

**STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION**

Illinois Commerce Commission
On Its Own Motion :
-vs- :
Atmos Energy Corporation :
Reconciliation of revenues collected under : No. 06-0741
gas adjustment charges with actual costs :
prudently incurred. :

**REPLY BRIEF ON EXCEPTIONS OF THE STAFF OF THE
ILLINOIS COMMERCE COMMISSION**

NOW COMES Staff (“Staff”) of the Illinois Commerce Commission (“Commission”), by and through its undersigned counsel, pursuant to Section 200.830 of the Commission’s Rules of Practice (83 Ill. Adm. Code 200.830), and respectfully submits its Reply Brief in the instant proceeding.

Staff has previously addressed in testimony and/or briefs most issues raised by Atmos in its BOE. Staff will not rehash every response that it has already made. Staff, however, does not concede an issue if it does not respond to it in this RBOE but is instead relying upon positions that Staff has already made in prior filings.

Legal Standard

As Staff noted in its Initial Brief (at 4), Section 9-220(a) of the Act requires the Commission to initiate annual public hearings "to determine whether the clauses reflect actual costs of . . . gas . . . purchased to determine whether such purchases were

prudent, and to reconcile any amounts collected with the actual cost of . . . gas . . . *prudently* purchased" (emphasis added). In each such proceeding, the burden of proof is on the utility to establish the *prudence* of its applicable costs.

Both the Commission and the Illinois Appellate Courts have defined prudence as the standard of care which a reasonable person would be expected to exercise under the same circumstances encountered by utility management *at the time decisions were made*. In determining whether a decision was prudently made, only those facts available *at the time judgment was exercised* can be considered. *Hindsight review is impermissible* in the context of a prudence determination. *Illinois Power Company v. Illinois Commerce Comm'n*, 245 Ill. App. 3d 365, 612 N.E. 2d 925, 929 (Ill. App. 1993); *Illinois Commerce Comm'n v. Commonwealth Edison Co.*, Ill. C.C. Docket No. 84-0395 (Order Date October 7, 1987, p. 17)(emphasis added).

Atmos Application of Legal Standard

Although, Atmos appears to agree with these fundamental prudency review principles, its application of these principles is novel indeed. Atmos also appears to take the position that the prudency standard is essentially one that always supports what it did, no matter how transparently inconsistent the argument is.

For instance, Atmos states that a hindsight review is designed to avoid putting "an additional burden" on the utility but then puts an additional burden on Staff by arguing that hindsight requires Staff to carry the burden of proof of what a reasonable gas price would have been. (Atmos BOE at 16-19.) Of course, this is nonsense in a few respects. First, Atmos cites to a case that is not a Section 9-220 case. Atmos contends that the purpose of the hindsight prohibition "is to avoid placing an additional

burden on utilities.” (Atmos RBOE at 17, *citing Business and Professional People for the Public Interest v. Ill. Commerce Comm’n*, 146 Ill. 2d 175, 209 (1991)(“BPI”). Atmos’ point is entirely misplaced. The BPI quote is inapposite as it was made regarding a Section 9-213 case, which does not contain a prudency review and which applies only to electric utilities’ generating plants. 220 ILCS 5/9-213. Further, Section 9-220 places the burden of proof squarely on Atmos’ shoulders. 220 ILCS 5/9-220(a).

Likewise, Atmos argues that Staff cannot look at a decision made over ten years ago. Atmos does not inform us why ten years is critical. It is unclear if five years is also too far past for a reconciliation proceeding. This too is nonsense because Section 9-220 specifically requires that the Commission go back in time to determine the prudency of gas purchases before reconciling the revenues collected with the actual costs of gas prudently purchased. 220 ILCS 5/9-220(a). Section 9-220 does not place any limits in how far back the Commission can go in reviewing PGAs. In fact, the very nature of a prudency review accommodates the Commission going back in time to review PGAs because it does prohibit hindsight review and its consideration is limited to those facts available at the time judgment was exercised.

Atmos contends that the prohibited hindsight review “applies against Staff (and intervenors). Atmos RBOE at 16-17. Well, yes and no. Since Staff is not a utility, it does not apply to Staff’s decision making process. Since Atmos is a gas utility it does apply to its decision making. This seemingly simple concept is well demonstrated by the Atmos use of the “Comparable Utilities” data. While Staff is free to seek out such data to see if there are outlier prices in the market place, it could not use this data to argue that Atmos was imprudent. Atmos contends that using the Comparable Utility

data is in fact hindsight review but is allowable in this proceeding by Atmos because (1) it is merely a secondary argument, and (2) an allegation that Staff argued that Atmos paid a “high” price. (Atmos BOE at 11.) First, Atmos misrepresents Staff’s position (see below). Second, Atmos fails to cite to any support for this novel theory because there is none. Third, Staff fails to see the fine distinction that Atmos appears to draw to have it both ways. Either hindsight review is prohibited or it is not. Staff simply cannot open the door to applying a hindsight review.

It is also noteworthy, that Staff never attempted to use the Comparable utility data in this proceeding. In fact, Staff objected to the introduction of it at the evidentiary hearing. Tr. at 53-56. It is Atmos that applies a hindsight factor to “wash clean” its imprudent decisions. Atmos attempts to “muddy” or misrepresent the once clear waters of the applicable legal standards because it must to support its unsustainable position.

Introduction

In its BOE, Atmos asserts that the PO ruled that Atmos’ decision in 1996 to eliminate its TETCO transportation and storage portfolio is the basis for the Commission determining that gas prices are imprudently high in 2006. (Atmos BOE, at 2) This misrepresents Staff’s position, and, in turn, the PO’s logic. So that the Commission understands Staff’s logic, Staff will clarify the sequence of events that transpired with respect to the Harrisburg-Galatia customers. It is that sequence that led Staff to conclude that gas costs associated with the AEM contracts were imprudently high.

As noted by Atmos in its BOE, its predecessor company (United Cities) began releasing capacity on TETCO in 1996. The utility completed the process by 2001. (*Id.*, at 3; see *also* fn. 5, at 3.) Thus, after the transfer and relinquishment were complete,

Atmos did not control the assets that could deliver gas to the Harrisburg-Galatia customers. (*Id.*) Those customers could only be served by TETCO. (Staff IB, at 8.) Woodward Marketing acquired some, though not all, of the TETCO assets. Woodward was a partially owned affiliate of United Cities. (Atmos BOE, at 3.)

When the TETCO transfers were occurring, Woodward, which Atmos acquired in full and renamed AEM (Atmos BOE, at 3), did not supply the Harrisburg-Galatia customers, except for four months in 1999. (Atmos Ex. 2.2.) However, beginning in November 2003, AEM was the only supplier for them going forward through the reconciliation period. (*Id.*) Beginning with the November 2005 contract, AEM imposed a large adder onto the market index price that had previously not had one. This same adder was continued in the November 2006 contract. (Staff IB, at 4-7)

Atmos asserts that the PO's conclusion that the contracts were imprudent is based upon two general ideas. They are, according to Atmos, that the 1996 decision to release TETCO capacity was imprudent and that Atmos' opt-in procedure for its RFPs was imprudent. Atmos contests both these claims. (Atmos BOE, 2-3) Atmos argues that what it calls the 1996 Capacity Release is not germane to whether the contracts are prudent. (*Id.*, at 3-12) It also posits that its RFP processes insulated it from any charges that the resulting contracts are not competitive. (*Id.*, at 12-15)

Atmos further contests the actual disallowances by considering the pricing from comparable utilities. It claims that its comparisons are not hindsight review, that it 'had general knowledge' of the market, and that market data obviated a disallowance. (*Id.*, at 15-21) Finally, Atmos also contests the PO's conclusion that utilities have an incentive to favor its affiliates. (*Id.*, at 21-25)

Staff considers each of these arguments in turn.

Atmos' misrepresents Staff's position concerning the relationship between the 1996 releases and the imprudence.

Staff argued in its testimony and briefs that stripping out the Harrisburg-Galatia TETCO assets made Atmos vulnerable to less competitive bids. Because Atmos lacked TETCO assets, the pool of potential bidders was restricted. (Staff IB, 7-8.) One, it was no longer able to source its purchases in more liquid, downstream markets. (*Id.*, 8-9.) Two, suppliers were needed to be able to deliver on TETCO. (*Id.*, 9.) Atmos asserts in its BOE that its bidding processes were appropriate and did not “discourage[] any qualified entity from bidding for business[.]”. (Atmos BOE, 15.) As explained by Staff in its IB, an auction is only as competitive as the underlying market. If the market is characterized by very few suppliers, the prices that result from an auction (or an RFP bidding process) are likely to be higher than the competitive level. (Staff IB, 8; see also Staff RB, 3-4)

Staff did assert that it was imprudent for Atmos to release its capacity on TETCO, but its arguments about 2006 gas costs does not depend on whether the Commission agrees that it was imprudent. (Staff RB, 4.) Notably, the fact remains that Atmos had few options to purchase gas besides AEM's response to the RFP. In fact, there were no other bidders for the 2005 contract. (Staff IB, 7.) Not having transportation assets available certainly contributed to limit the number of potential bidders, which in this case was only its affiliate AEM. (*Id.*, 8-9.)

Atmos argues that this docket should not reach a prudence determination about the 1996 Capacity Release. For example, it states, “the Commission should decline to

review the capacity release either generally (the release of all the capacity) or specifically (the release of the portion of capacity that was obtained by Woodward)...” (Atmos BOE, at 5.)

However, in the very next section, Atmos asserts that the releases were prudent and benefitted ratepayers. (*Id.*, at 6) Staff has acknowledged that such releases are not automatically imprudent, which does not mean that they are prudent. Obviously Staff questioned whether these particular releases were prudent. (Staff IB, 12; Staff RB, 4.) In particular, Staff distinguished between Atmos’ situation and other cases where a utility might have a better reason. In its RB, Staff stated “Staff emphasized that the comparison is usually made for utilities with well-developed markets.” (Staff RB, at 7.) Staff used the example of Peoples Gas, which “can readily purchase gas in liquid markets at the citygate. Access to a liquid market means that citygate gas purchases are a realistic alternative to field purchases within a portfolio that includes both types of purchases.” (*Id.*; see also Staff IB, at 12.)

Staff concluded that the AEM contracts were imprudent based upon the time in which the costs were incurred. (Staff Ex. 4.0, at 8:155-157; Staff IB, at 12.) As argued above, Harrisburg-Galatia’s reliance on a single interstate pipeline for delivery of gas enabled the ability to charge imprudently high costs. The capacity releases alone did not cause imprudently high costs, but made ratepayers vulnerable to a single supply source and a single bid in 2005. (Staff RB, at 4)

Atmos states that there is no “causal link” between the capacity releases and the change in the price of gas for the 2005 and 2006 contracts. (Atmos BOE, at 12) This may be accurate, but only if ‘no causal link’ means it cannot be established that capacity

release directly implies imprudently high price. As noted by Atmos, Staff acknowledged as much. (*Id.*) However, as noted above, Staff's logic is a bit more nuanced. Staff claims that the capacity releases make the Harrisburg-Galatia contract more vulnerable to a single or a few bids, which makes it more likely that ratepayers will end up paying too much for gas. Thus the Commission is not required to conclude that the releases were imprudent to disallow the excess gas costs. Similarly, the Commission may conclude the capacity releases were prudent, yet also decide that the 2005 and 2006 contracts have imprudently high gas costs.

Atmos several times notes that several other suppliers besides AEM supplied the TETCO customers. For the time period 1997-2006, it notes that there were 12 different suppliers. (Atmos BOE, at 10.) First, note that the releases were not completed until 2001. (*Id.*, at 10, fn. 5.) Second, however, the more relevant, recent period is from 2003 on and in that period, AEM was the sole supplier. (Staff IB, 6.)

Atmos has noted that the number of bids increased from the 2005 contract (one) to the 2006 contract (three). (Atmos IB, 21) However, note that for the latter year, Atmos ruled one bid non-conforming and evaluated the other non-AEM bid even though it did not strictly comply with the terms of the RFP. (Atmos IB, 9) Thus, the 2006 contract RFP, which Atmos counts as successful, does not substantially differ from the monopolistic 2005 contract RFP.

Conducting an RFP process does not automatically insulate Atmos from claims that the resulting prices are imprudently high.

Atmos objects to the PO's agreement with Staff's argument that it imprudently restricted the number of entities to which RFPs were distributed. Atmos focuses on the

op-out versus the opt-in approaches. (Atmos BOE, at 12.) In the opt-in approach, entities are crossed off the bid list when they do not positively indicate that they wish to receive an RFP, while they are retained on the list unless they communicate that they don't want to be on the RFP list. (Staff IB, at 9.) Staff contended that opt-in tended to unnecessarily restrict the number of potential bidders, and other things equal, would likely lead to fewer bids, which is what occurred. (*Id.*, at 9-10.) In Staff's view, this is imprudent. (Staff RB, at 4-5.) Of course, Staff never claimed that fewer RFPs mailed automatically led to fewer bids. However, AEM was the supplier for the 2003, 2004 and 2005 contracts. Fewer RFPs were mailed in each year. By 2005, only one bid was received. Further, for the 2006 contract, more RFPs were mailed (22 for 2006, 8 for 2005) and three bids were received. (Atmos Ex. 4.0, 199-120; Staff Ex. 3.0, 7:138-141). While this is not dispositive, it does not invalidate the relationship between number of RFPs and number of bids.

'Knowing the market' does not insulate Atmos from accepting excessive bids.

This is a meaningless argument, and should be dismissed. A utility could know the market and know that the price is excessive, but accept the bid nevertheless. This argument simply asks the Commission to trust the utility regardless of the outcome. It could be applied to any imprudence claim or proposed disallowance and would by its mere assertion be exculpatory. This argument should be summarily dismissed. (See also discussion above under Legal Standard.)

Atmos claims that a utility does not have an incentive to favor its affiliates is absurd.

Again, Atmos presents a readily discernibly unfounded argument that should be summarily dismissed. As a simple matter of arithmetic, it's an obvious and long-standing principle of utility regulation that a utility can increase shareholder profits at ratepayer expense by purchasing inputs at higher than market prices from its affiliates or selling to its affiliate at lower than market prices. (Staff Ex. 3.0, 7: 118-128) The Public Utilities Act ("PUA") contains two sections that directly address affiliate transactions. Sections 5/7-101, Transactions with Affiliated Interests, and 5/7-102, Transactions requiring Commission Approval, contain provisions for Commission oversight over utility transactions with affiliates. These PUA sections are in place to prevent improper transactions with affiliates.. The reason such extensive scrutiny is needed is that detecting and enforcing cross-subsidy is not an exact or transparent process. Staff acknowledges that the possibility that the utility might be caught decreases the incentive to favor an affiliate. (Atmos BOE, at 21-22.) However, by perusing the past fifteen years of Illinois utility regulation, one can easily find examples where the utility apparently calculated that its behavior would not be detected. (See *for example*, Peoples Gas Light and Coke Company, Docket No. 01-0707 and Nicor Gas Docket Nos. 01-0705/02-0067/02/0725.) On the other hand, since the Commission has limited authority to impose fines, the worst punishment that a utility is likely endure is to be ordered to disgorge imprudently incurred costs. This simply returns the utility to status quo ex ante.

Staff acknowledges that Atmos could not favor Woodward Marketing in 1996, simply because that date is before Atmos purchased United Cities. (Atmos BOE, at 3.) But Staff's disallowance dates from 2006, when Atmos did, in Staff's opinion, favor its affiliate, AEM. Atmos may not have planned the potential outcome that the TETCO capacity relinquishments created, but it purchased the arrangement when it bought United Cities. (Staff Ex. 3.0, at 7:139-147.)

Finally, Atmos asserts that it did not favor its affiliate. Here again, Atmos focuses on the TETCO capacity decisions. (Atmos BOE, at 24.) As noted above, this is not Staff's argument. Staff's proposed disallowance is based upon Atmos' decisions in 2005 and 2006, when it signed the contracts with AEM. (Staff IB, at 14-15.) The TETCO capacity decisions are, in Staff's view, one of the factors that permitted AEM to charge an excessively high price. (Staff Ex. 4.0, at 8.)

Conclusion

WHEREFORE, for all of the following reasons, Staff respectfully requests that the Commission's order in this proceeding reflect all of Staff's recommendations.

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Respectfully submitted,

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