STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Illinois Commerce Commission On Its Own Motion	)	
	)	
v.	)	01-0706
North Shore Gas Company	)	
	)	
Reconciliation of revenues collected under fuel and gas adjustment charges with actual costs.	)	

REPLY BRIEF

OF

NORTH SHORE GAS COMPANY

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

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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, North Shore Gas Company (the "Company" or "North Shore") hereby submits its Reply Brief in the above-captioned proceeding.

This Reply Brief is in response to the initial briefs of the Commission Staff Witnesses ("Staff In. Br."), the Citizens Utility Board ("CUB In. Br.") and People of the State of Illinois ("AG In. Br."). North Shore's Initial Brief showed the prudence of the gas costs it recovered from customers during the reconciliation year and refuted anticipated criticisms of Staff, CUB and AG. Accordingly, this Reply Brief is limited to responding to: (1) allegations from Staff and AG that North Shore's 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. 7): Peoples Energy's "strategic partnership with Enron *fundamentally alters* how North Shore' [sic] gas costs should be reviewed during a reconciliation proceeding" (emphasis added).

Staff'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.[1] Moreover, the legislature has demonstrated that it knows how to prohibit transactions by regulated entities and their affiliates that are designed to evade scope of regulatory review.[2] 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 claims that North Shore's 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

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[1] *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)).

[2] *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).

essence, Staff argues 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 North Shore and ENA to be imprudent. Staff makes this claim even though they have no direct evidence that these lawful transactions in any way influenced North Shore's 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 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 has not shown a connection between those lawful transactions and North Shore's gas costs. As a result, Staff'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.

Moreover, the Staff's, Attorney General's and CUB's claims are 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 North Shore's 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 North Shore's 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, the Attorney General, and CUB have not rebutted North Shore's 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 North Shore's Initial Brief, North Shores 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, North Shore 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.[3]

[3] *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.").

North Shore's burden under Section 9-220, therefore, is to show by a preponderance of the evidence that its gas costs were prudent. North Shore 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 North Shore's costs imprudent.

Here, North Shore 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.").

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*,[4] "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.

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 (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).

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[4] *See* Staff In. Br. at p. 13.

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.[5] As to prudence, North Shore's 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 North Shore's gas costs. Disallowances should not be recommended or allowed based upon criticisms of North Shore's business judgment; a finding of imprudence is required.[6]

AG argues that the scope of reconciliation cases is broad and that "[t]here were transactions during the reconciliation period that, while not gas costs that North Shore flowed through the PGA, had an effect on what ratepayers paid." AG In. Br. at p. 11. AG'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.[7] 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 for the Public Interest was a fuel adjustment clause reconciliation case, meaning that the prudence of ComEd's gas charges

[5] 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."
[6] *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.")
[7] See GCI In. Br. at pp. 18-20.

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 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 North Shore 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 for the Public Interest the Commission found ComEd imprudent, it did so based upon ComEd's undisputed, specific management decisions. In contrast, Staff and AG seek to expand the prudence inquiry far beyond North Shore's conduct to include lawful business transactions of its parent (Peoples Energy), other affiliates, and unrelated companies. Likewise, Staff and AG seek to penalize North Shore for conduct of these other companies of which Staff and AG 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 North Shore a more stringent standard than Section 9-220(a) "prudence." Specifically, Staff thinks that North Shore's decisions and contracts should be judged by whether they are "superior" to alternatives, historical practices [8] or other utilities (Staff In. Br. at p. 20-21, 28) or "no worse" (Staff In. Br. at p. 15) than other alternatives. This is erroneous. Likewise, even if Staff was correct that the GPAA was a change to North Shore's contracting practices (which it was not), the test for the GPAA's propriety is prudence, not a different or more stringent standard.

ARGUMENT

I. This Proceeding Is About North Shore's Gas Costs and Not a Survey of the <u>Enron Corporation/Peoples Energy Corporation Business Relationship</u>

As noted above, North Shore 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.

Staff and AG 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.[9] The prudence of completed transactions involving Enron that affected gas costs, such as the Gas Purchase and Agency Agreement ("GPAA") with ENA under

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

[9] As a prefatory matter, this spotlight on Enron is somewhat misleading. Of Staff's and AG's $3.96 million recommended disallowance (Staff In. Br. at p. 44; AG In. Br. at p. 39), over 57%, related to use of Manlove storage service, is unrelated to Enron. CUB's recommended $9.8 million disallowance for financial hedging has no relationship to Enron.

which North Shore 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 or those that did not occur are irrelevant.

Staff and AG do not take a fair view of the business relationships between Enron and Peoples Energy and North Shore. They posit a "secret" scheme between Peoples Energy and Enron, allegedly designed to harm North Shore's 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 North Shore's 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 North Shore's customers. Group Ex. 1.0 at ST-PG 201-202.

Contrary to Staff's suggestion, that on September 16, 1999 Peoples Energy and Enron entered into a Letter of Intent and North Shore and Enron entered into the GPAA does not establish a secret scheme.[10] 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.

The AG invents reasons to support its recommendation. For example, the AG asserts that North Shore imprudently engaged in third party storage transactions during the heating season. AG In. Br. at p. 4. North Shore does not own and operate a storage field. North Shore does not offer hub services. Resp. Ex. H at p. 19. The AG also refers

[10] *See* Staff In. Br. at p. 7.

throughout its Initial Brief to Peoples Gas, and it is often unclear if this is a drafting error or an improper effort to use evidence from another case in support of its theories in this case. *See, e.g.*, AG In. Br. at pp. 5, 7, 14-18, 22, 26, 31.

Any suggestion that North Shore 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 AG 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 North Shore 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 upon the substantial evidence that is required for a Commission decision to be upheld judicially.

In sum, Staff's and GCI's focus upon Enron is an improper attempt to cast aspersions upon North Shore merely because it, and its parent, Peoples Energy, decided to do business with Enron. Of course, Staff and AG 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 AG labor to paint North Shore 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, North Shore's gas costs, the parties, as well as the public, will be better served.

II. GCI's Attacks on the Credibility of North Shore and Its Witnesses Are Unfounded and Unduly Exaggerated

North Shore's 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 AG 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 1) that arguably might show that North Shore documented a quantitative analysis. This makes little sense.

First, AG's claim that Wear Cross Exhibit 1 undermines both Mr. Wear's testimony and "entirely poisons North Shore's claim of prudence" is unfounded. AG In. Br. at pp. 34-38. For the first time on cross-examination, Mr. Wear was confronted with Wear Cross Exhibit 1, 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 388. 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 North Shore's 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. D at pp. 14-15, which was not limited to written, formal studies. R at 401-405. Just because this analysis was not memorialized in a formal document does not mean that it was not undertaken or appropriately considered by North Shore prior to its entering into the GPAA.

Fourth, substantively, Wear Cross Exhibit 1 supports Peoples Gas' decision to enter into the GPAA.[11] This document's analysis shows a directional trend consistent with North Shore's concern about declining basis and that a contract like the GPAA could be beneficial.[12] Given that it would have benefited North Shore to use Wear Cross Exhibit 1 to its advantage during Mr. Wear's testimony, his inability to recall this document bolsters, rather than detracts from, his credibility.

III. Staff and GCI Have Failed to Rebut North Shore's Showing That the GPAA Was Prudent

Both the Staff and GCI devote significant portions of their initial briefs to the Gas Purchase and Agency Agreement ("GPAA") between North Shore and ENA. North Shore showed that the GPAA and the costs incurred pursuant to that agreement during the reconciliation period were prudent. *See* North Shore In. Br., pp. 28-46. Staff and AG continue to fault the process by which North Shore and ENA negotiated the GPAA, claim that specific provisions of the GPAA were detrimental to end users and apply an incorrect

[11] Wear Cross Exhibit 1 was admitted for impeachment purposes only in this proceeding. *See* R at 394. However, in their initial briefs, both Staff and AG rely on the substance of this document. *See* Staff In. Br. at pp. 29-30; AG In. Br. at pp. 16-17. Accordingly, this section is in reply to those arguments.
[12] *See infra* at p. 24-25.

prudence standard. Moreover, Staff ignores the flaw in its recommended disallowances that North Shore's witnesses identified and corrected.

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

Staff and AG 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.[13] Their allegations are inaccurate. However, assuming, *arguendo*, that this is correct, any departures in the GPAA from North Shore's 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 North Shore perform some type of economic analysis or analyze a request for proposals in choosing such a contract." Staff In. Br. at p. 22. Likewise, AG state that "Commission Staff concluded that North Shore's claim that it did not conduct an economic analysis of a proposed contract of this magnitude is in and of itself compelling evidence of imprudent management." AG In. Br. at p. 13; *also see* AG In. Br. at p. 36. This is not the law.[14]

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 317. Prudence requires North Shore to show that, based on information available at the

[13] *See e.g.*, Staff In. Br. at pp. 3, 22, 27 and AG In. Br. at pp. 7, 13, 23.
[14] *See* North Shore In. Br. at pp. 43-45.

time, the decision to enter into the GPAA was reasonable.[15] 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.[16]

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 401-405. Also, while North Shore 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 nine potential suppliers. Resp. Ex. C at pp. 4-6, 10; Resp. Ex. D at pp. 7, 12-14.

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 North Shore's decision to enter into the GPAA was imprudent is makeweight.

<u>Second</u>, Staff bases the GPAA's alleged imprudence upon its belief that this agreement was a departure from North Shore's prior practices and suggested that the

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[15] *See* North Shore In. Br. at pp. 17-19.
[16] *See* North Shore In. Br. at pp. 28-41.

GPAA should be compared to those prior practices. Staff's position here flies in the face of its opposition to 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 North Shore's negotiation of the GPAA to address these concerns compared unfavorably with other Illinois utilities' practices. [17]

2. GPAA Relative to Prior Contracting Practices

Staff's and AG's claims that the GPAA was a drastic departure from North Shore's 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 North Shore's prior supply 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 North Shore's agreements. Resp. Ex. D at pp. 10-11. If the GPAA had been split into multiple contracts with identical quantity and pricing terms, Staff presumably would not have alleged North Shore was behaving imprudently. Resp. Ex. D at pp. 9-10.

[17] Citing Mr. Anderson's testimony, Staff states that "[n]o 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. 19. Mr. Anderson, however, asserted that if a utility's purchasing practices were similar to that of other Illinois utilities, this would not be evidence of prudence. R at 318.

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. 28. In reality, the GPAA pricing could not have been simpler; as explained in North Shore's Initial Brief, it used indices that North Shore had used extensively prior to the GPAA.[18]

Further, Staff's expressed concern that the term of the GPAA was too long is baseless.[19] In the Peoples Gas case, Mr. Graves explained that 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, Docket 01-0707, at pp. 11-12.

North Shore's pre-GPAA contracts ranged from 4 months to 5 years. Resp. Ex. C at p. 3.

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

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

Staff and AG have placed far too much emphasis upon the so-called "Aruba" analysis and Wear Cross Exhibit 1. Contrary to Staff's and AG's claims, these

[18] *See* North Shore In. Br. at pp. 32-33; Resp. Ex. C at pp. 15-19, 22-23; Resp. Ex. 7 (describing in detail the publications used for GPAA pricing).
[19] *See* Staff In. Br. at p. 28. There is no record evidence supporting this statement and, instead, Staff cited testimony from Peoples Gas Docket 01-0707.

documents do not establish that North Shore knew before entering into the GPAA that the agreement was a bad deal for ratepayers. While Staff and AG can engage in conjecture, the record evidence as to these documents' meaning is far from clear. Further, there is no evidence that anyone at North Shore, 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 AG's claims,[20] neither the Aruba analysis nor Wear Cross Exhibit 1 prove that North Shore 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.[21] There is no concrete evidence that Mr. Rodriquez discussed his analysis with anyone.

At best, the Aruba analysis is consistent with North Shore's 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. H 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 290. In the absence of the author's explanation of his analysis, it should be accorded little weight.

Regarding Wear Cross Exhibit 1, contrary to Staff's and AG's claims,[22] this document does not show the GPAA to be unfavorable to customers. To make that claim,

[20] *See e.g.*, Staff In. Br. at p. 15; AG In. Br. at pp. 15-18.
[21] *See* Staff In. Br. at p. 15; *see also* Resp. Ex. H at pp. 3-4.
[22] *See* Staff In. Br. at p. 15; AG In. Br. at p. 17.

Staff and AG rely upon on the total cost for the full four years covered by the document.[23] This is an incorrect interpretation of the document.

Construing Wear Cross Exhibit 1 as a "backcast,"[24] Wear Cross Exhibit 1 shows a trend that is consistent with North Shore's concern about declining basis. The first two years (1996 and 1997) are sharply negative, which supports North Shore's 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 1 therefore can be interpreted to corroborate North Shore's concerns about the impact of declining basis and thus supports the prudence of entering into the GPAA.

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

Staff and AG each criticize specific terms and conditions of the GPAA. North Shore addressed the prudence of the GPAA, including many specific provisions, in its Initial Brief. North Shore In. Br. at pp. 8, 13-17, 28-41. Accordingly, this Reply Brief will be limited to correcting misstatements and flaws in the Staff and GCI initial briefs.

[23] *See* Staff In. Br. at p. 47, claiming the GPAA to be $50 million more costly; *also see* GCI In. Br. at p. 38.

[24] The AG compared Cross Exhibit 1 with Respondent's Exhibit 8. AG In. Br. at p. 17. 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 2¢ credit on baseload and SIQ volumes that Respondent receives as part of the GPAA.) Resp. Ex. C at p. 27.

1. Flexible Pricing Terms

Staff and AG each criticize the GPAA's flexible pricing terms.[25] Staff In. Br. at pp. 8-10, 33; AG In. Br. at pp. 29-30. This discussion ignores the key fact that ENA did not exercise either option. These 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). Staff In. Br. at p. 33.

2. Resale Provision

Section 4.1(e) of the GPAA gave North Shore the right to sell up to 10,000 MMBtu per day to ENA. This was an operational tool. As discussed below, the pricing varied depending on the timing and quantity of the resale. Sec. 4.1(e) of the GPAA, ICC Staff Ex. 2.00, Attach. 1.

Staff continues to erroneously characterize the resale pricing terms as a "penalty."[26] Staff In. Br. at pp. 11, 31, 33. Staff's assumption that anything less than 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.[27] Gas Daily, the publication used to price resales, publishes a range of prices for the reason

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[25] 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.

[26] Section 4.1(e) of the GPAA gave Peoples Gas the right to sell up to 10,000 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. 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. *See* Sec. 4.1(e) of the GPAA, ICC Staff Ex. 2.00, Attach. 1; Resp. Ex. H at p. 15.

[27] 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 North Shore 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.

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.[28] R at 330-331; Docket 01-0707 R at 1289.[29] 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 North Shore 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. D at pp. 16-18; Resp. Ex. C at pp. 23-24.

The record showed that the resale pricing compared favorably to North Shore's alternatives for addressing oversupply situations, such as pipeline park and loan services. Furthermore, 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.[30] Moreover, the services are interruptible, so, unlike the firm resale service under the GPAA, North Shore could not rely on the park and loan services to alleviate oversupply situations. Also, under a park and loan North Shore eventually would need to take delivery of the gas it had parked. There is no assurance

[28] 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.

[29] The ALJ granted North Shore's motion to take administrative notice of portions of Peoples Gas' cross-examination of Dr. Rearden in Docket 01-0707. R at 330-331.

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

that the days for which redeliveries (loans) are scheduled would be days that North Shore needed gas. Resp. Ex. C at pp. 23-24.

Another service alternative would be to use existing or purchase additional no-notice service. However, North Shore's 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 p. 26.

Finally, absent a resale provision, if North Shore 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 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. 26.

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 North Shore 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. 16-17.

First, operational considerations limit the extent to which North Shore can shift load; it is essential that North Shore maintain some amount of capacity with Natural. In

Respondent's case, Natural is far better integrated into Respondent's distribution system than is ANR. Respondent can, and has, supported its entire system load with only the interconnects that it has with Natural. This would not be possible with ANR. The ANR interconnect, though sized to accommodate up to 3,500 MMBtu per hour, is constrained by the take-away capacity on Respondent's system. This has the practical effect of limiting the amount of gas that can be delivered from ANR into Respondent's system to approximately 40,000 MMBtu per day (under ideal conditions during extreme cold). Resp. Ex. H at p. 12.

Finally, North Shore 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, North Shore *has* substituted one piece of pipeline transportation for another. In fact, Respondent has contracted for capacity on ANR in excess of the 40,000 MMBtu per day of take away capacity at the existing ANR/North Shore interconnect. Respondent has also contracted for capacity on Northern Border Pipeline Company that has no physical interconnection at all with North Shore. Resp. Ex. H at p. 12-13.

4. Commodity Only Pricing Structure

North Shore's goal not to pay commodity reservation or demand charges under the GPAA was indisputably achieved. North Shore explained why this was beneficial and not typical of swing contracts. Resp. Ex. C at p. 17. Staff's effort to contradict this by reference to pipeline demand charges is disingenuous. Staff In. Br. at p. 20; *also see* AG In. Br. at pp. 25-26. North Shore's articulated negotiating goal under the GPAA was to achieve market-based *commodity* pricing with no reservation or demand charges.

Resp. Ex. C at p. 10. 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 AG exaggerate the limited option rights associated with the quantity provisions that allowed Enron some control over the timing and amount of gas sold to North Shore under the GPAA. *See*, *e.g.*, Staff In. Br. at p. 22; AG In. Br. at pp. 6, 29. The SIQ was a fixed range within which ENA could select the summer delivery quantity; the SIQ quantity was a range of 1,220,000 MMBtu to 2,440,000 MMBtu during the year. Resp. Ex. C at p. 14; Sch. 2.1 of ICC Staff Ex. 2.00, Attach. 1. In contrast, the baseload quantity during the reconciliation year, which was fixed in the GPAA, was 11,449,788 MMBtu. Sch. 2.1 of the GPAA, ICC Staff Ex. 2.00, Attach. 1.

Moreover, North Shore retained total control over the amount of DIQ and resale quantities nominated – ENA had ***no*** control over either DIQ or the resale quantity.[31] 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 North Shore's daily nominations.

The pricing options were very limited, and, as discussed above, did not affect customers' gas costs. The two pricing options expired, unexercised, in fiscal 2000.

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[31] The DIQ was a quantity determined by an objective calculation and an amount of which North Shore could nominate any portion. The resale quantity of 10,000 MMBtu per day was prescribed in the GPAA and North Shore could nominate any portion.

6. Baseload Quantities

Criticism that baseload quantities were too high is unwarranted.[32] Staff In. Br. at pp. 22-23; *also see* AG In. Br. at p. 27. North Shore showed that the baseload was comparable to the year prior to the GPAA. Resp. Ex. C at pp. 12-13; Resp. Ex. 4. North Shore also explained why it does not set the baseload purchases at its baseload 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 North Shore undersupplied and buying gas on a daily basis. For North Shore, weather is the main factor affecting requirements. North Shore uses its experience to balance requirements and transportation customer deliveries to avoid excessive reliance on daily purchases. Resp. Ex. H at pp. 13-15.

D. Staff's Critique of North Shore's Testimony Is Flawed

1. Liquidity Premium

North Shore's 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. 35-37. 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

[32] 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 North Shore would purchase this quantity. Resp. Ex. C at p. 11.

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 330-331, Docket 01-0707 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. K at p. 7. The liquidity premium is a phenomenon that North Shore's traders (*i.e.*, the people who buy and sell gas), observe. Resp. Ex. I at p. 4.

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, 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. H at pp. 5-6.

Second, Dr. Rearden urged the Commission to give "considerable weight" to the Aruba analysis (ICC Staff Ex. 11.00 at p. 4), 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 it believes supports its arguments and ask that only those parts be given weight yet ignore the rest of that documents. Docket 01-0707, R at 1294-1295.

2. Basis Analysis

Staff complains that "[p]erhaps most importantly, the North Shore's witness Mr. Graves examined only variations in the Henry Hub-Chicago basis. The Company did not try to adjust for this fault." Staff In. Br. at p. 36. 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. 11.00 at p. 12), 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. J at pp. 12-13.

Staff and AG further criticize Mr. Graves' analyses because North Shore cannot show that it relied on the CERA and PIRA data he used. Staff In. Br. at p. 36. Also see

AG In. Br. at p. 23. That is not the relevant question for prudence. The data were available when North Shore 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 North Shore showed that it relied on those data[33] 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. K at pp. 12-13.. Given the standard by which prudence should be measured,[34] Mr. Graves' analyses and testimony met that test.

E. Staff Ignores North Shore's 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. 37-39. 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. Grave did provide an analysis of the GPAA with pricing modifications. Resp. Ex. K at pp. 9-10; Resp. Ex. FCG-AR4.

[33] 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. H at p. 8.
[34] *See*, e.g., pp. 10-11, *supra*.

The last row of Exhibit FCG-AR4 is the additional city-gate, first of month credit (on top of the GPAA's 2¢ 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 North Shore. 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 8.3¢ 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.

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 2¢, the disallowance should only be for the gap between the required credit and 2¢. 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. K at pp. 10-11; Resp. Ex. FCG-AR4.

Mr. Graves made these calculations, with and without corrections, and the resulting amounts are shown in the last column of Respondent's Exhibit FCG-AR4. Those adjustments range from an $855,000 million disallowance (offsetting Dr. Rearden's uncorrected GPAA cost disadvantage) to a $344,000 million disallowance after the corrections. (In contrast, Staff proposed a $1.7 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 4¢ credit (instead of a 2¢ credit) would have been prudent, the corresponding disallowance would be $271,000 million. Resp. Ex. K at p. 10-11; Resp. Ex. FCG-AR4.

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 $0.5 million of disallowance should ensue from the adverse basis prices in January of 2001. There are two problems with this.

<u>First</u>, had the Company entered a modified GPAA at an 8.3¢ 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. K at p. 10-11; Resp. Ex. FCG-AR4.

<u>Second</u>, 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. K at p. 11; Resp. Ex. FCG-AR4.

North Shore 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 North Shore's negotiation of the GPAA fell short. It is not to try to recreate what would have happened had North Shore bought gas using what Staff considers its historical purchasing practices. A correct method for calculating a disallowance could yield a disallowance ranging from $271,000 to $855,000.

IV. Staff and GCI Failed to Rebut North Shore's Showing that Its Use of the Manlove Storage Services Was Prudent

In its Initial Brief, North Shore 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. North Shore also demonstrated the impermissible hindsight nature of Staff's review.[35] Staff and AG have set forth no facts to the contrary. Staff In. Br. at pp. 39-41; AG In. Br. at pp. 32-34.

V. CUB Fails to Establish Any Imprudence in North Shore's Financial Hedging Decisions

North Shore addressed the prudence of its financial hedging decisions at length in its Initial Brief (at pp. 6-7, 19-28), 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, North Shore's decision not to use financial hedges for any winter purchases was prudent. North Shore showed that the CUB witness' recommendation supporting hedging was flawed.

[35] *See* North Shore In. Br. at pp. 8-9, 46-50.

By the spring of 2001, circumstances had changed and North Shore entered into fixed price agreements.

A. Commission Precedent Supports North Shore's Decisions

Contrary to CUB's claims, North Shore was not seeking an "express directive from the Commission to engage in hedging."[36] North Shore 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. J at pp. 3-5. After the Commission provided some guidance, in the form of the April 2001 NOI Manager's Report, North Shore began to use financial hedging in a substantial way. Resp. Ex. B at p. 7.

North Shore agrees with CUB (CUB In. Br. at p. 7) 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 CUB's assertion, this does not mean that prudence required the use of financial hedging during the 2000-2001 winter. 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. Docket No. 01-NOI-1, dated April 17, 2001 at pp. 43-44, 48.

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.

[36] CUB In. Br. at p. 2; *also see* CUB In. Br. at p. 11.

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. CUB's own argument shows this pronounced difference between the two types of business entities. CUB states that "the Commission need only look to North Shore's parent, which conducted its own hedging activity without the very same Commission pre-approval the regulated utility now insists on as a precondition to hedging." CUB In. Br. at p. 9. North Shore's parent company is not a regulated utility and, therefore, can safely engage in financial hedging with no risk of after-the-fact regulatory review. Obviously, the a non-utility would choose to use financial hedges without Commission pre-approval because the Commission has no jurisdiction over these non-utilities. Accordingly, contrary to claims (CUB In. Br. at pp. 3, 5, 9, 12-13), it is reasonable for the two types of companies to have different hedging strategies based on the regulatory climate. Resp. Ex. F at pp. 20-22.

C. North Shore's Supply Planning Properly Addressed Price Volatility

CUB argues that North Shore ignored price volatility and that its actions were imprudent. CUB In. Br. at pp. 2-3, 10. In its Initial Brief, North Shore 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. North Shore In. Br. at pp. 24-25. GCI add nothing that has not already been refuted. North Shore however will respond to some misstatements in CUB's Initial Brief.

CUB erroneously assert that North Shore's supply planning did not mitigate the winter 2000-2001 prices. CUB In. Br. at p. 2. North Shore managed price risk in the 2000-2001 winter through the use of storage. Physical hedging through storage generated approximately $25 million in savings for customers. Resp. Ex. D at p. 30. North Shore managed price risk after the winter through fixed price agreements. Resp. Ex. B at pp. 7-8.

D. Financial Hedging Was Not Prevalent Among Illinois Utilities or Other Utilities in the United States

CUB asserts that "[h[edging is a commonly used practice among large volume users of commodities such as gas to protect themselves from price volatility." CUB In. Br. at p. 3. This statement was not true of LDCs in the 2000-2001 winter.

First, the NOI Manager's Report made it clear that during the 2000-2001 winter only the Ameren companies hedged. Contemporaneous Commission actions (cited and discussed at length in witness Messrs. Zack's and Graves' testimony and in North Shore Initial Brief at pages 21-24) held that prudence did not require the use of financial hedges to mitigate price volatility.

Second, a July 2001 AGA Report found that 21 of the 49 LDCs that answered the question in the AGA survey indicated they used financial instruments and fixed-price contracts to hedge a portion of their gas supply purchases during the 2000-2001 winter.[37] This implies that 28 LDCs did not use financial instruments and fixed price contracts to hedge. Thus, within the AGA sample it is very common to have unhedged gas procurement. The finding in this report that 21 of 49 LDCs did hedge should be interpreted carefully since there is no information about how the sample was chosen or

[37] "LDC System Operations and Supply Portfolio Management During the 2000-2001 Winter Heating Season," American Gas Association, July 2, 2001, at 10.

how representative was the pool of respondents, especially in regard to their prevailing gas cost recovery mechanisms or regulatory standards. In particular, there is no indication whether the hedging occurred in states where it was required or encouraged under explicit regulatory policies. Resp. Ex. F at pp. 17-18.

VI. Other Recommendations

Staff made several recommendations with which no cost disallowance is associated. North Shore is not opposing some of those recommendations. For those recommendations that North Shore is contesting, it addressed them thoroughly in its Initial Brief and will not repeat those arguments. North Shore In. Br. at pp. 50-55.

North Shore demonstrated why, under the relevant Commission rule (83 Ill. Admin. Code Sec. 200.900), there is no basis for re-opening North Shore's fiscal year 2000 gas charge reconciliation case. North Shore In. Br. at pp. 50-51. 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 North Shore's Initial Brief.

CONCLUSION

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

WHEREFORE, North Shore Gas Company respectfully submits this Reply Brief.

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

Respectfully submitted,

The North Shore Light and Coke Company

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