STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

NORTHERN ILLINOIS GAS COMPANY d/b/a NICOR GAS COMPANY	:	
	:	No. 04-0779
Forecast general increase in rates, and revisions to other terms and conditions of service.	:	

NORTHERN ILLINOIS GAS COMPANY'S PRETRIAL MEMORANDUM

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In accordance with the "Notice of Continuance of Hearing, Notice of Administrative Law Judge's Ruling, and Notice of Schedule", dated January 7, 2005, Northern Illinois Gas Company d/b/a Nicor Gas Company ("Nicor Gas") submits this Pretrial Memorandum.

Introduction

Nicor Gas' case for rate relief is straightforward. Nicor Gas' base rates have been unchanged for nearly a decade. During that decade, Nicor Gas invested approximately $1.24 billion in new plant, saw its unit operating costs inexorably rise, and began serving approximately 300,000 new customers, many in areas requiring new infrastructure. (O'Connor Direct ("Dir.") and Surrebuttal ("Sur."), Nicor Gas Exhibits ("Exs.") 1B.0 and 34.0). At the same time, total sendout, increases in which normally help offset the costs that new customers impose, was essentially flat, while winter weather in its territory, which is critical to gas throughput, became warmer. (*See* Harms Dir., Nicor Gas Ex. 17.0; *see also* Nicor Gas Ex. 18.8). Throughout, Nicor Gas remained strikingly efficient, and remains today the lowest cost and lowest rate major gas utility in Illinois. (*See* Gordon Dir., Nicor Ex. 2.0; *see also* Hawley Dir., Nicor Gas Ex. 1A.0; O'Connor Rebuttal ("Reb.") and Sur., Nicor Gas Exs. 18B.0 and Ex. 34.0).

Nonetheless, no company of any type facing rising costs can survive on cost control and efficiency forever. Nicor Gas is now facing striking revenue deficiencies. In 2004, Nicor Gas had net operating income of $96,300,440 (O'Connor Reb., Nicor Gas Ex. 26A.0), which is $6,651,560 lower than the figure for 2004 in Nicor Gas' forecast used to prepare this case (Id.), and which is $36,450,560 less than the $132,751,000 allowed in its last rate case (*see* In re *Northern Illinois Gas Company*, Illinois Commerce Commission (the "Commission" or "ICC") Docket 95-0219 (April 3, 1996) (the "'95 Rate Case")). The same forecast estimates that in the

2005 test year, Nicor Gas will have net operating income of $84,043,000 or $93,458,000 with PGA pass-through. (Nicor Gas Ex. 26B.1). That figure yields a revenue deficiency of $61,726,000, assuming certain of Nicor Gas' proposed rate design changes (as discussed further below), or $77,573,000 without those changes. (Gorenz Reb., Nicor Gas Ex. 26B.0, Schedule ("Sch.") 26B.1). This type of financial performance cannot be sustained by an independent, financially sound utility; nor is it in the public interest. (*See* O'Connor Sur., Nicor Gas Ex. 34.0).

Nicor Gas considered the proposed rate increase carefully. It is modest, amounting to a 15.4% increase from current base rates, or a 3.3% increase on overall bills. The proposed increase is much less than inflation, and much less than the increases in prices of other essential goods and services, over the same period. (Gordon Dir., Nicor Gas Ex. 2.0, Figure 1). Moreover, even if granted in full, Nicor Gas will be the major gas utility with the lowest rates in the state, falling some well below the average. (*Id*., Figure 3). Furthermore, Nicor Gas, in order to narrow the issues, now proposes a rate design that uses both embedded and marginal costs, as appropriate, to promote efficiency, and follow cost causation. (*See* Harms Sur., Nicor Gas Ex. 44.0).

The evidence shows, as indicated above, that to cover its costs and earn an appropriate return, which is modest compared to recent approved returns for gas Local Distribution Companies ("LDCs") in the United States, Nicor Gas requires an increase in base rate revenues of $61,726,000 (assuming certain costs and revenues as proposed by Nicor Gas are flowed through its Rider 6, Gas Supply Cost or $77,573,000 without the Rider 6 flow through). (*See* Gorenz Sur., Nicor Gas 41.0). Rates increased in that amount will not multiply Nicor Gas' profits; this remains a cost-driven request. By contrast as indicated above, a lower award will result in incomplete cost recovery and earnings (net operating income) below the level allowed in the ’95 Rate Case. (*See*, O’Connor Sur., Nicor Gas Ex. 34.0).

Nonetheless, the ICC’s Staff (“Staff”), in its revised rebuttal testimony, proposes allowing Nicor Gas what is characterized as a $38,900,000 increase, claiming that this is sufficient to meet Nicor Gas’ needs. However, most of that increase simply reflects moving revenues to base rates from other sources and, on an apples-to-apples basis, Staff would allow an increase of only approximately $17.9 million.[1] (Struck Reb., Staff Revised Ex. 10, Sch. 10.1). At those rates, Nicor Gas would be earning net operating income <u>approximately $48 million less than allowed in the ’95 Rate Case</u>, and less even than in 2004, when this case was filed. This is an unjust and unreasonable result, that would leave Nicor Gas financially wounded. As is discussed below, the bulk of the inadequacy of Staff’s recommendation flows directly from : (1) use of an unrealistic overall return, accomplished by including a lower return on equity than awarded to any other LDC in recent times and the novel approach of adding all of Nicor Gas’ short-term debt to its capital structure at an artificially low cost (O’Connor Sur., Nicor Gas Ex. 34.0), that would place Nicor Gas at the bottom of recent approved returns for gas LDCs in the United States; (2) disagreements over financial assets; and (3) use of an inappropriate and unfair average rate base methodology that effectively excludes a portion of prudently incurred new investments during the test yea as well as other appropriate rate base. (O’Connor Sur., Nicor Gas Ex. 34.0) In so doing, Staff takes inconsistent positions of Commission precedent (citing precedent when it is favorable to Staff’s position, but disregarding it entirely when precedent is not favorable, for example, proposing to add short-term debt to Nicor Gas’ capital structure) and

[1] Please not that it is Nicor Gas’ understanding that Staff is correcting its revenue requirement calculations, but Nicor Gas is unable to reflect those forthcoming changes at this time.

urges the Commission to ignore the absolutely undisputed evidence on statistical accuracy of ten versus thirty year weather normalization periods and regional climate change and establish rates as if there had been no such evidence submitted.

Intervenors Citizens Utility Board ("CUB"), Cook County States Attorney's Office ("CCSAO"), and the office of the Attorney General of the State of Illinois ("AG") (collectively referred to as "GCI") in combination continue to argue that Nicor Gas is actually over-earning and that its rates should be cut. (*See*, Effron Dir., AG Ex. 1.0). As the evidence identified herein shows, GCI's position is fanciful and dependent on such groundless constructs as treating shareholders' investment in working gas as a liability.

Other intervenors raise a variety of claims concerning Nicor Gas' proposed rate design and terms and conditions implicating operational issues. Nicor Gas has compromised on several of these issues. The evidence concerning the remaining issues is summarized below.

I. Statement Of Uncontested Facts And Stipulations

A number of facts are not contested and while Nicor Gas and Staff and certain intervenors have come to agreement on various issues noted below, no stipulations *per se* have been reached.

A. Nicor Gas Has Been Extremely Efficient And Has Operated At Consistently Low Cost.

- Nicor Gas has consistently performed at a high level of efficiency relative to other Illinois Gas Local Distribution Companies ("LDCs"). (*See* Gordon Direct, Nicor Gas Ex. 2.0; *see also* Hawley Dir., Nicor Gas Ex. 1A.0; O'Connor Reb. and Sur., Nicor Gas Exs. 18B.0 and 34.0).

- Nicor Gas has continued to perform at a higher level of efficiency than its peer national group. (*See* Gordon Dir. and Reb., Nicor Gas Exs. 2.0 and 19.0).

- Nicor Gas' low service costs have allowed it to offer very low rates for over a decade. (*See* Gordon Dir., Nicor Gas Ex. 2.0).

- Nicor Gas currently has by far the lowest rates for gas delivery of any major utility in the State of Illinois. (*See* Gordon Dir., Nicor Gas Ex. 2.0 *see also* Hawley Dir., Nicor Gas Ex. 1A.0; O'Connor Reb. and Sur., Nicor Gas Exs. 18B.0 and 34.0).

- Nicor Gas will continue to have the lowest rates by a substantial margin if its proposed rates are allowed to go into effect. (*See* Gordon Dir., Nicor Gas Ex. 2.0).

B. <u>Nicor Gas' Investments And Total Costs Have Risen Over The Past Decade.</u>

- Nicor Gas has invested approximately $1.24 billion in new plant since the '95 Rate Case. (O'Connor Reb. and Sur., Nicor Gas Exs. 18B.0 and 34.0.

- Nicor Gas' costs have risen inexorably, despite Nicor Gas' effective cost-control programs. (*See, e.g.,* Hawley Dir., Nicor Gas Ex. 1A.0).

- Nicor Gas has faced nearly a decade of inflation since the '95 Rate Case. (*See* Gordon Dir., Nicor Gas Ex. 2.0).

- The rate of increase in certain key costs, such as employee benefits, natural gas, pipeline safety, security, and corporate governance compliance, has far surpassed the overall consumer price inflation rate. (*See* Gordon Dir., Nicor Gas Ex. 2.0).

- These cost increases have affected not only Nicor Gas, but also other LDCs and companies throughout the last decade. (*See* Gordon Dir., Nicor Gas Ex. 2.0).

- Despite the addition of approximately 300,000 customers since that last filing, Nicor Gas' operating margins have lagged. (*See* Gordon Dir., Nicor Gas Ex. 2.0, and McCain Dir., Nicor Gas Ex. 6.0).

- Nicor Gas has not filed for a rate increase in a decade (*i.e.*, since the '95 Rate Case). (*See* Gordon Dir., Nicor Gas Ex. 2.0).

C. <u>The Proposed Net Operating Income Is Moderate.</u>

- In the '95 Rate Case, Nicor Gas was granted an allowed return (*i.e.*, net operating income) of $132,751,000. (In re *Northern Illinois Gas Company*, ICC Docket 95-0219 (Order April 3, 1996).

- This case, in its simplest form, is a request for $61,726,000 in base rate revenues to cover increases in Nicor Gas' expenses and capital outlays, assuming Nicor Gas' proposed rate design proposals are accepted. (Gorenz Sur., Nicor Ex. 41.0).

- Granting Nicor Gas' request in its entirety would result in net operating income of approximately $130,130,000, $2,621,000 less than Nicor Gas was awarded in the '95 Rate Case. (Nicor Gas Ex. 26B.1).

D. 10-Year Weather Normalization Period

- For the purposes of the weather normalization factor of the billing determinants, Nicor has proposed using a ten-year average of heating degree day statistics. Based on an analysis of the statistics over the past 75 years, compared to using an average of the past thirty years, an average of the past ten years will more accurately predict the heating degree days over the period of time that Nicor Gas' proposed rates are expected to be in effect.

- Average winter temperatures in Nicor's service territory have begun to rise over the past several years, likely related to global warming, and the consensus among climate scientists is that the trend will continue for many years to come, decreasing the number of heating degree days.

II. Statement of Uncontested Issues

The issues in this proceeding that are contested are described in Part III below. All of the remaining issues, including several matters specifically addressed in the Nicor Gas' direct testimony, are not contested by any other party. In addition, a number of other issues that were contested have been resolved by the efforts of Nicor Gas and Staff, which, in an effort to limit such issues, have accepted or withdrawn certain proposals. Although many of these uncontested and no-longer-contested issues are discussed below in this Part II, there are others that are not so discussed. It should be assumed for this Memorandum that all issues not expressly listed in Part III below are uncontested, regardless of whether they are discussed in this Part II.

A. Issues That No Party Contests

The issues that no party is contesting in this proceeding include, but are not limited to, the following:

1. Test year

- Nicor Gas has used 2005 as its test year for this proceeding. No Staff or intervenor witness has proposed or otherwise supported use of a different test year.

2. Aspects of Rate Base

Although Staff has argued for an average rate base on a general level for most rate base components, and the Staff and the AG have proposed certain general adjustments relating to capital additions and Gross Utility Plant as a whole, there are a number of specific rate base items that are not individually contested, including:

- **Materials and Supplies —** Nicor Gas has forecast $4,313,000 as attributable to Materials and Supplies for rate base. No Staff or intervenor witness now contests this figure.

- **Mercury Inspection and Remediation Program —** Nicor Gas has excluded from rate base any expenditures associated with its Mercury Inspection and Recovery Program. No Staff or intervenor witness has contested that Nicor Gas has excluded such expenditures.

- **Reserve for Injury and Damages —** Nicor Gas has forecast, as a deduction from rate base, Reserve for Injury and Damages of $1,597,000. No Staff or intervenor witness now contests this figure.

- **Service Pipe Extension —** Nicor Gas has forecast, as a result of proposed updates of service pipe extension charges, a $12,000 reduction in rate base.

- **Major Capital Additions –** Nicor Gas has identified in Schedule F-4 of its Part 285 filing the major capital projects that it has undertaken since the '95 Rate Case. Nicor Gas witness Anthony McCain discussed in his direct testimony, that these projects, specifically the largest four projects, were necessary, used and useful, and prudent and reasonable. No Staff or intervenor witness has contested that these projects. (McCain Dir., Nicor Gas Ex. 6.0) (Staff incorrectly challenges a small fraction of the cost of one project on the theory that that fraction was not approved under a Nicor Gas policy. (*See* Suppes Reb. and Sur., Nicor Exs. 23.0 and 38.0).

3. Operating Revenue And Expense Adjustments

- **Hub Revenues —** Nicor Gas has forecast test year hub gross revenues of $7,790,000, with administrative expenses of $1,079,000. No Staff or intervenor witness has contested these figures.

- **Transmission Expenses —** Nicor Gas has forecast $4,340,000 in test year Transmission expenses. No Staff or intervenor witness has contested this figure.

- **Distribution Expenses —** Nicor Gas has forecast $51,282,000 in test year Distribution expenses. No Staff or intervenor witness has contested this figure.

- **Customer Service And Information Expenses** — Nicor Gas has forecast $474,000 in test year expenses associated with Customer Service and Information. No Staff or intervenor witness has contested this figure.

- **Injury and Damages Expenses** — Nicor Gas has forecast $11,979,000 in test year expenses for Injury and Damages. No Staff or intervenor witness now contests this figure.

4. <u>Capital Structure and Cost of Capital</u>

- **Embedded Cost of Long-Term Debt and Preferred Equity** — No issues remain concerning the cost of the long-term debt (6.72%)and non-redeemable preferred stock (4.77%) in Nicor Gas' 2005 capital structure.

- **Measurement Time for Capital Structure** — Nicor Gas proposes to use a year-end capital structure for rate base. No Staff or intervenor witness continues to contest this proposal.

- **Actual Capital Structure —** Nicor Gas proposes to use its actual capital structure. Although parties contest which the components should be included in that structure for ratemaking purposes, no Staff or intervenor witness argues for an explicitly hypothetical capital structure.

5. <u>Elements of Rate Design</u>

- **Budget Payment Plan Review Schedule** — Nicor Gas has proposed eliminating the requirement that it review each budget payment amount on a quarterly basis and replacing the requirement with a more individualized review process tailored to different types of payment amounts. No Staff or intervenor witness has contested this elimination and replacement.

- **Rate 10 Cancellation** — Nicor Gas has proposed to cancel its Rate 10, Compressed Natural Gas, which, among other things, no longer has an appropriate purpose. No Staff or intervenor witness has contested this cancellation.

- **Rate 11 Cancellation** — Nicor Gas has proposed to cancel its Rate 11, Energy Service (cogeneration), which, among other things, no longer has its economic justification. No Staff or intervenor witness has contested this cancellation.

- **Rider 9 Cancellation** — Nicor Gas has proposed to cancel its Rider 9, Air Conditioning Service, which, among other things, no longer effectively serves its purpose. No Staff or intervenor witness has contested this cancellation.

- **Not Sufficient Funds Charge Update** — Nicor Gas has proposed to update its charge for Not Sufficient Funds ("NSF") checks from $10 to $16, which will reflect better the cost associated with such checks. No Staff or intervenor witness has contested this update.

- **Damage to Pipe Charge Update —** Nicor Gas has proposed to update its charge for damage to a gas service pipe ($1^{1}/_{8}^{th}$ inch or less in diameter) from $260 to $360 per hit on the pipe, which will reflect better the cost associated with such damage. No Staff or intervenor witness has contested this update.

- **Service Pipe Extension Charges Update —** Nicor Gas has proposed to update its charges for installations of service pipe extensions, which charges have not been reset since the '95 Rate Case. No Staff or intervenor witness has contested these updates.

- **New Rate 5 —** Business Energy Alliance and Resources, LLC ("BEAR") has proposed a new Rate 5, Seasonal Use Service, which concerns non-commercial and non-industrial grain dryers with minimal peak winter usage. No Nicor Gas, Staff, or other intervenor witness has contested this proposal.

- **New Rate 75 —** BEAR has proposed a new Rate 75, Seasonal Use Transportation Service, which concerns commercial and industrial grain dryers with minimal peak winter usage. No Nicor Gas, Staff, or other intervenor witness has contested this proposal.

B. Proposals To Which Nicor Gas Has Agreed In An Effort To Limit The Number Of Contested Issues

Other parties' proposals that Nicor Gas has accepted, for this proceeding only, in the interest of limiting the number of contested issues, include the following:

- **Computation of Long-Term Debt —** Nicor Gas has accepted Staff witness Michael McNally's proposal to remove approximately $87,225 of annualized amortization of debt discount and expense associated with the 3.0% and 5.75% series first mortgage bonds that were retired during 2003 and were not outstanding at year-end, and Mr. McNally's proposal to use a 365-day straight-line amortization convention.

- **Calculation of Gross Revenue Conversion Factor —** Nicor Gas has accepted Staff witness Scott Struck's proposal to use the state income tax rate of 7.3% for calculation of the Gross Revenue Conversion Factor.

- **Computation of Outside Professional Services Expenses —** Nicor Gas has agreed to Staff witness Theresa Ebrey's proposed $213,000 reduction of jurisdictional operating income attributable to lobbying expenses.

- **Computation of Operating Expenses —** Nicor Gas has agreed to Staff witness Leslie Pugh's proposal to reduce test year operating expenses by $276,000 with

> respect to advertising costs of a goodwill nature. Nicor Gas has also agreed to Ms. Pugh's proposal to reduce operating expenses by $58,000 to remove charitable contributions for Nicor Gas' Matching Gift Program.

III. Statement of Contested Issues

This section describes the contested issues, briefly outlining their natures, the important facts and primary arguments concerning them, and the impacts from adopting various positions on them. Nicor Gas notes that it is often impossible to isolate a single "revenue impact" that hinges on the decision of these contested issues because of the interplay between issues, *i.e.*, the financial impact of one issue will often depend upon the resolution of another. Nonetheless, in such cases, illustrative financial impacts are presented on the bases stated in the individual items. Nicor Gas' witnesses addressing these issues also are identified. Unless otherwise stated, the impact of proposals on Nicor Gas' revenue requirement have been calculated using the witnesses' own rate of return.

A. Total Amount of Nicor Gas' Proposed Base Rate Revenue Increase

Nicor Gas has proposed a revised base rate revenue increase of $61,726,000. This figure is based on a comparison of proposed rates with existing rates in which existing rates have been adjusted to reflect the four rate design assumptions identified below. If proposed rates are compared with existing rates without such adjustments Nicor Gas' proposed base rate revenue increase is $77,573,000. If either or both of Staff's two rate design proposals (relating to "clauses (1) and (2)" below) were to be adopted, then the base rate revenue increase would also increase. The foregoing base rate figures reflect the following four assumptions about Nicor Gas' rate design: (1) Nicor Gas' commodity-related uncollectibles expenses are to be recovered through Rider 6; (2) the gross Hub revenues collected by Nicor Gas are to be included in Rider 6; (3) the expenses (fees) associated with the generation of the Hub revenues (*i.e.*, the difference between the gross and net Hub revenues figures) are to be recovered as operating expenses through base rates; and (4) the costs of storage gas losses (the 2% storage withdrawal adjustment) are to be recovered as operating expenses through Rider 6.

Staff has suggested severely limiting Nicor Gas' base rate revenue increase to $17,921,000 (after correcting for nominal increase elements reflecting movement of costs between tariffs). The AG witness Mr. Effron on behalf of GCI has gone even further, claiming a base rate revenues excess of $15,230,000 at current rates, and thus asserting that base rate revenues actually should decrease by the same amount. These counterproposals are unsupportable, unfair, unrealistic, and confiscatory. The impact of these proposals on Nicor Gas, its customers, employees, shareholders, and the communities it serves cannot be overlooked. (Hawley Reb., Nicor Gas Ex. 18A.0). Without its requested increase, Nicor Gas will face increased cost pressure and financial risk. Nicor Gas directly supported the components of its base rate revenue requirement through the testimony of twelve witnesses (Hawley, O'Connor, Mudra, Makholm, D'Alessandro, McCain, Suppes, Bartlett, Bacidoire, Madziarczyk, Gorenz, and Harms). In rebuttal, and in some case surrebuttal, Nicor Gas' witnesses Hawley, O'Connor, Suppes, Bartlett, Bacidore, Mudra, Makholm, and Harms discuss these issues. Dr. Gordon also provided supporting benchmark data.

B. Weather Normalization

Nicor Gas has proposed using a ten-year weather normalization averaging period. As described above, it is uncontested (in terms of evidence submitted) that a ten-year period will be a more accurate predictor of the actual weather during the period in which the rates will be in effect. This is particularly true because of the warming trend currently under way in Nicor's service territory during the winter months; a thirty-year average includes many older years of data that are no longer typical of the winter weather Nicor Gas' customers experience. Nicor

Gas witnesses Takle, Herrera, Gordon, Harms and Karegianes provide testimony on this issue. (Nicor Gas Exs. 16.0, 17.0, 19.0, 27B.0. 28.0). Staff witness Gene Beyer, however, has suggested that the Commission defer consideration of Nicor Gas' ten-year weather normalization to a state-wide generic proceeding and impose a less accurate thirty-year normalization period in this case. Although Nicor Gas proved it inaccurate for its service territory and the upcoming period, a thirty-year average is traditional (though not prescribed) in rate cases.

In addition, it should be noted that using sendout associated with 30 year weather to set rates will certainly deprive Nicor Gas of the ability to fairly collect the revenue allowed as substantiated by the evidence in this case. Staff's rate design is clearly more weather sensitive and combined with their use of 30 year weather normalization will handicap Nicor Gas in being able to achieve the revenue granted by the Commission. Nicor Gas witnesses Takle, Herrera, Gordon, Harms and Karegianes provide testimony on this issue. (Harms Reb., Nicor Gas Ex. 32.0)

Mr. Beyer's proposal effectively would inappropriately reduce by $8,435,000 from Nicor Gas' recovery of its proposed revenue requirement (See, Harms Sur., Nicor Gas 44.0 (explaining this calculation in more detail)).

C. Rate Base

1. Year-End Rate Base

Nicor Gas has used a year-end rate base in calculating its proposed rate base. Staff witness Mr. Struck has proposed that the Commission instead require use of an average rate base. His proposal, however, should be rejected. The effect of Mr. Struck's proposal is to disallow, for this case, a substantial portion of costs that Nicor Gas already has incurred or will incur in the test year that are used and useful, prudent, and reasonable in order to provide adequate, safe, and reliable tariffed services to customers in this and following years. Moreover, because the rates to be set in this case likely will go into effect in the latter part of 2005 (Commission order anticipated in early October 2005) and likely will remain in effect for at least some years (although this is not certain) it would be neither logical nor fair to calculate rate base items based on an average of their balances as of the ends of 2004 and 2005. Nicor Gas witness James Gorenz offers testimony on and relating to this issue. (Gorenz Reb., 11B.0).

Mr. Struck's proposed adjustment (as Nicor understands it will be revised) would inappropriate disallow $40,069,000 from rate base in this case, which in turn would inappropriately reduce its revenue requirement by $5,092,000.[2]

2. <u>Capital Expenditures and 2004 Plant Figures</u>

Staff witness Thomas Griffin has proposed to reduce Nicor Gas' capital budgets for each of 2004 and 2005 by 3.3% based on a six average (1998-2003)and AG witness David Effron has proposed to base Nicor Gas' net capital additions on a three-year average (years 2002-2004) and reduce gross utility plant and net plant based on the figures as of December 31, 2004. None of these proposals should be adopted, as each is based on arbitrary averaging. Mr. Griffin's uses a six-year average of actual to budgeted capital expenditures. Mr. Effron's uses of a three-year average of net capital additions and an arbitrary mid-point. Each proposal ignores the impact of any infrequent and non-recurring events and the results that would be obtained if different averaging period were selected. More importantly, each ignores that Nicor Gas' capital expenditure budget for the test year was developed from the bottom up by subject matter experts and Nicor Gas management, and was subject to a set of consistent budget guidelines and key assumptions of economic drivers. Nicor Gas' Mr. James Gorenz offers testimony on these issues. (Gorenz, Nicor Ex 11B.0)

[2] Calculations herein are the relevant parties' proposed rate of return.

Mr. Griffin's proposed adjustment would inappropriately disallow $8,742,000 from rate base, which in turn would inappropriately reduce the revenue requirement by $1,111,000. Mr. Effron's proposed adjustments would inappropriately disallow $14,196,000 from rate base, which in turn would inappropriately reduce the revenue requirement by $1,837,000, assuming a 2005 year-end rate base is utilized as proposed by Nicor Gas.

3. Daily Metering Project

Nicor Gas has included in rate base $6,917,000 in capital costs associated with the Daily Metering Project, which involved Nicor Gas' provision of daily metering as an option for variable backup transportation customers. Staff's Mr. Griffin has proposed disallowing $389,000 of these costs, claiming that Nicor Gas violated its own budgeting policy with respect to this Project. This proposal should be rejected, as there is no merit to Mr. Griffin's claim. Nicor Gas completed the Daily Metering Project within the authorized budget, and was in fact $131,000 under budget when overheads are excluded as they should be. The Project was approved, implemented, and completed in accordance with Nicor Gas' policies, procedures, and sound business practices, it was and is prudent and reasonable, needed, and used and useful, and its costs should be allowed in full. Nicor Gas witness Christine Suppes. (Suppes Reb. and Sur., Nicor Gas Exs. 23.0 and 38.0).

Mr. Griffin's proposed adjustment would inappropriately disallow $389,000 from rate base, which in turn would inappropriately reduce the revenue requirement by $49,000.

4. Mainframe Project

Nicor Gas has included in rate base $4,700,000 in capital costs for the Mainframe Project, which involved replacement of Nicor Gas' 1992 mainframe computer. Mr. Griffin has proposed a reduction to Gross Utility Plant of $522,000 stemming from an early purchase discount associated with this Project. This proposal should not be adopted. Mr. Griffin's identification of one instance in 2004 where Nicor Gas realized an early pay discount that resulted in a specific project's being under budget does not justify a corresponding reduction in Nicor Gas' forecast December 31, 2005 Gross Utility Plant balances. When a utility or other business sets and then manages to a budget, it is common that individual projects or base capital expenditures may be over or under budget by some amount. It would be inappropriate to accept as an adjustment to Gross Utility Plant a single project variance without adjusting for other variances, and it would be highly impractical to try to adjust for all such variances. Nicor Gas' Mr. James Gorenz and Ms. Suppes offer testimony on this issue. (Gorenz Reb., Nicor Ex. 26B.0; Suppes Reb., Nicor Ex. 23.0).

Mr. Griffin's proposed adjustment would inappropriately disallow $522,000 from rate base, which in turn would inappropriately reduce the revenue requirement by $66,000.

5. <u>Depreciation Reserve</u>

Nicor Gas has forecast an Accumulated Provision for Depreciation and Amortization ("Depreciation Reserve") of $2,240,383,000. Staff's Mr. Griffin has proposed reducing this Reserve by $562,000, based on his proposed gross plant adjustments and the AG's Mr. Effron has proposed increasing the Reserve by $12,097,000, based on his proposed gross and net plant adjustments. As discussed above, however, neither Mr. Griffin's nor Mr. Effron's proposed adjustments are justified, and thus their proposed reductions in the Depreciation Reserve based on such adjustments are not justified, either. If the Commission decided to accept Staff's proposal, Mr. Griffin in his rebuttal testimony, agreed to the $562,000 adjustment as opposed to his miscalculated $592,000 as set forth in his direct testimony. Mr. Griffin acknowledged on Schedule 10.4 –Revised, that the adjustment to accumulated deferred income taxes related to his adjustments was double counted. A positive adjustment of $1,590,000 is required. (Griffin Dir.

and Reb., Staff Exs. 4.0 and 13.0). Nicor witness Mr. James Gorenz will provide testimony on this issue. (Gorenz Reb., 26B.0).

Mr. Griffin's proposed adjustment (as corrected) would inappropriately adjust $562,000 from rate base, which in turn would inappropriately increase the revenue requirement by $71,000. Mr. Effron's proposed adjustment would inappropriately disallow $12,097,000 from rate base, which in turn would inappropriately reduce the revenue requirement by $1,566,000.

6. <u>Gas In Storage</u>

a) <u>13-Month Average For Computing Gas In Storage</u>

Nicor Gas has used a 13-month average to calculate Gas in Storage for rate base. This 13-month averaging is the same method used and approved by the Commission in the '95 Rate Case. Staff accepts this methodology. CUB/CCSAO witness Jerome Mierzwa, however, has proposed using a 12-month average instead. This proposal should be rejected. A 13-month average is more representative of the average balance for an entire calendar year, as it accounts for the daily balances of each day of that year, while a 12-month average measures only the average of each daily balance from January 31 to December 31. Nicor Gas' Mr. Gorenz offers testimony on this issue. (Gorenz, Reb. and Sur., Nicor Exs. 26B.0 and 41.0).

Mr. Mierzwa's proposed adjustment would inappropriately disallow $11,469,000 from rate base, which in turn would inappropriately reduce the revenue requirement by $1,484,000.

b) <u>Gas In Storage - LIFO</u>

CUB/CCSAO's Mr. Mierzwa has proposed $95,308,248 in adjustments to the computation of Gas in Storage, claiming, among other things, that it was unreasonable for Nicor Gas to have liquidated certain low-cost Gas in Storage inventory while its Gas Cost Performance Program ("GCPP") was in effect. Mr. Mierzwa's proposal should be rejected. This case is not the proper forum for evaluating Nicor Gas' decisions under the GCPP, as the Commission is already evaluating them in its Docket 02-0067, and any relief deemed appropriate by the Commission can be effectuated in that proceeding. Further, Nicor Gas has fully evaluated the impacts of the GCPP program on its LIFO accounting and all appropriate adjustments have been reflected in Nicor Gas' restated financial statements. In addition, Mr. Mierzwa's incremental cost of $95,308,248, which he has proposed to deduct from the year-end inventory balance, is incorrectly calculated even based on his incorrect theory. If this were adopted, it would need to be reduced to $12,988,874, so as to reflect ratepayers' receipt of half of the benefit of lower gas costs under the GCPP, as well as computation based upon a 13-month average. Nicor Gas' Messrs. O'Connor and Gorenz offer testimony on this issue. (Gorenz, Reb. and Sur., Nicor Exs. 26B.0 and 41.0).

Mr. Mierzwa's adjustments, as proposed, would inappropriately disallow $95,308,248 from rate base, which in turn would inappropriately reduce the revenue requirement by $12,335,000. His adjustments, if properly calculated based on his faulty theory, would inappropriately disallow $12,988,874 from rate base, which in turn would inappropriately reduce the revenue requirement by $1,681,000.

c) <u>Valuation of Gas in Storage</u>

CUB/CCSAO's Mr. Mierzwa has proposed $57,999,286 in adjustments to the computation of Gas in Storage to account for beneficial cash flow. Mr. Mierzwa argues that Nicor receives significant cash flow advantage due to the Gas in Storage. That assertion simply does not reflect economic reality. At the beginning of a calendar year, Nicor Gas has a large Gas in Storage balance. That gas would have been purchased and paid for by Nicor Gas at current market prices during the preceding summer and fall for injection into storage. The carrying cost of that gas is borne by Nicor Gas until the winter withdrawal season. Mr. Gorenz provides testimony on this issue. (See, Gorenz Reb. and Sur., Nicor Gas Exs. 26B.0 and 41).

Mr. Mierzwa's adjustments, as proposed, would inappropriately disallow $57,999,286 from rate base, which in turn would inappropriately reduce the revenue requirement by $7,506,000.

d) <u>Gas in Storage – Reduction in Transportation Customer Volumes</u>

Nicor Gas has proposed to decrease the volume of Gas in Storage allocated to transportation customers from 26 to 23 times the Maximum Daily Contract Quantity ("MDCQ") to account for the impact of proposed revisions its transportation service tariffs that would reduce the portion of storage volumes owned by transportation customers. This would result in a $18,453,000 increase to rate base to reflect the increased volume of Gas in Storage that Nicor Gas will be responsible for filling. Although no Staff or intervenor witness has opposed this calculation, there was, as discussed below, opposition to the rate design aspect of this proposed adjustment to Nicor Gas transportation tariffs. Nicor Gas witnesses Albert Harms, Gary Bartlett, and James Gorenz discuss this issue. (Bartlett Reb., Nicor Gas Ex., 24.0; Gorenz Reb., Nicor Gas Ex. 26B.0).

If the proposed tariff change is adopted, Nicor Gas' proposed rate base would be increased by $18,453,000, which in turn would increase the revenue requirement proposed by Nicor Gas by $2,805,000.

7. <u>Pension Asset</u>

Nicor Gas has forecast a prepaid pension balance of $186,882,000, from which $75,156,000 in associated ADIT has been deducted, leaving a net $111,726,000 to be included in rate base as attributable to retirement benefits. Staff's Ms. Pugh and the AG's Mr. Effron have proposed disallowing from rate base the net amount of this pension asset, which they claim is $105,410,000 and $111,726,000, respectively. Neither of these proposed adjustments is valid, particularly given that the rates set in the '95 Rate Case included an annual pension credit to ratepayers of $6,550,000, and the rates forecast in this case include an annual pension credit to ratepayers of $3,486,000. Ms. Pugh and Mr. Effron erroneously contend that the pension asset is the result of over funding by ratepayers, and thus that the credit to ratepayers should continue and that Nicor Gas shareholders should not benefit. In effect, Ms. Pugh's and Mr. Effron's theory amounts to a novel form of retroactive ratemaking combined with single issue ratemaking. Ratepayers do not pay for any particular asset or cost in a utility's regulated revenue requirement, but rather for gas delivery service. They are not investors in Nicor Gas by virtue of paying rates. The pension trust holds an asset (represented by amounts that exceed benefits to be paid out) that is owned by Nicor Gas. Ratepayers have not contributed to the pension trust since before the last rate case under Ms. Pugh's theory. Yet they have had a reduction in rates of approximately $62.2 million since the '95 Rate Case.

Should the Commission ultimately agree with Ms. Pugh's position, this $62 million still should be allowed in rate base. In the alternative, since the last rate case, the pension asset has grown by around $67.9 million, none of which increase resulted from ratepayer contributions. However, should the Commission ultimately agree with Ms. Pugh's position and deny the full pension asset, this amount of $67.9 million should be allowed in rate base. At a minimum, if the Commission should not allow the pension asset or the increase in its value since the last rate case, it should remove from operating expenses the negative pension expense as a credit on a going forward basis. This credit is an accounting accrual, not cash. Nicor Gas' Messrs. O'Connor and Gorenz present testimony regarding this issue. (O'Connor Reb., Nicor Gas Ex. 26A.0; Gorenz Reb., Nicor Gas Ex. 26B.0).

Ms. Pugh's proposed adjustment would inappropriately disallow $105,410,000 from rate base, which in turn would inappropriately reduce the revenue requirement by $13,395,000 Mr.

Effron's proposed adjustment would inappropriately disallow $111,726,000, from rate base, which in turn would inappropriately reduce the revenue requirement by $14,460,000.

8. Section 263A

Nicor Gas initial filing included a reduction of ADIT of approximately $84,881,000 relating to the resolution of its election pertaining to Section 263A of the Internal Revenue Code. In its rebuttal testimony, Nicor Gas accepted Staff's computation of the impact of the Section 263A election on ADIT. Nicor and Staff agree on the treatment of Section 263A and only differ on the use of an average rate base as discussed above.

The AG's Mr. Effron opposes the reduction of ADIT proposed by Nicor Gas and Staff and has suggested that if the IRS review of Nicor Gas' Section 263A election results in the current payment of income taxes that had been deferred, then Nicor Gas could be allowed to accrue the return on the resulting reduction to ADIT for future recovery during its next general rate case. Mr. Effron's proposal should be rejected. Nicor Gas' Mr. O'Connor offers testimony on this issue. (O'Connor Reb., Nicor Gas Ex. 26A.0).

Mr. Effron's proposed adjustment would inappropriately disallow $66,563,000 from rate base, which in turn would inappropriately reduce the revenue requirement by $8,615,000.

9. Tax Liability

a) Deferred Income Taxes Related To The Pension Asset

Nicor Gas has included in rate base $75,156,000 of deferred income taxes related to the pension asset for the test year. In valuing the same taxes, both Ms. Pugh has inappropriately excluded the federal tax benefit of the state income tax deduction related to that asset, which is a debit to deferred tax of $4,626,000 at December 31, 2004, and $4,763,000 at December 31, 2005. Moreover, if the Commission were to rule that the net pension asset be excluded from rate base, the correct adjustment would be $111,726,000, representing the gross pension asset of

$186,882,000, less the associated deferred taxes of $75,156,000 (which Nicor Gas' direct testimony incorrectly said was $76,883,000). Nicor Gas' Mr. Gorenz offers testimony on this issue. (Gorenz Reb., Nicor Gas Ex. 26B.0).

Ms. Pugh's proposed adjustment would inappropriately allow an additional $4,695,000 from rate base, which in turn would inappropriately increase the revenue requirement by $597,000.

b) <u>Use of Year-End Rate Base for ADIT</u>

Nicor Gas has forecast its ADIT reduction of $346,060,000 to rate base. Staff witness Mr. Struck has proposed adjusting ADIT to reflect an average rate base. This proposal should be rejected for the reasons noted above for rejecting the use of a year-end rate base. Nicor Gas' Messrs. O'Connor and Gorenz offer testimony on this issue. (O'Connor Reb., Nicor Gas Ex. 26A.0; Gorenz Reb., Nicor Gas Ex. 26B.0).

Mr. Strucks proposed adjustment would inappropriately disallow $24,546,000 from rate base, which in turn would inappropriately reduce the revenue requirement by $3,119,000

c) <u>ADIT Not Based on Certain Gross Utility Proposals</u>

In computing ADIT, Nicor Gas has not used any of the adjustments to Gross Utility Plant suggested by Staff's Mr. Griffin. As discussed above, these proposed adjustments (which concerned a blanket reduction to capital expenditures, the Daily Metering Project, and the Mainframe Computer Project) are not warranted. Accordingly, Mr. Griffin's proposed adjustments to deferred income taxes that are derived from such Gross Utility adjustments – $1,264,000 (blanket reduction), $100,000 (Daily Metering), and $145,000 (Computer Mainframe) – are not warranted, either. Nicor Gas' Messrs. O'Connor and Gorenz offer testimony on this issue. (O'Connor Reb., Nicor Gas Ex. 26A.0; Gorenz Reb., Nicor Gas Ex. 26B.0).

Mr. Griffin's proposed ADIT adjustments would inappropriately disallow $1,590,000 from rate base, which in turn would inappropriately reduce the revenue requirement by $192,000.

10. Customer Deposits

Nicor Gas has forecast Customer Deposits of $23,711,000 as a deduction to rate base. Staff has agreed with this forecast. The AG's Mr. Effron, however, has proposed to increase Customer Deposits to $27,259,000, based upon information through December 31, 2004. Nicor Gas has shown that its test year forecast is on target. Therefore, Nicor Gas is not updating test year forecasts generally. As a result, Mr. Effron's proposed adjustment would be selective, and should not be made. Nicor Gas' Mr. Gorenz provide testimony regarding this issue. (Gorenz Reb., Nicor Gas Ex. 26B.0).

Mr. Effron's proposed adjustment would inappropriately increase the deduction to rate base by $3,548,000, which in turn would inappropriately reduce the revenue requirement by an $459,000.

11. Budget Payment Plan

a) Valuation of Budget Payment Plan

Nicor Gas has forecast a Budget Payment Plan balance of $60,965,000 as a deduction to rate base. The AG's Mr. Effron has proposed adjusting this balance to $83,427,000, using information through December 31, 2004. Like Mr. Effron's suggestion regarding Customer Deposits, this proposal should not be adopted, as Nicor Gas is not updating its test year forecasts generally, and thus such a proposal would be selective and therefore improper. Nicor Gas' Mr. Gorenz offer testimony on this issue.(Gorenz Reb., Nicor Gas Ex. 26B.0).

Mr. Effron's proposed adjustment would inappropriately increase the deduction to rate base by $22,462,000, which in turn would inappropriately reduce the revenue requirement by an $2,907,000.

b) <u>Computation of Budget Payment Plan Interest Expense</u>

AG witness Mr. Effron has proposed adjusting the interest expense related to the adjusted Budget Payment Plan balances. Nicor Gas does not agree with Mr. Effron's adjusted Budget Payment Plan balance. Accordingly, Nicor Gas does not agree with the related adjustment to Budget Payment Plan interest expense. Nicor witness Mr. O'Connor provides testimonoy on this issue. (O'Connor Reb., Nicor Gas Ex. 26A.0).

Mr. Effron's proposed adjustment would increase the jurisdictional operating income by $1,428,000, which in turn would inappropriately increase Nicor Gas' revenue requirement by $1,446,000.

12. <u>Uncollectibles Reserve</u>

Nicor Gas tracks an Uncollectibles Reserve for accounting purposes. CUB/CCSAO witness Mr. Mierzwa has forecast the amount for the Uncollectible Reserve for 2005 to be $24,185,247. Mr. Mierzwa has proposed to deduct this amount from rate base. He argues that the Uncollectible Reserve is a source of funds, paid by ratepayers, which is available to Nicor Gas. However, there is no "pot of money" out there labeled "uncollectibles reserve balance" on which Nicor Gas can draw to pay its expenses. Nor does Nicor Gas receive a return on the uncollectibles reserve balance, as Mr. Mierzwa apparently believes to be the case. The uncollectibles reserve is not available as a source of funds for Nicor Gas, in fact it cannot even be used as a form of collateral to help secure financing from lending institutions. The uncollectibles reserve balance is simply an accrual that is tracked for accounting purposes only, one that is booked to appropriately offset the accrual associated with booking the amount of billings, and it has no effect on Nicor Gas' rate base. Nicor witness Mr. Gorenz provides testimony on this issue. (Gorenz Reb., Nicor Ex. 26B.0). Staff also rejections Mr. Mierzwas proposal.

Mr. Mierzwa's proposal improperly disallows $24,185,247 from rate base, which results in a $3,806,494 reduction in revenue requirement.

D. <u>Expenses</u>

1. <u>Depreciation Expense</u>

Nicor Gas has forecast a depreciation expense of $154,700,000. Staff witness Mr. Griffin has proposed a reduction to this expense by $320,000 in correspondence with his proposed plant adjustments, and the AG's Mr. Effron has proposed reducing the expense by $568,000, in correspondence with his proposed plant adjustments. As discussed above, none of their plant proposals are warranted. Accordingly, their respective proposals to reduce depreciation expense should be rejected. If, however, the Commission decides to accept any of their plant proposals, then it should also adopt the corresponding proposal(s) for reducing depreciation expense, though in Mr. Griffin's case, that reduction would be $320,000, as agreed in his rebuttal testimony, as opposed to his miscalculated amount of $287,000, as set forth in his direct testimony. Nicor Gas' Messrs. O'Connor and Gorenz provide testimony on this issue. (Gorenz Reb., 26B.0).

Mr. Effron's proposed adjustment would inappropriately reduce jurisdictional operating income by $568,000, which in turn would inappropriately reduce the revenue requirement by $575,000. Mr. Griffin's proposed adjustment (as corrected) would inappropriately reduce jurisdictional operating income by $320,000, which in turn would inappropriately reduce the revenue requirement by $325,000 .

2. <u>Other Operating and Maintenance Expenses – Participation in Groups</u>

Nicor Gas has proposed other operating and maintenance expenses ("OO&M") of $224,973,000. Staff's Ms. Pugh has sought to reduce these expenses by suggesting the disallowance of dues paid to fifteen "industry associations" of which Nicor Gas is a member, which would result in a disallowance of $93,000, and of dues paid to "social and service club[s]", which would result in a further disallowance of $85,000, based on the contention that participation in such groups is a promotional and goodwill practice. These expenses, however, are not for promotional or goodwill purposes. Rather, Nicor Gas participates in these organizations in order to better serve its customers and to benefit the communities it serves and, as such, these expenditures are properly recovered. Nicor Gas' Ms. Suppes offers testimony on this issue. (Suppes Reb. and Sur., Nicor Gas Exs. 23.0 and 38.0).

Ms. Pugh's proposed adjustments would inappropriately reduce jurisdictional operating income by $178,000, which in turn would inappropriately reduce the revenue requirement by $180,000.

3. Branding Expenses Paid By Nicor Inc.

Nicor Gas has included $340,000 in expenses associated with advertising and branding efforts. The AG's Mr. Effron has suggested disallowing these expenses, which reflect Nicor Gas' allocated share of expenditures by its parent, Nicor Inc., contending that these expenditures are designed to improve the corporate image and reputation of Nicor Inc. Contrary to Mr. Effron's suggestion, this budget item is not merely advertising for the parent, but provides clear and tangible benefits to Nicor Gas' customers. The amount allocated to Nicor Gas, which constitutes roughly 39% of the total, is based upon the proportional benefit that its customers receive from the dollars spent by Nicor Inc. Nicor Gas' Ms. Suppes offers testimony on this issue. (Suppes Reb. and Sur., Nicor Gas Exs. 23.0 and 38.0).

Mr. Effron's proposed adjustment would inappropriately reduce jurisdictional operating income by $340,000, which in turn would inappropriately reduce the revenue requirement by $345,000.

4. Office Supplies and Expenses

Nicor Gas has included $23,633,000 for Office Supplies and Expenses (Account 921). The AG's Mr. Effron has proposed a $5,067,000 reduction in such Office Supplies and Expenses, based on 2003 figures. This proposal should be rejected. Nicor Gas' test year budget was developed from the bottom up, requiring preparers to build from the lowest level of detail, and using exhaustive, formal processes with multiple steps and reviews. The costs charged to Account 921 are or will be prudently incurred and include necessary items such as telephone, office supplies, and general and administrative rental expense. Nicor Gas' Messrs. O'Connor, Gorenz, and D'Alessandro provide testimony regarding this issue. (*See*, Gorenz Reb. and Sur., Nicor Gas Exs. 26B.0 and 41.0; *see also* D'Alessandro Dir., Nicor Gas Ex. 5.0; O'Connor Reb. and Sur., Nicor Gas Exs. 26A.0 and 34.0).

Mr. Effron's proposed adjustment would inappropriately reduce jurisdictional operating income by $5,067,000, which in turn would inappropriately reduce the revenue requirement by $5,134,000.

5. Amortization for Rate Case Expenses

Nicor Gas has used a five-year amortization period for rate case expenses. Staff's Ms. Ebrey has proposed changing this amortization period to eight years. This proposal should be rejected. A five-year period is conservative and more than reasonable, given the facts and prior Commission orders. For example, in the '95 Rate Case, the Commission approved a five-year period for amortization of rate case expenses. Nicor Gas witnesses Messrs. O'Connor and

Gorenz offer testimony on this issue. (*See*, Gorenz Reb. and Sur., Nicor Gas Exs. 26B.0 and 41.0; O'Connor Reb. and Sur., Nicor Gas Exs. 26A.0 and 34.0).

Ms. Ebrey's proposed adjustment would inappropriately reduce jurisdictional operating income by $268,000, which in turn would inappropriately reduce the revenue requirement by $271,000.

6. <u>Uncollectibles Expense</u>

Nicor Gas has proposed to update projected 2005 uncollectibles expense as filed by $4,807,000 (non-PGA pass-through), as Nicor Gas is now experiencing a loss ratio of about 1.40 percent, rather than the originally projected loss ratio of 1.30 percent. The AG's Mr. Effron has opposed this update, but Mr. Effron's analysis is flawed on several counts and should be rejected. Nicor Gas' update should be approved because Nicor Gas has demonstrated the continuing up trend in uncollectibles expense and has shown that this trend is expected to continue. Staff witness, Mr. Struck has accepted Nicor Gas' use of 1.40% in his Schedule 10.09. Nicor Gas' Ms. Suppes and Mr. Gorenz present testimony on this issue. (*See*, Gorenz Dir., Reb., and Sur., Nicor Gas Exs. 11B.0, 26B.0, and 41.0; O'Connor Dir, Reb., and Sur., Nicor Gas Exs. 11A.0, 26A.0, and 34.0).

Nicor Gas' proposal would increase jurisdictional operating income by $4,807,000, which would in turn would increase the revenue requirement by $4,874,000.

7. <u>Incentive Compensation and Payroll Expenses</u>

Nicor Gas has included incentive compensation costs of $6,089,000 and related payroll tax expenses of $466,000. Staff's Ms. Pugh has proposed to disallow the $6,089,000 in the incentive compensation costs, as well as $466,000 of associated payroll tax expenses, asserting that such costs do not benefit ratepayers. Using the same assertion, the AG's Mr. Effron has proposed reducing incentive compensation costs by $5,769,000, along with a corresponding

$441,000 reduction in payroll tax expenses. None of these proposals should be accepted. To be competitive, Nicor Gas has to attract and retain quality employees. As a result, Nicor Gas has long followed a total cash compensation philosophy that rewards professional employees with base pay and annual incentive opportunities. To achieve this goal at a reasonable cost, Nicor Gas targets its professional employees' total compensation package at a "50th percentile" level, i.e., base pay plus annual incentive opportunities are targeted at the median of the relevant labor market. This approach certainly benefits ratepayers, maintaining quality service while keeping rates lower. Nicor Gas witness Ms. Bacidore offers testimony on this issue. (Bacidore Dir, Reb. and Sur., Nicor Gas Exs. 9.0, 25.0, and 40.0).

Ms. Pugh's proposed adjustments would inappropriately reduce jurisdictional operating income by $6,555,000, which in turn would inappropriately reduce the revenue requirement by $6,647,000. Mr. Effron's proposed adjustments would inappropriately reduce jurisdictional operating iIncome by $6,210,000, which in turn would inappropriately reduce the revenue requirement by $6,292,000.

8. <u>Stock Option Expense</u>

Nicor Gas has included $891,000 in expenses associated with stock options. The AG's Mr. Effron has proposed to disallow these expenses, asserting that do not benefit ratepayers. In rebuttal testimony Staff's Ms. Pugh joined with Mr. Effron and also proposed to disallow these expenses. This proposal should be rejected. Like incentive compensation discussed above, stock options are part of Nicor Gas' compensation plan designed to attract quality personnel at reasonable costs to ratepayers. As a result, expenses associated with such options are properly recovered. Nicor Gas' Ms. Bacidore provides testimony on this issue. (Bacidore Reb. and Sur., Nicor Gas Exs. 25.0 and 40.0).

The proposed adjustment by Mr. Effron and Ms' Pugh would inappropriately reduce jurisdictional operating income by $891,000, which would inappropriately reduce the revenue requirement by $904,000.

9. <u>Corporate Benefit Plan Expense</u>

Nicor Gas has included $2,206,000 of expenses billed to it by Nicor Inc. for administering Nicor Gas' corporate benefit plans. The AG's Mr. Effron has proposed to reduce these expenses by $1,103,000, which reflects the forecast increase in such expenses over 2004. This proposal should not be accepted. It is just another inappropriate attempt to make a selective update of Nicor Gas' test year forecast, which Nicor Gas properly assembled through the work of a great number of trained people and which Nicor has shown to be on track. Nicor Gas' Ms. Bacidore provides testimony on this issue. (Bacidore Dir, Reb. and Sur., Nicor Gas Exs. 9.0, 25.0, and 40.0).

Mr. Effron's proposed adjustment would inappropriately reduce jurisdictional operating income by $1,103,000, which would inappropriately reduce the revenue requirement by $1,118,000.

10. <u>Interest on Customer Deposits Expenses</u>

Nicor Gas has forecast $314,000 in interest expense related to customer deposits. The AG's Mr. Effron has proposed an upward adjustment of $477,000 to reflect 2004 year-end numbers. This adjustment should not be adopted. As explained above, it is inappropriate to make selective adjustments to reflect 2004 year-end numbers, when the vast majority of other numbers are not based on such numbers. Nicor Gas' Messrs. O'Connor and Gorenz offer testimony on this issue. (*See*, Gorenz Dir. and Sur., Nicor Gas Exs. 11B.0 and 41.0; O'Connor Reb. and Sur., Nicor Gas Exs. 26A.0 and 34.0).

Mr. Effron's proposed adjustment would inappropriately increase jurisdictional operating income by $477,000, which would inappropriately increase the revenue requirement by $483,000.

11. Interest Synchronization

Nicor Gas has proposed an interest expense component of $42,080,000. The interest expense is computed by multiplying rate base ($1,441,082,000) by the weighted cost of debt (2.92%). Staff's Mr. Struck has proposed an interest expense of $36,367,000 based on his use of a rate base of $1,289,611,000 and a cost of debt of 2.82%. In addition, Mr. Struck has proposed adjustments for the tax effect of the difference in interest expense, an increase of $417,000 in state tax expense and $1,854,000 in federal tax expense. These proposed adjustments should be rejected. AG witness Effron has proposed an interest expense of $29,399,000 with a corresponding tax impact of $926,000 for state taxes and $4,114,000 for federal taxes. Nicor Gas' Mr.Gorenz provides testimony on this issue. (*See*, Gorenz Dir., Reb., and Sur., Nicor Gas Exs. 11B.0, 26B.0, and 41.0).

Mr. Struck's proposed adjustments would inappropriately increase jurisdictional operating income by $2,271,000, which would inappropriately increase the revenue requirement by $3,822,000 . Mr. Effron's proposed adjustments would inappropriately increase jurisdictional operating income by $12,681,000, which would inappropriately increase the revenue requirement by $8,475,000 .

E. Rate Of Return

1. Summary

Nicor Gas' total cost of capital is 9.03% *per annum*, and Nicor Gas contends that this should be its allowed rate of return. Staff witness McNally proposes a rate of return of 7.55%, CUB/CCSAO witness Christopher Thomas proposes a rate of return of 7.697%, which AG witness Effron rounds to 7.70%. Their proposals should be rejected for the reasons summarized below; Nicor Gas' witnesses Mr. Hawley, Mr. O'Connor, Mr. Mudra, and Dr. Makholm (Nicor Gas Exs. 3A.0, 18A.0, and 20A.0; 18B.0 and 34.0; 3B.0, 20B.0, and 36.0; 4.0, 21.0, and 37.0, respectively) offer testimony on these issues.

Mr. McNally's proposed rate of return would inappropriately reduce the revenue requirement by $35.9 million. Mr. Effron's or Mr. Thomas' proposed rate of return (which are essentially the same) would inappropriately reduce the revenue requirement by $32.26 million. (*See* Nicor Gas Ex. 36.1; analogous calculation made for the GCI proposal).

2. <u>Cost of Equity</u>

Nicor Gas' cost of equity is reasonably set at 10.82% *per annum*. This return on equity ("ROE") is updated for changes in stock price and other factors through February 7, 2005, the same date used by Staff for its updates. It is less than the 11.22% cost of equity originally proposed and less than the average of the original and updated discounted cash flow data. Staff witness McNally proposes an ROE of 9.54%, and CUB/CCSAO's Mr. Thomas proposed an ROE of 9.86%. (Thomas Reb., Staff Ex. 14.0, Sch.. 14.1; CUB-CCSAO Ex. 3.0 at 2). These proposals are each based on unsupportable assumptions, especially relating to the selection of the sample group used in the discounted cash flow (DCF) methodology and the use of growth rates from limited sources. Their recommendation, moreover, lie far outside the norm and Mr. McNally's would result in Nicor Gas being awarded the lowest return on equity of any LDC in 2004 or 2005 to date. Nicor Gas' witnesses Mr. Hawley, Mr. O'Connor, Mr. Mudra, and Dr. Makholm (Nicor Gas Exs. 3A.0, 18A.0, and 20A.0; 18B.0 and 34.0; 3B.0, 20B.0, and 36.0; 4.0, 21.0, and 37.0, respectively) offer testimony on these issues.

Mr. McNally's proposed ROE would inappropriately reduce the revenue requirement by $17,000,000. Mr. Thomas's proposed ROE would inappropriately reduce the revenue requirement by $13,100,000. (*See* Nicor Gas Ex. 36.1; analogous calculation made for the GCI proposal).

3. <u>Short-Term Debt</u>

In accordance with the decision in the '95 Rate Case on the same facts, short-term debt should not be included in Nicor Gas' capital structure for ratemaking purposes. Staff witness Mr. McNally proposes to include 100% of Nicor Gas average short-term borrowings in its capital structure. (*See, e.g.*, McNally Dir., Staff Ex. 5.0, Sch. 5.2). This proposal should be rejected. Nicor Gas uses short-term debt for seasonal cash flow management purposes only. The fact that cash is "fungible" does not imply that, for ratemaking purposes, seasonal cash management tools should be deemed the equivalent of capital financing rate base, nor added to the capital structure for ratemaking purposes. Nicor Gas does not use rolled-over or revolving short-term debt balances as a means to finance its rate base assets through the test year, or over any longer-term. Adding short-term debt to Nicor Gas' capital structure would be inappropriate given its use and volatility and especially unfair given its past exclusion and the fact that short-rates are temporarily near all time lows at this time. Nicor Gas' witnesses Mr. Hawley, Mr. O'Connor, and Mr. Mudra (Nicor Gas Exs. 18A.0, and 20A.0; 18B.0 and 34.0; 3B.0, 20B.0, and 36.0; 4.0, 21,0, and 37.0, respectively) offer significant testimony on this issue.

Mr. McNally's proposed addition of short-term debt would inappropriately reduce the revenue requirement by $18.9 million. (*See* Nicor Gas Ex. 36.1).

a) <u>Quantification Of Any Short-Term Debt Adjustment</u>

If the Commission were, despite the persuasive evidence to the contrary, decide to include short-term debt in Nicor Gas' capital structure for ratemaking purposes, there is no basis for included all of such debt, as Staff witness Mr. McNally proposes (this proposal is adopted without analysis by CUB/CCSAO witness Thomas in his rebuttal testimony, CUB/CCSAO Ex. 3.0). This proposal is unsupportable and inaccurate. Total short-term debt exceeds the total increase in rate base during any year; clearly it <u>cannot</u> all support to rate base assets. This is confirmed by the fact that short-term debt must fund many non-rate base seasonal cash flow needs, including many that are expensed. Furthermore, including 100% of short-term debt ignores other short-term sources of funds that would be used before short-term debt. If only the additional rate base deductions that Staff supports – which total $88.6 million – are recognized as being available to fund asset purchases, the remaining amount that could be supported under Mr. McNally's proposal by short-term debt amounts to no more than $36.6 million, about 3% of the capital structure instead of the nearly 14% that Mr. McNally has proposed to include. Nicor Gas' witnesses Mr. Hawley and Mr. Mudra (Nicor Gas Exs. 3A.0, 18A.0, and 20A.0; 3B.0, 20B.0, and 36.0, respectively) offer significant testimony on this issue.

Mr. McNally's proposed adjustment would inappropriately reduce the revenue requirement by $13.8 million. (*See* Nicor Gas Exs. 36.1, 36.2).

b) <u>Cost Of Short-Term Debt</u>

If the Commission were, despite the persuasive evidence to the contrary, to decide to include short-term debt in Nicor Gas' capital structure for ratemaking purposes, it must at least be included at an accurate cost. The cost of Nicor Gas' test year short-term borrowing is accurately forecast as 4.12%. Staff witness McNally proposes a lower rate by (a) ignoring Nicor

Gas' survey of available borrowing rates in favor of a one-day, one-source point estimate or required interest; and (b) simply ignoring Nicor Gas reasonable and necessary commitment fees. Nicor Gas' witness Mr. Mudra (Mudra Reb. and Sur., Nicor Gas Exs. 20B.0 and 36.0) offers significant testimony on this issue.

Mr. McNally's proposal to exclude commitment fees and to use a unreliable estimate of interest would inappropriately reduce the revenue requirement by $5.1 million.

4. Adjustments To Capital Balances

Nicor Gas proposes using book balances for its capital structure components. Staff witness McNally proposes reducing Nicor Gas' book long-term debt balance by the amount of unamortized discounts and expenses attributable to certain retired debt. Nicor Gas utilized actual 2005 test year-end capital structure balances.

Because he proposes (incorrectly) to include short-term debt in Nicor Gas' capital structure, Staff witness Mr. McNally also proposes to reduce the other components of Nicor Gas' capital structure based upon the allocation of funds to CWIP accruing AFUDC in months when Nicor Gas has no short-term borrowings at all. Given that short-term debt should not be included in the capital structure, these adjustments are unwarranted and should be rejected. Mr. Mudra presents testimony on this issue. (Mudra Sur., Nicor Gas Ex. 36.0).

5. Flotation Costs

Nicor Gas has proposed to recover its flotation costs of $4,695,771 which are the costs associated with its five issuance of financing since its inception as an independent utility in 1953. Mr. McNally has objected to recovery of these costs, asserting that Nicor Gas has not sufficiently proven that these costs were incurred for utility purposes and not recovered. This objection is without merit. Using its books and records and the testimony of Mr. Mudra, Nicor Gas has quantified these costs, established that they were for utility purposes, and determined that no portion of them has been recovered. Nicor Gas' Mr. Mudra presents testimony on this issue. (Mudra Dir., Reb., and Sur., Nicor Gas Exs. 3B.0, 20B.0, and 36.0).

Mr. McNally's proposal to exclude flotation costs would inappropriately reduce jurisdictional operating income by $576,435, which would inappropriately reduce the revenue requirement by $970,239

F. Rate Design

1. Cost Of Service Study

a) Marginal Cost Of Service Study

Nicor Gas has presented a detailed marginal cost of service study ("MCOSS") as a basis for allocating revenues to rate classes and for rate design. Staff witness Mike Luth and Constellation New Energy ("CNE")/ Illinois Industrial Energy Consumers ("IIEC") witness Alan Rosenberg have opposed Nicor Gas' use of the MCOSS and the Equal Percentage of Marginal Cost ("EPMC") method based on their conclusions concerning the merits of marginal cost pricing for gas LDCs and the history of using embedded cost pricing in Illinois. Despite this opposition, Nicor Gas' maintains that the use of the MCOSS and the EPMC method, with gradualism, is appropriate. However, for the purposes of this case, Nicor Gas has accepted the concept of an Embedded Cost of Service Study ("ECOSS"), if properly calculated, for the purposes of revenue allocation, although Nicor Gas maintains that marginal cost principles should be applied to its rate design. (*See*, Harms Reb., Nicor Gas Ex. 44.0; *see also* Parmesano Dir. and Reb., Nicor Gas Exs. 13.0 and 30.0).

Nicor Gas' proposed MCOSS would not affect the revenue requirement, but only rate design.

b) Embedded Cost Of Service Study

Nicor Gas has proposed an embedded cost of service study ("ECOSS"), as well. Staff's Mr. Luth has presented the results of his own ECOSS, but Nicor Gas' study is preferable in two significant respects. First, only Nicor Gas' ECOSS allocates distribution main-related costs based on a Modified Distribution Main ("MDM") study, which more accurately assigns distribution main costs to all rate classifications than a general class allocation factor, and which was part of the ECOSS methodology approved by the Commission in the '95 Rate Case. Second, Mr. Luth has used the Average and Peak day allocation ("A&P") method, which is less appropriate than the Coincident Peak day allocation ("CP") method used and supported by Nicor Gas witness Alan Heintz. Fore the sake of narrowing the issues, Nicor Gas agreed in its surrebuttal testimony to utilize the A&P method rather than the CP method. However, there are errors in Mr. Luth's alleged A&P method that Nicor Gas opposes. Mr. Heintz and Nicor Gas' Mr. Harms present testimony on this issue. (*See*, Harms Dir., Reb., and Sur., Nicor Gas Exs. 17.0, 32.0, and 44.0; Heintz Dir, Reb., and Sur., Nicor Gas Exs. 14.0, 31.0, and 42.0)

Nicor Gas' proposed ECOSS would not affect the revenue requirement, but only the allocation of costs among ratepayers.

2. <u>Elimination of Rate 81</u>

Nicor Gas has proposed the elimination of its Rate 81, Energy Transportation Service. Although CNE witness John Oroni has opposed this proposal, claiming that it would increase prices for customers on such Rate, it should be approved for a number of reasons. Customers have been aware of Nicor Gas' intent to phase out the promotional aspects of Rate 81 for almost 10 years. Additionally, as the current ECOSS shows, Rate 81 customers provide a rate of return that is significantly below their cost of service, and thus it is appropriate to eliminate that Rate. Furthermore, Rate 81 customers should be adequately served on other rates. Nicor Gas' Mr.

Harms offers testimony on this issue. (*See*, Harms Dir. and Reb., Nicor Gas Exs. 12B.0 and 27B.0).

Mr. Oroni's proposed maintenance of Rate 81 would result in the inappropriate continuation of an uneconomic rate.

3. Rider 6

a) Recovery Of Hub Expenses Through Revenue Requirement

Nicor Gas and Staff witness Mr. David Borden have agreed that gross revenues from Hub services collected by Nicor Gas should be credited to customers through Rider 6, and that the administration fees associated with these revenues, which have been forecast at $1,079,000, should be recovered as operating expenses through base rates. In his original proposal reflecting these items, however, Mr. Borden has not correctly adjusted Nicor Gas' base rate revenue requirement to recover such administration costs through base rates. Accordingly, under Mr. Borden's proposal, these costs need to be added to Nicor Gas' OO&M expenses in its base rate revenue requirement. Nicor Gas' Messrs. O'Connor and Gorenz provide testimony on this issue. (*See*, Gorenz Dir., Reb., and Sur., Nicor Gas Exs. 11B.0, 26B.0 and 41.0; O'Connor Sur., Nicor Gas Ex. 34.0).

Mr. Borden's proposal (as now corrected) would not affect the revenue requirement, but only the allocation of costs among ratepayers.

b) Customer Accounts – Uncollectibles

Nicor Gas has proposed to recover commodity-related uncollectibles expenses through Rider 6 and the remainder of such expenses through base rates. Staff's Mr. Struck and CUB/CCSAO's Mr. Mierzwa have opposed this proposal, claiming that uncollectible expenses should be recovered as operating expenses through base rates. This opposition is unjustified, as Nicor Gas' split of uncollectibles identifying the gas commodity portion to be 66.6% with the balance attributable to Nicor gas' delivery services, appropriately reflects the sources of uncollectibles. Also unjustified is Mr. Mierzwa's further assertion that the uncollectibles reserve balance is a source of funds. That balance is simply an accrual that is tracked for accounting purposes, and it has no effect on Nicor Gas' rate base. In total, Nicor Gas' proposal to collect the gas commodity portion of uncollectibles through Rider 6, with its annual review in the PGA Reconciliation case, is the most accurate and reasonable method to collect these expenses without an over recovery or under-recovery. Nicor Gas' Ms. Suppes and Messrs. O'Connor and Gorenz offer testimony on this issue. (*See*, Gorenz Dir., Reb., and Sur., Nicor Gas Exs. 11B.0, 26B.0 and 41.0; O'Connor Sur., Nicor Gas Ex. 34.0).

Nicor Gas' proposal reduces the base rate operating expenses by over $20 million.

c) Establishment of Commodity Portion Of Cost Of Gas

Nicor Gas has not proposed to periodically re-examine the commodity portion of uncollectible accounts. Staff's Mr. Struck, however, has suggested that if the Commission adopts Nicor Gas' proposed revisions to Rider 6 to include the commodity portion of uncollectible accounts, Nicor Gas should re-examine each year the portion attributable to the cost of gas. This suggestion should not be adopted, as such an annual review of this factor would simply add potential for greater disagreements in the reconciliation process. It is better public policy to set the factor during this proceeding, where all intervenors are participating, than to reargue it each year. In addition, gas costs represent about 75% of a residential customer's bill, greater than the commodity factor proposed in this case. Nicor Gas used a sampling method to establish a reasonable split between gas costs and non-gas costs, and no further adjustments are necessary. Nicor Gas' Mr. O'Connor and Mr. Gorenz offer testimony on this issue. (*See*, Gorenz Dir., Reb., and Sur., Nicor Gas Exs. 11B.0, 26B.0 and 41.0; O'Connor Sur., Nicor Gas Ex. 34.0).

It is difficult to calculate with precision any impact (*e.g.*, on base rates) that Mr. Struck's annual review of the commodity portion of gas costs would have, as such reviews, if adopted, would occur in the future.

d) <u>Gas Storage Losses (2% Withdrawal Factor)</u>

Nicor Gas had proposed continue to collect expenses related to gas storage losses through Rider 6. Staff's Ms. Pugh, however, has proposed that these expenses be collected through base rates as operating and maintenance expenses. Nicor Gas still believes that the most efficient method of reflecting the costs associated with the 2% withdrawal factor is through the Gas Supply Cost to sales customers and through the lost and unaccounted for adjustment to transportation customers. The net impact is recovery of current costs from both sales and transportation customers on a current basis. It is Nicor Gas' understanding that Staff is proposing to require that Nicor Gas will expense the cost of the 2% storage withdrawal adjustment related to storage withdrawals for sales customers only, which has been estimated as 61% of the $16.6 million Mr. Gorenz identified in his rebuttal testimony. The resulting approximately $10.1 million would, under Staff's theory, be included in base rates for sales customers. For transportation customers, the recovery of the 2% withdrawal factor would still be effected through the application of Nicor Gas' lost and unaccounted for factor to reduce deliveries to the citygate.

If the Commission adopts Staff's proposal to charge sales customers the cost of the 2% storage withdrawal adjustment while continuing the recovery from transportation customer through the lost and unaccounted for adjustment to deliveries, customers served under Rider 25 would receive a credit. Based on the characteristics of Rate 4 and Rate 6, Nicor Gas believes that the appropriate credit would be $0.0032 for Rate 4 (the 0.0005 was an error in Mr. Harm's surrebuttal testimony, an errata will be filed to correct this error) and $0.0011 for Rate 6, multiplied by the customer-owned therms that they would use in the billing month. In addition, Nicor Gas will need to modify the Rider 25 tariff to incorporate this credit. Customer Select customers should also receive a credit of $0.0032 which is the cost for sales customers of approximately $10.1 million divided by total therms for Rate 1 and 4. (Harms Reb., Nicor Gas Ex. 32.0).

The Staff proposal and allowing for the credit described above would increase the base rate revenue requirement by approximately $10.1 million.

e) Working Capital on Gas Storage

Nicor Gas has not proposed to modify Rider 6 to permit collection of working capital on gas in storage. Dominion witness James Crist, however, has made such a proposal. This proposal is unnecessary, and therefore should not be adopted. Working capital on gas storage inventory should not even be an issue for a Customer Select supplier like Dominion. As a result of Docket Nos. 00-0620 and 00-0621 consolidated, Nicor Gas has adjusted its administrative account charge to provide a credit of $0.44 per month per account for the gas storage inventory working capital. Absent an increase in Customer Select administrative charges for the lower gas storage inventory costs – which Mr. Crist has not proposed – no changes are needed to the accounting of gas storage inventory. Nicor Gas' Mr. Harms offers testimony on this issue. (Harms Reb. and Sur., Nicor Gas Ex. 27B.0 and 44.0).

Mr. Crist's proposed adjustment would not affect the revenue requirement, but only the allocation of costs among ratepayers.

4. Rate 1

Nicor Gas has proposed to retain the three block declining rate design for Rate 1 that was approved in Nicor Gas' last general rate case. Nicor Gas proposes to set the tail block of that design in accordance with marginal cost principles. (Nicor Gas Ex. 44.0) Staff witness Mr. Luth has proposed that Rate 1 have a single declining block rate that is for all intent and purposes a single flat rate. This proposal should be rejected as it has no justification in economic theory, provides poor price signals to customers and would leave Nicor Gas with a huge risk of under recovery its allowed revenue requirement. Nicor Gas' witnesses Dr. Gordon and Dr. Parmesano discuss the virtues of marginal cost pricing and Mr. Harms discusses the specifics of the Rate 1 rate design. (Nicor Gas Exs. 2.0, 19.0 and 35.0; 13.0 and 30.0, 17.0, and 32.0, respectively).

Nicor Gas' proposal would not affect the allowed revenue requirement, but would affect the relative levels of the different rates residential customers pay.

5. <u>Rider 7</u>

Nicor Gas has proposed to clarify and expand the scope of Rider 7 to include the recovery of all franchise and related costs imposed on Nicor Gas by a unit of local government so that these costs are recovered from customers taking service within the boundaries of that local governmental unit and not all customers. Staff's Mr. Luth has opposed Nicor Gas' proposal on two grounds. First, he claims that it would be administratively burdensome for Staff to track and reconcile the various charges that may come about in the future. Second, Mr. Luth contends that Nicor Gas has not shown that changes to Rider 7 are needed to avoid significant subsidies between customers. . Nicor Gas has recognized Mr. Luth's concerns and has proposed that a separate rider, Rider 2, Franchise Cost Adjustment be implement that would recover franchise gas costs from customers residing within the boundaries of that governmental unit. Nicor Gas has franchise agreements with some 464 municipalities that allow Nicor Gas to do work within the community in exchange for providing free gas to the municipalities' buildings. Some communities receive a cash payment for the equivalent amount of gas they are entitled to and others use the free gas in their buildings. Rider 2 would collect the value of the gas provided to each franchisee from those Nicor Gas customers within its boundaries. In addition, Rider 7 would be limited to certain costs other then franchise fees that a governmental agency might impose on Nicor Gas. As modified, Rider 7 would essentially be equivalent to ComEd's Rider 28. Several agencies currently are considering imposing such costs and Nicor Gas anticipates more agencies will be imposing these costs in the future. Nicor Gas' Mr. Harms offers testimony on this issue. (Harms Dir., Reb., and Sur., Nicor Gas Exs. 12B.0, 17.0, and 44.0).

Nicor Gas' proposal would not affect the revenue requirement, but only the allocation of costs among ratepayers.

6. Rider 12

a) Rider 12 – Research And Development Costs

Nicor Gas has proposed to include certain research and development ("R&D") costs in Rider 12, Environmental Cost Recovery. Staff's Ms. Ebrey has taken exception to this proposal, based on the activities presently included in that Rider. Certain incremental R&D expenses, however, fall within the purpose of Rider 12 and should be recoverable based on existing tariff language. In fact, R&D costs associated with manufactured gas plants ("MGPs") appear to be within the scope of Rider 12 already. Regardless, Nicor Gas' proposed revision would make clear that those and certain other R&D expenses are includable. Ms. Ebrey's position also should be rejected as being inconsistent with the Commission's decision in granting MGPs cost recovery riders. Nicor Gas' Mr. Harms offers testimony on this issue. (Harms Dir, Reb. and Sur., Nicor Gas Exs. 12B.0, 27B.0, and 44.0).

b) Rider 12 – "Manufactured Gas Operations"

Nicor Gas has also proposed to modify Rider 12 by inserting the words "Manufactured Gas Operations" into the definition of "Environmental Activities." Ms. Ebrey has objected to this proposal, claiming that it will be confusing. This objection, however, is not warranted. In comparing Nicor Gas' MGP recovery rider with similar riders of other Illinois utilities, it appears that such other companies are able to recover costs relating to MGP operations that are other than remediation costs; Nicor Gas simply desires the same treatment. Nicor Gas' Mr. Harms offers testimony on this issue. (Harms Dir, Reb., and Sur., Nicor Gas Exs. 12B.0, 27B.0, 44.0).

7. <u>Rate 21</u>

Nicor Gas has proposed to continue offering certain services under Rate 21, Interruptible Transport and Storage Services, under which Nicor Gas offers a collection of services to end-users, local distribution companies, and other customers that permit such customers to store and transport gas using the Nicor Gas system. Nicor Gas has proposed to permit hub loans under Rate 21, as well as the removals of the one-year limitation on Rate 21 contracts and of the 120-day limits currently in place. Staff's Mr. Borden has opposed the removal of such limitations, claiming that possible harm to sales customers. Yet Mr. Borden has not provided any reasoning or evidence to indicate any such harm. In fact, the removal of the limitations may result in additional Hub revenue, which would be passed through Rider 6, thus benefiting sales customers. Nicor Gas' Mr. Bartlett provides testimony on this issue. (Bartlett Dir., Reb., and Sur., Nicor Gas Exs. 8.0, 24.0, 39.0).

Nicor Gas' proposal would not affect the revenue requirement, but only the allocation of costs among customer classes.

8. <u>Storage Banking Services – Rates 74, 76, 77</u>

a) <u>Allocation</u>

Nicor Gas has proposed changing the allocation of storage to Rate 74, 76, and 77 (Storage Bank Services ("SBS")) customers from 26 times the maximum daily contract quantity ("MDCQ"), which is the maximum amount of gas that the customer requires Nicor Gas to deliver on a given day, to 23 times MDCQ, to reflect the volume of cyclable gas for allocation.

Nicor Gas also has proposed a conforming change in Rider 16, Customer Select. Various intervenor and Staff witnesses have opposed these changes, suggesting different allocations: CNE/IIEC's Dr. Rosenberg (28.5 times); Staff's Mr. Borden (27 times); and Vanguard witness Neil Anderson (26 times). CNE's Mr. Oroni also has objected to Nicor Gas' proposed reduction, and Dominion's Mr. Crist has objected to the use of MDCQ in calculating allocation of SBS, but has stated that if MDCQ is used, then 34 times is appropriate. These objections, however, fail, as they are erroneously based on total working gas instead of cyclable gas. Cyclable gas is the appropriate metric because Nicor Gas' storage assets require cycling to maintain their operability, and Nicor Gas must maintain a certain volume of working gas in the system to ensure that peak day delivery is adequate as the inventory reduced. Nicor Gas' Messrs. Harms and Bartlett provide testimony on these issues. (Bartlett Dir., Reb., and Sur., Nicor Gas Exs. 8.0, 24.0, 39.0; *see also* Harms Dir, Reb., and Sur., Nicor Gas Exs. 12B.0, 27B.0, 44.0).

Nicor Gas' proposal would not affect the revenue requirement, but only the allocation of costs among customer classes.

b) <u>Cycling</u>

Nicor Gas has proposed a requirement that SBS customers "cycle" their gas, meaning to withdraw and inject a certain amount each year. Nicor Gas has proposed a target of 10% inventory by April 1 and 90% inventory by November 1, in line with operational requirements of Nicor Gas' storage assets. Nicor Gas has further proposed restrictions on the withdrawal and injection rights of customers that fail to meet these targets. Staff's Mr. Borden has agreed with the 90% target, but not the 10% one, and has proposed different reductions for missing cycling targets. CNE/IIEC's Dr. Rosenberg has agreed that cycling is necessary, but has argued that it should not be required for SBS customers. Mr. Oroni has proposed targets of 50% and 75%. These proposals should be rejected. Cycling is an operational requirement for Nicor Gas' system, and Nicor Gas' proposed targets and reductions for missing such targets will help meet that need. Moreover, because the burden of cycling currently falls upon Nicor Gas and thus the sales customers, Nicor Gas' proposal will distribute the burden and cost of maintaining the storage system amongst various classes of customers rather than just sales customers. Nicor Gas' Mr. Bartlett discusses these issues. (Bartlett Dir., Reb., and Sur., Nicor Gas Exs. 8.0, 24.0, 39.0).

Nicor Gas' proposal would not affect the revenue requirement, but only the allocation of costs among customer classes.

9. <u>Energy Efficiency Programs</u>

Environmental Law and Policy Center witness Martin Kushler has proposed an annual expenditure of between $10 million and $38 million on energy efficiency programs. CUB/CCSAO's Mr. Thomas has supported this proposal, although with no additional analysis. This proposal should be rejected. The proposal both lacks sufficient detail for the Commission to impose a charge on consumers and consideration of his proposal is not appropriate for inclusion in this rate setting proceeding. For these same reasons, Staff's Mr. Borden also has advocated such rejection. IIEC's Dr. Rosenberg has opposed this proposal, as well, as it would force certain classes of ratepayers to subsidize efficiency programs designed for other classes of ratepayers. Dr. Kushler's proposal should be rejected. Nicor Gas witnesses Mr. Val Jensen and Dr. Kenneth Gordon present testimony on this issue. (Jensen Reb. and Sur., Nicor Gas Exs. 33.0 and 45.0; s*ee also*, Gordon Reb. and Sur., Nicor Gas Exs. 19.0 and 35.0).

Dr. Kushler's proposal would inappropriately increase jurisdictional operating income by $10,000,000.

10. <u>Rider 13</u>

Nicor Gas has proposed no change to Rider 13's service group size limitation (currently 50 accounts). CNE's Mr. Oroni, however, has proposed that Nicor Gas eliminate the limit on the number of non-common ownership accounts that can be formed into a group under Rider 13. This proposal should not be adopted. Among other things, increased administrative costs and delays would arise with larger group sizes. In addition, because suppliers frequently change the composition of their groups, as customers move in and out, larger groups would generate more flux that would require continual monitoring. Nicor Gas' Mr. Harms offers testimony on this issue. (Harms Dir, Reb., and Sur., Nicor Gas Exs. 12B.0, 27B.0, 44.0).

11. Demand Gas Costs - Rider 25

Nicor Gas has proposed an increase of Demand Gas Costs ("DGC") payable by Rider 25, Transportation Service customers from the current 40% to 53%. Vanguard witness Neil Anderson has questioned this proposal, but it should be approved. The increase is necessary, as Rider 25 provides 100% back-up service to transportation customers choosing this option. For that service, they are required to pay their share of firm interstate pipeline capacity and leased storage costs. The customer's MDCQ is the basis from which it is billed. As with daily metered traditional transportation customers, Nicor Gas' on-system storage would provide 47% of their MDCQ and pipeline deliveries would meet the remaining 53%. Consequently, Rider 25 customers would be required to pay pipeline costs (DGC) for 53% of their MDCQ to provide them with 100% backup service. Nicor Gas witness Mr. Harms offers testimony on this issue. (Harms Dir, Reb., and Sur., Nicor Gas Exs. 12B.0, 27B.0, 44.0).

G. Gross Revenue Conversion Factor

Nicor Gas has used a gross revenue conversion factor of 1.683178. Staff's Mr. Struck has proposed substantially the same gross revenue conversion factor(with a minor different due to rounding) of 1.683179 with uncollectibles of 1.4% included in base rates, and of 1.659613, with uncollectibles not so included. The AG's Mr. Effron has proposed a gross revenue conversion factor of 1.681472 with uncollectibles of 1.3% included in base rates. These alternative proposals should be rejected. Nicor Gas' Mr. Gorenz offers testimony on this issue.

Mr. Struck and Mr. Effron's proposed conversion factors would inappropriately reduce the revenue requirement.

H. <u>Citizens Utility Board Additional Witness</u>

On May 5, 2005, CUB filed a motion to submit additional direct testimony for an additional witness. In ruling on the motion, the Administrative Law Judge allowed CUB to present this testimony live at the hearing and permitted Nicor Gas and other parties to serve data requests regarding such testimony. Nicor Gas served some such data requests but has received very little information other than the bare-bones information contained in the motion. It appears that CUB's additional direct testimony will relate to Nicor Gas and Nicor Service Company as they pertain to sales of Comfort Guard and heating and air conditioning services. Given these circumstances, Nicor Gas reserves the right to cross-examine CUB's additional witness, call Nicor Gas's own witnesses regarding any and all topics covered by that additional CUB witness, present arguments concerning such topics, and otherwise to address any other issues related to CUB's additional witness.

IV. <u>Table Of Proposed Adjustments</u>

The following table summarizes adjustments proposed in this proceeding, first with respect to rate base, and second with respect to jurisdictional operating income. For each such proposed adjustment, the table lists the amount, the sponsoring witness(es), and the impact if adopted.

FORECAST ADJUSTMENT	AMOUNT	WITNESS	REVENUE REQUIREMENT IMPACT
WEATHER NORMALIZATION			
Weather Normalization	$8,435,000	Harms, Takle, Herrera, (Nicor) Beyer, (Staff)	
RATE BASE			
Mercury Inspection & Remediation Program	$8,425,000	O'Connor and Gorenz (Nicor)	$1,281,000
Service Pipe Extension	$12,000	McCain (Nicor)	$2,000
Year-end Rate Base	$40,069,000	Struck (Staff)	$5,092,000
Capital Expenditure Budget	$8,742,000	Griffin (Staff)	$1,111,000
Capital Expenditure Budget	$14,196,000	Effron (AG)	$1,837,000
Daily Metering Project	$389,000	Griffin (Staff)	$49,000
Mainframe Project	$522,000	Griffin (Staff)	$66,000
Depreciation Reserve	$562,000	Griffin (Staff)	$71,000
Depreciation Reserve	$12,097,000	Effron (AG)	$1,566,000
Gas in Storage – Rate 21	$18,453,000	Bartlett, Gorenz (Nicor)	$2,805,000
Gas in Storage Valuation	$5,143,000	Gorenz (Nicor)	
Gas in Storage – 13 month average	$11,469,000	Mierzwa (CUB-CCSAO)	$1,484,000
Gas in Storage - LIFO	$95,308,000	Mierzwa (CUB-CCSAO)	$12,335,000
Gas in Storage - Valuation	$57,999,000	Mierzwa (CUB-CCSAO)	$7,506,000
Pension Asset	$105,410,000	Pugh (Staff)	$13,395,000
Pension Asset	$111,726,000	Effron (AG)	$14,460,000

FORECAST ADJUSTMENT	AMOUNT	WITNESS	REVENUE REQUIREMENT IMPACT
263a	$33,046,000	Struck (Staff)	$4,199,000
263a	$66,563,000	Effron (AG)	$8,615,000
Tax Liability – ADIT related to Pension Asset	$4,695,000	Pugh (Staff)	$597,000
Tax Liability – year-end rate base	$24,546,000	Struck (Staff)	$3,119,000
Tax Liability – Proration of ADIT on Property	$1,590,000	Griffin (Staff)	$192,000
Customer Deposits	$3,548,000	Effron (AG)	$459,000
Budget Payment Plan - Valuation	$22,462,000	Effron (AG)	$2,907,000
Uncollectible Reserve	$24,185,247	Mierzwa (CUB/CCSAO)	$3,806,494
JURISDICTIONAL OPERATING INCOME			
Hub Administrative Expenses	$1,079,000	Gorenz (Nicor)	$1,094,000
Depreciation Expense	$287,000)	Griffin (Staff)	$325,000
Depreciation Expense	$568,000	Effron (AG)	$575,000
Budget Payment Plan – Interest Expense	$1,428,000	Effron (AG)	$1,446,000
Participation in Groups	$178,000	Pugh (Staff)	$180,000
Nicor Inc. Advertising Expenses	$340,000	Effron (AG)	$345,000
Office Supplies and Expenses	$5,067,000	Effron (AG)	$5,134,000
Amortization for Rate Case	$268,000	Ebrey (Staff)	$271,000
Uncollectibles Expense	$4,807,000	Ebrey (Staff)	

FORECAST ADJUSTMENT	AMOUNT	WITNESS	REVENUE REQUIREMENT IMPACT
Incentive Compensation associated Payroll Taxes	$6,555,000	Pugh (Staff)	$6,647,000
Incentive Compensation and associated income tax	$6,210,000	Effron (AG)	$6,292,000
Stock Option	$891,000	Effron (AG)	$904,000
Corporate Benefit Plan	$1,103,000	Effron (AG)	$1,118,000
Flotation Costs	$4,695,771	McNally (Staff)	
Interest on Customer Deposits	$477,000	Effron (AG)	$483,000
Interest Expense Component	$12,681,000	Effron (AG)	$8,475,000
Interest Expense Component	$22,71,000	Struck (Staff)	$3,822,000
RATE OF RETURN			
Rate of Return	9.03%	Mudra (Nicor)	
Rate of Return	7.55%	McNally (Staff)	
Rate of Return	7.697%	Thomas (CUB/CCSA)	
RETURN ON EQUITY			
Return on Equity	10.82%	Mudra (Nicor)	
Return on Equity	9.54%	McNally (Staff)	
Return on Equity	9.86%	Thomas (CUB/CCSAO))	
GROSS REVENUE CONVERSION FACTOR			
Gross Revenue Conversion Factor – with uncollectibles	1.683179	Struck (Staff)	
Gross Revenue Conversion Factor – without uncollectibles	1.659613	Struck (Staff)	

FORECAST ADJUSTMENT	AMOUNT	WITNESS	REVENUE REQUIREMENT IMPACT
Gross Revenue Conversion Factor – without uncollectibles	1.681472	Effron (AG)	
RATE DESIGN			
Hub Revenues	$6,711,000	Gorenz, Bartlett (Nicor)	
Budget Payment Plan Review Schedule			
Rate 10 Cancellation		Harms (Nicor)	
Rate 11 Cancellation		Harms (Nicor)	
Ride 9 Cancellation		Harms (Nicor)	
Not Sufficient Funds Charge Update	$51,000		
Damage To Pipe Charge Update	$127,000		
Service Pipe Extension Charges Update			
New Rate 5			
New Rate 75			
Energy Efficiency Program	$10,000,000	Kushler (ELPC)	

V. Acronyms and Terms

The following list defines acronyms and terms that Nicor Gas expects to be used at trial in this matter.

1. **A & G**

   Administrative and General.

2. **A & P**

Average and Peak, a functional factor in energy volume, mixing or combining both the average use (or throughput) and peak use (or demand).

3. **ABSC**

Aggregator Balancing Service Charge.

4. **ADIT**

Accumulated Deferred Income Taxes.

5. **AFUDC**

Allowance for Funds Used During Construction.

6. **AG**

Attorney General of the State of Illinois.

7. **AGA**

American Gas Association.

8. **APB**

Accounting Principles Board, an accountant regulatory group.

9. **Bcf**

Billion Cubic Feet.

10. **BEAR**

Business Energy Alliance Resources LLC, an intervening party.

11. **BLS**

United States Federal Bureau of Labor Statistics.

12. **C & I**

Commercial and Industrial.

13. **CAGR**

Compound Annual Growth Rate.

14. **CAIC**

Customer Advances in Aid of Construction.

15. **CAPM**

Capital Asset Pricing Model, a means of estimating required returns on equity investments.

16. **CCM**

Certified Consulting Meteorologist.

17. **CCSAO**

Cook County State's Attorney's Office.

18. **Chicago Hub or The Hub**

The Chicago Hub is a collection of services that Nicor Gas offers to end-users, local distribution companies, and other customers that permit those customers to store and transport gas and, in some cases, to borrow gas, using the Nicor Gas system. These services include those offered under the jurisdiction of the Federal Energy Regulatory Commission and, on an intrastate basis, under the jurisdiction of the Illinois Commerce Commission.

19. **CILCO**

Central Illinois Light Company.

20. **CIS**

Customer Information System.

21. **CMT**

Capital Management Team.

22. **CNA**

Central North America.

23. **CNE**

Constellation New Energy, an intervening party.

24. **CNG**

Compressed Natural Gas.

25. **Commission or ICC**

Illinois Commerce Commission.

26. **Cons**.

Consolidated (with respect to two or more dockets pending before the Illinois Commerce Commission).

27. **CP**

Coincident Peak.

28. **CPA**

Certified Public Accountant.

29. **CPI**

Consumer Price Index.

30. **CPI-Chicago**

Consumer Price Index for Chicago.

31. **CPI-U**

Consumer Price Index for all urban customers.

32. **CSBC**

Customer Select Balancing Charge.

33. **CUB**

Citizens Utility Board.

34. **CWIP**

Construction Work in Progress.

35. **DCF**

Discounted Cash Flow, a means of estimating required returns on equity investments.

36. **DEM**

Direct assignment to demand.

37. **DGC**

Demand Gas Cost.

38. **DHS**

United States Department of Homeland Security.

39. **ECC**

Economic Carrying Charges.

40. **ECOSS**

Embedded Cost of Service Study.

41. **ELPC**

Environmental Law and Policy Center, an intervening party.

42. **EPMC**

Equal Percentage of Marginal Cost.

43. **ERC**

Earnings Review Committee.

44. **FBS**

Firm Backup Service.

45. **FCC**

Federal Communications Commission.

46. **FCCA**

Chartered Certified Accountant, which in the United Kingdom is approximately equivalent to a Certified Public Accountant.

47. **FERC**

Federal Energy Regulatory Commission.

48. **FOM**

First of the Month.

49. **FPC**

Financial Policy Committee.

50. **G & I**

General and Intangible Plant.

51. **GAAP**

Generally Accepted Accounting Principles.

52. **GCI**

Collectively, the Cook County State's Attorney's Office, the Citizens Utility Board, and the Attorney General of the State of Illinois.

53. **GCPP**

Nicor Gas' Gas Cost Performance Program, which was discontinued several years ago.

54. **GSC**

Gas Supply Cost.

55. **GTI**

Gas and Technology Institute.

56. **GU-T**

Gas Usage Tax.

57. **HDD**

Heating Degree Days, calculated by calculate the heating degree days for a particular day, find the day's average temperature by adding the day's high and low temperatures and dividing by two. If the number is above 65, there are no heating degree days that day. If the number is less than 65, subtract it from 65 to find the number of heating degree days.

58. **The Hub or Chicago Hub**

TheHub is a collection of services that Nicor Gas offers to end-users, local distribution companies, and other customers that permit those customers to store and transport gas and, in some cases, to borrow gas, using the Nicor Gas system. These services include those offered under the jurisdiction of the Federal Energy Regulatory Commission and, on an intrastate basis, under the jurisdiction of the Illinois Commerce Commission.

59. **IAPA**

The Illinois Administrative Procedure Act, 5 ILCS 100/1 *et seq*..

60. **IAWC**

Illinois American Water Company.

61. **IIEC**

Illinois Industrial Energy Consumers, an intervening party.

62. **Iowa Curve**

Curve representing mortality data of comparable classes of property.

63. **IPCC**

Intergovernmental Panel on Climate Change.

64. **IRS**

Internal Revenue Service.

65. **ISO**

Independent System Operator.

66. **IT**

Information Technology.

67. **LIFO**

Last-in, first-out.

68. **LDC**

Local Distribution Company.

69. **Maine PUC**

Maine Public Utilities Commission.

70. **Mass. DPU**

Massachusetts Department of Public Utilities.

71. **MBS**

Miscellaneous Billing System.

72. **MCOSS**

Marginal Cost of Service Study.

73. **Mcf**

Thousand Cubic Feet.

74. **MDCQ**

Maximum Daily Contract Quantity.

75. **MDM**

Modified Distribution Main.

76. **MDN**

Maximum Daily Nominations.

77. **MidCon**

MidCon Corporation.

78. **Moody's**

Moody's Investors Service.

79. **NAESB**

North American Energy Standards Board.

80. **NARUC**

National Association of Regulatory Utility Commissioners.

81. **NAST**

United States National Assessment Synthesis Team.

82. **NCOG**

Non-Common Ownership Group.

83. **NERA**

National Economic Research Associates.

84. **Nicor Gas**

Northern Illinois Gas Company d/b/a Nicor Gas Company.

85. **NIU**

Northern Illinois University.

86. **NSF**

Not Sufficient Funds.

87. **O & M**

Operations and Maintenance.

88. **OATT**

Open Access Transmission Tariff.

89. **OLS**

Ordinary Least Squares, a demand determiner.

90. **OO&M**

Other Operations and Maintenance.

91. **OTD**

Operations Technology Development.

92. **PGA**

Purchased Gas Adjustment.

93. **Pipeline Safety Act**

Pipeline Safety Improvement Act, 49 U.S.C. § 60129.

94. **POLR**

Provider of Last Resort.

95. **RAS**

Revenue Accounts System.

96. **The "1995 Rate Case" or the "'95 Rate Case"**

Northern Illinois Gas Company: Proposed General Increase in Rates for Gas Service, Illinois Commerce Commission Docket No. 95-0219.

97. **RFP**

Request for Proposals.

98. **RMSE**

Root Mean Squared Error.

99. **ROE**

Return on Equity.

100. **ROR**

Rate of Return.

101. **RTO**

Regional Transmission Organization.

102. **S & P**

Standard and Poor's.

103. **SBS** (Nicor Gas Exhibit 7.0, Direct Testimony of Christine Suppes)

Special Billing System.

104. **SBS** (Nicor Gas Exhibit 8.0, Direct Testimony of Gary Bartlett)

Storage Banking Services.

105. **SFAS**

Statement of Financial Accounting Standards.

106. **SMYS**

Specified Minimum Yield Strength.

107. **Staff**

Staff of the Illinois Commerce Commission.

108. **UG**

Underground Storage Plant.

109. **USDOT**

United States Department of Transportation.

110. **USOA**

Uniform System of Accounts.

111. **W & S**

Wages and Salaries.

112. **WACC**

Weighted Average Cost of Capital.

113. **WP**

Work Papers.

114. **Zacks**

Zacks Investment Research.