

**Phase Two of an Investigation of
Peoples Gas Light and Coke Company's
Accelerated Main Replacement Program**

**Recommendation Implementation Monitoring
First Quarterly Report**

**Presented to:
The Illinois Commerce Commission**



**Presented by:
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Table of Contents

Summary 1

Scope of Liberty’s Engagement..... 2

Other AMRP Needs Outside Liberty’s Scope 3

Monitoring Activities Prior to September 4th 5

Monitoring Activities Since September 4th 5

Company Approach to Implementation Plan Development 6

Next Steps 8

Mission Threats..... 9

Summary

- Liberty has worked with Peoples Gas since early summer to advance development of plans for implementing the 95 recommendations of Liberty’s May 2015 Phase 1 report regarding the Accelerated Main Replacement Program (“AMRP”).
 - The goal of this work has been to produce implementation plans that will provide a sound basis for: (a) monitoring implementation progress and effectiveness meaningfully, and (b) assessing whether change is progressing appropriately.
- New management of Peoples Gas has been undertaking major reorganization efforts at the gas company executive level and within AMRP management groups.
 - Those efforts remain underway, and likely will extend significantly into the future.
 - The greater than expected complexity Peoples Gas has experienced in implementing these changes has drawn attention away from creating implementation plans for the 95 recommendations.
- The Peoples Gas plans for implementing the 95 recommendations (set forth in the Company’s September 4, 2015 filing to the Commission) need substantial improvement in a number of areas; *e.g.*:
 - Clear indication that Peoples Gas understands the purpose and substance of each recommendation.
 - Clear statements of how post-implementation circumstances will differ from those existing up to and through Liberty’s Phase 1 work.
 - Clearly defined, sequenced, and scheduled actions that allow for clear and timely opportunities for progress verification and tangible measures of implementation success.
- Liberty has offered a template and sample plan to guide Company development of more suitable plans:
 - Peoples Gas has generally agreed to the implementation plan model offered by Liberty.
 - The most notable exception is reluctance to commit to clear expression of how post-implementation circumstances will differ from those existing during Liberty’s investigation.
- At best, effective implementation plans will exist for somewhat less than a third of the highest priority recommendations by the end of October 2015.
 - Liberty is not optimistic that Peoples Gas can reach a one-third target, but continues to press the Company to do so.
 - Even reaching the October target means that Company efforts to recast plans for the remainder of the 95 recommendations is expected to extend until the end of 2015.
- Company work during the last quarter of this year to improve implementation plans will take place in an environment destined to produce overarching questions falling outside the scope of (but likely to have negative impacts on) Liberty’s work to monitor implementation of the 95 recommendations.
- The Commission likely will face imminently the need to address foundational questions bringing profound AMRP re-definition into play. These questions include:
 - The impact that a cost estimate likely to double the current one will have on realistically achievable program scope, schedule, and accelerated cost recovery.
 - The pace at which high-risk pipe replacement should be authorized to proceed during the next one or two construction seasons, as Peoples Gas continues at the same time to work through major gas company and AMRP management changes (and the accompanying

- disruption), and while the parameters under which that work has been planned undergo major change.
- Discussions with the Company indicate that its anticipated November 2015 filing will not present cost and schedule “plans” as Liberty contemplated them in making its Phase 1 recommendations.
 - Rather, the filings appear likely to frame broad strategic alternatives for discussion about AMRP parameters and future direction; definitive can plans presumably only follow sometime down the road, after final public judgments about new AMRP fundamentals are reached.
 - Those issues appear to include, for example:
 - What goals the AMRP and work proceeding together with it should seek.
 - What scope (*e.g.*, pipe replacement, meter moves, and pressure increases) the work should encompass.
 - How much longer completion under the current scope would take under a vastly increased cost estimate.
 - What funding mechanisms would be needed to support significantly increased expenditures.
 - How vastly increased AMRP costs will affect customer affordability.
 - Such questions are beyond the scope of Liberty’s work to monitor recommendation implementation.
 - Nevertheless, their importance and complexity have the potential for further extending the time it will take for the Company first to produce sound plans, and then to execute the actions needed to implement the recommendations.

Scope of Liberty’s Engagement

Liberty’s May 2015 report addressed the findings, conclusions, and recommendations resulting from an essentially year-long investigation of management and execution of the AMRP. That report set forth 95 recommendations for improving AMRP planning and execution. The May 2015 report ended Phase 1 of a two-phased project. Liberty’s defined scope for Phase 2 is to conduct a structured, two-year program of monitoring the effectiveness of Company implementation of those 95 recommendations.

At the outset of Phase 1, Liberty anticipated issuance of a detailed Phase 2 work plan shortly after delivery of the report concluding Phase 1. What had not been anticipated was the pendency of a change of control proceeding, which later brought Integrys, and in turn Peoples Gas, under WEC. The Commission order permitting the acquisition to proceed called for Peoples Gas to submit four plans by September 4, 2015. These plans included:

- A plan for implementing Liberty’s 95 recommendations
- A cost plan for the AMRP
- A schedule plan for the AMRP
- A transition plan reflecting changes in management of the AMRP.

Liberty deferred formulation of its detailed Phase 2 work plans pending the filing of the first of the four Peoples Gas plans. Liberty’s scope of work, as discussed below, does not address the other three plans, although Liberty recognizes that actions to address those plans likely have implications for plans to implement the 95 recommendations.

Liberty's principal Phase 2 deliverables will consist of quarterly reports (with this report representing the first) describing and evaluating progress in addressing the 95 recommendations. The particular verification work required will depend on the nature of the recommendations, but will involve interviews, field visits, other information exchanges, and analysis.

During the deferral of the detailed Phase 2 work plan, Liberty devised standard reports and templates for managing verification efforts and for assessing Company implementation progress. Liberty held a number of meetings and review sessions with Peoples Gas (discussed below) before and since the filing of the Company's September 4, 2015, plan for implementing the 95 recommendations. Liberty will continue regular conference calls, meetings, and other exchanges to remain current with progress, problems, successes, and issues during the intervals between quarterly monitoring reports. As the Company moves from effective plan creation to plan execution, Liberty will schedule field visits as work proceeds over the two-year monitoring period, based on the dictates of progress across quarters.

As each quarterly report approaches (and mid-quarter if required) Liberty will schedule site interviews and inspections as appropriate to address progress. Continuing quarterly reports will summarize Liberty's monitoring work, and set forth findings, analyses, conclusions, and recommendations.

Liberty will also provide a comprehensive, final implementation report at the end of Phase 2's two year duration. This report will state whether and when Peoples Gas completed implementation of each Phase 1 recommendation. The report will provide Liberty's opinions of the quality and suitability of implementation of each recommendation and conclusions about overall AMRP improvements since the beginning of Phase 1.

Other AMRP Needs Outside Liberty's Scope

Major cost, schedule, organization, and management changes have taken place since Liberty's May 2015 Phase 1 report. These changes continue and they raise fundamental questions about the short- and long-term situation of and prospects for the AMRP. These questions place implementation of Liberty's 95 recommendations in an uncertain and fluid context. The resulting uncertainties:

- Have complicated and delayed the process for formulation of implementation plans by the Company.
- Question the long-term context in which implementation of the recommendations will occur.
- Expose the risks of proceeding under an old AMRP overall plan and schedule when:
 - Organizational change and turmoil remain, and will continue for some time to have the potential for affecting rates of progress and the efficiency and effectiveness of work to attain that progress.
 - Short-term work plans (most particularly those for the construction season that will begin next spring and perhaps the following one) have been formulated on the basis of long-range objectives and plans whose continuing achievability and validity are and will remain highly questionable and speculative for some time.

In late July, Peoples Gas leadership brought in by WEC acknowledged to Liberty the existence of a “new” AMRP cost estimate. It initially became available within the gas company around January 2015. Although never securing final management approval, that estimate work indicated a second near-doubling of AMRP costs across the program’s short history. Program costs had been estimated at \$2.6 billion in 2009; they rose to \$4.45 billion in 2012. Those undertaking new estimate work under Integrys management produced a projection of more than \$8 billion around January 2015.

The fact that this \$8+ billion remains “subject to check” by WEC is not, however, the most critical point. Discussions with new management over the past several months led Liberty to conclude that continuing cost estimating work is not likely to generate an amount under \$8 billion, and is more likely to produce a higher amount.

Thus, the real “news” is the need for re-examining and re-baselining fundamental AMRP parameters. Awaiting the November 2015 filing by Peoples Gas may put greater definition around the alternatives that a vastly increased estimate will bring into play. Nevertheless, the fundamental questions are already clear today. Any number in the current “ballpark” moots key defining elements of the AMRP. The circumstances do no less than question whether the AMRP as currently defined has substantial meaning anymore. Events invite debate about whether the gas system improvements currently contemplated (as the Commission and stakeholders have come to understand them) remain achievable for a cost that will continue to be considered by a broad range of stakeholders to be: (a) worth much higher expenditures, and (b) on a schedule that will eliminate public safety risks at a sufficient pace. The AMRP is destined in the next several months for public exposure of a range of scopes, cost estimates, and schedules that will raise profound questions about:

- Ability to sustain a level of progress that will meet 20-year completion.
- Financeability.
- Customer affordability.
- How much time it will realistically take to eliminate high-risk pipe from the system.
- The value proposition of continuing to address pressure improvements and meter relocations after a reasonably sound reflection of their true costs becomes known, sometime down the road.
- The commitment of Peoples Gas to continue such high-cost work under current rate recovery methods and limits.

Liberty’s implementation monitoring work will provide insights on the questions that will arise from the Company’s November 2015 filing. However, and more importantly, Phase 2’s limits will not permit meaningful participation in addressing them in the coming months. Those questions concern broad alternatives to the current AMRP, such as:

- A significantly longer schedule, in order to produce a more realistic annual spend (a 20-year completion schedule will require near-term annual spends to approach \$600 million per year - - double what Peoples Gas has struggled to manage to date).
- A significant reduction in the scope of the work to be performed, in order to reduce expenditures to a level more consistent with considerations of customer “affordability” and rate path “sustainability,” hopefully without compromising efforts to mitigate public safety risk.

- A change in current recovery methods or limits to support what management described to Liberty as the need for reasonable assurances of “appropriate” rate treatment of significantly expanded costs.

Monitoring Activities Prior to September 4th

The establishment of the September 2015 filing date for plans to implement the 95 recommendations meant the lack of a comprehensive set of implementation plans to guide Liberty’s first quarter monitoring work. Liberty held a number of meetings and exchanges with Peoples Gas prior to the Company’s September 4th filing. The goal was to determine when and how to begin active monitoring of recommendation implementation.

Discussions with management since Phase 2 began have emphasized Liberty’s view of the essential characteristics of effective and monitorable implementation plans. The five characteristics Liberty has been communicating since the start of Phase 2 include:

1. Show that Peoples Gas understands the recommendation and what drove its creation.
2. Explain how the changes contemplated will alter pre-implementation circumstances (*i.e.*, fulfill the need underlying the recommendation).
3. Describe a clear set of deliverables, whose execution will demonstrate implementation of the recommendation.
4. Include specific, logically ordered tasks from beginning to end of the implementation process.
5. Allow for clear, measurable milestones by which to judge implementation progress and depth.

Liberty reviewed the 10 or so plans that Peoples Gas shared, beginning early in Phase 2 work. They addressed specific Phase 1 recommendations. Discussions considered the merits of those plans, but Liberty focused primarily on dialogue seeking to get the Company to move plans for the whole body of Phase 1 recommendations to a more advanced stage. Early monitoring work made clear that changes in the content and detail of the Peoples Gas implementation plans would be required to: (a) support effective implementation by the Company, and (b) provide a basis for Liberty’s assessment of progress in doing so. Following early discussions, Peoples Gas pulled back the small number of plans it had provided, and committed to recast them as part of its September 4th filing.

Monitoring Activities Since September 4th

Management’s agreement to recast its implementation plans came with an intention to make available to Liberty some revised plans before the September 4th filing. Peoples Gas also stated that its filing with the Commission would recast plans generally to reflect the five characteristics urged by Liberty. Peoples Gas eventually proved unable to provide any pre-September 4th samples. Then, the plans filed on September 4th continued to lack sound treatment of at least some of the five characteristics, with a small number of exceptions. Liberty discussed with management on September 15 the continuing inability of the plans to provide a monitorable course of action, and, more importantly, to give a clear sense that the Company:

- Understands the recommendation
- Has a clear sense of how implementation would change current circumstances

- Has outlined a clear and logically sequenced set of actions that would, when completed, demonstrate effective implementation.

The continuing need for significant plan improvement led Liberty to recommend on September 21st a specific plan template, illustrated by providing Peoples Gas with a hypothetical plan for a recommendation. The goal was to secure concurrence on the structure and content of typical plans.

Company Approach to Implementation Plan Development

The early set of plans reviewed (covering about 10 of the 95 recommendations) did not exhibit the five necessary characteristics with clarity and sufficient detail. Of particular, but not sole concern was that the lack of focus on the first two characteristics (from the list of five above) made it:

- Difficult to assess how well the Company understood and agreed with the changes called for by the recommendation involved
- Impossible in many cases to distinguish what the Company was saying: (a) had been accomplished subsequent to the recommendation, versus (b) what it has been doing all along (*i.e.*, before Liberty’s Phase 1 work).

Management provided a number of reasons behind its approach and progress to date in implementation planning. Gas company executive leadership cited more pressing needs that affected its ability to prepare implementation plans:

- Getting new leadership on top of day-to-day AMRP management
- Making its own assessments of improvement needs
- Deferring firm implementation commitments pending changes in gas company and executive management.

With respect to the third point, Peoples Gas executive leadership observed that those who would become directly responsible for meeting implementation commitments needed sufficient time (which had not yet elapsed in its view) to “take ownership” of any commitments to be set forth in implementation plans. Peoples Gas totally changed out executive management at the gas company soon after WEC assumed control. These changes brought a new president to Peoples Gas. He has chosen three, also new, executive reports. They include a construction vice president, who has principal responsibility for the AMRP. The construction vice president exercises responsibility for the AMRP in a manner that integrates (rather than separates out full-scope AMRP responsibility) management of all Peoples Gas construction work. The other two vice presidents who report to the Peoples Gas president have responsibility for customer service and for operations. They also have significant AMRP-related responsibilities. They also still appear to be working through their coordination needs with respect to the AMRP and with respect to approaching implementation of the Liberty recommendations that affect their particular responsibilities.

As this past summer progressed, the construction vice president continued to fill the positions directly reporting to him. He only recently completed filling the full complement of these directors (most of them moving into Peoples Gas positions from other WEC entities). Liberty learned of and met a number of them for the first time on September 15.

Accompanying these gas company leadership changes, new management decided to end the AMRP relationship with the outside firm whose personnel had, since AMRP inception, filled key

AMRP program leadership and most other program management roles. Removing that firm's many personnel has led to a broad and still-continuing set of changes in program management. The Company reports that this reconstitution of the AMRP program management team has proven much more difficult and time consuming than anticipated.

Apart from the direct challenges that the top-level and AMRP-level organization and staffing changes have produced, certain other aspects of new management's philosophy in addressing the AMRP have contributed to a less than robust Company view of recommendation implementation planning. Management points frequently to a history of success in tackling construction management challenges at its other operations. Management believes its history lays a persuasive basis for confidence that it can quickly and effectively get a handle on and meet AMRP management needs and challenges. Management has also frequently cited what it describes as its very short period "at the helm" of Peoples Gas. In judging the strength of this statement, it bears consideration that Peoples Gas began major gas company corporate and AMRP reorganization and change with (and somewhat before on some matters) the issuance of Liberty's January 2015 interim report. It does not appear that current management considers those efforts to have had eased its burdens.

Management also cites what it describes as broad agreement between Liberty and WEC views of effective management of programs like the AMRP. Management follows with the notion that this common understanding will suffice in ensuring real change and that the test of this premise will lie in improved AMRP results sometime in the future. In other words, executive leadership at the gas company considers those improved results (rather than focus on the 95 recommendations at the individual level) to be the best judge of its implementation of effective AMRP change. These observations from new leadership came in the specific context of management's:

- Responding to Liberty's view emphasizing the need for clear and suitably detailed planning and implementation of the 95 recommendations.
- Urging of measurement of results improvements, versus overseeing recommendation implementation progress, as the best method for monitoring Company progress.

Liberty has made clear to management that:

- The Phase 2 scope includes monitoring the 95 recommendations, and is limited to that function.
- Liberty believes that implementing those recommendations will in fact bring about the management and operational attributes appropriate to effective and improved performance.
- That belief is why Liberty made the recommendations.
- The Phase 2 scope does not include continuing investigation, auditing, and oversight of progress on an essentially real-time basis; only through such work could an outsider even hope to be able to interpret performance results in meaningful connection with the improvement opportunities that the 95 recommendations address.
- Even if the scope of Phase 2 were changed or expanded, past problems in measuring performance effectiveness (which Liberty's May 2015 report addresses) would make any effort to compare prior performance results against future performance results very problematic.

Next Steps

In any case, Peoples Gas executive leadership continues to posit that AMRP improvement can better be measured by results improvement than through addressing the 95 Phase 1 recommendations in detail. Leadership underscores this point with its observation that other current AMRP needs have more immediacy. It has, however, agreed to recast its plans for the 95 recommendations generally in accord with the model that Liberty has offered. That agreement includes incorporating four of the five characteristics listed above.

Liberty and the Company identified roughly one-third of the recommendations on which to focus initially. This number reflects the maximum number that the Company expects it can recast before the end of October. This priority list ensures that early implementation plan recasting efforts will focus on the most important changes. The Company believes it will require until the end of December to complete recasting plans for all 95 recommendations. Only at that time will an overall assessment of the adequacy of the Company's proposed quality of and pace for making changes be possible.

There is one notable exception to the Company's agreement to recast its plans in accord with Liberty's proposed model and the five characteristics. That characteristic involves its reluctance to explain what will be different after implementation and how resulting differences will fulfill the recommendation's purpose. Management has described its lack of knowledge about how things were done in the past as one of the impediments to providing such discussion.

Liberty continues to believe that implementation plans need to address explicitly how pre- and post-implementation conditions and expectations will differ. Liberty finds it difficult to understand how the Company can address change without a knowledge of "how things work" today and what forces, factors, and barriers have driven current approaches. Such influences will tend to continue to drive those approaches, unless Peoples Gas acknowledges and addresses root causes.

Dialogue with the Company makes clear that the potential for Phase 2 documentation to be used in examining questions about the prudence of past company performance plays a significant role in what it is now willing to document. Liberty understands that phenomenon. Certainly, Liberty's Phase 2 focus falls strictly on future improvement. Whether circumstances do or do not call for measures to ensure information confidentiality is a matter that can be further explored with the Commission. Whatever the balance to be struck between encouraging frank disclosure intended to make improvements important to the public, on the one hand, and reasonable stakeholder expectations about transparency, on the other hand, should not, however, sacrifice what Liberty considers a central element in change planning and subsequent effectiveness measurement.

Over the next months, Liberty plans to:

- Work with the Company in its efforts to bring implementation plans for the 30 or so highest-priority recommendations to a fully satisfactory state.
- Test Liberty's recommendation implementation system and templates developed to provide real-time tracking of implementation status and to simplify quarterly reporting.
- Work to close out report recommendations addressing the need for changing the ranking system for identifying neighborhoods and facilities to address first; these recommendations

address one of Liberty's overarching concerns about the AMRP (the ability to maximize reduction of leaks in highest-risk pipe).

- Revisit recommendations and reach conclusions on recommendations for which Peoples Gas has expressed less than full agreement.

Phase 2 goals for the last quarter of 2015 thus are:

- Get Peoples Gas to complete effective implementation plans for all 95 recommendations.
- Begin monitoring completion of interim implementation actions on high priority recommendations.
- Close out any other recommendations for which satisfactory implementation plans have been completed, because they have a short-duration implementation schedule.

Mission Threats

The most direct threat is the risk that Peoples Gas will not succeed in meeting the October goal (effective implementation plans for about a third of the 95 recommendations) and the December goal (effective implementation plans for the remainder).

Other threats external to implementation monitoring may prove far more significant over the coming months. Liberty will continue to provide the services promised as part of the monitoring effort. Doing so must, however, take place in the context of two fundamental changes afoot in the broader environment:

- Major changes in AMRP definition (scope, cost, and schedule, for example) and the Company's level of commitment to the program as defined now or as changed.
- An organization that has been in transition already, and will for a significant time remain in a state of flux when compared with that existing during most of Phase 1.

Liberty did not anticipate such changes in defining the work required for Phase 2, which is limited to implementation monitoring. Liberty also did not anticipate the broad scope, depth, and number of recommendations that Phase 1 eventually produced. Liberty nevertheless remains comfortable that the level of effort budgeted remains sufficient to monitor implementation of the 95 recommendations.

This is not to say that matters outside the scope of implementation monitoring do not raise concerns. Three in particular bear mention.

First, at least through the end of this year, management will be operating under an estimate that understates work (measured by costs) by half or more. During this time, the key planning drivers of work for the next construction season will need to be executed by AMRP management. The need to continue eliminating high-risk pipe remains both a short- and long-term priority. Nevertheless, spending in the hundreds of millions of dollars per year under a plan recognized as out-of-date and out-of-touch with current knowledge is problematic.

Second, the difficulties management has experienced in organizing, populating, and directing a new organization add significantly to near-term AMRP challenges. Whether within the AMRP program management group or broadly across Peoples Gas, significant progress remains to be

achieved in settling the new organization and in coordinating the work required among executive, program, project level, and interdepartmental resources.

Third, new management's persistence in seeking to break linkages to the past reduces confidence that it has (or is using if it has it) the knowledge it needs with respect to the drivers of performance problems. This persistence also requires a large increase in trust by outsiders that things are well in hand under leadership tested in other circumstances in other places. The disconnect of greatest concern involves understanding and acknowledging the past performance gaps that drove the long and complex change agenda represented by the 95 Phase 1 recommendations. Even with massive executive- and director-level changes, those performing and supervising the work day-to-day remain largely the same. However different new management's philosophy and approach may be and however compelling its past successes may prove, it cannot be effective to approach the management of the change process without understanding what has been and how it should differ from what is to be.

It would require extraordinary optimism to anticipate full resolution of these uncertainties in the few weeks remaining until the expected November 2015 filing by Peoples Gas. Nor would a full solution to them avoid what is already "on the table" and what will become even more clear with the November filing -- ***the need for a fundamental revisit of AMRP scope, cost, and schedule***. These three uncertainties and the need for the AMRP to proceed under a realistic set of parameters (scope, cost, schedule, rate of risk reduction, and customer rate impacts, for example) call into question what level of AMRP work should continue over the next 12 to 24 months.

Continuing high expenditure rates should be accompanied by assurances of an adequate ability to manage them effectively. At the same time, whatever level of confidence exists in that ability, large volumes of high-risk pipe continue to threaten public safety. This threat requires that a substantial level of work continue, and that it focus on the highest-risk pipe. The November filing will confirm what is already largely known -- that an appropriate, consensus long-range vision, scope, and plans for the AMRP do not exist. It may take an extended length of time to develop long-range plans that adequately address safety risk, quantity, cost, and schedule factors. These circumstances make it appropriate to consider the need for a clear and firm short-term, interim plan, rather than continuing to make large expenditures in the framework of a long-term plan that has become a dead letter.

Rider QIP (providing for recovery of Qualifying Infrastructure Plant costs) has operated, and might perhaps continue for the time being to operate, as an effective limiter on annual expenditures. However, given the public importance of eliminating high-risk pipe, and of eliminating it effectively and efficiently, the Rider QIP does not provide a sound substitute for a clearly thought out interim plan pending the AMRP redefinition that looms.