Direct Testimony

of

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Policy Program

Energy Division

Illinois Commerce Commission

Application for Approval of a Reorganization pursuant to

Section 7-204 of the Public Utilities Act

Commonwealth Edison Company

Docket No. 11-0046

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Introduction

Q. Please state your name, job title and business address.

A. My name is David Rearden and I am a Senior Economist on the Staff ("Staff") of the Illinois Commerce Commission ("Commission") in the Policy Program. My business address is 527 East Capitol Avenue, Springfield, Illinois 62701.

Q. Please outline your education.

A. I have a Ph.D. (1991) in economics (specialties in econometrics and microeconomic theory) from the University of Kansas. I received a Bachelor's degree in economics and history from Eastern Illinois University in 1982, and studied economics at the Southern Illinois University graduate school from 1982-1984.

Q. Please state your work background.

A. Before joining Staff in 2002, I was a Manager of Regulatory Policy for Sprint Corporation ("Sprint") from 1998 until 2001. I wrote and defended testimony before state regulatory commissions, helped develop policy for Sprint, provided analysis and advice for the business units and supported other aspects of Sprint's external affairs activity.

I was a Managing Regulatory Economist at the Kansas Commerce Commission from 1994 until 1997. I wrote and defended testimony on both energy and telecommunications issues. I was promoted to Chief of Rate Design and Managing Telecommunications Economist in 1997. I supervised five employees that analyzed rate design for regulated energy companies in Kansas.

I taught economics at the undergraduate and graduate levels at the University of Kansas (1992-1994) and Cleveland State University (1990-1992). Besides introductory and basic intermediate courses, I taught public finance, econometrics and graduate level microeconomics.

Q. Have you filed testimony in Illinois before?

A. Yes, I have prepared written testimony and appeared on the stand for cross examination in several dockets. Most recently, I filed testimony in ComEd's Alternative Regulation docket, Docket No. 10-0527.

Q. What is the purpose of your direct testimony?

A. I investigate whether the proposed reorganization requested by AGL Resources Inc., Nicor Inc., and Northern Illinois Gas Company d/b/a Nicor Gas Company (jointly, the "Joint Applicants" or individually, "AGL Resources," "Nicor," or "Nicor Gas") complies with Section 7-204(b)(6) of the Public Utilities Act ("Act"). The Joint Applicants filed four contracts with their Application in order to comply with Section 7-204A(a)(5), and I consider whether the contracts should be approved. I discuss whether and under what conditions the proposed merger complies with Section 7-204(b)(2). I analyze ways that the Commission can protect ratepayers if the utility wants to enter into an Asset Management Agreement ("AMA").

Q. What are your conclusions?

A. With respect to the small volume transportation market, I recommend that the Commission find as required by Section 7-204(b)(6), that the proposed reorganization is not likely to have a significant adverse effect on competition.

However, I did not receive the relevant data for the traditional transportation market before my testimony needed to be filed. Therefore, until I can analyze that data, I withhold judgment on whether the Commission can conclude that the reorganization complies with Section 7-204(b)(6) for that market. The four existing contracts filed under Section 7-204A(a)(5) should be approved. But I recommend that the Commission restrict Sequent from being able to have the right of last refusal for spot market purchases. In order to make a finding with respect to Section 7-204(b)(2), that the reorganization will not result in the unjustified subsidization of non-utility activities by the utility or its ratepayers, I recommend that the Commission impose a condition on its approval of the Operating Agreement ("OA"). Finally, I recommend that the Commission require the Joint Applicants take certain, explicit steps and receive Commission approval before Joint Applicants are allowed to enter into an AMA.

Q. What is the condition that you recommend that the Commission impose?

A. The Commission should only approve the OA between Nicor Gas and the AGLR companies if Sequent is not a party. The other existing agreements allow Sequent to conduct routine transactions with Nicor Gas. If Nicor Gas seeks to enter into more elaborate transactions with Sequent, those agreements should be separately approved so the Commission can ensure that ratepayers are adequately protected.

Section 7-204(b)(6)

Q. What constraint does Section 7-204(b)(6) impose?

A. It states that the Commission must find that “the proposed reorganization is not likely to have a significant adverse effect on competition in those markets over which the Commission has jurisdiction.”

Q: How do the Joint Applicants address Section 7-204(b)(6) in their testimony?

A: Joint Applicants witness Lingenfelter states that, “AGL Resources can appreciate the gas distribution model in Illinois and intends to take no action that would have a significant adverse effect on that market.” (Joint Applicants Ex. 1.0, pp. 12-13) Joint Applicants witness O’Connor disaggregates the retail market into traditional transportation and the small volume program. The traditional transportation market serves relatively large customers, as evidenced by the fact that these customers account for 35% of total deliveries. He avers that this market is currently robustly competitive, and the merger will not harm that competition. The small volume program is called Customer Select. Its customers are more than 10% of qualified customers. He notes that there are 16 sellers in the program and that none have more than 25% of the market volumes, while five sellers have each more than 10% of the market. He concludes that the Joint Applicants support customer choice programs and touts the benefits of the programs to customers. (Joint Applicants Ex. 6.0, pp. 5-7)

Q. Do you agree that these are the relevant markets for Section 7-204(b)(6)?

A. Yes.

Q: What does it mean to have a “significant adverse impact on competition”?

A: A significant adverse impact on competition is an increased ability to profitably sustain higher prices. The ability to keep prices above costs is termed market power. The higher the markup over costs that firms can charge, the more market power a firm has. The finding required by Section 7-204(b)(6) prevents mergers that grant firms significantly more market power at retail customers' expense.

Q. Is market power easy to measure?

A. No. It requires a lot of data to estimate market power and the effect a merger has on it. A shortcut is to investigate market shares. The idea is that a market with few big sellers, called a concentrated market, implies that the sellers have greater control over price than a market with many, small firms.

Q. What are the *Horizontal Merger Guidelines*[1]?

A. The Department of Justice ("DOJ") formulated the Horizontal Merger Guidelines ("Guidelines") as a rule of thumb to indicate when a merger might grant the resulting firm a significant increase in market power. The Guidelines are a way for the DOJ to screen mergers for those unlikely to increase market power and thus, do not require further investigation and those that may indicate a problem and need further investigation. The Guidelines use the change in a market concentration index called the Herfindahl-Hirschman Index ("HHI") to examine a merger's effects. The index is equal to the sum of the square of the market share of each firm in percentage points. In a pure monopoly, the HHI equals 10,000 (=

[1] The Guidelines were most recently updated in 2010. They can be found at http://www.justice.gov/atr/public/guidelines/hmg-2010.html. Here I refer to Section 5.3.

100^2), while the HHI for pure competition is essentially zero.[2] In a market with four equal sized firms, the HHI = 2500 (= $4x25^2$).

Markets are classified by degree of concentration and increase in concentration resulting from a merger. If there is little increase in concentration, the Guidelines state that the merger is, "unlikely to have adverse competitive effects and ordinarily require[s] no further analysis." (Guidelines, Section 5.3) If a market is more concentrated and there is a big enough increase in concentration, the issue merits further investigation. Finally, the Guidelines deem concentrated markets with a big increase in concentration from the merger to be market power enhancing.[3]

Q. What is the HHI for the relevant pre-merger markets and the value of the index for the relevant markets post-merger?

A. The HHI for the Customer Select market in 2010 is 1,338.[4] This market is classified as 'Unconcentrated' under the Guidelines. Since Sequent does not participate in this market, there can be no increase in concentration and the reorganization does not harm competition in this market. The HHI for Nicor Gas' traditional transportation market in 2010 is not currently known, since the relevant data has not been received from Nicor Gas.[5] The classification for this market according the Guidelines is unknown, and it is not known whether the reorganization will lead to a significant increase in concentration.

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[2] In pure competition, each firm has a market share that is almost zero.
[3] The Guidelines offer merging entities the chance to show that the increased market concentration does not lead to increases in market power.
[4] Data provided in Nicor Gas' response to Staff data request DTR 2.1, Exhibit 1, which is confidential.
[5] The response to Staff data request DTR 2.3 has been received, but the response to DTR 2.2 was not received prior to the filing of testimony.

Q. Will the proposed reorganization harm competition in the transportation market?

A. For the Customer Select market, it is my opinion that it will not. According to the Guidelines, this market is not currently concentrated, and the proposed reorganization will not change concentration. I have not received the data to calculate the HHIs for the current and prospective markets for the traditional transportation market.

Section 7-204A(a)(5)

Q. Have the Joint Applicants filed any affiliate agreements besides the OA and the Services Agreement?

A. Yes. The Joint Applicants filed four existing agreements between Sequent and Nicor Gas' affiliates under Section 7-204A(a)(5). The agreements between Nicor Gas and Sequent are: a NAESB contract, one interstate standard form Hub agreement and one intrastate standard form Hub agreement. The other agreement that the Joint Applicants filed is between Sequent and Gas Exchange to use Gas Exchange's electronic data network.

Q. Do you object to the agreements?

A. No. These are existing standard form agreements. Only the Gas Exchange agreement sets prices, in its Appendix A. The Hub agreements and the NAESB agreement do not establish prices for individual transactions. As such, they do not affect whether there is any cross-subsidy between affiliates.

Q. Did an issue come up during your investigation?

A. Yes. During my analysis of these agreements, I read the Final Report on the Focused Audit of Affiliated Transactions and Management Audit of Elizabethtown Gas ("Liberty Audit"), prepared by the Liberty Consulting Group and presented to the New Jersey Board of Public Utilities. The Liberty Audit of AGLR affiliate Elizabethtown Gas (See Attachment A, Joint Applicants' response to Staff data request DLH 6.01, Exhibit 2, pp. 46-47) found that the utility granted to Sequent the right of last refusal for spot market purchases. That is, after all other sellers bid on a particular spot market purchase, Sequent was permitted to underbid all other sellers. Liberty warned that this behavior would eventually discourage competing unaffiliated suppliers and ultimately raise gas prices. (*Id*.) Liberty recommended that Elizabethtown Gas develop alternative procedures that did not allow Sequent to match the lowest bid. (*Id*., p. 54)

Q. Do any of the four contracts you reviewed grant Sequent the right of last refusal for spot market purchases?

A. No.

Q. What do you recommend?

A. I recommend that the Commission specifically prohibit the Joint Applicants from granting Sequent the right of last refusal for spot market purchases. Sequent should only have the same bidding rights as unaffiliated traders. That way, unaffiliated suppliers will not be discouraged, and Nicor Gas can receive the market price for each spot market purchase.

Sections 7-204(b)(2) and (3)

Q. What do you recommend with respect to the OA?

A. I recommend that the Commission condition its findings that the proposed reorganization will not result in the unjustified subsidization of non-utility activities by the utility or its customers under Section 7-204(b)(2) and that costs and facilities are fairly and reasonably allocated between utility and non-utility activities in such a manner that the Commission may identify those costs and facilities which are properly included by the utility for ratemaking purposes under Section 7-204(b)(3) on Sequent not being a signatory to the OA. All transactions with Sequent besides those provided under the four contracts discussed under Section 7-204A(a)(5) should be governed by a separate agreement subject to separate Commission approval.

Q. Why?

A. Sequent sells gas and provides management services to utility affiliates. The existing agreements between Nicor Gas and Sequent filed under Section 7-204A(a)(5) cover commodity and storage transactions, but AMAs or other management services such as for Hub services are different. They involve close interaction between the parties. For example, in AMAs, the utility and the asset manager must consult on intra-day and intra-month changes in nominations to the interstate pipelines. These types of transactions between Sequent and utility affiliates are generally not constrained by a market. The Commission needs to scrutinize those larger and more complex transactions more closely to protect ratepayers' interests.

Q. Please explain how utilities typically buy gas.

A. Typically, the utility assembles a portfolio of transportation contracts and storage services. Interstate transportation pipelines receive gas in the field and transport that gas to the utility's citygate or delivery point.

Storage services are provided by interstate pipelines or independent providers, or the physical assets can be owned by the utility. Storage allows the utility to purchase more gas than its customers use and withdraw it later at a more opportune time. Storage is most useful in providing deliverability to the utility. Typically, the utility buys extra gas in the summer when demand is low, stores it, and withdraws it in the heating season when the demand is high. Gas prices are typically, but not always, lower in the summer and higher in the winter. This behavior usually reduces the total cost of gas relative the case with no storage. This is called the physical hedge.

Given the demand for gas by the utility's customers, the utility's task is to assemble a portfolio of assets that meets the demand in an optimal way. The considerations include availability of assets, how much each asset costs, and the markets the asset enables the utility to reach. In any case, there is a very strong incentive to create a portfolio that meets peak demand. Utility customers face severe consequences if they are not able to heat their homes, or hospitals or other public buildings. And insufficient pressure within the pipelines might create safety concerns. Utilities thus typically construct portfolios that have greater capacity than they are likely to need at any one particular time, so they have a margin for error.

A utility purchases gas, which it then sells to its customers. The utility typically makes three kinds of purchases. Baseload purchases are when the same amount of gas is purchased each day, usually at a first of month price. The customer usually pays a reservation price, either as a fixed amount per month or as an addition to the volumetric price. Swing contracts grant the utility the right, but not the obligation, to buy up to a given amount. Swing purchases are sometimes, though not always, priced at a daily price. Spot market purchases are typically purchases only for a day or two in the market at a fixed or daily index price.

Utilities typically buy gas in the field and transport the gas using transportation. But citygates have price indexes as well, and gas can be bought there.

Q. What changes with the use of an AMA?

A. AMAs operate differently. The asset manager, rather than the utility, schedules receipts and deliveries with transportation and storage service providers. The utility provides its estimated load over some future period to the asset manager. The asset manager is then tasked with delivering the gas where it’s needed. And the asset manager can use the assets to enter into non-utility deals that generate profits.

Q. Please discuss how gas is priced under AMAs.

A. The usual practice is to price gas using index prices. Baseload gas is typically priced at First-of-the-Month prices for the relevant field locations. Swing gas can use a daily or monthly price, while spot gas will use some type of daily price. The utility pays the demand charges as well as the fuel and variable costs for all transportation and storage services.

Q. How are asset managers paid?

A. There are several ways that the utility can compensate the asset manager for its services. A typical method is to share the profits that the asset manager can generate. Another way is to reflect the value of the assets to the asset manager through a discount off of the index price that the utility pays.

Q. Why should the Commission concern itself at this time with AMAs between Sequent and AGLR utility affiliates?

A. Sequent has an AMA with every AGLR utility affiliate. In my opinion, it appears that AMAs are an important part of AGLR's business strategy.

Q. What are your concerns with the use of AMAs?

A. First, there is an obvious concern with these arrangements when they are between affiliates, since a higher gas price for ratepayers would raise Sequent's profits. The costs are recovered from ratepayers under the Purchased Gas Adjustment, but at least some of the profits accrue, below the line, to Sequent's shareholders.

Second, there are many ways that the agreement can be manipulated to the shareholders benefit, and some are nearly undetectable. For example, the utility might establish its nominations and storage usage to accommodate its affiliate. These arrangements can be changed mid-month, prices might be agreed to that are too high, or the utility might abjure from declaring *force majeure*, which might result in the utility unnecessarily paying pipeline penalties. Further, any sharing that occurs may be enabled by utility behavior that raises ratepayers' costs. If the utility buys excess transportation capacity, the AMA has greater scope for engineering unregulated deals, which may increase profits, but it likely raises ratepayers' costs overall. Finally, note that any winning bidder for an AMA has an incentive to make side deals with the utility.

Q. What should be a prerequisite for Commission approval of an AMA?

A. AGLR should be required to demonstrate that an AMA will decrease gas costs relative to the Local Distribution Company buying its own gas.

Q. What do you recommend for conditions on AMAs for Nicor Gas?

A. I recommend that, Nicor Gas be required to consult with Staff when developing the form of its AMA and to submit any proposed AMA to the Commission for approval. By requiring Nicor Gas to develop its proposal in consultation with Staff and subject to Commission approval, the Commission can satisfy itself that ratepayers' interests are protected. Further, the AMA can be so constructed as to derive as much bidding interest as is reasonable.

Q. Please summarize your recommendations.

A. I recommend that the Commission find that the proposed reorganization is not likely to have a significant adverse effect on competition in those markets over which the Commission has jurisdiction in compliance with Section 7-204(b)(6). I recommend that the Commission approve the four existing agreements between Nicor Gas and Sequent filed under Section 7-204A(a)(5). However, I recommend that the Commission prohibit Nicor Gas from granting Sequent the right of last refusal for spot market gas purchases. The Commission should condition its findings that the proposed reorganization will not result in the unjustified subsidization of non-utility activities by the utility or its customers under Section 7-204(b)(2) and that costs and facilities are fairly and reasonably allocated between utility and non-utility activities in such a manner that the Commission may identify those costs and facilities which are properly included by the utility for ratemaking purposes under Section 7-204(b)(3) on excluding Sequent from the OA. The Commission should also require the Joint Applicants to take certain, explicit steps and receive Commission approval before Joint Applicants are allowed to sign an asset management agreement (“AMA”). For example, any AMA should be developed in consultation with the Commission Staff and opened up for bidding by all interested marketers. In addition, AGLR should be required to demonstrate that an AMA would reduce gas costs for Nicor Gas.

Q. Does this conclude your direct testimony?

A. Yes.

The Company awarded four contracts totaling 17,000 Dth/day: one for 5,000 Dth/day and three for 4,000 Dth/day, on three different pipelines. Carryover contracts from competitions in prior years provided another 22,000 Dth/day. The four winners included: (a) two who had won the competitions in both 2006/07 and 2007/08, (b) a new non-affiliated supplier, and (c) SEM. Post-bid negotiations for the 2008/09 competition resulted in reduced volumes from three of the four winners (including SEM). Affiliate SEM was not a supplier of peaking services in 2005/06, 2006/07 or 2007/08. SEM did submit a bid in 2007/2008, but its bid was disqualified because it came after the submission deadline.

The Company did not inform other bidders of SEM's participation, but ensured confidentiality of all their bid information, stating that only ETG personnel and AGL Service Company employees supporting ETG would have access to that information.

e. Spot-Market Gas

The Gas Purchase and Sale Agreement that forms part of the Asset Management and Agency Agreement addresses what happens should ETG's nominations turn out not to provide enough gas, or when a change in the availability of anticipated supplies occurs. Insufficient gas results typically when ETG experiences an unanticipated load change. SEM in such cases will find more gas, but "... at a mutually agreeable price," rather than at the prices defined for normal purchases.[26] Such purchases comprise "spot-market" transactions. There exists no reference price for them; rather, SEM finds some gas in the marketplace, and charges ETG a price that SEM and ETG agree on. ETG has the option of obtaining price quotes from third parties, but SEM has the right to match any offer that ETG finds.

The table attached to this chapter lists the days in the last two winters (2007/08 and 2008/09) when ETG made spot purchases. It also lists the circumstances under which the spot purchases were made, who the suppliers were, and what ETG paid for the gas. The table shows that SEM was a frequent provider of spot gas on Texas Eastern and Transco. Other suppliers also provided some supply during the first winter; by the second winter, however, SEM sold the gas in all but two purchases. These exceptions occurred in early December 2008. ETG's Manager, Gas Supply, reported that he "made some calls" to seek additional gas on these days, but SEM was often the only one who had supply available. ETG also reports that it has not maintained active gas-supply agreements with suppliers other than SEM.[27] Liberty examined comparable prices to

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[26] Gas Purchase and Sale Agreement, p. 10. The Gas Purchase and Sale Agreement was provided as part of the Company's response to DR #29.

[27] In comments on Liberty's Draft Report, the Company reports that "ETG does have active GISB/NAESB contracts in place with suppliers other than SEM to contract for spot supply." In response to a data request on this question, however, the Company stated, "With a few exceptions, these contracts were executed by NUI Utilities, Inc. and nearly all have remained inactive since January 13, 2004..." (Response to DR #872) When asked about the discrepancy, the Company stated:

> *The response to DR #872 was meant to indicate that ETG has not used the majority of its GISB/NAESB gas supply contracts during the past 5 years. ... A majority of the GISB/NAESB contracts that ETG holds are with counter-parties that provide supply to receipts other than at ETG's city-gates. Given that intra-day purchases require those purchases to be made at ETG city-gates, the majority of the currently held contracts are not used.* (Response to DR #1028)

Liberty also notes that the asset-management agreement requires ETG to buy all of its nominated supplies from SEM; thus, gas-supply contracts that provide for delivery other than on an intra-day basis at ETG's city gates cannot be used.

test the competitiveness of such purchases from SEM. SEM's prices were about the same as those from the non-affiliated suppliers on days when others provided supply to the same places on the same day.

f. Forecasting and Supply Planning

The 2008 goals for AGLR's Gas Supply and Capacity Planning department include:

- Finalize the extension of ETG's asset-management relationship with SEM
- Develop a long-range portfolio plan for ETG
- Hire an analyst to assist with regulatory processes in New Jersey.

Another goal was to "Investigate, recommend and analyze projects providing incremental revenue to AGLR." None of the goals addressed the possibility of reducing ETG's gas costs.

The Company reports that the performance quality of the Gas Supply and Capacity Planning department consists primarily of evaluation against individual performance objectives established for the department's leadership. The Managing Director's number-one goal for 2008 was extension of ETG's asset-management agreements with SEM; his objectives for 2009 include looking for on-system peaking opportunities for all of the LDC subsidiaries, but nothing about seeking to reduce ETG's gas costs.

g. Violations of FERC Rules

The Company reported that SEM had recently paid a civil penalty for self-reported violations of the U.S. Federal Energy Regulatory Commission's (*FERC's*) policies on capacity release, including the posting and bidding requirements and the shipper-must-have-title rule, over a 28-month period. Part of the civil penalty included settlement of an alleged violation of the rules prohibiting buy/sell transactions.

The Company reported that some of the violations involved one of ETG's Texas Eastern contracts. These violations occurred over 20 months, from September 2005 through April 2007. The Company also reported that, upon learning of the FERC settlement with BP Energy related to capacity release, shipper-must-have-title and the prohibition of buy/sell transactions, AGLR retained outside counsel to conduct a review of its compliance with the FERC's capacity-release and other rules.

AGLR's Internal Audit department participated in the review, "... at the request and direction of counsel." Accordingly, the Company argued that Internal Audit's work is protected from disclosure by attorney-client privilege and the work product doctrine. Liberty was provided access to "documents relating to the ETG assets produced by outside counsel to FERC Enforcement Staff in response to Enforcement Staff's data requests," but three months after our request, which was well after the close of field work. Thus, Liberty was unable to pursue the impact of these violations as part of this audit.

The violations occurred during the term of ETG's first asset-management agreement with SEM. That agreement provided a fixed payment for SEM's access to ETG's gas-supply assets, rather than the sharing arrangement which is part of the current agreement. Thus, to the extent that SEM assigned an ETG asset to itself and then used that asset in a transaction in which ETG did