCI have not rebutted Peoples Gas' position that the GPAA and the other transactions at issue were prudent.

## SCHEDULES

Pursuant to the ALJ's July 12, 2005 Notice, attached is a schedule showing that, for the reasons set forth herein and in Peoples Gas' Initial Brief, Peoples Gas asserts that, except for two uncontested items, the amount of disallowance to be entered is zero. With respect to pre-existing numbers relevant to this reconciliation, Peoples Gas attaches Respondent's Exhibit 1 with its schedule.

## BURDEN OF PROOF AND LEGAL STANDARDS

In a July 12, 2005 Notice, the ALJ requested that the parties' reply briefs discuss the applicable burden of proof for the matters at issue. A discussion of the applicable burden of proof, as well as other applicable legal standards, follows.

### I. Burden of Proof

This proceeding is subject to Section 9-220(a) of the Act, which regarding burden of proof, states: "[i]n each such proceeding, the burden of proof shall be on the utility to establish the prudence of its cost of fuel, power, gas, or coal transportation purchases and

costs." 220 ILCS 5/9-220(a). Neither the Act nor the Commission's Rules of Practice elaborate upon this standard. However, the Illinois Administrative Procedure Act ("IAPA") provides: "Unless 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." 5 ILCS 100/10-15. The instant proceeding is a "contested case," as defined in the IAPA.[4]

Peoples Gas' burden under Section 9-220, therefore, is to show by a preponderance of the evidence that its gas costs were prudent. Peoples Gas is not required to show that its gas costs were lower than they would have been under alternative purchasing strategies or that its practices were superior to other utilities' practices. That Staff, intervenors or even the Commission may prefer a different approach to supply procurement does not make Peoples Gas' costs imprudent.

Here, Peoples Gas presented substantial evidence in support of the prudence of its gas costs. Having presented a *prima facie* case in support of its gas costs, the burden of going forward with the evidence shifted to Staff and intervenors. Board of Trade of the City of Chicago v. Dow Jones & Company, Inc., 108 Ill. App. 3d 681, 686 (1st Dist. 1982) ("'the burden of proof' has two aspects: (1) the burden of producing evidence as to a particular matter; and (2) the burden of persuading the trier of fact as to the existence of the fact asserted. The burden of producing evidence, which is sometimes called the burden of going forward, shifts from party to party during the course of the trial, but the burden of persuasion …does not shift.").

[4] *See* 5 ILCS 100/1-30 ("'Contested case' means an adjudicatory proceeding (not including ratemaking, rulemaking, or quasi-legislative, informational, or similar proceedings) in which the individual legal rights, duties, or privileges of a party are required by law to be determined by an agency only after an opportunity for a hearing.").

In the analogous context of a Section 9-201 rate proceeding, in which the public utility similarly bears the burden of proof, the Illinois appellate court stated: "In proceedings before the Commission, once a utility makes a showing of the costs necessary to provide service under its proposed charges, it has established a *prima facie* case. [citation omitted]. The burden then shifts to others to show that the costs incurred by the utility are unreasonable because of inefficiency or bad faith." Illinois Bell Tele. Co. v. Illinois Commerce Commission, 327 Ill. App. 3rd 768, 776, 762 N.E.2d 1117, 1124 (3rd Dist. 2002).

## II. ***Res Judicata***

While Commission decisions are not *res judicata*,[5] "a consistent and long-standing administrative interpretation cannot but have persuasive effect." Mississippi River Fuel Corp. v. Illinois Commerce Commission, 1 Ill. 2d 509, 513-514, 116 N.E.2d at 396-397 (1953) ("MRT"). In MRT, the Commission ruled that because a private company supplied natural gas from its pipelines to twenty-three companies, it was a public utility subject to the Commission's jurisdiction. The trial court affirmed the Commission's decision. The appellate court reversed. In so doing, the appellate court recognized that Commission orders were not *res judicata* such that a prior Commission order that the company was not a public utility, standing alone, was not dispositive. While not binding, however, the MRT court stated that a prior Commission order was persuasive. 1 Ill. 2d at 14, 116 N.E.2d at 397. As a result, although the Commission may not be bound by precedent, a court presumably will not ignore prior Commission decisions. Neither should the Commission.

[5] *See* Staff In. Br. at pp. 32, 73.

Further, if the Commission departs from past practice, its decision is entitled to less deference. Abbott Laboratories, Inc. v. Illinois Commerce Commission, 289 Ill. App. 3d 705, 715, 682 N.E. 2d 340, 349 (1st Dist. 1997). S*ee* Business and Professional People for the Public Interest v. Illinois Commerce Commission, 136 Ill. 2d 192, 228, 555 N.E.2d 693, 709 (1990). Moreover, the Commission cannot create and impose after the fact standards, as the Staff would have it do with respect to its GPAA adjustment as well as its off-system transaction recommendations. Illinois Power Co. v. Illinois Commerce Commission, 339 Ill. App. 3d 425, 439-440 (5th Dist. 2003).

Staff's reliance upon Illinois Commerce Commission v. Illinois Power Company, Order dated February 19, 2004, in Docket No. 01-0701, is misplaced. That case involved a swing contract that spanned both the 2000 and 2001 reconciliation periods for Illinois Power. In the 2000 reconciliation proceeding, the Commission agreed with Staff that $2000 of costs associated with this contract was imprudent. In the 2001 reconciliation proceeding, Staff argued, based upon the conclusions in the 2000 PGA order, that an additional $2000 of costs should be disallowed for the same swing contract. The Commission rejected Staff's argument, however, because Illinois Power showed that this contract resulted in savings over an alternative contract during the 2001 reconciliation period when analyzed under the same criteria used by Staff in the 2000 proceeding. In other words, this case shows the Commission rejecting an attempt by Staff to treat a single contract differently in two different reconciliation periods. Id. at 5-7.

Here, Staff is trying to do the same thing that the Commission rejected in the Illinois Power Company order: subject the same contract to different prudence analysis and criteria in different reconciliation periods. In this case Staff seeks the reversal of the

Commission's finding in the 2000 reconciliation proceeding that the costs incurred under the very same GPAA were prudent. While perhaps not *res judicata*, the Commission's order in the 2000 reconciliation case is entitled to great deference. If there is a departure from this decision, which will be drastic given that the identical contract is involved, this great deference will not attach.

## III. Scope of the Case

A Section 9-220(a) proceeding is limited to the prudence of recoverable gas costs and the accuracy of reconciling costs and revenues.[6] As to prudence, Peoples Gas' Initial Brief showed the prudence of its gas costs, as well as the propriety of its conduct in connection with other issues raised in this proceeding. Any recommended cost disallowance must be connected to the prudence of People Gas' gas costs. Disallowances should not be recommended or allowed based upon criticisms of Peoples Gas' business judgment; a finding of imprudence is required.[7]

Peoples Gas' position is not, as GCI state, "that a reconciliation proceeding is a series of very narrow tasks -- a simple review of actual purchases; a comparison of claimed costs to actual collections; and an arithmetic exercise to compute any difference between costs and collections."[8] Consistent with Section 9-220(a), Peoples Gas consistently has agreed that this reconciliation proceeding is more than an arithmetic exercise, but it is far less than a boundless review of Peoples Energy's, its subsidiaries' and affiliates' gas-related purchases and sales.

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[6] Section 9-220(a), 220 ILCS 5/9-220(a), provides: "Annually, the Commission shall initiate public hearings to determine whether the [purchased gas adjustment] clauses reflect actual costs of fuel, gas, power, or coal transportation purchased to determine whether such purchases were prudent, and to reconcile any amounts collected with the actual costs of fuel, power, gas, or coal transportation prudently purchased."

[7] *See* Staff In. Br. at p. 84 ("The Commission should find this deal to be imprudent, so as to discourage other gas utilities from establishing similar arrangements in an attempt to end run the Act.")

[8] *See* GCI In. Br. at p. 25.

While actions affecting gas costs are within the scope of the case, this does not give Staff and GCI carte blanche to seek disallowances for any reason they choose. A recommended disallowance must be based upon evidence that the challenged transaction or action adversely affected the gas charges paid by customers. Likewise, a recommended disallowance must be related to the prudence of those charges. The disallowances sought regarding, for example, enovate, the Storage Optimization Contract and the Trunkline transactions do not meet these criteria. Contrary to Staff's suggestion, Peoples Gas does not claim that "enovate's operations are outside the scope of this investigation."[9] Rather, enovate's operations are relevant only if and to the extent these operations affected recoverable gas costs – which they did not.[10]

GCI's reliance upon Business and Professional People for the Public Interest v. Illinois Commerce Commission, 171 Ill. App. 3rd 948, 525 N.E.2d 1053 (1st Dist. 1988), is misplaced.[11] In that case, the Commission approved a $70 million refund to Commonwealth Edison's ("ComEd") customers after concluding that the company's prediction of the operating capacity of a nuclear reactor placed in service during the reconciliation year was imprudent. Business and Professional People however was very different than the present case.

Initially, Business and Professional People was a fuel adjustment clause reconciliation case, meaning that the prudence of ComEd's gas charges was governed not only by Section 9-220(a) of the Act but also the federal Public Utilities Regulatory Policies Act of 1978 ("PURPA"). This difference is conspicuously absent from GCI's

[9] Staff In. Br. at p. 16; *see also* GCI In. Br. at pp. 19-20.
[10] In the context of responding to enovate recommendations, Peoples Gas accurately stated that the subject matter of the proceeding "is limited to the prudence of Respondent's gas costs that it recovered through its Gas Charge during the reconciliation year." Resp. Ex. K at p. 12.
[11] See GCI In. Br. at pp. 18-20.

discussion of the case. Under PURPA, ComEd is required to "insure maximum economies in those operations and purchases which affect the rates to which such clauses apply." This is a requirement to which Peoples Gas is not subject. It was ComEd's failure to insure these maximum economies, not just Section 9-220(a) prudence, that subjected it to the disallowance. 171 Ill. App. 3d at 958, 525 N.E.2d at 1056.

Further, when in Business and Professional People the Commission found ComEd imprudent, it did so based upon ComEd's undisputed, specific management decisions. In contrast, Staff and GCI seek to expand the prudence inquiry far beyond Peoples Gas' conduct to include lawful business transactions of its parent (Peoples Energy), other affiliates, and unrelated companies. Likewise, Staff and GCI seek to penalize Peoples Gas for conduct of these other companies of which Staff and GCI disapprove. There should be little doubt that such an expansive inquiry is far beyond the parameters of Section 9-220(a).

## IV. Prudence

In Illinois Power Co. v. Illinois Commerce Comm'n, 339 Ill. App. 3d 425, 439, 790 N.E.2d 377, 388 (5th Dist. 2003), the court made it clear that Section 9-220(a) does not set forth any specific type of analysis that a utility must perform to show its gas costs are prudent. The key factor in determining prudence is what information was available to the utility at the time it made the decisions in question. Id. at 428. If it would have been prudent for a utility to make the decisions that resulted in those gas costs, based on information available to that utility at the time of the decisions, the resulting costs are prudent even if the Commission would prefer a different decision making process.

Here, Staff has tried to impose upon Peoples Gas a more stringent standard than Section 9-220(a) "prudence." Specifically, Staff thinks that Peoples Gas' decisions and contracts should be judged by whether they are "superior" to alternatives, historical practices [12] or other utilities (Staff In. Br. at p. 37) or "no worse" (Staff In. Br. at p. 35) than other alternatives. This is erroneous. Likewise, even if Staff was correct that the GPAA was a change to Peoples Gas'contracting practices (which it was not), the test for the GPAA's propriety is prudence, not a different or more stringent standard.

## V. Recoverable Gas Costs and 83 Ill. Admin. Code Sec. 525.40(d)

The case is about recoverable gas costs. Peoples Gas agrees that "recoverable gas costs" includes crediting certain revenues pursuant to Section 525.40(d) of the Commission's rules. 83 Ill. Admin. Code Sec. 525.40(d).[13] Staff's and GCI's reading of this rule is far too broad. After Peoples Gas refuted Staff's and GCI's argument that Peoples Gas' hub revenue is derived from the use of assets that are recoverable gas costs under 525.40(d),[14] Staff and GCI now claim that the revenue of companies *other* than Peoples Gas is a recoverable gas cost under 525.40(d). This claim makes little sense and should be rejected.

In its Initial Brief, Staff states: "The transactions with Enron MW are a method to allocate value between the PEC and Enron corporate families. That value involved

[12] *See* Staff In. Br. at pp. 39-40. While Staff witness Anderson claimed he was not holding Peoples Gas to this standard (R at 864-865), Staff's initial brief perpetuates this improper standard.

[13] Section 525.40(d), in pertinent part states: "Recoverable gas costs shall be offset by the revenues derived from transactions at rates that are not subject to the Gas Charges(s) if any of the associated costs are recoverable gas costs as prescribed by subsection (a) of this Section." Subsection (a) of Section 525.40 states that costs recoverable through the Gas Charge are costs of gas, storage, transportation and other out-of-pocket direct noncommodity costs. Examples of revenues that must be credited pursuant to Section 525.40(d) are those associated with (a)off-system sales, (b) capacity releases and (c) Peoples Gas' Storage Optimization Contract ("SOC"), which involves recoverable gas costs with associated revenues that flow through the Gas Charge.

[14] *See* Peoples Gas' Initial Brief at pp. 71-75.

recoverable gas costs all of whose related revenues are to be flowed through the PGA for ratepayers' benefit."[15] The flaw in Staff's argument is that when Peoples Gas buys gas that is distributed to its customers, the purchase cost is a recoverable gas cost, which Peoples Gas recovers through its Gas Charge. Any revenue that the selling company earns from the sale does not flow through Peoples Gas' Gas Charge. Under Staff's application of Section 525.40(d), these transactions in which Peoples Gas was not involved would flow through the Gas Charge. This, of course, is not what Section 525.40(d) requires.

Peoples Gas assumes that any for-profit entity with which it does business has the goal of making money. Resp. Ex. K at p. 12. Typically, Peoples Gas would not know how much money its business partner made. Staff's and GCI's interpretations of Section 525.40(d) would require Peoples Gas to refund an amount equal to other company's profits if those profits were from a transaction that involved Peoples Gas' recoverable gas costs. Neither Section 525.40(d) nor any precedent suggests such an anomalous result.

## ARGUMENT

### I. This Proceeding Is About Peoples Gas' Gas Costs and Not a Survey of the Enron Corporation/Peoples Energy Corporation Business Relationship

As noted above, Peoples Gas has the burden of proof to show that its gas costs and revenues were reconciled accurately and that its recoverable gas costs were incurred prudently. To that end, if a gas purchase is prudent, then it is prudent regardless of the seller's identity. Moreover, the prudent gas purchase does not become imprudent simply because a non-utility affiliate also has business dealings with that seller.

[15] *See* Staff In. Br. at p. 14.

Staff and GCI each devote a significant portion of their initial briefs to actual or contemplated transactions involving ENA and its subsidiaries and Peoples Energy and its subsidiaries (GCI dub the transactions the "Enron Strategy").[16] The prudence of completed transactions involving Enron that affected gas costs, such as the Gas Purchase and Agency Agreement ("GPAA") with ENA under which Peoples Gas purchased approximately two-thirds of its gas supply, are relevant to this proceeding. On the other hand, transactions and business relationships that did not affect Respondent's gas costs, such as enovate's physical and financial trades with other companies, or those that did not occur are irrelevant.

Staff and GCI do not take a fair view of the business relationships between Enron and Peoples Energy and Peoples Gas. They posit a "secret" scheme between Peoples Energy and Enron, allegedly designed to harm Peoples Gas' customers, but offer no real proof that such a scheme existed. Moreover, the lawful business dealings from which they attempt to divine this alleged secret scheme do not support their theory.

Significantly, there was nothing secret about Peoples Energy's or Peoples Gas' dealings with Enron. The announcement of their joint activities was announced by a press release – hardly what might be expected if these parties truly were engaging in a secret conspiracy to harm Peoples Gas' customers. Group Ex. 1.0 at ST-PG 201-202.

[16] GCI In. Br. at p. 4. As a prefatory matter, this spotlight on Enron is somewhat misleading. Of GCI's $381 million recommended disallowance (GCI In. Br. at pp. 97-98), over 70%, related to financial hedging and gas lost and unaccounted for, is unrelated to Enron. An additional $51 million GCI recommended disallowance concerning storage usage is of questionable relationship to Enron. Similarly, nearly half of Staff's $92 million recommended disallowance concerning storage and hub transactions is of questionable relationship to Enron. ICC Staff Ex. 5.00, Sch. 5.03. Regarding recommendations that have an Enron connection, Staff and GCI draw no distinctions between transactions that affected Peoples Gas' gas costs and those that did not. Staff and GCI also make no distinction between transactions that occurred and those that never moved beyond drafts or expressions of intent.

Contrary to Staff's suggestion, that on September 16, 1999 Peoples Energy and Enron entered into a Letter of Intent and Peoples Gas and Enron entered into the GPAA does not establish a secret scheme.[17] The Letter of Intent was a three page nonbinding description of possible initiatives that the parties would consider, including several transactions and the formation of a business. Group Ex. 1.0 at ST-PG 192. Seven months later, Peoples Energy and Enron formed enovate. At this point however the GPAA was in place. As a result, the formation of enovate could not harm the ratepayers.

Likewise, GCI's description of the so-called "Enron Strategy" is inaccurate. For example, the claim that Peoples Gas and Enron developed a fixed gas charge (GCI In. Br. at p. 3) is inconsistent with the timeline in the record. Peoples Gas filed a fixed gas charge in October 1998. It solicited responses to a request for qualification in December 1998. This was months before the spring of 1999 when Peoples Gas began negotiating with Enron. Resp. Ex. C at p. 5.

Any suggestion that Peoples Gas was forced by Peoples Energy to enter into the GPAA, knowing that it would be detrimental to the ratepayers, based upon the prospect of additional, unrealized business with Enron is wholesale conjecture. Neither Staff nor GCI present a single piece of evidence to support such a speculative theory. There is not a single document evidencing such an agreement. No witness with knowledge of the events in September, 1999 testified to such a scheme. While Peoples Energy and Peoples Gas may have had interlocking boards, there is no documentary or testimonial evidence of any specific conduct by any individual establishing the alleged secret scheme.

In the absence of proof, Staff's and GCI's theories are entitled to no weight. At a minimum, there is no way that a decision finding such a secret scheme could be based

[17] *See* Staff In. Br. at pp. 10-11.

upon the substantial evidence that is required for a Commission decision to be upheld judicially.

Nor have Staff or GCI produced a shred of evidence involving any other conduct of Peoples Energy or Peoples Gas that would establish the alleged secret scheme with Enron. During the reconciliation period, Peoples Gas did not enter into any off-system sales transaction with any affiliate and, with the exception of providing a Commission-approved storage service to North Shore Gas Company ("North Shore") and the sale of Federal Energy Regulatory Commission ("FERC") jurisdictional services to enovate, Peoples Gas provided no gas services to affiliates. While Peoples Gas purchased a peaking service from Peoples Energy Resources Corp., an affiliate, this service was provided pursuant to a Commission-approved agreement; Peoples Gas did not purchase any other gas supply services from an affiliate. Regarding enovate, it had no direct business relationship with Peoples Gas. enovate did not administer the GPAA; this was done by a completely different part of Enron. Resp. Ex. O at p. 2. During the reconciliation period, enovate did not sell gas to or purchase gas from Peoples Gas, Resp. Ex. C at pp. 37-38, nor did enovate manage Respondent's hub. Resp. Ex. L at pp. 20-21. Thus, enovate's costs and revenues had no relevance or connection to Peoples Gas' gas costs during the reconciliation period.[18]

[18] In its Initial Brief (at pp. 76-77), Staff relies on an Enron-created document ("enovate P&L" – Staff Ex. 9, Attach. H) to support its position that enovate transactions impacted Peoples Gas' Gas Charge. There is no authoritative evidence in the record concerning this document, and Staff's statements concerning this document are mere speculation about what the Enron employee who created this document meant and assume that the descriptions used by the Enron employees on this document are accurate. Accordingly, the Commission should assign no weight to this document. Moreover, contrary to the statement by Staff in its brief, Peoples Gas in no way "acknowledges" that its Gas Charge was impacted by enovate operations. Rather, Peoples Gas denies that there is any evidence that enovate's operations had any impact on its Gas Charge.

Moreover, Staff's attempt to find something untoward in hub revenue sharing is disingenuous, at best. The chart at page 12 of Staff's initial brief, produced by Peoples Gas during discovery, surely does not represent anything problematic. While Staff reproduces the chart, it omits the text immediately underneath explaining what the chart is intended to depict. This text, which makes it clear that the diagram represents how the two members of enovate will share revenue, states: "Peoples Gas receives and keeps all hub revenue." Moreover, this text describes agreements between enovate and Peoples Gas' hub: "In these agreements enovate is a routine customer of the Hub. As with any Hub counterpart, each agreement is unique, so there are different sharing arrangements between enovate and the Hub based on the nuances of each deal." Group Ex. 1 at ST-PG 15-16. Given that there is nothing unique about enovate's purchase of hub services and Peoples Gas did not share revenue with enovate, *See* R at 810-11, Staff fails to show that the sharing of hub revenue established or was part of a secret scheme between Enron and Peoples Energy and Peoples Gas.

In sum, Staff's and GCI's focus upon Enron is an improper attempt to cast aspersions upon Peoples Gas merely because it, and its parent, Peoples Energy, decided to do business with Enron. Of course, Staff and GCI ignore that when those decisions were made, Enron was perhaps the preeminent gas marketer in this country. Now that Enron's name has been tarnished, Staff and GCI labor to paint Peoples Gas with that same brush in the hope of obtaining far greater disallowances than the evidence would allow. If the focus properly is placed upon the real issue at bar, Peoples Gas' gas costs, the parties, as well as the public, will be better served.

## II. GCI's Attacks on the Credibility of Peoples Gas and Its Witnesses Are Unfounded and Unduly Exaggerated

Peoples Gas' consistent position has been that no quantitative analysis of the GPAA was memorialized prior to its execution – and that none was required. See Illinois Power Co. v. Illinois Commerce Comm'n, 339 Ill. App. 3d 425, 439, 790 N.E.2d 377, 388 (5th Dist. 2003) ("[S]ection 9-220(a) of the Act does not set forth any specific type of analysis that a utility must perform to show that its costs are prudent"). While on the one hand Staff and GCI claim that the GPAA was imprudent for the lack of documented quantitative analysis, on the other hand they claim the prudence of the GPAA is undermined based upon two documents (the so-called "Aruba" document and Wear Cross Exhibit 15) that arguably might show that Peoples Gas documented a quantitative analysis. This makes little sense.

First, regarding Wear Cross Exhibit 15, GCI's claim that this exhibit undermines both Mr. Wear's testimony and the "entire case presented by the utility" is unfounded. GCI In. Br. at p. 7. For the first time on cross-examination, Mr. Wear was confronted with Wear Cross Exhibit 15, a one-page document consisting largely of numbers with almost no text to provide context, which apparently was created and revised in a three-day period almost six years prior. R at 1011. That Mr. Wear did not recall this one page document is not terribly surprising. To say that this lack of recollection undermines the entirety of Peoples Gas' case is nonsensical.

Second, regarding the Aruba analysis, there is no substantive evidence establishing that this document, a review undertaken by one person without any directive to develop an economic or financial analysis, is a quantified analysis of the GPAA.

Third, while there may have been no documented quantitative analysis (which is not required to establish prudence), this does not mean that there was no analysis of the GPAA. The GPAA was the subject of extensive review, Resp. Ex. C at pp. 5-10; Resp. Ex. F at pp. 14-15, which was not limited to written, formal studies. R at 1009-1010, 1081. Just because this analysis was not memorialized in a formal document does not mean that it was not undertaken or appropriately considered by Peoples Gas prior to its entering into the GPAA.

Fourth, substantively, Wear Cross Exhibit 15 supports Peoples Gas' decision to enter into the GPAA. This document's analysis shows a directional trend consistent with Peoples Gas' concern about declining basis and that a contract like the GPAA could be beneficial.[19] Given that it would have benefited Peoples Gas to use Wear Cross Exhibit 15 to its advantage during Mr. Wear's testimony, his inability to recall this document bolsters, rather than detracts from, his credibility.

Finally, Peoples Gas' objections to certain data requests (GCI In. Br. at pp. 27-31) in no way undermine its credibility. Parties are not required to respond to improper discovery. The Commission's discovery policy is to obtain disclosure of "relevant and material facts" and does not permit discovery the purpose of which is harassment and delay. 83 Ill. Admin. Code Sec. 200.340.

The exercise of procedural rights does not bear upon a party's credibility or the merits of a case. When GCI disagreed with Peoples Gas' objections, it had and, along with Staff, exercised, the procedural right to seek a ruling. In some cases the ALJ agreed with the Staff and GCI and in some cases the ALJ agreed with Peoples Gas. *See, e.g.*, R

[19] *See infra* at p. 29.

at 267-288. GCI's suggestion that Peoples Gas' proper use of the discovery process is a gauge of its credibility is nonsense.

## III. Staff and GCI Have Failed to Rebut Peoples Gas' Showing <u>That the GPAA Was Prudent</u>

Both the Staff and GCI devote significant portions of their initial briefs to the Gas Purchase and Agency Agreement ("GPAA") between Peoples Gas and ENA. Peoples Gas showed that the GPAA and the costs incurred pursuant to that agreement during the reconciliation period were prudent. *See* Peoples Gas In. Br., pp. 8, 16-20, 42-64. Staff and GCI continue to fault the process by which Peoples Gas and ENA negotiated the GPAA, claim that specific provisions of the GPAA were detrimental to end users and apply an incorrect prudence standard. Moreover, Staff and GCI ignore the flaws in their recommended disallowances that Peoples Gas' witnesses identified and corrected.

### A. The Review and Negotiation Process that Led to the GPAA Was Prudent

Staff and GCI each make much of the process that led to the execution of the GPAA. Staff opines that the GPAA represented a "dramatic" and "significant" departure from past contracting practices.[20] Their allegations are inaccurate. However, assuming, *arguendo*, that this is correct, any departures in the GPAA from Peoples Gas' prior practices reflects the Company's efforts to address what was perceived as an upcoming change in the pipeline transportation market.

#### 1. Flaws with Staff's and GCI's Standard of Prudence

<u>First</u>, Staff and GCI seek to create and apply a prudence standard that demands a particular way of showing and measuring prudence. For example, Staff asserts that "[p]rudence requires that Peoples Gas perform some type of economic analysis or

[20] *See e.g.*, Staff In. Br. at pp. 40, 45, 46 and GCI In. Br. at pp. 6, 35, 36.

analyze a request for proposals in choosing such a contract." Staff In. Br. at p. 40. Likewise, GCI state that "Commission Staff correctly concluded that Peoples Gas' claim that it did not conduct an economic analysis of a proposed contract of this magnitude is itself compelling evidence of imprudent management." This is not the law.[21]

There is not a single way to establish prudence. As Staff witness Anderson agreed, any number of gas purchasing methodologies can be considered prudent. R at 866. Prudence requires Peoples Gas to show that, based on information available at the time, the decision to enter into the GPAA was reasonable.[22] This decision was reasonable -- witnesses Wear and Graves showed that the GPAA's pricing structure was a reasonable way to address conditions affecting the Chicago commodity and transportation market.[23]

Both in pre-filed testimony and at the hearing, Mr. Wear explained the analysis that led to the GPAA. As noted above, this analysis was extensive and any suggestion to the contrary is wrong. While this analysis may not have culminated in a formal, written quantitative analysis that memorialized the lengthy negotiation process, this does not mean that an extensive analysis was not undertaken. Indeed, many people were involved in reviewing, analyzing, refining and modeling the agreement that became the GPAA. *See* R at 1009-1010, 1081. Also, while Peoples Gas never issued a request for proposal ("RFP"), it demonstrated why the GPAA was not conducive to an RFP and explained that it conducted an RFQ (request for qualification) process that vetted the qualifications of

[21] *See* Peoples Gas' In. Br. at pp. 57- 59.
[22] *See* Peoples Gas In. Br. at pp. 30-32.
[23] *See* Peoples Gas In. Br. at pp. 42-55.

nine potential suppliers. Resp. Ex. C at pp. 4-6, 10-11; Resp. Ex. F at pp. 12-15; R at 1081-1082.

A thoughtful nine-month process, including the RFQ, the review of potential suppliers and adjusting the terms to reflect an environment without a fixed gas charge (which the Commission's ruling made untenable), led to the GPAA. Under these circumstances, to suggest that Peoples Gas's decision to enter into the GPAA was imprudent is makeweight.

Second, Staff bases the GPAA's alleged imprudence upon its belief that this agreement was a departure from Peoples Gas' prior practices and suggested that the GPAA should be compared to those prior practices. Staff's position here flies in the face of its opposition to Peoples Gas' efforts to demonstrate the GPAA's prudence.

Of course, a utility's decision to pursue a different approach to gas supply contracting cannot subject it to a different and more exacting standard of prudence. Moreover, there is no record evidence of what, if anything, other Illinois utilities may have done to address basis concerns, weather and varying usage or that Peoples Gas' negotiation of the GPAA to address these concerns compared unfavorably with other Illinois utilities' practices. [24]

### 2. GPAA Relative to Prior Contracting Practices

Staff's and GCI's claims that the GPAA was a drastic departure from Peoples Gas' prior contracting practices. This is untrue. To make that claim elevates form over substance and fundamentally misapprehends the agreement. Regarding the former, the GPAA was a single source supply contract that encompassed Peoples Gas' prior supply

[24] Citing Mr. Anderson's testimony, Staff states that "no other Illinois gas utility dealt with the potential for eroding bases by entering into an agreement similar to the GPAA." Staff In. Br. at p. 37. Mr. Anderson, however, admitted that he had not reviewed other utilities' practices to support this conclusion. R at 867.

contracts with several vendors. The GPAA included quantity and pricing terms (*e.g.*, a baseload contract, a storage refill contract, a swing contract and a resale contract, with each type of purchase priced at published citygate indices) that are and historically have been common in Peoples Gas' agreements. Resp. Ex. F at pp. 11-12. If the GPAA had been split into multiple contracts with identical quantity and pricing terms, Staff presumably would not have alleged Peoples Gas was behaving imprudently. Resp. Ex. F at p. 11.

Regarding Staff's fundamental misapprehension of the GPAA, Staff incorrectly describes the key commercial components of the agreement. For example, Staff states that "[t]he GPAA uses several different and complex pricing schemes." Staff In. Br. at p. 46. In reality, the GPAA pricing could not have been simpler; as explained in Peoples Gas' Initial Brief, it used indices that Peoples Gas had used extensively prior to the GPAA.[25]

Further, Staff's expressed concern that the term of the GPAA was too long is baseless.[26] The GPAA was not a long-term, fixed price contract with a pipeline, which City-CUB witness Decker claimed was outmoded. Rather, the GPAA was an index-priced contract with a gas marketer. As such, there was no risk that the GPAA prices would depart from market prices. Resp. Ex. E at pp. 11-12.

Additionally, the GPAA's five-year term was consistent with industry practice and was reasonable in light of Peoples Gas' goals related to basis. Regarding industry practice, an American Gas Association survey showed that long-term contracts (one year

[25] *See* Peoples Gas In. Br. at pp. 46-47; Resp. Ex. C at pp. 15-19, 24-25; Resp. Ex. 7 (describing in detail the publications used for GPAA pricing).
[26] *See* Staff In. Br. at p. 46 (The GPAA "has a longer term than most gas-supply contracts had during the period").

or more) accounted for 26% of LDCs' 2000-2001 peak day purchases, and, among those contracts, 67% were priced at a first of month index. Resp. Ex. E at pp. 11-12. Moreover, Peoples Gas' pre-GPAA contracts ranged from 4 months to 5 years. Resp. Ex. C at p. 4. Mr. Graves also identified other LDCs that entered into long-term (three year) gas supply and management agreements.

Regarding mitigating declining basis, the expected basis decline was not an event that would occur immediately. Consequently, a long-term contract was a reasonable vehicle for protecting customers against what was expected to be a multi-year change in market conditions. Resp. Ex E at pp. 11-14.

In sum, the GPAA, including the types of service, pricing and term, was consistent with Peoples Gas' prior practices. As a result, Staff's and GCI's claims that the GPAA was imprudent because it was a drastic departure from prior contracting practices should be rejected.

### B. Staff's and GCI's Claims With Respect to the Aruba and Wear Exhibits Are Misplaced

Staff and GCI have placed far too much emphasis upon the so-called "Aruba" analysis and Wear Cross Exhibit 15. Contrary to Staff's and GCI's claims, these documents do not establish that Peoples Gas knew before entering into the GPAA that the agreement was a bad deal for ratepayers. While Staff and GCI can engage in conjecture, the record evidence as to these documents' meaning is far from clear. Further, there is no evidence that anyone at Peoples Gas, besides the documents' creators, were privy to their analyses. This focus upon these two documents is a classic case of "much ado about nothing" or, at best, much ado about very little.

Initially, contrary to Staff's and GCI's claims,[27] neither the Aruba analysis nor Wear Cross Exhibit 15 prove that Peoples Gas knew that the GPAA would be more costly than alternative purchasing methods. Regarding the Aruba analysis, Staff concedes that Mr. Rodriguez undertook his review on his own.[28] There is no concrete evidence that Mr. Rodriquez discussed his analysis with anyone.[29]

At best, the Aruba analysis is consistent with Peoples Gas' testimony that there were many possible ways to consider the costs and benefits of the GPAA -- the Aruba analysis is but one of several that were introduced. Resp. Ex. L at p. 5. Unlike Mr. Graves and Dr. Rearden who explained their analyses, the author of the Aruba analysis never testified about what this document meant. Although Staff had the subpoena power to compel Mr. Rodriquez' appearance, it chose not to do so and simply included the Aruba document in a group exhibit. R at 828. In the absence of the author's explanation of his analysis, it should be accorded little weight.

Regarding Wear Cross Exhibit 15, contrary to Staff's and GCI's claims,[30] this document does not show the GPAA to be unfavorable to customers. To make that claim, Staff and GCI rely upon the total cost for the full four years covered by the document.[31] This is an incorrect interpretation of the document.

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[27] *See e.g.*, Staff In. Br. at p. 15; GCI In. Br. at pp. 6, 37.
[28] *See* Staff In. Br. at p. 15; *also see* Resp. Ex. L at p. 4.
[29] *See* GCI In. Br. at p. 37. At his discovery deposition, Mr. Rodriguez was unsure about with whom, if anyone, he had such a discussion. For example, in response to questions about a discussion of his work with Company personnel, he stated: "I would be guessing on who was there" and "since, again, I work for risk management, I was just kind of a person kind of reviewing and giving kind of a recommendation or whatever you want to call it. In most cases, you know, people from the gas supply department at the utility attends these -- a meeting such as this." City-CUB Ex. 1.8, page 78 of the deposition transcript.
[30] *See* Staff In. Br. at p. 15; GCI In. Br. at p. 7.
[31] *See* Staff In. Br. at p. 47, claiming the GPAA to be $50 million more costly; *also see* GCI In. Br. at p. 38.

Construing Wear Cross Exhibit 15 as a "backcast,"[32] Wear Cross Exhibit 15 shows a trend that is consistent with Peoples Gas' concern about declining basis. The first two years (1996 and 1997) are sharply negative, which supports Peoples Gas' practice of buying most gas in the field and transporting it to the citygate. For the following two years (1998 and 1999), the data changes. In 1998, the data is significantly less negative and, in 1999, the data is significantly positive. Consistent with Respondent's Exhibit 8, a more precise and sophisticated "backcast" analysis, the two years immediately prior to the GPAA show that, relative to historical practices, a contract like the GPAA could be beneficial. Wear Cross Exhibit 15 therefore can be interpreted to corroborate Peoples Gas' concerns about the impact of declining basis and thus supports the prudence of entering into the GPAA.

### C. Staff's and GCI's Statements Concerning the Specific Terms and Conditions of the GPAA are Incorrect

Staff and GCI each criticize specific terms and conditions of the GPAA. Peoples Gas addressed the prudence of the GPAA, including many specific provisions, in its Initial Brief. Peoples Gas In. Br. at pp. 16-20, 46-51, 54-55. Accordingly, this Reply Brief will be limited to correcting misstatements and flaws in the Staff and GCI initial briefs.

[32] During the hearing, Cross Exhibit 15 was compared with Respondent's Exhibit 8. R at 1010-1013, 1054. Assuming the two are similar, a "backcast" can defined in terms of the analysis that Respondent performed and sponsored as Respondent's Exhibit 8. This exhibit compared Respondent's actual monthly gas costs for the two fiscal years prior to the GPAA (1998 and 1999), to the same monthly gas purchase volumes priced using the citygate indices used in the GPAA. (Note that Exhibit 8 did not reflect the application of the 3¢ credit on baseload and SIQ volumes that Respondent receives as part of the GPAA.) Resp. Ex. C at p. 28; *also see* R at 1013.

### 1. Flexible Pricing Terms

Staff and GCI each criticize the GPAA's flexible pricing terms.[33] Staff In. Br. at pp. 21-22; GCI In. Br. at p. 47. This discussion ignores the key fact that ENA did not exercise any of these terms. Two such provisions were one-time rights that expired in fiscal 2000 without being exercised (Secs. 4.2(b) and (c) of the GPAA, ICC Staff Ex. 2.00, Attach. 1) and the third (baseload price adjustment) was not exercised during the year. Resp. Ex. C at pp. 20-21.

Indeed, while GCI attempt to criticize the baseload price adjustment in their Initial Brief, stating that "[u]nder each of these scenarios, ENA benefited from its decisions to shift between the FOM and Daily citygate prices, and PGL ratepayers paid higher prices," GCI acknowledge three sentences later that Enron ***did not use*** the baseload price adjustment. GCI In. Br. at p. 45. In other words, contrary to GCI's claim, Enron did not benefit from the pricing options during the reconciliation year because it never exercised them and, consequently, there was no impact on customers.[34]

### 2. Resale Provision

Staff continues to erroneously characterize the resale pricing terms as a "penalty."[35] Staff In. Br. at pp. 22, 51, and 56. Staff's assumption that anything less than

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[33] Section 4.2, entitled "flexible pricing," of the GPAA included two pricing options under which ENA could convert pricing for a specified quantity of the baseload from first of month to daily pricing. One had to be exercised by October 1, 1999. The second had to be exercised by January 1, 2000. Sec. 4.2 of the GPAA, ICC Staff Ex. 2.00, Attach. 1. The GPAA also included a "baseload price adjustment," which was another type of pricing option. Sec. 1.4 of the GPAA, ICC Staff Ex. 2.00, Attach. 1.

[34] Witness Effron's effort to tie the baseload price adjustment to Transaction 19 (GCI In. Br. at 46) is wholly without support. Resp. Ex. F at 52-53.

[35] Section 4.1(e) of the GPAA gave Peoples Gas the right to sell up to 150,000 MMBtu per day to ENA. This was an operational tool. The pricing varied depending on the timing and quantity of the resale. For nominations the afternoon of the business day before pipeline nominations were due, the resale price ranged from the midpoint minus $0.01 to minus $0.03. For nominations two and one-half hours prior to the nomination deadline (11:30 a.m. the day prior to gas flow), the resale price ranged from the midpoint minus $0.015 to minus $0.035. *See* Sec. 4.1(e) and 4.3 of the GPAA, ICC Staff Ex. 2.00, Attach. 1; Resp. Ex. L at p. 26.

the midpoint is a "penalty" ignores the dynamics of the market and is inconsistent with witness Rearden's testimony on cross-examination that a sale that occurs at some price less than the midpoint does not necessarily reflect a penalty to the seller. R at 1291.[36] Gas Daily, the publication used to price resales, publishes a range of prices for the reason that transactions take place at many prices. Dr. Rearden stated that the midpoint is the weighted average of what Gas Daily calls the "common" range.[37] R at 1289. It is common sense that if a range has a midpoint, then there are transactions occurring below and above that midpoint. In the context of the wholesale gas market, therefore, nothing is unique or notable about Peoples Gas selling gas at a price below the midpoint. It is not always possible to transact at the midpoint, especially when trying to sell unneeded supply into a saturated market. Resp. Ex. F at pp. 17-19; Resp. Ex. C at pp. 23-24.

Further, the record showed that the resale pricing terms of the GPAA compared favorably to Peoples Gas' previous resale transactions as well as alternatives for addressing oversupply situations (such as pipeline park and loan services). In particular, the resale pricing terms of the GPAA compared favorably to a gas purchase contract, that included resale rights, which Peoples Gas had in 1996-1998. Under that contract, unlike the GPAA, (a) the resale quantity diminished as the nomination deadline grew closer; (b) the contract included a reservation charge; and (c) the purchase price for gas under that

[36] It is obvious why Dr. Rearden reached that conclusion. If a sale at less than the midpoint means that the seller is transacting at a penalty, then how can Dr. Rearden support a cost disallowance for the GPAA under which Peoples Gas was the beneficiary of ENA selling gas at a penalty, *i.e.* at 3¢ less than the index price for the baseload quantity and Summer Incremental Quantity purchases.

[37] More specifically, according to Gas Daily, the midpoint is the average of the high and low of the Common Range, which is always within a half-cent of the volume weighted average of all deals reported to Gas Daily for each point. The common range takes the absolute range of prices for the day and builds a range around the volume weighted data, assuming a standard bell curve-shaped distribution of data. Resp. Ex. 7.

contract was the index plus $0.02, and the resale was at the index minus $0.02. Resp. Ex. C at pp. 24-25.

The GPAA resale provision also compared favorably with alternatives to selling back gas. One alternative would be to purchase a park and loan service from an interstate pipeline, such as Natural Gas Pipeline Company of America ("Natural"), or from Nicor Gas, which operates a FERC-jurisdictional hub. The rates for these services are daily rates based on the quantity parked and loaned and maintained in the parking/loaning balance account.[38] Moreover, the services are interruptible, so, unlike the firm resale service under the GPAA, Peoples Gas could not rely on the park and loan services to alleviate oversupply situations. Also, under a park and loan Peoples Gas eventually would need to take delivery of the gas it had parked. There is no assurance that the days for which redeliveries (loans) are scheduled would be days that Peoples Gas needed gas. Resp. Ex. C at p. 25.

Another service alternative would be to use existing or purchase additional no-notice service. However, Peoples Gas' no-notice storage contracts provide a defined level of no-notice swing down rights. If these rights are exceeded, then penalties apply. As discussed below, these penalties can be substantial. Also, no-notice services are costly and carry fixed charges that are payable irrespective of whether the service is used. Resp. Ex. C at pp. 26-27.

Finally, absent a resale provision, if Peoples Gas was unable to make a resale or purchase a park and loan service, it may incur unauthorized overrun charges. These charges can be substantial. As one example, the unauthorized overrun charge under

[38] The maximum tariff rates for such services range from 10.92¢ per MMBtu to 28.94¢ per MMBtu of daily inventory.

Natural's tariff is $10 per MMBtu and there are tiered imbalance charges, increasing with the amount of the imbalance, based on commodity prices. Resp. Ex. C at p. 27.

Accordingly, it is more cost-effective to use off-system sales, even with a price below the midpoint of the published index, as a means of addressing some oversupply situations.

**3. Load Shifting Among Pipelines**

Staff's claims that Peoples Gas failed to take advantage of load shifting among pipelines are unfounded. By load shifting, Staff means moving transportation capacity from one pipeline to another in an effort to obtain a lower price. Staff In. Br. at pp. 36-37.

First, Staff witness Anderson agreed during the hearing that price is not the only consideration in selecting pipeline capacity. R at 868-869. Second, operational considerations limit the extent to which Peoples Gas can shift load; it is essential that Peoples Gas maintain some amount of capacity with Natural. Specifically, Natural is the only interstate pipeline directly connected with Peoples Gas' distribution system. This is significant because deliveries from Natural are unaffected by the availability of capacity in Peoples Gas' Mahomet transmission pipeline. Throughput on the Mahomet pipeline is limited and must be shared among Natural, five other interstate pipelines, and storage withdrawals from Manlove field. This means that Natural, by virtue of its three additional interconnects directly into the distribution system, can provide a degree of reliability that the others cannot. Resp. Ex. L at pp. 12-13.

In addition to being the only interstate pipeline directly connected to the distribution system, Natural is the only pipeline with which Peoples Gas has "pressure

control" operations versus "flow control." Because of this feature, when operating under pressure control with Natural, Peoples Gas receives true no-notice service from the pipeline. This means that as consumption on Peoples Gas' system changes, pressure will also change, and Peoples Gas will take more or take less from Natural as conditions dictate. When operating under flow control, as the other pipelines must, changes in pressure on Peoples Gas' system will not change the amount that Peoples Gas receives from the upstream pipeline. These pipelines, therefore, are not assisting Peoples Gas in the process of real time balancing. Id.

Real time balancing is critical. Peoples Gas' Exhibit 18 showed its hourly sendout for the gas days of February 1, 2001, and July 25, 2001. The data showed a low flow level of 42,767 MMBtu per hour and a high flow level of 77,271 MMBtu per hour for the winter day and a low flow level of 4,570 MMBtu per hour and a high flow level of 13,145 MMBtu per hour for the summer day. This data illustrates that hourly changes on Respondent's system occur year-round, showing that Respondent could not rely solely upon deliveries from upstream pipelines delivering only an even amount each hour of the gas day. Resp. Ex. L at pp. 13-14; Resp. Ex. 18.

Finally, Peoples Gas has used load shifting to take advantage of the opportunities offered by the several pipelines serving the Chicago area. Over time, where and when determined to be appropriate, Peoples Gas *has* substituted capacity on one pipeline for capacity on another. Respondent's Exhibit 19 showed how Peoples Gas' firm pipeline transportation portfolio has changed over the years. Resp. Ex. L at p. 14; Resp. Ex. 19.

### 4. Commodity Only Pricing Structure

Peoples Gas' goal not to pay commodity reservation or demand charges under the GPAA was indisputably achieved. Peoples Gas explained why this was beneficial and not typical of swing contracts. Resp. Ex. C at pp. 16-17. Staff's effort to contradict this by reference to pipeline demand charges is disingenuous. Staff In. Br. at p. 38; *also see* GCI In. Br. at p. 43. Peoples Gas' articulated negotiating goal under the GPAA was to achieve market-based *commodity* pricing with no reservation or demand charges. Resp. Ex. C at pp. 10-11. Under the GPAA that there were no such charges. Secs. 4.1(a), (b) and (c) of the GPAA, ICC Staff Ex. 2.00, Attach. 1.

### 5. Quantity and Pricing Was Clearly Defined

As with Staff's claims that the pricing is complex, Staff and the GCI exaggerate the limited option rights associated with the quantity provisions that allowed Enron some control over the timing and amount of gas sold to Peoples Gas under the GPAA. *See, e.g.*, Staff In. Br. at p. 40 and GCI In. Br. at pp. 8, 36, and 44. The SIQ was a fixed range within which ENA could select the summer delivery quantity; the SIQ quantity was a range of 10,980,000 MMBtu to 30,500,000 MMBtu during the year. Resp. Ex. C at p. 14; Sch. 2.1 of ICC Staff Ex. 2.00, Attach. 1.[39] In contrast, the baseload quantity during

[39] GCI's claim that "[t]his provision of the GPAA gave Peoples Gas no control over the SIQ volumes that it was required to purchase from ENA" is misleading. GCI In. Br. at p. 47. ENA was required to deliver at least 45,000 MMBtu and no more than 125,000 MMBtu per day of SIQ throughout the summer months (March through November); ENA had control over the SIQ, but it was constrained by the defined range. Secs. 1.47, 1.48 of GPAA, ICC Staff. Ex. 2.00, Attach. 1. Similarly, the claim that the SIQ provisions forces Peoples Gas to purchase daily gas when ENA chose not to deliver full SIQ is wrong and another example of exaggeration. Staff In. Br. at p. 42. Staff acknowledged this does not happen. Staff In. Br. at p. 43. Mr. Anderson also agreed that the GPAA imposed no such obligation. R at 869. Finally, Peoples Gas explained why allowing ENA to select the SIQ, within a range, is a reasonable operational decision; Peoples Gas needs gas for storage, but the timing of deliveries is less important. Resp. Ex. F at p. 30; Peoples Gas In. Br. at p. 18.

the reconciliation year, which was fixed in the GPAA, was 70,155,993 MMBtu. Sch. 2.1 of the GPAA, ICC Staff Ex. 2.00, Attach. 1.

Moreover, Peoples Gas retained total control over the amount of DIQ and resale quantities nominated – ENA had ***no*** control over either DIQ or the resale quantity.[40] Furthermore, ENA had no rights to change winter deliveries. ICC Staff Ex. 2.0, Attach. 1; Resp. Ex. C at pp. 11-15. Accordingly, the great majority of the delivery quantity was determined not by ENA but by the terms of the GPAA or Peoples Gas' daily nominations.

The pricing options were very limited, and, as discussed above, did not affect customers' gas costs. Two of the three pricing options expired, unexercised, in fiscal 2000, and the third, for only 45,000 MMBtu per day in the period December through March, was not exercised in fiscal 2001. For context, one degree day in December or January equates to about 22,400 MMBtu, which means that the option was about two degree days of gas; the average forecast error is 6.5º F. Resp. Ex. L at p. 26. The magnitude of the option was relatively small for a utility with Peoples Gas' requirements.

**6. Baseload Quantities**

Criticism that baseload quantities were too high is unwarranted.[41] Staff In. Br. at pp. 41-42; *also see* GCI In. Br. at p. 43. Peoples Gas showed that the baseload was comparable to the year prior to the GPAA. Resp. Ex. C at pp. 13-14; Resp. Ex. 5. Peoples Gas also explained why it does not set the baseload purchases at its baseload

[40] The DIQ was a quantity determined by an objective calculation and an amount of which Peoples Gas could nominate any portion. The resale quantity of 150,000 MMBtu per day was prescribed in the GPAA and Peoples Gas could nominate any portion. ICC Staff Ex. 2.0, Attach. 1.

[41] The "baseload quantities" are the quantities in effect for each month. The baseload quantity changed during the term of the GPAA, and it was an amount that ENA was contractually obligated to deliver each day and Peoples Gas would purchase this quantity. Resp. Ex. C at p. 11.

consumption levels. Because contracts generally set the baseload for a month or longer, setting the baseload based on actual baseload requirements would be a lowest common denominator type approach (for example, set the baseload quantity at the amount determined by the warmest day of the month) that would often leave Peoples Gas undersupplied and buying gas on a daily basis. For Peoples Gas, weather is the main factor affecting requirements. Peoples Gas uses its experience to balance requirements and transportation customer deliveries to avoid excessive reliance on daily purchases. Resp. Ex. L at pp. 14-16.

### D. Staff's Critique of Peoples Gas' Testimony Is Flawed

#### 1. Liquidity Premium

Peoples Gas' analysis of Staff's recommended adjustment showed that the absence of a liquidity premium in Staff's calculation improperly increased the recommended disallowance. Staff alleges that the liquidity premium is unsupported. Staff In. Br. at pp. 53-54. Staff is incorrect.

Staff witness Rearden defined his use of the term "liquidity premium" as follows: "When Mr. Graves proposes to add a liquidity premium onto the regional price or the price in the field or price at the delivery point, I believe his justification was that the utility buy in large quantities at a point that doesn't have much volume would drive the price above index." R at 1292. Dr. Rearden acknowledged that including a liquidity premium would reduce his recommended disallowance. R at 1293.

First, Staff's rejection of a liquidity premium is contrary to how gas markets operate. Dr. Rearden's field-area basis prices tend to understate the actual field prices because those areas are less liquid than larger trading hubs (like Chicago or Henry Hub).

Significant purchases at those locations are likely to entail an additional cost. Resp. Ex. E at pp. 18-19. The liquidity premium is a phenomenon that Peoples Gas' traders (*i.e.*, the people who buy and sell gas) observe. Resp. Ex. O at pp. 4-5.

The Chicago market for physical gas generally is accepted to be fairly liquid, but even in a large market hub like Chicago, there are times when liquidity is reduced and the market demands a premium for physical delivery. At smaller trading hubs this phenomenon is seen more frequently and to a higher degree. For example, the Harper Transfer Point on Northern Border Pipeline Company's system, unlike Chicago, is a trading point with a relatively small volume of trades, and index premiums in the area of several cents are common. This is relevant because a considerable amount of transportation capacity that was made part of the GPAA originates from this point. Resp. Ex. L at p. 6.

Second, Dr. Rearden urged the Commission to give "considerable weight" to the Aruba analysis (ICC Staff Ex. 12.00 at p. 8), but he gave no weight to Mr. Rodriguez's incorporation of a liquidity premium. Unsurprisingly, Dr. Rearden offered no explanation why some parts of the Aruba analysis warrant deference yet other parts (like the liquidity premium) should be ignored. Staff cannot cherry-pick those parts of a document that it believes supports its arguments and ask that only those parts be given weight yet ignore the rest of that document. R at 1294-1295.

**2. Basis Analysis**

Staff complains that "[p]erhaps most importantly, Graves examined only variations in the Henry Hub-Chicago basis. Peoples Gas did not try to adjust for this fault." Staff In. Br. at p. 54. In fact, Mr. Graves addressed and refuted this alleged flaw.

He explained that he used Staff witness Rearden's approach. Specifically, Mr. Graves did not rely upon CERA forecasts for other locations because they were not relevant for the analysis. He followed Dr. Rearden's lead in assuming that gas flows from either Henry Hub or Ventura. Dr. Rearden modeled prices as Henry Hub futures prices plus the basis forecasts. Only basis forecasts for Chicago-Henry Hub and Henry Hub-Ventura were relevant.

As for the Chicago-Henry Hub basis, Mr. Graves substituted the basis forecasts Dr. Rearden used with the CERA forecasts under four different scenarios. As for the Chicago-Ventura basis, Mr. Graves could have used the Chicago-AECO basis forecast from CERA, but, as Dr. Rearden correctly pointed out in his rebuttal testimony (ICC Staff Ex. 12.00 at p. 17), AECO is hundreds of miles away from locations applicable in the GPAA. Therefore, Mr. Graves modeled the Chicago-Ventura basis as the Chicago-Henry Hub basis plus Henry Hub-Ventura basis. Again, he was following Dr. Rearden's approach. Resp. Ex. R at pp. 17-18.

Staff and GCI further criticize Mr. Graves' analyses because Peoples Gas cannot show that it relied on the CERA and PIRA data he used. Staff In. Br. at p. 53. Also see GCI In. Br. at pp. 39-40. That is not the relevant question for prudence. The data were available when Peoples Gas entered into the GPAA. Just as Dr. Rearden created an ex post analysis using data available at the time the GPAA was negotiated, Mr. Graves created analyses using such data. Whether Peoples Gas showed it relied on that data[42] does not change the results, which were that the GPAA was prudent based on information available at the time it was being negotiated. Resp. Ex. R at pp. 11-12; R at 1178-1179.

[42] Respondent was clearly aware of the information when it was negotiating the GPAA. Respondent's Gas Supply Division received CERA publications, and personnel commonly read and discussed relevant studies and other relevant publications. Resp. Ex. L at p. 9.

Given the standard by which prudence should be measured,[43] Mr. Graves' analyses and testimony met that test.

### E. Staff Ignores Peoples Gas' Criticism of Dr. Rearden's Approach to His Calculation of a Recommended Disallowance

Staff ignores Mr. Graves' criticism of Dr. Rearden's calculation of a disallowance. *See* Staff In. Br. at pp. 55-56. Assuming, *arguendo*, that a disallowance is warranted, the approach should be to ascertain the amount by which the GPAA produced imprudent gas costs. Dr. Rearden compared the costs that would arise with and without the GPAA. If a decision is imprudent, there is typically a modified decision or variation on the chosen plan that would have been prudent. A utility only should be penalized for the gap between what it chose and what would have been prudent.

Dr. Rearden did not address what alternative terms and conditions would have made the GPAA acceptable. Instead, he rejected, *in toto*, the concept of a citygate purchase agreement. Mr. Graves did provide an analysis of the GPAA with pricing modifications. Resp. Ex. E at pp. 20-21; Resp. Ex. FCG-AR5.

The last row of Exhibit FCG-AR5 is the additional city-gate, first of month credit (on top of the GPAA's 3¢ credit) that would have been necessary to make the scenario in that column an *ex ante* breakeven in a planning study of the GPAA, compared to continued transportation management and field-area supply procurement by Peoples Gas. Query whether the Staff or GCI would have found the GPAA imprudent if, for example, it had been presented in 1999 with a credit of 11.4¢ below citygate prices. That is a very stiff test of prudence because this is the size of the credit that would be sufficient to eliminate all of Dr. Rearden's uncorrected GPAA cost disadvantages.

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[43] *See*, e.g., pp. 11-12, *supra*.

If the Commission felt that some weight should be put on the CERA and PIRA outlooks that Mr. Graves used in his analyses, as well as the structural changes occurring in the pipeline market serving the Chicago area, then a much smaller credit would have been required to make the GPAA a breakeven agreement. Since the actual credit was 3¢, the disallowance should only be for the gap between the required credit and 3¢. That is the amount of increased costs per MMBtu relative to having entered a contract with terms that would be deemed prudent under Staff's approach. That amount should be multiplied by the first of month volumes actually taken in the reconciliation period to determine the corresponding disallowance quantities. Resp. Ex. E at p. 21; Resp. Ex. FCG-AR5.

Mr. Graves made these calculations, with and without corrections, and the resulting amounts are shown in the last column of Respondent's Exhibit FCG-AR6. Those adjustments range from an $8.0 million disallowance (offsetting Dr. Rearden's uncorrected GPAA cost disadvantage) to a $5.3 million disallowance after the corrections. (In contrast, Staff proposed a $13.3 million disallowance.) These calculations only apply if Dr. Rearden's single-scenario analysis is all the Commission considers in deciding prudence. If it should regard his criticism as too strong, *e.g.*, such that a 6¢ credit (instead of a 3¢ credit) would have been prudent, the corresponding disallowance would be $2.9 million. Resp. Ex. E at p. 22; Resp. Ex. FCG-AR5.

There are sound reasons for the differing results. The main flaw with Dr. Rearden's disallowance calculations is that they treat all of the anomalous results of the 2000-2001 reconciliation period as attributable to the GPAA, including the extent to which basis increased rather than decreased and the value of the supplier options. For

instance, he finds (ICC Staff Ex. 7.05) that $4.8 million of disallowance should ensue from the adverse basis prices in January of 2001. There are two problems with this.

First, had the Company entered a modified GPAA at an 11.4¢ credit to the citygate prices, it still would have experienced some adverse costs in that month, when the bidweek basis from Henry Hub to Chicago increased dramatically from $0.12 per MMBtu in December 2000 to $0.96 per MMBtu in January 2001. The daily basis behaved similarly, *e.g.*, during the last ten days of December it ranged from $0.43 per MMBtu to $5.22 per MMBtu. Exposure to such a striking event was inevitable under the GPAA, as it would have been under any citygate purchase contract, even if it had modified terms that were expected to reduce costs more than it already does in most situations. Resp. Ex. E at p. 23; Resp. Ex. FCG-AR6.

Second, the basis prices in December and January did not involve a situation that was foreseeable or that should have been included in any prudence analysis of the GPAA's merits. Indeed, Dr. Rearden did not include a bizarre January basis spike in his own critique of the GPAA. Instead, he used Mr. Rodriguez's basis outlook, which is much smoother. Resp. Ex. E at p. 23; Resp. Ex. FCG-AR6.

Peoples Gas has demonstrated that the GPAA and costs incurred during the reconciliation year were prudent. However, if the Commission disagrees and determines that a disallowance is warranted, the proper way to calculate such a disallowance is to ascertain the extent to which Peoples Gas' negotiation of the GPAA fell short. It is not to try to recreate what would have happened had Peoples Gas bought gas using what Staff considers its historical purchasing practices. A correct method for calculating a disallowance could yield a disallowance ranging from $2.9 million to $8 million.

## IV. Staff and GCI Failed to Rebut Peoples Gas' Showing that Its Use of the Manlove Storage Field and Hub Services Were Prudent

### A. Peoples Gas Showed the Prudence of Its Winter 2000-2001 Use of Its Manlove Field

In its Initial Brief, Peoples Gas addressed its use of Manlove Field during the reconciliation year to serve its end users and summarized the extensive evidence showing that this use properly balanced economic and operational considerations and was prudent.[44] Staff's and GCI's have set forth no facts to the contrary.

First, Staff's and GCI's exclusive focus on Manlove Field ignores the total storage portfolio. In addition to Manlove Field, Peoples Gas purchased storage services from interstate pipelines. The use of storage (purchased and owned) during the 2000-2001 winter was comparable to the prior year's use. When looked at in aggregate, total storage withdrawals for four of the five winter months (November, December, February and March) were greater than those in the prior year. January 2001, which had similar heating degree days as the prior year but much lower (by more than two Bcf) total system requirements, had less storage withdrawals because, given that storage inventories are finite, an offsetting reduction in withdrawals had to occur at some point. Resp. Ex. F at pp. 36-37; Resp. Ex. 13.

Second, Staff's claim is incorrect (Staff In. Br. at p. 59) that interrupting hub services would have had a beneficial effect on Manlove withdrawals for end users. When Peoples Gas plans its use of Manlove Field, there were sound operational reasons for

[44] *See* Peoples Gas In. Br. at pp. 8-9, 22-25, 64-71, 75-81.

targeting 25.5 Bcf of winter supply to come from Manlove Field.[45] Planning to inject and use more than 25.5 Bcf is entirely a product of impermissible hindsight review.

Knowing the prices, weather and requirements that actually were experienced in the 2000-2001 winter allows retrospective reconstruction of how much and when to use Manlove Field storage to reduce total gas costs. This is entirely different from knowing months before how much gas can prudently be injected into and then withdrawn from Manlove Field and knowing on a day-to-day basis how the entire withdrawal season will play out in terms of price, weather and requirements so that the daily mix of services is optimal on a cost basis. Neither Staff nor GCI has presented evidence to dispute Peoples Gas' showing that 25.5 Bcf was a prudent planning target and that cost is only one consideration in daily storage decisions.

Finally, operational considerations primarily drive the use of Manlove Field. During cross-examination, Staff witness Anderson, characterizing decisions about storage use as a complex problem, agreed. R at 873-874.

Peoples Gas demonstrated that its use of Manlove Field was strongly affected by operational considerations. Peoples Gas In. Br. at pp. 76-78. Notably, December 2000 Manlove withdrawal activity was limited by sendout that fell short of forecast sendout. January 2001 Manlove withdrawal activity was affected by warmer than normal weather. Resp. Ex. L at p. 25. Adjusting the planned use of storage -- Manlove Field and

[45] Resp. Ex. F at pp. 38-40; Resp. Ex. L at pp. 21-25. It is undisputed that during the 2000-2001 winter Peoples Gas planned to inject approximately 25.5 Bcf into Manlove Field to serve its end users. Due to its decision to turn Manlove Field from injections to withdrawals two weeks earlier than usual, Peoples Gas actually injected slightly less. Peoples Gas used the full amount of the gas it injected into Manlove Field to serve its end users.

purchased services -- to address these operational issues was a reasonable solution to a complex problem. Resp. Ex. L at p. 27.

### B. Peoples Gas Hub Loans Did Not Increase Gas Costs

#### 1. Recoverable Gas Costs Are Not Needed to Support Hub Services

As a prefatory matter, the Staff speculates that the expansion of Manlove Field was solely to support hub services and was connected to the business activities of Peoples Energy and Enron. Staff In. Br. at pp. 4, 57. A review of relevant dates show that Staff's speculation is false.

In March 1998, the FERC approved Peoples Gas' Operating Statement. The Peoples Gas Light and Coke Company, 82 FERC ¶62,145 (March 2, 1998). The expansion of Manlove Field and significant cushion gas injections (1996-1998) therefore pre-dated both the FERC certificate that authorized hub services and the September 16, 1999 Peoples Energy/Enron letter of intent.[46]

Staff's repeated assertions that only system supply gas can be used for hub transactions (Staff In. Br. at pp. 25, 28, 31) is unsupported and elevates form over substance. *Also see* GCI In. Br. at pp. 25-26. The flaws in these arguments are addressed in Peoples Gas Initial Brief at pages 71-73.

First, there are several potential sources of supply and, because molecules are not color coded, there is no way to ascertain the source that supports a specific hub transaction. Resp. Ex. L at pp. 22-23. There are many sources of gas that do not touch the Gas Charge (*e.g.*, recoverable cushion, hub customers' deliveries, transportation

[46] See Staff. Resp. Ex. F at p. 44.

customers' deliveries). *See* 83 Ill. Admin. Code Sec. 525.40, which defines recoverable gas costs. Yet, Staff witness Anderson claimed that system supply (by which he means "PGA gas" (R at 871)) is necessarily used. Mr. Anderson, whose testimony is key to Staff's arguments, knew that Peoples Gas had transportation programs but could not testify if the gas was purchased from Peoples Gas or others. R at 871-872. Forty percent of Peoples Gas' annual throughput is gas supplied by third parties who buy their gas from non-utility sources. Resp. Ex. L at p. 15. Moreover, gas in storage affects the Gas Charge only when it is withdrawn from and delivered to end users. 83 Ill. Admin. Code Sec. 525.40. In other words, there is no basis for concluding that "PGA gas" is necessarily used to perform hub transactions. Many "non-PGA" sources exist.

Staff's claim that "[t]he fact that injections and withdrawals of gas occur at different physical locations and at different times is sufficient proof that the delivery process requires the use of displaced gas," Staff In. Br. at p. 67, is a *non sequitur*. This fact is not proof that recoverable gas costs are involved in hub transactions, and it has no record support.

For example, under a transportation transaction, a third party can deliver gas to a Natural/Peoples Gas interconnect and take redelivery at an ANR/Peoples Gas interconnect. That the transaction physically may involve displacement does not mean that it was necessary that Peoples Gas have gas, which it purchased, for which costs are recovered through the Gas Charge. Similarly, that a park or loan may happen on one day and the other side of the transaction happens on another day does not mean that recoverable gas costs are needed to effectuate the service. On any given day, there is gas on Peoples Gas' system that it did not purchase and for which costs are not recovered

through the Gas Charge. Indeed, there are days when transportation customers' deliveries of gas purchased from non-utility suppliers exceed total system sendout for the day. Resp. Ex. C at p. 26.

Second, Staff witness Anderson agreed that it is impossible to know if the molecules placed in the system by an entity are the same as those later delivered to that entity. R at 870-871. Displacement is how gas transactions occur. The Commission's rule is a nullity if this fact determines what revenues go through the Gas Charge because, unless Peoples Gas did not have a Gas Charge, it could never show that recoverable gas costs were not theoretically involved in a transaction -- one cannot prove a negative.

Finally, hub services can be supported without Gas Charge assets. For example, interstate pipelines with no merchant functions provide a wide array of what Peoples Gas calls hub services, including park and loan service. Resp. Ex. L at p. 36. Additionally, Natural offers a form of park and loan service called "line pack service." Notwithstanding the prevalence of displacement in the gas industry, the FERC found that this service, unlike Natural's park and loan service, was supported by line pack, rather than storage. Natural Gas Pipeline Company of America, 96 FERC ¶61,181 (2001). In other words, the FERC looked at resources available to Natural to perform its proposed service and concluded that line pack could support the service. The FERC did not try to verify that line pack gas would literally be the source used to provide the proposed service. Clearly, there are "non-PGA" sources of gas that can support hub services.

### 2. Commission Precedent Does Not Support Staff's and GCI's Theories

Staff's theory on displacement is contrary to the Commission's decisions in the Nicor Gas/North Shore cases involving revenue treatment for transportation services.

Staff In. Br. at pp. 71-73; *also see* GCI In. Br. at pp. 51-55. Under Staff's theory, such transactions necessarily involve displacement and deliveries at one point on the system and receipts at another; thus, they involve recoverable gas costs and revenues should flow through the Gas Charge and not be accounted for above the line. Staff's statement that these transactions are exempt because they are "in contracts entered into pursuant to such tariffs" (Staff In. Br. at p. 72) is wrong. The contracts were filed pursuant to Section 7-102 of the Act. There is no tariff under which Nicor Gas provides transportation service to North Shore. If there were such a tariff, it is unlikely that Nicor Gas and North Shore would have filed for Commission approval of the transaction.

While Peoples Gas' hub revenues never have been a contested issue at the Commission (Staff In. Br. at p. 68), the three Nicor Gas decisions discussed in Peoples Gas' Initial Brief (pages 73-75) support above the line treatment for these revenues. Moreover, while Peoples Gas has not had a rate case since 1995, it has had annual gas charge reconciliation cases. In none of those cases did Staff question the treatment of hub revenues, notwithstanding considerable evidence that the Commission knew that Peoples Gas offered hub services.[47]

Given that hub revenues were an issue in Nicor Gas' 1995 rate case, the Commission is aware of the concept of hub services and revenues. Based upon the Commission's prior inaction regarding identical types of costs and revenues in Peoples Gas' annual reconciliation proceedings, action now would constitute the drastic departure

[47] For example, the Commission was a party to the 1998 case in which Peoples Gas received certificate authority from the FERC to offer hub services and the Commission was a party to a related rate proceeding at the FERC. The Commission was also a party to Nicor Gas' hub certificate case and two of its FERC hub rate proceedings. Resp. Ex. G at pp. 23-24. Further, details concerning Peoples Gas' hub services are a matter of public record. Peoples Gas files an annual transportation report and a semi-annual transportation report with the FERC. These public filings are posted on the FERC's website and the FERC's rules require Peoples Gas to serve the transportation report on its state regulatory commission. 18 C.F.R. Sec. 284.126(b).

from prior decisions that would be entitled to little judicial deference. As noted above, that Commission decisions are not *res judicata* does not mean that the Commission has *carte blanche* to depart from precedent.

Staff's speculation that the Commission may not have given due consideration to the relevance of Section 525.40(d) to Nicor Gas' hub revenues is of no moment.[48] The Nicor Gas rate case and the Gas Charge rule were being litigated in the same time frame, indicating that the interrelationship of the two would have been considered.[49]

Moreover, the Central Illinois Light Company ("CILCO") case cited by GCI[50] is inapposite. In that case, CILCO argued that certain management fees were unrelated to recoverable gas costs. Unlike Peoples Gas' hub services, which do not involve selling gas to or buying gas from hub customers, and pipeline services, which do not support hub services,[51] the CILCO transactions to which the management fees related involved recoverable gas costs in the form of commodity sales or pipeline reservation charges.[52]

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[48] Staff In. Br. at p. 69 ("Since hub operations were a new concept and furthermore the fact that Subsection 525.40(d) was recently enacted it is conceivable that their combined impact was not fully considered in both dockets.")

[49] The Gas Charge rulemaking was initiated on October 5, 1994, marked heard and taken on April 13, 1995, and an order was issued on August 23, 1995. The Nicor Gas rate case was filed on May 8, 1995, marked heard and taken on November 9, 1995, and an order was issued on April 3, 1996.

[50] GCI In. Br. at 55. Illinois Commerce Commission v. Central Illinois Light Company, Docket No. 00-0710, Order dated February 6, 2002.

[51] Resp. Ex. C at p. 34; The Peoples Gas Light and Coke Company, 86 FERC ¶61,226 (1999) ("Peoples Gas proposes to provide a parking and loaning service that reflects the use of transportation and storage facilities. Peoples Gas will accommodate requests for the park and loan transactions through the flexible use of its own on-system storage field and through available line-pack. In no circumstance would Peoples Gas need to use any contract transmission or storage resources above those already available to meet system supply requirements.")

[52] Regarding one class of CILCO costs, the Commission found that "[m]ost of the management fees identified on Staff Cross Exhibit 1 were collected along with commodity revenues, the costs for which are recoverable gas costs under Section 525.40(a). Notably, CILCO also considers such commodity costs recoverable costs." Illinois Commerce Commission v. Central Illinois Light Company, Docket No. 00-0710, Order dated February 6, 2002, Slip Op. at 8. Regarding a second class of costs, the Commission concluded that the revenues appeared to be for capacity reservation, which is a recoverable gas cost. Consequently, the Commission concluded that the management fees associated with these transactions must flow through the gas charge. Id. at 9.

The CILCO order better applies to Peoples Gas' off-system gas sales for resale, not its hub transactions. In off-system sales for resale, Peoples Gas sells gas to non-end users. Recoverable gas costs are clearly involved because Peoples Gas is buying and selling gas and, in some cases, it must use its pipeline transportation to effectuate a sale. The costs and revenues associated with these transactions are properly flowed through the Gas Charge pursuant to Section 525.40(d). Resp. Ex. C at p. 30. Were Peoples Gas to include a management charge or other fee in such a transaction, it would properly flow through the Gas Charge.

### 3. Manlove Field Supports End User and Hub Services Through a Single Inventory

Dividing the Manlove inventory into different categories ("PGA" and "third party") (Staff In. Br. at p. 27) is a theoretical accounting exercise that is unrelated to the reality of Peoples Gas' business. Specifically, Staff artificially divides Manlove Field into classes of customers and erroneously assumes that a delivery to one class of customer diminishes the quantity of gas available on that day from Manlove Field for other customers. Staff's exercise does not reflect how the field is operated and how services are provided and does not recognize that, if necessary, the full daily capacity was available for end users from Manlove Field. Resp. Ex. L at p. 24.

Staff's approach also elevates accounting distinctions over operational decisions. Manlove Field has a single inventory, not individual inventories for different classes of customers. Significantly, at no time during the withdrawal period was inventory in Manlove Field negative.

What is proper and necessary for accounting reasons has no bearing on the day-to-day operational considerations affecting use of the field. Resp. Ex. L at p. 24. The

reason why how much gas each customer delivers and receives is tracked is to allow Peoples Gas to bill customers and ensure that they stay within their tariff and contract rights.

Whether Peoples Gas' customers purchase sales, transportation or hub services, they purchase rights to a service that is supported, in whole or in part, through Manlove Field. They do not purchase space at Manlove Field or acquire any right to demand that their gas be injected into or withdrawn from Manlove Field. Resp. Ex. L at 23. As Mr. Puracchio, the Manager of Manlove Field stated: "Operation[ally], I don't make a distinction between hub volumes and utility volumes...." R at 679. Staff incorrectly uses the term "PGA gas" in connection with Manlove Field to imply that end users pay for all gas that is injected into Manlove Field. Under the Commission's Gas Charge rules, gas cost is added to the monthly Gas Charge paid by customers only when gas is withdrawn from Manlove Field (or any other storage service) and delivered to end use customers.[53]

#### 4. Hub Services Are Supported with Costs Recoverable in Base Rates

GCI makes the odd observation that "although Mr. Wear maintains that the costs of hub transactions are recovered through base rates, [citation omitted], PGL has failed to establish that any of these costs was considered in its last rate case in 1995." GCI In. Br. at pp. 55-56. Presumably, GCI are not arguing that Manlove Field, the Mahomet pipeline and various O&M and A&G costs can be recovered other than through base rates. (Were the Commission to authorize such cost recovery, Peoples Gas readily would concede that

[53] Under the Commission's rules, the cost of gas injected into storage is subtracted from gas costs for the month in which the gas is injected and the cost of gas withdrawn from storage is added to gas costs when it is withdrawn. *See* the Schedules adopted by the Commission in its order approving 83 Ill. Admin. Code Part 525. Illinois Commerce Commission, on its own motion, Docket 94-0403, Order dated August 23, 1995, 1995 Ill. PUC LEXIS 579.

hub revenues must flow through the Gas Charge.) Whether and to what extent these costs are in Peoples Gas' current base rates has nothing to do with the relevant question: are hub transactions supported by assets for which the costs are recovered through the Gas Charge. The assets supporting hub services are ***not*** recovered through the Gas Charge and, if and to the extent that they are or can be recovered, it is through base rates.

### C. Staff's Proposed Disallowance Is Inflated by Flawed Assumptions

Staff's calculation of a disallowance for Peoples Gas' use of Manlove Field assumes that the highest priced gas should be displaced with storage gas. Staff In. Br. at p. 61. This assumption simply increases the disallowance rather than mimicking in any realistic way how more storage on a day would affect purchases. Peoples Gas cannot know what gas is the highest priced until after the day is over and prices are published. As a result, there is no reason to assume that the use of more storage on a day would have displaced the highest priced purchases on that day. Additionally, in the case of the LIFO rate, which also figures into Staff's calculation, this is not known until the end of the fiscal year. It would be impossible for Peoples Gas to know, at the time it was making purchase decisions and storage decisions, what gas to displace with storage to achieve the biggest dollar impact. Yet, the Staff adjustment erroneously assumes that this decision could be made. Resp. Ex. L at pp. 33-34.

## V. Peoples Gas Has Established the Prudence of the <u>Off-System Transactions at Issue</u>

### A. Transaction 19

In its Initial Brief, Peoples Gas addressed the prudence of the off-system sale for resale identified as Transaction No. 19 at length. Peoples Gas In. Br. at pp. 29, 92-95. Transaction No. 19, entered into in late November 2000, was a sale of 50,000 MMBtu

per day by Peoples Gas to ENA in December 2000. This sale was supported by sound operational considerations. Only in hindsight, with perfect knowledge of prices, weather and end user requirements, is it possible to conclude that end users would have been better off had the sale not been made.

Staff, however, claims that "Peoples Gas does not justify the need to enter into such a transaction." Staff In. Br. at pp. 78-79. In so doing, Staff disregards the consequences of Peoples Gas' prudent operational decision to begin withdrawing gas from its Manlove Field approximately two weeks earlier than usual. Specifically, to reverse the tendency for gas and water to flow outward toward the perimeter of reservoir, and to create a tendency for gas and water to move toward the center of the reservoir, Peoples Gas' reservoir engineers prescribed that approximately 6,000,000 MMBtu be withdrawn from Manlove Field during the first seventeen days of winter operations. This equates to an average daily withdrawal amount of more than 350,000 MMBtu. Resp. Ex. L at pp. 18-19; Resp. Ex. I at p. 6. Contrary to Staff's assertions, this was a significant operational fact that affected planning and, in particular, influenced how Peoples Gas evaluated warm weather scenarios.

Further, Staff's claim that "Peoples Gas should not be shedding its gas supply coming into a heating season," Staff In. Br. at p. 78, is incorrect. Peoples Gas showed why, under the circumstances that existed in late November 2000 when this decision was made, shedding supply was a prudent operational decision. Given that prudence is based on circumstances existing at the time the decision was made, Staff's claim ignores the fundamental importance of considering the circumstances surrounding the decision.

Moreover, while Staff propounds an inflexible operational rule about shedding gas supply, in the very next sentence Staff states that it was unreasonable for Peoples Gas to focus on "one potential outcome over others." Apparently, Staff believes it is reasonable to completely ignore one potential outcome and never sell supply before a winter month. Peoples Gas however did consider multiple scenarios. While its decision was driven by potential problems that would arise under a warm weather scenario, that does not mean that other scenarios were ignored or disproportionate attention was given to one scenario. Resp. Ex. F at pp. 50-51, 53-54.

Staff's criticism that Transaction 19 was not performed pursuant to the resale provision in the GPAA, Staff In. Br. at pp. 78-79, is puzzling. By not being under the resale provision, Transaction 19 allowed Peoples Gas to retain the GPAA's 3¢ credit. Resp. Ex. F at p. 49. Also, the first of month pricing avoided the discounts associated with daily off-system sales during over-supply situations. Resp. Ex. F at p. 50. Far from being a problem, placing this transaction outside the GPAA was beneficial to ratepayers.

Staff's criticism of Transaction 19 as "contrary to Peoples Gas' expressed concern that it would be long gas during December 2000," Staff In. Br. at pp. 79-80, also is puzzling. Peoples Gas was concerned about being "long" (*i.e.*, having too much gas) in December 2000. The response to being long is to shed supply, which Transaction 19 achieved. This is completely consistent with, not contrary to, concerns about being long and with the operational considerations associated with the early turnaround of Manlove Field. Resp. Ex. F at pp. 49-51; Resp. Ex. L at pp. 17-20.

### B. Transaction 103

Peoples Gas addressed the prudence of the off-system sale for resale identified as Transaction No. 103 in its Initial Brief. Peoples Gas In. Br. at pp. 29-30, 95-96. Like Transaction No. 19, this sale was supported by sound operational considerations. Transaction No. 103 was a sale to EMW in December 2000 that was entered into the preceding spring. It was a way for Peoples Gas to preserve, without paying a pipeline charge, valuable injection rights under a storage service (Rate Schedule DSS) that it purchased from Natural.

Staff's criticism of Transaction No. 103 is that the economics of the transaction were unfavorable, based on futures prices. Staff In. Br. at pp. 80-81. Staff's purely theoretical economic analysis is inconsistent with the nature of the transaction and would have required taking financial positions that were unsupported by the service rights associated with the transaction and the underlying storage. Peoples Gas could not have paid the pipeline charge and hedged the October/December spread because the benefit of the service it maintained – DSS rights – was a no notice service that could not be hedged. Also, NYMEX prices at the time the transaction was entered into suggested that the transaction would generate a positive margin. Resp. Ex. L at pp. 44-45.

## VI. Neither Staff Nor GCI Have Established A Nexus Between <u>enovate's Activities and the Prudence of Peoples Gas' Gas Costs</u>

### A. No Impact Can Be Shown on the Gas Costs Relevant to This Proceeding

Staff and GCI claim that Peoples Gas tried to exclude consideration of enovate from this proceeding. That is misleading. Peoples Gas has argued that this proceeding is about the prudence of its recoverable gas costs. Accordingly, only transactions that affect

those gas costs are relevant. Staff's and GCI's recommended disallowances are PEC's share of enovate income plus Enron MW, LLC's share. Staff In. Br. at p. 77; GCI In. Br. at p. 62. First, neither Staff nor GCI ties this income to the prudence of Peoples Gas' fiscal 2001 recoverable gas costs so their recommendations about enovate are irrelevant. Second, neither Staff nor GCI have offered any proof that the lawful business dealings between Peoples Energy and Enron that resulted in enovate harmed Peoples Gas' ratepayers. In the absence of such proof, the activities of enovate have no basis being the subject of a disallowance.

Contrary to Staff's statement, Peoples Gas never has "admitted" or "acknowledged" that enovate's activity affected Peoples Gas' Gas Charge. Staff In. Br. at pp. 73-74, 77. Regarding a document Staff mentions in making that claim, Peoples Gas stated only that it did not create the document and therefore could not interpret it. Peoples Gas requested that its affiliate, Peoples Energy Resources Company, LLC, review the document and that company likewise could not interpret a document it had not created. Group Ex. 1 at ST-PG 49. This is not a legitimate basis from which to conclude Peoples Gas should refund to its customers an amount equal to the income of two other companies that are not Illinois utilities.

### B. Contrary to Staff and GCI, No Evidence Exists Showing that enovate Improperly Used Peoples Gas' System to Generate Revenue

Staff and GCI base their recommended disallowances upon unsupported conclusions – and no actual proof – that enovate made its profits through the use of Peoples Gas' system. For example, the Staff claimed that the "potential windfall" was limited by Peoples Gas' assets. Staff In. Br. at p. 4. GCI, citing their and Staff witnesses' testimony and ignoring contrary evidence, claimed that "[t]hese experts

concluded that the only plausible explanation for enovate's more than 10,000% profit on its meager investment was its use of Peoples Gas' PGA assets and costs." GCI In. Br. at pp. 8-9, 58-59. These claims are without merit.

First, Staff and GCI have shown no connection between enovate's ability to make money and Peoples Gas. Couching their conclusions in amorphous terms like using[54] or leveraging (ICC Staff Ex. 7.00 at p. 71) Peoples Gas' assets does not alter that result.

Second, even if enovate benefited from transacting on Peoples Gas' system (for example by buying hub services or selling gas to other marketers doing business on Peoples Gas' system), the Staff and GCI have shown no connection between enovate's profits and the prudence of Peoples Gas' recoverable gas costs. Neither the Act nor any other law prohibits a marketing company from having a corporate affiliation with an Illinois public utility. Neither the Act nor any other law prohibits an affiliated gas marketing company from buying or selling gas that may touch Peoples Gas' system. Neither the Act nor any other law prohibits a marketing company from making profits.

Third, GCI's reference to a "10,000% profit" is misleading. As discussed in Peoples Gas' Initial Brief, while enovate's members made modest initial cash contributions, they contributed significant non-cash assets in the form of office space, personnel, back office functions and corporate guaranties.

Fourth, Peoples Gas' inability to quantify the amount of revenue attributable to speculative trading was reasonable under the circumstances and not a shortcoming in

[54] Staff's claim that "[t]he record clearly shows that transactions conducted by enovate could not have been conducted without the use of Peoples Gas' system supply" is an example of the hyperbole on which this recommendation rests. Staff In. Br. at p. 74; *also see* Staff In. Br. at p. 77. First, enovate purchased services through which it could generate revenue. Second it engaged in speculative trading that requires no purchased services or owned facilities. Third, Staff witnesses agreed that a company can earn revenue without physical assets. R at 1306-1307 (cross-examination of Staff witness Rearden) and R at 1125 (cross-examination of Staff witness Hathhorn).

processes or controls as argued by GCI. *See* GCI In. Br. at pp. 61-62. Peoples Gas' witness, Mr. Morrow, explained:

> Q. Can you tell us now what the split was between speculative trading and the other business of Enovate?
>
> A. I can't define that precisely. We have not received all the records necessary to make that precise calculation. Because Enron managed the partnership, they kept the books, and we were given certainly some recent financial information on a basis, but the data we have is not fine cut enough to be able to precisely calculate the amount. I mean, we understand approximately what we think it is, but not anything definitive at this point.
>
> Q. Why didn't the Company need that kind of information?
>
> A. The Company understood, as long as we were monitoring all of the compliance with our risk policies and the risk limits that were established and as long as we were in there and we were also receiving our accounting data, you know, we didn't feel it was necessary or required of us to have a sub-split of every business activity.

R at 805-806. Accordingly, Staff and GCI have not provided any proof in support of their claim that enovate profited through use of Peoples Gas' system.

### C. Staff and GCI Attempt to Rely on an Improper Burden of Proof to Make Their Claims

GCI assume facts that are not in evidence and invent a burden of proof that lacks any support in the Act.[55] Peoples Gas' burden is to demonstrate the prudence of its gas costs, which it has done. GCI and Staff have not adduced any evidence to establish that enovate's profits affected Peoples Gas' gas costs. Peoples Gas has no burden to respond to unsupported allegations about the source of another company's profits.

[55] *See* GCI In. Br. at p. 62: "To avoid a disallowance of the $20 million of revenues that PGL improperly diverted to enovate during the reconciliation period, Peoples Gas was required, under the law, to do more than offer unsubstantiated claims of prudence and propriety."

## VII. GCI Fails to Establish Any Imprudence in Peoples Gas' Financial Hedging Decisions

Peoples Gas addressed the prudence of its financial hedging decisions at length in its Initial Brief (at pp. 7-8, 32-42), as well as in an earlier briefed motion for summary disposition. Based on both substantial Commission precedent and circumstances existing at the time decisions about 2000-2001 winter hedging would have been made, Peoples Gas' decision not to use financial hedges for any winter purchases was prudent. Peoples Gas showed that the City and CUB witnesses' recommendations supporting hedging were flawed. By the spring of 2001, circumstances had changed and Peoples Gas entered into fixed price agreements.

### A. Commission Precedent Supports Peoples Gas' Decisions

Contrary to GCI's claims, Peoples Gas was not seeking "detailed instructions and a virtual guarantee against risk from the Commission" before it hedged.[56] Peoples Gas witness Graves' testimony was that, based on the regulatory record and given the extreme and anomalous conditions in 2000-2001, it was not imprudent to go unhedged. Also, the extensive use of hedging is a major shift that should involve the Commission. Resp. Ex. R at pp. 4-6. After the Commission provided some guidance, in the form of the April 2001 NOI Manager's Report, Peoples Gas began to use financial hedging in a substantial way. Resp. Ex. B at p. 7; Cross Ex. 6.

Peoples Gas agrees with GCI (GCI In. Br. at p. 23) that hedging (price and supply management) costs are recoverable gas costs under the Commission's rules. 83 Ill. Admin. Code Sec. 525.40(a)(4). However, contrary to GCI's implication, this does not mean that prudence required the use of financial hedging during the 2000-2001 winter.

[56] *See* GCI In. Br. at p. 16; *also see* GCI In. Br. at pp. 88-89.

As GCI correctly state (GCI In. Br. at p. 22), in 1995, the Commission adopted the new gas charge rules. Yet, no decision after the adoption of that rule, including Section 525.40(a)(4), require the use of financial hedging to mitigate price volatility. Permitting recovery of hedging costs is not the same as requiring hedging to show prudence, nor is it encouragement of hedging. By contrast, the NOI Manager's Report suggested that the Commission and its Staff were more receptive to financial hedging. Cross Ex. 6.

Contrary to GCI claims (GCI In. Br. at p. 90), hedging among Illinois utilities was not prevalent nor did the Commission's actions "demonstrate the error of Mr. Graves' testimony." The NOI Manager's Report made it clear that during the 2000-2001 winter only the Ameren companies hedged and that Peoples Gas' limited hedging occurred in 1998. Contemporaneous Commission actions (cited and discussed at length in witness Messrs. Zack's and Graves' testimony and in Peoples Gas Initial Brief at pages 34-37) held that prudence did not require the use of financial hedges to mitigate price volatility.

No Commission rules or precedent requires a utility to use financial hedges to mitigate price volatility as a condition of showing prudence. To the contrary, the Commission held that prudence does not require such a showing.

**B. Hedging by PEC Non-Utility Companies Is Irrelevant**

Utilities, subject to *ex post* review of their decisions, face asymmetric risks when they hedge. An Illinois utility with a Gas Charge cannot recover more than its prudent gas costs, but the Commission can disallow cost recovery. Non-utilities face no such risks. Accordingly, contrary to GCI's claims (GCI In. Br. at pp. 15-16, 82), it is reasonable for the two types of companies to have different hedging strategies based on the regulatory climate. Resp. Ex. H at pp. 22-24.

### C. Peoples Gas' Supply Planning Properly Addressed Price Volatility

GCI argue that Peoples Gas ignored price volatility and that its actions were imprudent. GCI In. Br. at pp. 81-85. In its Initial Brief, Peoples Gas responded fully to these claims about winter prices and detailed the extreme and unprecedented nature of the 2000-2001 volatility as well as the timing for when that volatility became apparent. Peoples Gas In. Br. at pp. 40-42. GCI add nothing that has not already been refuted. Peoples Gas however will respond to some misstatements in GCI's Initial Brief.

GCI erroneously assert that Peoples Gas' supply planning had no means to address price volatility. ("These are the risks that Peoples Gas decided not to manage" (GCI In. Br. at p. 77)). Peoples Gas managed price risk in the 2000-2001 winter through the use of storage. Physical hedging through storage generated approximately $130 million in savings for customers. Resp. Ex. F at p. 58. Peoples Gas managed price risk after the winter through fixed price agreements. Resp. Ex. B at pp. 7-8.

GCI claim (GCI In. Br. at pp. 85-86) that storage was not an effective physical hedge, apparently because the nature of LIFO accounting means that the price is not fixed. GCI misunderstand or ignore how storage is reflected in the Gas Charge. If summer replacement prices are lower than winter withdrawal prices, then storage provides an effective hedge because customers pay only the actual gas costs incurred by Peoples Gas. LIFO accounting has no effect on that simple fact. Witness Grace explained that City witness Herbert confined his analysis to injections made in the beginning of fiscal 2001 and did not consider injections made during the summer of fiscal 2001. The LIFO rate, which is how storage withdrawals are priced, is determined by using purchased gas costs for the entire fiscal year. Consequently, under the Company's

LIFO method, customers get the benefit of any lower cost gas that replaces, through injection, the gas that is withdrawn from storage. The cost of storage withdrawals included in the Gas Charge and recorded on the Company's books would reflect the cost of any lower priced summer purchases. Resp. Ex. J at pp. 2-4; Resp. Ex. Q at pp. 2-3.

### D. GCI's Proposed Disallowance Calculation Is Improper

GCI characterize City witness Herbert's recommendation as a conservative, objective strategy. GCI In. Br. at p. 93. It was not. In determining the quantity of winter purchases that could be hedged, Mr. Herbert ignored storage activity -- withdrawals from storage are not winter purchases that would have been hedged. Mr. Herbert ignored daily variability. Using monthly data to determine how much baseload can be hedged ignores the fact that daily purchases may fall below what warm weather monthly data show. Both errors result in his strategy hedging a greater quantity than, in fact, could be hedged under his theory. Resp. Ex. F at pp. 58-59.

### E. Contrary to GCI, Staff Never Stated that Peoples Gas' Hedging for October-March of the Reconciliation Period Was Imprudent

Staff testified that it did not support a disallowance related to Peoples Gas' decisions related to financial hedging. ICC Staff Ex. 7.00 at p. 74. Nonetheless, GCI claims that "Staff admits that Peoples Gas' hedging for October-March … was not prudent." GCI In. Br. at pp. 91-92. This is incorrect. R at 1312-1313.

### F. Peoples Gas Presented Expert Testimony on Hedging

GCI incorrectly assert that "[i]n contrast, Peoples Gas presented only the testimony of company executives who claim no special expertise in price risk management." GCI In. Br. at p. 78. Peoples Gas' principal witness on the hedging issue

was Frank Graves, a principal with the Brattle Group, who has extensive expertise analyzing gas issues, including price risk management. Resp. Ex. FCG-1.

## VIII. GCI Can Show No Imprudence Regarding Gas Lost and Unaccounted for ("GLU")

Peoples Gas thoroughly addressed and refuted arguments related to the prudence of costs associated with its gas lost and unaccounted for during the reconciliation year. Peoples Gas In. Br. at pp. 11, 26-27, 88-92.

GCI rely exclusively on witness Decker's testimony to support their recommendation. Her credibility as an expert on this issue is suspect for several reasons. First she used two very different and inconsistent theories -- apparently abandoning the first theory when Peoples Gas identified the blatant errors. Those errors including using incorrect data in her calculation to inflate the GLU percentage.[57] Second, she selected two completely different and arbitrary "standards" to calculate a disallowance with no explanation for why she abandoned her first "standard" in favor of a more stringent standard.[58] Third, she ignored the fact that Peoples Gas is not contesting an adjustment that affects GLU. Resp. Ex. K at p. 11; Resp. Ex. P at pp. 2-5.

GCI's focus on the percentage increase in GLU is a red herring. GCI In. Br. at pp. 14, 75. While Peoples Gas' GLU increased from 2000 to 2001, large percentage changes (up or down) in GLU are unsurprising. Ms. Decker agreed that GLU fluctuates

[57] GCI call this "quibbling" with Ms. Decker's calculation. It is hardly "quibbling" when a witness takes a number that is identified as including "purchased storage compressor fuel, Company use, franchise requirements and unaccounted for gas" and uses it as equivalent to unaccounted for gas in a calculation.

[58] Ms. Decker's first standard was 3%, and she cited Kansas Pipeline data for this figure. Interestingly, a Staff data request used by Ms. Decker (City-CUB Ex. 1.11) required utilities to provide an explanation if the unaccounted for percentages in the response exceeded 3%. Ms. Decker's second standard was 1%.

from year to year.[59] GLU percentages are small, as is apparent from the data submitted to the Commission by Illinois utilities in their annual reports. Resp. Ex. K at pp. 6-7. Changes in small percentages necessarily produce large percentage changes (*e.g.*, Illinois Power's GLU increased by 526% from 2001 to 2002 (.39% to 2.44%); CIPS' GLU increased 1,137% from 2000 to 2001 (.46% to 5.69%)). Zack Ex. P at p. 4. Thus, the fact Peoples Gas' GLU percentage increased 400% from 2000 to 2001 has nothing to do with prudence.

GCI seek to discount the value of comparing GLU, over time, with other Illinois utilities.[60] First, it is ironic that GCI express concerns about a comparison with other Illinois utilities when Ms. Decker's first approach was to compare Peoples Gas to an interstate pipeline (City-CUB Ex. 1.0 at p. 29). Certainly, a comparison to other Illinois utilities makes more sense than a comparison to a single interstate pipeline in Kansas. Second, under GCI's approach, any increase in GLU would be suspect, even if it reversed itself in a subsequent year(s). Third, utilities would be vulnerable to future disallowances any time GLU declined and then increased, as is the nature of GLU. As Mr. Zack explained on cross-examination:

> I have seen both, within the state of Illinois and nationally, GLU levels up to the 6 percent area. And quite frequently 4 or 5 percent. You also see some years -- and that's on an annual basis. You also see some years where it's negative which seems to go against logic that you sold more gas to the customer than you put in the system; but it happens because of these aberrations year to year. So for me to look at a few years, I think it -- I think it's a reason for the company to take notice so that in case it did become a long-term trend, they

[59] *See* City-CUB Ex. 1.0 at p. 28. City-CUB Exhibit 1.11 and data filed with the Commission (Resp. Ex. K at p. 6), show GLU percentages for three fiscal years, five calendar years and for the twelve month period ending June 30, 2000; the nine percentages are all different and show increases and decreases with no apparent trend.

[60] GCI In. Br. at p. 74: "The question before the Commission, however, is not whether Peoples Gas' GLU fell within the range of results experienced by any Illinois utility. The question is whether the utility's GLU was reasonable and prudent, for that utility, in the circumstances that existed at the time."

> were on top of it. But I'm not surprised that over a few year period you have a few numbers that might be higher than the previous year.

R at 705-706.

Finally, Ms. Decker used multiple years of data in other parts of her testimony (notably, the GPAA (City-CUB Ex. 1.0 at pp. 21-24)), and GCI has not found this approach problematic.

Peoples Gas' GLU costs in the reconciliation period were prudent. GCI's recommended disallowance is based on flawed and contradictory theories.

## IX. <u>The Storage Optimization Contract ("SOC") Was Prudent</u>

As explained in its Initial Brief, Peoples Gas, as it has done in previous years, entered into a contract to optimize the storage capacity associated with services that are important to its portfolio to meet end users' needs but that require Peoples Gas to purchase capacity in excess of what it needs to serve end users. As in previous years, the costs and all optimization revenues received by Peoples Gas were flowed through the Gas Charge. Peoples Gas In. Br. at pp. 9-10, 26, 81-84. Staff's and GCI's arguments in favor of a cost disallowance are unavailing. As with the enovate profits and the recommendation for the so-called Trunkline transaction, Staff's and GCI's recommendations have no relationship to recoverable gas costs and are beyond the Commission's authority in a Section 9-220(a) proceeding.

### A. Contracting with EMW Was Reasonable

Staff contends that Peoples Gas rejected a more favorable offer ("As Staff's testimony shows, the terms offered by TPC appear to be a more favorable revenue split for the ratepayers." Staff In. Br. at p. 88.) Given the acquisition of TPC by Nisource and the ongoing Columbia acquisition, at the time Peoples Gas was making its decision, it

was concerned about entrusting the transaction to a company with an uncertain future. Resp. Ex. L at p. 40. Rejecting the TPC offer was reasonable. Similarly, GCI cited Dr. Rearden's testimony as support for characterizing the EMW transaction as "patently inferior" to TPC's offer. GCI In. Br. at p. 64. In fact, Dr. Rearden stated that TPC "appeared to be superior." ICC Staff Ex. 7.00 at p. 66. He provided no basis for that conclusion, and, even taken at face value, it falls far short of GCI's claim that EMW's SOC was "patently inferior."

**B. Peoples Gas Had Supply Planning Reasons for Two NSS Contracts**

GCI, again citing Dr. Rearden, questioned why Peoples Gas did not optimize the NSS contracts itself. As Peoples Gas explained, third parties have superior tools and resources to perform the spread trades associated with optimization contracts. Resp. Ex. L at p. 39. Moreover, one can infer from the Commission's Gas Charge rules that third party management is an acceptable tool because those rules permit recovery of supply management costs. 83 Ill. Admin. Code Sec. 525.40(a)(4). It was reasonable for Peoples Gas to expect that a third party would be more successful than Peoples Gas in optimizing the storage capacity.

GCI questioned why Peoples Gas had two NSS contracts and speculated that the purpose was to divert more Manlove gas to EMW. GCI In. Br. at pp. 66-68. That speculation is unfounded. As explained in its Initial Brief and in testimony, which GCI ignore, the transfer of title in Manlove Field was an administrative vehicle to satisfy the FERC's shipper must have title policy. Resp. Ex. L at p. 41. The transfer conferred no substantive rights on EMW ("Such classification [transfer of title to EMW] shall confer no rights or obligations on EMW, nor shall it alter the Delivery Point under this

Contract." City-CUB Ex. 1.24, Art. XI.1 of the SOC). In fact, Peoples Gas had two NSS contracts because one was an extension of an existing arrangement and the second replaced a 30-day storage service contract that was not renewed. Resp. Ex. L at p. 41.

GCI's notion that having two NSS contracts, given that NSS is a service that provides for 75 days of service, when Respondent only needed 10, 15 or 20 days of service unnecessarily drove up costs is incorrect. Contrary to GCI's assumptions, two such contracts is not the same as having 150 days of service. R at 1002. Instead, these two contracts, through the associated transportation contracts, translated into a 10-day and a 20-day contract. Resp. Ex. L at p. 37.

**C. Sales and Purchases under the SOC Did Not Affect Gas Costs**

GCI complained that witness Decker was unable to compute a disallowance because "Peoples Gas had failed to produce data -- such as "the pricing (on both the buys and sells), quantity transferred, and the timing of transactions" -- that would have allowed her to offer an estimate of the harm." GCI In. Br. at pp. 68-69. That complaint is baseless. It is clear from the plain terms and conditions of the SOC, which Ms. Decker appended to her testimony as an exhibit, that the buys and sells under the SOC had no effect on the Gas Charge because the pricing offset. For gas to be injected into the NSS accounts, "The price of such gas for both transactions [sale to EMW associated with the title transfer and sale to Peoples Gas related to the NSS injection] shall be EMW's purchase price for gas injected into Peoples Gas' NSS storage." City-CUB Ex. 1.24, Art. V.1 of the SOC. For the reversal (sale to EMW associated with NSS withdrawal and sale to Peoples Gas associated with the title transfer), "The price of both transactions shall be determined on a weighted average cost of gas basis for the equivalent volumes to be sold

by EMW, and EMW shall optimize the value of such gas in accordance with this Contract." City-CUB Ex. 1.24, Art. V.2 of the SOC. These transactions netted to zero, and there was no effect on the Gas Charge.

The SOC was a prudent way to mitigate gas costs associated with a valuable storage service. Peoples Gas received a service that filled an important niche in its portfolio, and a third party managed the unnecessary capacity such that Peoples Gas was able to maintain its full withdrawal rights and receive credits that flowed through the Gas Charge. Resp. Ex. L at pp. 37-41.

## X. Staff Failed to Establish any Imprudence in the Trunkline Transaction

Staff recommended a disallowance for what it called the Trunkline deal, but it does not even try to tie the recommended disallowance to imprudent gas costs. (GCI echoed Staff's recommendation. GCI In. Br. at pp. 71-73.) This is obvious from Staff's statement that: "The Commission should find this deal to be imprudent, so as to discourage other gas utilities from establishing similar arrangements in an attempt to end run the Act." Staff In. Br. at p. 84. The Trunkline transaction was a gas purchase agreement that Peoples Gas showed was reasonable. It was a citygate purchase at an index price and included valuable flexibility. The reservation charge was for both the firm swing rights and the implied cost of transportation from the field index price used in the commodity pricing to the citygate delivery point. Resp. Ex. L at pp. 42-43.

The purpose of this proceeding is not for the Commission to send messages because it does not like the structure of a transaction. The purpose is to review the prudence of gas costs and disallow costs that were not prudently incurred. Gas purchase costs under the Trunkline transaction were prudent. As with the enovate disallowance,

ordering Peoples Gas to refund an amount equal to profits, particularly profits of another company, is beyond the Commission's authority in a Section 9-220(a) proceeding.

## XI. Other Recommendations

Staff made several recommendations with which no cost disallowance is associated. Peoples Gas is not opposing some of those recommendations. For those recommendations that Peoples Gas is contesting, it addressed them thoroughly in its Initial Brief and will not repeat those arguments. Peoples Gas In. Br. at pp. 99-104. However, Peoples Gas will respond to a few erroneous statements.

### A. Internal and External Audits

Peoples Gas explained why the recommended internal and external audits are unnecessarily burdensome. Peoples Gas proposed that it submit a report to the Staff detailing actions it has taken to enhance its supply management and address Staff's concerns. The Staff and the Commission could then determine if further actions, such as audits, are needed. Peoples Gas' alternative would be at least as effective as the proposed audits and would be a better use of Company and Commission resources. Moreover, the Staff's recommendations fail to take into account that Peoples Gas and its affiliates now operate in a corporate world governed by the heightened auditing requirements of the Sarbanes-Oxley Act, which should give the Commission further pause before imposing yet more requirements on the Company's auditing committee and board.

In connection with its criticism of Peoples Gas' processes, Staff referred to what it called an "unusual amount of oral agreements." Staff In. Br. at p. 3; *also see* Staff In. Br. at p. 5. While Staff does not elaborate on what it considers an "unusual" amount, this statement suggests that oral agreements are improper. Oral agreements are not, *per se*,

evidence of problems with internal controls or of imprudent transactions. Moreover, the record shows that oral transactions can be subject to written master contracts and certain employees are authorized to enter into oral agreements. R at 1085-1086.

**B. Fiscal Year 2000 Gas Charge Proceeding**

Peoples Gas demonstrated why, under the relevant Commission rule (83 Ill. Admin. Code Sec. 200.900), there is no basis for re-opening Peoples Gas' fiscal year 2000 gas charge reconciliation case. Peoples Gas In. Br. at pp. 99-100. Staff, in its initial brief, makes no effort to show that re-opening is proper under the Commission's rules. It is not, for the reasons set forth in Peoples Gas' Initial Brief. The principle underlying the long-standing legal doctrines of *res judicata* and collateral estoppel is that at some point, there is finality to an issue of fact or law to be decided in litigation. This finality is essential to businesses, especially those such as Peoples Gas that operate in a highly regulated environment. This finality was achieved in the fiscal year 2000 Gas Charge proceeding and should not be disturbed.

**C. Uniform System of Accounts**

Peoples Gas does not agree with Staff's contentions related to the compliance with the Uniform System of Accounts, but it does not oppose the recommendation to file an explanation of steps it takes to ensure such compliance.

**D. Compliance with Section 525.40(d)**

Staff asserts that Peoples Gas must come into compliance with Section 525.40(d). Peoples Gas complies with this rule. As explained above and in its Initial Brief, accounting for hub revenues above the line is consistent with Commission precedent and proper under the rule.

### E. GCI Support of Staff Recommendations

GCI support Staff's recommendations and adds nothing that needs a response. GCI In. Br. at pp. 94-96. However, GCI incorrectly stated, at page 94, that the proposal to update the intercompany services agreement is contested; it is not. Peoples Gas agreed to file a revised intercompany services agreement. Resp. Ex. K at pp. 13-14.

## CONCLUSION

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

WHEREFORE, The Peoples Gas Light and Coke Company respectfully submits this Reply Brief.

Dated at Chicago, Illinois this 19th day of August 2005.

Respectfully submitted,

The Peoples Gas Light and Coke Company

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