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CHIEF CLERK'S OFFICE

Illinois Commerce Commission)
On Its Own Motion)
)
vs.)
)
Reconciliation of revenues collected)
under gas adjustment charges with)
actual costs prudently included.)

Docket 00-0720

THE CITY OF CHICAGO'S BRIEF ON EXCEPTIONS

Pursuant to Section 200.830 of the Rules of Practice of the Illinois Commerce Commission (the "Commission") and the schedule established in the Administrative Law Judges' Proposed Order ("Proposed Order") dated November 16, 2001, the City of Chicago (the "City"), by its attorney, Mara S. Georges, Corporation Counsel, submits its Brief on Exceptions in the above-captioned case.

SUMMARY

The Proposed Order is incomplete. The Proposed Order sets forth a definition of "prudence" and then fails to apply that definition to the facts in this case. The Proposed Order concludes that because the City did not recommend a cost disallowance, it is not necessary for the Proposed Order to determine whether The Peoples Gas Light and Coke Company's ("Peoples") failure to use financial hedges during the reconciliation period was imprudent. It is not incumbent on the City to recommend a cost disallowance. Peoples' actions were imprudent irrespective of any cost disallowance. Nor is it the City's job – as the Proposed Order asserts – to present "evidence as to what strategy implementing financial hedges, if any, would be an effective tool in the reduction of price volatility." Proposed Order at 7.

The evidence in this case is clear. It is not, as the Proposed Order suggests, ““honest differences of opinion””, (Proposed Order at 6) as to whether there was price volatility at the time Peoples was planning for its purchasing strategies for the 1999-2000 winter heating season. City witness Dr. Robert J. Michaels – a professor of economics at California State University, Fullerton, and an expert in regulation, deregulation, and competition in the electric and gas industries – showed that price volatility fluctuated widely in Spring 1999 using (1) the data Peoples had available to it in Spring 1999 (the time in which Peoples was planning its purchases for Winter 1999-2000) and (2) a commonly-used method for measuring volatility. Peoples presented no substantive challenge to Dr. Michaels’ analysis. All Peoples could muster was to insist repeatedly that the projected price data it reviewed in Spring 1999 showed little volatility.

This is not “honest differences of opinion.” The uncontradicted evidence of record is that there was great price volatility in Spring 1999 and that Peoples was imprudent for not having a financial hedging program in place during the reconciliation period. This conclusion is required whether or not the City or any other party showed that Peoples could have saved money if it had had a financial hedging program in place.

ARGUMENT

A. The Proposed Order Fails to Apply Its Definition of “Prudence” to the Facts of this Case.

At page 6, the Proposed Order provides the definition of “prudence” that it purports to apply to the record evidence. However, after setting forth this definition, the Proposed Order notes that the City did not present “evidence as to the amount of money that [Peoples] could have saved, had it embarked on a strategy involving the use of financial hedging instruments. Without

such evidence, it is difficult to ascertain what savings, if any, could have been achieved.”

Proposed Order at 7. In essence the Proposed Order finds that since the City made no recommendation for a cost disallowance, it need not determine whether Peoples failure to have a financial program in place during the reconciliation was imprudent.

The Proposed Order’s “no harm, no foul” approach does not comport with the requirements of the Public Utilities Act (the “Act”). The Commission cannot act as a passive observer in rate proceedings before it. The Illinois supreme court held in *People ex. rel. Hartigan v. Illinois Commerce Commission*, 117 Ill. 2d 120, 135, 510 N.E.2d 865, 871 (1987), that:

“under the comprehensive scheme set out in the Public Utilities Act, the Commission is to be an active participant. The Commission is not merely an arbitrator between a utility seeking a rate increase and any parties who happen to oppose it. Rather, the Commission is an investigator and regulator of the utilities, and ... it may not rely on intervening parties to contest a rate increase or to challenge the evidence offered by the utility.”

Acting in accordance with its duties under the Act, if the Commission finds that Peoples was imprudent for failing to have a financial hedging program in place for Winter 1999-2000, then it is incumbent on the Commission to determine what imprudent costs should be refunded to ratepayers.

In short, the fact that the City did not recommend a cost disallowance does not mean that the Commission can forego its obligation to weigh the evidence to determine if Peoples was imprudent for failing to have a financial hedging program in place during the reconciliation period. If the Commission finds that Peoples should have had a financial hedging program in

place for Winter 1999-2000, then it should conduct additional investigation to determine what additional costs Peoples incurred during the reconciliation period.

B. The Proposed Order's Conclusion that the Conflicting Evidence Represents an "Honest Difference of Opinion" Cannot Withstand Even Minimal Scrutiny.

After briefly discussing the evidence in the case, the Proposed Order states that there is conflicting evidence as to whether price volatility existed in Spring 1999 and that, at best, "the Commission is presented with 'honest differences of opinion.'" Proposed Order at 6. The Proposed Order concludes "that there is no basis for substituting the City's judgment for [Peoples'] on the issue of using financial instruments." *Id.* This conclusion is overwhelmed by the evidence in this case.

In reality, the evidence is almost completely one-sided. Using data available to Peoples at the time it was planning its purchases for the Winter 1999-2000 and a widely accepted formula for calculating volatility, Dr. Michaels' showed that "volatility in the Spring of 1999 fluctuated widely." City Ex. 1 at 20, Ex. ___ (RJM-2); City Ex. 2 at 4-5, Ex. ___ (RJM R-1). Dr. Michaels added that price volatility increased as Winter 1999-2000 approached. He also stated that:

[i]n September 1999, volatility more than doubled, and then remained at that higher level for the three ensuing months. A sustained change of this size was unprecedented in the years since the deregulation of gas markets. The increase in volatility is a phenomenon quite independent of any change in the average price. Page 2 of Exhibit ___ (RJM-2) shows that while price was indeed rising between April and September, its instability is more pronounced during and after September than before.

City Ex. 1 at 20. Peoples still refused to purchase financial hedges during this "unprecedented" change in volatility, although it was not foreclosed from doing so. *Id.* at 22.

Dr. Michaels' analysis went completely unchallenged on the record. As Dr. Michaels pointed out in his rebuttal testimony, Peoples did not present any evidence in its rebuttal testimony that Dr. Michaels' analysis was incorrect or irrelevant. City Ex. 2 at 2. Moreover, after Dr. Michaels, in his rebuttal testimony, directly challenged Peoples' assertion that projected prices showed little volatility in Spring 1999 (City Ex. 2 at 3-5), Peoples elected not to file surrebuttal testimony to respond to this charge. Also, Peoples did not conduct any cross-examination concerning Dr. Michaels' analysis.

All Peoples did in response to Dr. Michaels' quantification of "unprecedented" price volatility was to insist over and over that it did not perceive any price volatility in Spring 1999. This assertion was completely unsupported. As Dr. Michaels noted, Peoples did not provide "any algebraic formula [it] used ... in calculating volatility, any numerical exhibit regarding volatility, or any standard for determining whether volatility is high or low." City Ex. 2 at 3-4.

The contrast between Dr. Michaels' unchallenged and rigorous analysis showing price volatility and Peoples' bare assertion to the contrary is striking. The contradictory conclusions are not – as the Proposed Order declares – "at best, 'honest differences of opinion.'" Peoples' unsupported assertion is contradicted by Dr. Michaels' analysis – which, in contrast, is unassailed on the record.

The Proposed Order notes that Dr. Michaels agreed that "it is not *per se* imprudent not to use financial instruments." Proposed Order at 7. The Proposed Order ignores the rest of Dr. Michaels' testimony. He explained that while

[f]ailure to [financially] hedge is not *per se* imprudent, ... hedging need not be an all-or-nothing decision. A prudent risk management program may indicate that at certain times a company

should decrease its hedged positions, conceivably even to zero. Assuming that a corporation's shareholders bear the risks in question and the commodity is an important part of the firm's costs, it is hard to imagine a prudent risk manager would choose not to hedge any of it for several years running. This would particularly be the case if [the commodity's] cash price were highly volatile and liquid instruments like NYMEX futures and options were in common use.

City Ex. 2 at 1. Moreover, with that said, the reconciliation period was certainly not a time to reject financial hedges. As noted above, Dr. Michaels testified that "volatility in the Spring of 1999 fluctuated widely." (City Ex. 1 at 20, Ex. ____ (RJM-2); City Ex. 2 at 4-5, Ex. ____ (RJM R-)) and that price volatility increased as Winter 1999-2000 approached. City Ex. 1 at 20.

In sum, the only fair reading of the record shows that projected prices showed great volatility in Spring 1999. For this reason, the Commission should find that Peoples was imprudent for failing to have a financial hedging program in place to manage that volatility.

C. Exceptions.

For the reasons discussed above, the Proposed Order should be modified as follows:

1. The portion of the **COMMISSION ANALYSIS AND CONCLUSIONS** section beginning in the second full paragraph on page 6 through third full paragraph on page 7 should be deleted. The following language should be inserted in its place:

The Commission finds that the evidence in this case is almost completely one-sided. Using (1) the data Peoples had available to it in Spring 1999 (the time in which Peoples was planning for the 1999-2000 winter heating season) and (2) a commonly-used method for measuring volatility, City witness Dr. Michaels showed that projected prices showed great volatility in Spring 1999. Peoples did not challenge the accuracy of Dr. Michaels' testimony or calculations in either its rebuttal testimony or during cross-examination.

In response, all Peoples did was to insist that the projected price data it reviewed in Spring 1999 showed little volatility. However, Peoples provided no studies, calculations, or analyses to support its claim.

Peoples' claim that it perceived little price volatility in Spring 1999 is further belied by the actions of its corporate brethren. Dr. Michaels testified that Peoples' affiliates – in their roles as gas producers and gas users – engaged in substantial price hedging during the reconciliation period. Dr. Michaels stated that:

In its 2000 Annual Report Peoples Energy [Peoples' corporate parent] states that approximately 74 percent of production in its oil and natural gas properties is hedged for the next 12 months by swaps and options. (Annual Report at 28.) Peoples Energy views these properties themselves as “providing the company a hedge against the effect of gas price fluctuations on [its] other businesses.” (Annual Report at 16.)

In its role as consumer, Peoples has hedged 7.3 Bcf of gas purchases for its Elwood power plant, a joint venture with Dominion Resources. The program is intended to “reduce price risk, stabilize cash flow, and extract maximum value from its investment.” (Annual Report at 29.) Peoples Energy's total hedged gas rose from 9.3 Bcf to 26.7 Bcf between September 30, 1999 and September 30, 2000. City Ex. 1 at 16.

Thus, it appears that while Peoples was content to allow its captive customers to bear the risks of volatile prices, its corporate affiliates nearly tripled their total hedged gas during the reconciliation period. This business management behavior – by Peoples' own corporate affiliates – establishes a standard of prudence the utility failed to meet.

The Commission has declined in past cases to create an obligation to use financial hedges and it does not do so here.. However, as Dr. Michaels explained, financial hedging instruments are designed to mitigate price volatility, such as that that existed in Spring 1999. The Commission finds that Peoples failure to

develop a financial hedging program in light of such price volatility was clearly imprudent.

The Commission notes that Peoples may have viewed financial hedges as an unnecessary luxury because it recovers its gas costs through its PGA. PGAs allow gas utilities to recover their gas costs on a dollar-for-dollar basis. They have the virtue of making costly, time-consuming rate cases less necessary, but they insulate gas utilities from price volatility risks because those risks are passed on to its captive customers.

In its order in its order adopting a uniform fuel adjustment clause (“FAC”) (the electric utility analog to the PGA) (Docket 78-0457), the Commission warned that the automatic flow-through of fuel costs through the FAC could discourage prudent purchasing because utilities would have fewer incentives to manage their fuel supplies actively. Therefore, the Commission added, “[i]t is absolutely essential, if fuel adjustment clauses are to be used correctly, that the manner by which a utility acquires, handles and accounts for fuel supplies be wholly prudent and defensible.” 45 Pub. Util. Rep. 4th at 19.

The record in this case indisputably shows that the manner in which Peoples acquired, handled and accounted for fuel supplies is not “wholly prudent and defensible.” Apparently, Peoples’ ability to pass price volatility risks on to its captive customers made it indifferent in its fuel procurement practices. As a result, the Commission finds that Peoples was imprudent for not using financial hedging tools during the reconciliation period.

The fact that the City did not present any analysis of savings that Peoples would have realized if it had had a financial hedging program in place is not relevant. The Commission cannot act as a passive observer in rate proceedings before it. The Illinois supreme court held in *People ex. rel. Hartigan v. Illinois Commerce Commission*, 117 Ill. 2d 120, 135, 510 N.E.2d 865, 871 (1987), that

“under the comprehensive scheme set out in the Public Utilities Act, the Commission is to be an active participant. The Commission is not merely an arbitrator between a utility seeking a rate increase and any parties who happen to oppose it.

Rather, the Commission is an investigator and regulator of the utilities, and ... it may not rely on intervening parties to contest a rate increase or to challenge the evidence offered by the utility.”

In accordance with the Commission’s duties under the Act, and in light of our conclusion that Peoples was imprudent for failing to have a financial hedging program in place for Winter 1999-2000, the Commission orders that the record be reopened to determine what additional costs Peoples incurred because of its imprudent actions.

2. The fourth paragraph of the **Finding and Ordering Paragraphs** section should be deleted. The following finding should be inserted in its place:

- (4) the evidence shows that Peoples was imprudent for failing to have a financial hedging program in place during the reconciliation period;

3. The sixth paragraph of the **Finding and Ordering Paragraphs** section should be modified as follows:

- (6) the reconciliations submitted by the Peoples Gas Light and Coke Company of the costs actually incurred for the purchase of natural gas with revenues received for such gas for the reconciliation period beginning October 1, 1999 through September 30, 2000 ~~may properly be~~ are approved pending the investigation described in Finding and Ordering Paragraph (7);

4. The following text should be added as paragraph (7) to the **Finding and Ordering Paragraphs** section:

- (7) the Commission finds that the record in this case should be re-opened to determine what additional costs Peoples incurred – if any – for failing to have a financial hedging program in place during the reconciliation period.

5. The first ordering paragraph of the **Finding and Ordering Paragraphs** section should be modified as follows:

IT IS THEREFORE ORDERED that the reconciliations submitted by the Peoples Gas Light and Coke Company of the costs actually incurred for the purchase of

natural gas with revenues received for such gas for the reconciliation period beginning October 1, 1999 through September 30, 2000, as shown in Appendix A hereto, ~~be, and~~ are hereby approved pending the investigation described in Finding and Ordering Paragraph (7):

6. The following text should be added as second ordering paragraph to the **Finding and Ordering Paragraphs** section:

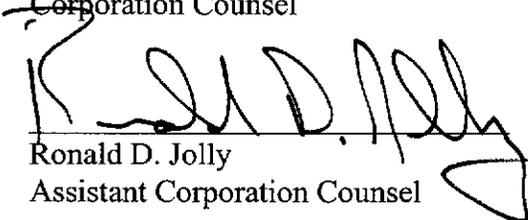
IT IS THEREFORE ORDERED that the record in this case should be re-opened to determine what additional costs Peoples incurred – if any – for failing to have a financial hedging program in place during the reconciliation period.

CONCLUSION

For the reasons discussed herein, the City of Chicago respectfully requests that the Proposed Order be modified as described in this Brief on Exceptions.

Dated: November 30, 2001

Respectfully submitted,
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**STATE OF ILLINOIS
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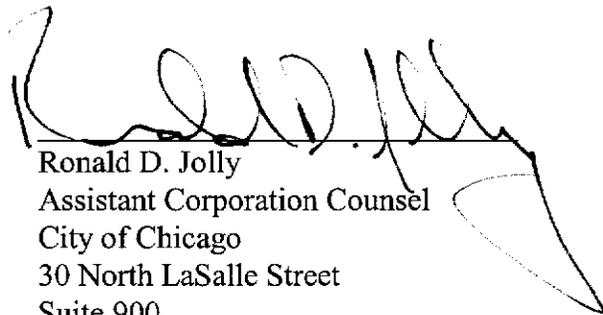
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NOTICE OF FILING

To: Attached Service List

Please take notice that on this date I caused to be sent to Donna M. Caton, Chief Clerk, Illinois Commerce Commission, 527 East Capitol Avenue, Springfield, Illinois 62701, by Federal Express, the original and eleven (11) copies of the City of Chicago's Brief on Exceptions in the above-captioned docket.

Dated: November 30, 2001



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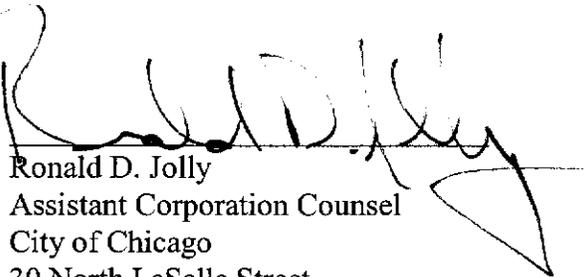
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CERTIFICATE OF SERVICE

I, Ronald D. Jolly, hereby certify that a copy of the City of Chicago's Brief on Exceptions in the above-captioned docket was served upon the party or parties listed in the attached service list, by hand-delivery, by express mail, by e-mail, and/or by first class mail, postage prepaid, in accordance with the Rules of Practice of the Illinois Commerce Commission.

Dated: November 30, 2001


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