STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Northern Illinois Gas Company d/b/a NICOR Gas Company	)	
	)	Docket No. 04-0779
Proposed general increase in natural gas rates. (Tariffs filed on November 4, 2004.)	)	

INITIAL BRIEF

OF

THE CITIZENS UTILITY BOARD AND THE COOK COUNTY STATE'S ATTORNEY'S OFFICE

June 22, 2005

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THE CITIZENS UTILITY BOARD AND THE COOK COUNTY STATE'S ATTORNEY'S OFFICE ("CUB/CCSAO"), through their attorneys, hereby submit the following Initial Brief in response to the request by Northern Illinois Gas Company d/b/a Nicor Gas Company ("Nicor" or "Nicor Gas") for an increase in its natural gas rates. CUB and CCSAO have structured this brief in accordance with the outline that the Administrative Law Judges ("ALJs") directed the parties to use in their May 31, 2005 Notice, as amended by the ALJs' June 8, 2005 ruling.

INTRODUCTION

In this docket, Nicor requests that the Illinois Commerce Commission (the "Commission") increase its natural gas distribution rates by $61,726,000 million dollars. As in any rate case, the Commission must judiciously scrutinize both Nicor's request for the overall increase in rate base and its method of allocating those costs among its customer classes. This case adds the unique element that on one critical issue, Nicor's request to increase its storage inventory carrying charges by $25.9 million, is also before the Commission in another proceeding, Docket No. 02-0067. In the Commission's review of Nicor's Gas Cost Performance Program (GCPP), parties allege that Nicor improperly liquidated its storage inventory in order to exceed the benchmark and produce savings. The parties further argue that the depletion of its

storage inventory forced the company to replace that gas at a much higher cost. In this proceeding Nicor is attempting to place that higher cost gas into rates.

While Nicor is free to seek rate relief at any time, the Commission cannot allow the company to circumvent the investigation in the GCPP proceeding. Nicor's filing completely ignores this issue and its request assumes the Company has acted prudently in managing its storage inventory while this issue remains open in the other active docket. The Commission cannot find that Nicor has acted prudently regarding the storage inventory carrying charges until it has ruled on that issue in Docket No. 02-0067.

Ultimately, the adjustments proposed by CUB-CCSAO and the Illinois Attorney General (AG) in this case demonstrate that Nicor's request is not supported by the record and that Nicor is over earning by approximately $12.7 million. CUB-CCSAO recommend that the Commission place a portion of this overearning into energy efficiency initiatives and that it refund Nicor's customers approximately $2.7 million. Finally, Nicor's proposal to establish an uncollectibles expense tracking mechanism should be rejected.

II. RATE BASE

G. GAS IN STORAGE

When a utility such as Nicor purchases gas and injects it into storage, it is not able to collect the cost of purchasing that gas from ratepayers until it is withdrawn from storage. Thus, the utility has an investment in its storage inventory. Therefore, in the base rate setting process, a utility's average investment in storage inventory is reflected as an addition to rate base upon which the utility is permitted to earn a return. This return is commonly referred to as storage inventory carrying charges. In determining storage inventory carrying charges, differences

between the cost of the gas in storage and the price being charged to ratepayers should also be recognized. CUB-CCSAO Ex. 2.0 at 9-10.

An explanation of Nicor's accounting procedures for gas in storage inventory is necessary to understand why Nicor's request for higher storage carrying charges should be denied as unjust and unreasonable. Nicor utilizes the last-in, first-out ("LIFO") method to price storage activity. Under the LIFO method utilized by Nicor, monthly storage injections and withdrawals are priced at the estimated weighted average cost of gas ("WACOG") purchased for an applicable accounting year. For Nicor, the accounting year is the same as a calendar year. Thus, if at the beginning of the year, Nicor projected its annual WACOG to be $6.00 per Dth, and that projection proved accurate, all monthly injection and withdrawal activity during the period January through December of that year would be priced at $6.00 per Dth. Theoretically, over the course of an accounting year, it would be expected that storage injections and withdrawals would be equal, or net to zero. Of course, this rarely occurs. If at the end of an accounting year storage injections exceed withdrawals, an annual "LIFO layer" is established. The LIFO layer is priced at the actual annual WACOG. The LIFO layer gas is no longer reflected in the calculation of gas cost rates. The established LIFO layer remains on Nicor's books until a subsequent annual accounting period is experienced wherein storage withdrawals exceed injections. When this occurs, gas in LIFO layers is liquidated. With the start of a new accounting period, a new estimated annual WACOG is used to price storage activity. The creation or liquidation of LIFO layers is an annual accounting concept. CUB-CCSAO Ex. 2.0 at 7; CUB-CCSAO Ex. 4.0 at 4-5.

Procedural History of Nicor's Gas Cost Performance Program - Docket 02-0067

The procedural history of Nicor's Gas Cost Performance Program, ICC Docket 02-0067, is necessary to understand CUB-CCSAO's argument that Nicor's request for storage carrying charges should be reduced because the carrying charges proposed by Nicor are unjust and unreasonable. Nicor filed for approval of a GCPP in March 1999 (Docket No. 99-0127). The GCPP was filed pursuant to Section 9-244 of the Illinois Public Utilities Act ("Act"). The Commission approved and Nicor accepted the GCPP effective January 1, 2000. CUB-CCSAO Ex. 2.0 at 4-7.

Under Section 9-244(c) of the Act, the ICC was required to conduct a review of the GCPP after two years of operation to determine whether the GCPP was meeting its objectives. On January 24, 2002, the ICC initiated Docket No. 02-0067 to review the GCPP as required by the Act. An evidentiary hearing was held in Docket No. 02-0067 on June 10, 2002. At the close of the hearing, the record was marked "Heard and Taken." *Id.*

On June 20, 2002, CUB received a "whistleblower" fax that alleged that Nicor was operating improperly under the GCPP. In response, CUB filed a Motion to Reopen the Record on June 27, 2002. As a result, the parties to the proceeding agreed through Stipulation that additional discovery was necessary, and that the existing procedural schedule should be suspended. On December 9, 2002 the parties to Docket No. 02-0067 filed a Joint Motion to Reopen the Record and Expand Scope of the Proceeding. On December 17, 2002, the ICC issued an order reopening the review of Nicor's GCPP. On November 7, 2002, Nicor filed documents with the ICC canceling its GCPP effective January 1, 2003. *Id.*

In response to the allegations contained in the whistleblower fax, the Company formed a Special Committee of the Board of Directors ("Special Committee") to investigate Nicor's GCPP

activities. The Special Committee in turn engaged Scott R. Lassar of Sidley, Austin, Brown and Wood ("Sidley") to investigate Nicor's GCPP activities. To assist in the investigation, Sidley hired the accounting firm KPMG LLP ("KPMG"). On October 28, 2002, Sidley filed a Report ("Lassar Report") with the Special Committee that presented its findings and conclusions. The Lassar Report found that Nicor's GCPP activities had adverse consequences on ratepayers and recommended certain adjustments to eliminate the adverse consequences. The Lassar Report further recommended that the Board of Directors direct the Company to promptly undertake a re-audit of its financial statements for the years 1999-2001 and the first two quarters of 2002, and to make any filings with the ICC, the U.S. Securities and Exchange Commission and any other regulatory agencies as necessary as a result of the re-audit or any of the recommendations in the Lassar Report. *Id.*

On April 1, 2003 Nicor filed with the ICC restatements of the results of its performance under the GCPP for 2000 and 2001, and its GCPP results for 2002. The accounting firm Deloitte & Touché LLP audited Nicor's financial results for the period 1999-2002. This audit resulted in Nicor's parent company, Nicor, Inc., restating its earnings for 2000 and 2001 to reflect a number of adjustments, including those associated with the GCPP and the Lassar Report. On August 5, 2003, the Company filed testimony with the ICC supporting the restated results of its performance under the GCPP. Since then, the Company and the intervening parties have filed two additional rounds of testimony. In its testimony, GCI presented evidence that Nicor misled and deceived the Commission with respect to the GCPP in both Docket No. 99-0127 in which the GCPP was approved, and Docket No. 02-0067 in which the approved GCPP was subject to review. GCI found that ratepayers were due significant refunds. GCI also presented evidence that Nicor improperly manipulated its GCPP results. *Id.*

A hearing on Nicor's GCPP was scheduled to begin on April 19, 2004. However, the hearing was postponed due to the discovery that certain conversations between employees of Nicor and employees of a company that assisted Nicor with its GCPP operations had been taped. Since the discovery of these tapes, the employment of four key Nicor employees involved with the GCPP have been terminated, suggesting additional wrong doing. Therefore, at this time, the complete story with respect to Nicor's activities under the GCPP is simply unknown, and the Commission has not evaluated the reasonableness of Nicor's actions. *Id.*

Nicor's Claim For Higher Storage Carrying Charges Should Be Reduced Because The Carrying Charges Proposed by Nicor are Unjust and Unreasonable

Prior to the adoption of the GCPP, Nicor had approximately 75,000,000 Dth of gas in a number of older LIFO storage inventory layers on its books much of which was valued at about $0.30 per Dth. The market value of this gas was significantly in excess of $0.30 per Dth. Under the traditional regulatory system that Nicor operated under prior to the GCPP, if Nicor accessed or liquidated any of the low-cost gas in inventory, the entire benefit of the low-cost gas would have accrued to ratepayers.

In order to capture a portion of the low-cost storage inventory liquidation benefit for itself, Nicor proposed the GCPP. Under the GCPP, Nicor was rewarded with 50 percent of the difference between the market price of gas and the price of the liquidated low-cost storage inventory. When Nicor proposed the GCPP, it failed to disclose its plan to liquidate the low-cost storage inventory to the Commission and, therefore, the reasonableness of its plan could not be evaluated. After considering the adjustments recommended in the Lassar Report, Nicor liquidated 25,565,000 Dth of its low-cost storage inventory during the term of the GCPP, enabling Nicor to realize a reward of $25.638 million. Nicor's questionable practices under the

GCPP are discussed in greater detail in CUB-CCSAO witness Mierzwa's direct testimony in Docket No. 02-0067. *Id.* at 8.

Nicor liquidated 25,565,000 Dth from low-cost storage inventory layers during the term of the GCPP. Approximately 57,000,000 Dth of gas in old LIFO storage inventory layers with an average cost of $0.30 per Dth still remains. The average cost of the liquidated inventory was approximately $2.00 per Dth. This average cost was greater than $0.30 per Dth because Nicor also liquidated storage inventory layers with a price greater than $0.30 per Dth. Nicor has replaced the liquidated storage inventory layers with gas that is priced at $5.81 per Dth. Because it was unreasonable for Nicor to liquidate its low-cost storage inventory layers, it should be denied carrying charges on the difference in cost between the $5.81 and $2.00 per Dth priced gas. CUB-CCSAO Ex. 2.0 at 10. Nicor's replacement of low-cost storage inventory with higher cost inventory increased the Company's beginning of test period storage inventory balance by $95.3 million. CUB-CCSAO Ex. 2.1. This beginning of test period balance serves as the starting balance for computing Nicor's average test period storage inventory and its claim for storage inventory carrying charges.

The Commission should deny Nicor's request for higher storage carrying charges and reduce Nicor's requested base rate increase of $61.7 million by $25.9 million. CUB-CCSAO Ex. 2.0 at 4. As shown by CUB-CCSAO witness Jerome D. Mierzwa, his recommendations reduce Nicor's average storage inventory balance from a positive $98.7 million to a negative $66.1 million. CUB-CCSAO Ex. 2.1. This reduction to rate base has the effect of reducing Nicor's requested rate increase by $25.9 million. CUB-CCSAO Ex. 2.0 at 13. As CUB-CCSAO witness Mierzwa testified:

> It would be improper to allow Nicor to recover higher carrying charges in this proceeding because the reasonableness of the liquidation of its low-cost storage

> inventory has yet to be determined. The proper forum to evaluate the reasonableness of the liquidation is Docket No. 02-0067, where all of the evidence can be examined. Nicor should not be authorized to recover carrying charges on the difference between the high cost replacement gas and the low-cost liquidated storage inventory unless the decision to liquidate the low-cost storage inventory is found to be reasonable. Nicor's request assumes that the Commission has approved its liquidation of the low-cost storage inventory. However, because Nicor concealed its intention to liquidate the low-cost storage inventory, the Commission in Docket Nos. 99-0127 and 02-0067 has been unable to evaluate whether it was in the best interest of ratepayers to do so.
>
> CUB-CCSAO Ex. 2.0 at 9; CUB-CCSAO Ex. 4.0 at 3-4.

If the Commission determines customers are entitled to a refund in the GCPP proceeding, then it cannot allow customers to bear the indirect hit that the Company caused when it purchased the far more expensive replacement gas, and that Nicor now attempts to include in rate base. Doing so would mean that Nicor has effectively gotten away with imposing both a direct hit -- imposing imprudently incurred expenses on customers through the GCPP, and an indirect hit -- customers will pay the higher carrying charges on that gas in their rates indefinitely. CUB-CCSAO Ex. 4.0 at 3.

The evidence in this case and the Public Utilities Act require that Nicor's storage inventory carrying charge request be reduced in this proceeding. Because the issue of the liquidation of Nicor's low cost gas is currently being litigated in Docket 02-0067, Nicor does not and cannot meet its burden in this case of showing that its requested carrying charges on the higher cost replacement gas – bought to replace the low cost gas liquidated under its GCPP plan - are just and reasonable under section 9-201(c) of the Public Utilities Act. 220 ILCS 5/9-201(c).

Witness Gorenz's claim that any disallowance in this proceeding cannot be adequately rectified in Docket No. 02-0067 does not properly frame the issue. The Company has the burden of proof of demonstrating that its actions that resulted in an increase in the storage inventory carrying charge were prudent. That issue is being decided in Docket No. 02-0067. Until that

issue is resolved, the Commission cannot grant Nicor's request for an increase in its storage inventory carrying charge. If it is legally permissible, the Commission can include a provision in its order in this proceeding that specifically provides for the recovery of any disallowed storage inventory carrying charges should they later be found to be recoverable. Until that time, however, Nicor's claim for storage inventory carrying charges should be reduced as CUB-CCSAO witness Mierzwa has proposed. CUB-CCSAO Ex. 4.0 at 3-4.

With respect to the storage inventory balances reflected on Nicor's financial statements, it cannot be determined whether those statements have been appropriately restated until the Commission completes its investigation in Docket No. 02-0067. Moreover, as explained in witness Mierzwa's direct testimony, additional evidence has been discovered related to matters in Docket No. 02-0067, and the parties to that docket have not had the opportunity to fully examine that evidence. The issue at hand is whether Nicor should be entitled to higher carrying charges because it replaced low-cost storage inventory with higher cost inventory. Again, that determination can only be made in Docket No. 02-0067. *Id.* Until that time, Nicor's request for an increase in storage inventory carrying charges should be denied.

Nicor's Calculation of Storage Inventory Carrying Charges is Flawed Because it Fails to Recognize the Significant Cash-Flow Advantage Enjoyed by Nicor and is Based on an Average of 13-Month Ended Balances, and Must be Corrected Accordingly.

Nicor's calculation of storage inventory carrying charges is flawed for two reasons. First, Nicor's calculation fails to recognize the significant cash-flow advantage it receives. Second, the Company's calculation is based on an average of 13-month ended balances that gives an inappropriate weight to one month. CUB-CCSAO Ex. 2.0 at 11; CUB-CCSAO Ex. 4.0 at 8, 10. Nicor's storage inventory carrying charge calculations must be corrected for these deficiencies.

These corrections are reflected in CUB-CCSAO's proposed $25.9 million reduction to Nicor's requested $61.7 rate increase.

Cash-Flow Advantage

The gas in Nicor's storage inventory exists in layers at various prices. A significant quantity of this gas exists in layers valued at $0.30 per Dth. The test period in this proceeding is calendar 2005. Nicor's annual LIFO accounting period extends from January through December. During the period January-April 2005, much of the gas Nicor is projecting to withdraw from storage will come from LIFO layers that are priced at $0.30 per Dth. That is, this gas will have cost Nicor $0.30 per Dth. Under the LIFO accounting procedures utilized by Nicor, when the $0.30 per Dth gas withdrawn from storage is replaced later in the year, it will still be priced on Nicor's books in LIFO layers at $0.30 per Dth. Ratepayers do not get the benefit of $0.30 per Dth gas. Rather, for 2005, Nicor is projecting that its weighted average cost of gas for the year will be $5.90 per Dth. Thus, storage injections and withdrawals included in its purchase gas cost rates will be priced at $5.90 per Dth, even though much of the gas withdrawn by Nicor over the storage cycle will only have an associated cost of approximately $0.30 per Dth. Nicor's sales customers will pay purchased gas cost rates based on the $5.90 per Dth price. Thus, in terms of cash flow, Nicor will benefit by $5.60 per Dth. As such, the revenues Nicor receives will exceed its storage inventory investment. Nicor's storage inventory carrying charge calculation ignores this significant benefit. CUB-CCSAO Ex. 2.0 at 11-12. Witness Mierzwa has corrected this deficiency in his storage inventory carrying charge recommendation.

In Nicor's GCPP which is currently under investigation in Docket No. 02-0067, gas withdrawn from storage was priced at the amount Nicor paid for the gas. This included gas from

low-cost LIFO layers valued at $0.30 per Dth. Under the GCPP, Nicor is attempting to realize a reward reflecting 50 percent of the difference between the price it paid for gas and the market price of gas. During the term of the GCPP, the market price of gas ranged from approximately $2.25 to $8.00 per Dth. The price assigned to gas withdrawn from storage in this docket for purposes of determining storage inventory carrying charges should be consistent with that utilized under the GCPP. CUB-CCSAO Ex. 4.0 at 7-8.

Contrary to Nicor witness Gorenz' claims, CUB-CCSAO witness Mierzwa is not proposing to treat the gas withdrawn from storage during the January – April period as a LIFO liquidation or to ignore the expected cost of the replacement gas. CUB-CCSAO witness Mierzwa is proposing to recognize that the amount collected from ratepayers for the gas withdrawn from storage is more than the amount paid by Nicor. In other words, ratepayers are paying for all gas at the current replacement cost of $5.90 in January through April prior to the time Nicor purchases all of the gas. As a result, Nicor is "borrowing" lower cost gas already in storage to meet the customer's needs. CUB-CCSAO witness Mierzwa's testimony demonstrates that customers are advancing Nicor the money to replace that gas in May through October. Nicor's claim for storage inventory carrying charges should be based on the price Nicor paid for the gas withdrawn from storage. CUB-CCSAO Ex. 4.0 at 6.

It is important to note that under the LIFO method, the cost of the gas injected into storage during the summer is completely recovered from ratepayers during the year the gas was injected into storage, unless a new LIFO layer is established. During 2004, the year preceding the test year in this proceeding, a new LIFO layer was not established. During 2004, ratepayers were charged approximately $6.00 per Dth for the gas withdrawn from storage by Nicor, even though gas in LIFO layers priced at $0.30 per Dth existed. *Id.*

Number of Month Ended Balances

The calendar year average balance of gas in storage inventory should be utilized to determine Nicor's storage inventory carrying charge allowance. The most precise way to determine the calendar year average would be to average the balances which existed on each day during the calendar year. However, this would be impractical for ratemaking purposes because 365 daily balances would need to be projected. To simplify the ratemaking process, monthly balances are typically utilized. CUB-CCSAO Ex. 4.0 at 9.

Nicor has based its calculation of the average balance of gas in storage on the average of the 13-month ending inventory balances for the period December 2004 through December 2005. The balances for each December are identical. The purpose of this calculation is to find the average balance that exists during the year or test period. Nicor's approach gives a double weighting to the month of December and thus distorts the balance of gas in storage calculation. If the month of April were used as the beginning month, the Company's method would produce a lower claim for storage inventory carrying charges. It is unreasonable to utilize a procedure that produces a different result depending on the first month used in the calculation. If one were to average the storage inventory balance which existed on each day during the year, one would not obtain a different result depending on the first day used in the calculation. CUB-CCSAO Ex. 4.0 at 9. To correct this distortion, a 12-month average of January through December month ending balances should be utilized. *Id.* at 12-13.

Nicor witness Gorenz incorrectly claims that the use of a 12-month average is flawed because it fails to consider the opening balance for the calendar year, and that a 13-month average is more representative of the calendar year average balance than a 12-month average. Mathematically, witness Gorenz is wrong. An alternative and more precise way to calculate

storage inventory carrying charges would be to compute an average balance for each month by averaging the balances that existed at the beginning and end of the month, and then averaging these 12 monthly balances. Witness Gorenz concedes that this method is more accurate, but fails to recognize that this **is** the approach recommended by witness Mierzwa. Nicor Gas Ex. 41.0, at 16. Under this approach, the opening balance for the calendar year is appropriately considered. However, with this alternative approach, results identical to that derived by using the 12-month average approach that witness Mierzwa has recommended are obtained. This is because the beginning of year and end of year balances are the same under Nicor's forecast of storage activity.

M. UNCOLLECTIBLES RESERVE

Nicor utilizes reserve accounting to record uncollectible expense. Under this approach, Nicor adds or accrues an estimate of its anticipated uncollectible expense to an uncollectible reserve account each month. The rates approved in Nicor's last base rate case included an amount for uncollectible expense. Nicor's uncollectible accrual is an estimate based on management judgment. An estimate is required because Nicor doesn't know how much of the revenues it bills each month will eventually be uncollectible. When a customer is delinquent in paying their bill, the amount of the bill is initially written-off and deducted from the uncollectible reserve. The delinquent account is then typically turned over to a collection agency that is generally successful in recovering a portion of the Company's initial write-offs. These recoveries are added back to the uncollectible reserve. The difference between write-offs and recoveries represents Nicor's actual uncollectible expense. CUB-CCSAO Ex. 2.0 at 15.

Nicor's Uncollectible Expense Reserve Should be a Reduction to Rate Base

Nicor's uncollectible reserve balance represents the difference between the amount charged to expense for anticipated uncollectible revenues and actual amounts which have not been collected. Since the amount charged to expense is collected in rates, it represents a source of ratepayer funds and the reserve should be reflected as a reduction to rate base. In the alternative, uncollectible expense for ratemaking purposes should be reduced to reflect a normalized level of actual net write-offs based on historical experience. CUB-CCSAO Ex. 4.0 at 11.

Nicor's accruals to its uncollectible reserve have consistently exceeded its actual uncollectible expense. By the end of the 2005 test period, it is forecasted that Nicor's uncollectible reserve balance will be $24.2 million. This represents a ratepayer-supplied source of funds because Nicor bases its ratemaking claim for uncollectibles expense on its reserve accruals rather than on its actual net write-offs. Accordingly, the uncollectible reserve should be reflected as a reduction to rate base. CUB-CCSAO Exhibit 2.2 reflects an adjustment for this ratepayer-supplied source of funds. As shown in CUB-CCSAO Ex. 2.2, eliminating this ratepayer-supplied source of funds reduces Nicor's requested rate increase by $3.8 million. CUB-CCSAO Ex. 2.0 at 15-16, CUB-CCSAO Ex. 4.0 at 10-11.

1. Uncollectible Expense Tracker

The Commission Should Reject Nicor's Proposed Uncollectible Expense Tracker Because it Violates the Prohibition Against Single Issue Ratemaking and is Not an Appropriate Expense for a Rider

Nicor's rates to sales customers include a base rate component and a gas cost component. Because they do not buy gas from Nicor, rates to transportation customers include only a base

rate component. Nicor's current base rates include a fixed amount for the recovery of sales and transportation customer uncollectibles. Under Nicor's proposal, the gas cost portion of Nicor's uncollectibles would be removed from base rates and tracked and recovered through the gas cost component of Nicor's rates. The base rate portion of uncollectibles will continue to be recovered through base rates. CUB-CCSAO Ex. 2.0 at 13.

Nicor's proposed uncollectible tracker should be rejected as inappropriate for several reasons. First, the uncollectible tracker would constitute improper single-issue ratemaking. That is, one component of Nicor's overall base rate revenue requirement would be singled out for reconciliation and recovery. In a complete base rate proceeding, the rule against single-issue ratemaking requires that the Commission "examine all elements of the revenue requirement formula to determine the interaction and overall impact any change will have on the utility's revenue requirement." *Citizens Util. Bd. v. Ill. Commerce Comm'n,* 166 Ill.2d 111, 138 (1995).

In addition, the uncollectible tracker would apply to costs which are a normal cost of providing service and, as such, do not warrant special recovery through a rider separate and apart from the other costs included in base rates. The Illinois Supreme Court has held that a rider mechanism is appropriate for cost recovery only when a utility is faced with unexpected, volatile, or fluctuating expenses. *A Finkl & Sons Co. v. Ill. Commerce Comm'n,* 250 Ill. App. 3d 317 (1st Dist. 1993), *citing City of Chicago v. Ill. Commerce Comm'n,* 13 Ill. 2d 607, 610-11, (1958). As witness Mierzwa testified, that is not the case here; uncollectibles are ongoing costs that are neither non-recurring nor extraordinary nor impossible to anticipate. CUB-CCSAO Ex. 2.0 at 14.

Nicor's last base rate case was in 1995. The rates approved in that proceeding, which are currently in effect, included $8 million for uncollectibles. Nicor's uncollectible expense claim in

this proceeding is $30 million. This increase in uncollectibles has been offset by other cost reductions and increases in revenues that have occurred since 1995. If they weren't, Nicor would have filed for a base rate increase long before now. Thus, had an uncollectibles tracker been adopted in 1995, Nicor's rates would have been unreasonably and unnecessarily higher. *Id.* at 14-15. Nicor has failed to meet its burden of proving that its uncollectibles tracker is just and reasonable and the Commission should deny this request.

V. RATE OF RETURN

The objective of effective regulation is to provide utilities with a fair return on their prudent and reasonable investments in exchange for providing service to consumers at just and reasonable rates. CUB-CCSAO Ex. 1.0 lines 101-04. The primary basis for determining a fair rate of return is the cost that Nicor incurs to attract capital from the marketplace. Two key decisions have established the framework for determining a fair rate of return on invested capital for regulated natural gas local distribution companies ("LDCs"). The first is *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679, 692 (1923) (Bluefield), and the second is the *Federal Power Commission et. al. v. Hope Natural Gas Co,.* 320 US 591 (1944) (Hope). Together the *Hope* and *Bluefield* decisions establish that:

1. A utility is entitled to a return equal to that generally being made at the same time by business undertakings of similar risk;
2. A utility is entitled to a return reasonably sufficient to ensure financial soundness and support existing credit, as well as to raise new capital;
3. A fair return can change along with economic conditions and capital markets; and

4. Regulation provides an opportunity for, but not a guarantee of utility profits.

Nicor requests a 9.03% overall rate of return, and Staff Witness McNally recommended a 7.55% rate of return. Nicor Gas Ex. 36.0 line 541; Staff Ex. 14.1. Christopher C. Thomas testified for CUB and CCSAO on the appropriate rate of return for Nicor's Gas Distribution operations. *See*, CUB-CCSAO Ex. 1.0 and 3.0. Mr. Thomas recommends the Commission allow Nicor Gas to earn a 7.697% rate of return through its rates:

	Capital ($000)	%	Cost	Weighted
Short Term Debt	177,608	13.38%	2.58%	0.35%
Long-term Debt	500,376	37.69%	6.72%	2.53%
Non Redeemable Preferred Stock	1,401	0.11%	4.77%	0.01%
Common Equity	648,156	48.82%	9.86%	4.81%
	1,327,541			7.697%

The overall rate of return is composed of the sum of the component costs of Nicor's capital structure after each component is weighted in its proportion to Nicor's total capitalization. This rate of return represents the cost required to meet investors' return expectations. Staff Exhibit 5.0 lines 28-32. Nicor would have the Commission believe that any rate of return set below the level recommended in its testimony would drastically inhibit Nicor's ability to attract capital at reasonable rates, and that this should be the Commission's primary concern. Nicor Gas Ex. 18 lines 438-40 and Nicor Gas Exhibit 21 lines 652-53. This is simply not true. In fact, during cross examination, Staff witness McNally testified that "Nicor Gas could fall from double A to A minus, for instance, one might say that their financial strength has been impaired, but I think it's still a very strong company and would not have problems raising capital at reasonable terms." Transcript at 903. While Nicor could withstand a credit downgrade CUB-CCSAO and Staff neither support not foresee such a downgrade. CUB-CCSAO presented evidence to

demonstrate that Nicor Gas will meet its investors' expectations with an approved 7.697% overall rate of return. Therefore, Nicor can reasonably be expected to retain its access to capital at reasonable terms.

The parties agree on the appropriate cost of long-term debt, cost of non-redeemable preferred stock and capital structure measurement date. CUB-CCSAO Ex. 3.0 lines 75-76. All of the other contested issues are detailed in the following sections.

A. CAPITAL STRUCTURE (INCLUSION OF SHORT-TERM DEBT)

The primary dispute with regard to capital structure is whether or not short-term debt, which typically refers to debt that is issued for only 30 or 60 days, should be included in Nicor Gas' capital structure for ratemaking purposes. CUB-CCSAO and Staff testified that Nicor Gas uses short-term debt to finance a portion of its rate base, and that short-term debt is included in Nicor Gas' actual capital structure. Both support a short-term debt balance of $177,608,000 (Staff Exhibit 14.1 and CUB-CCSAO Exhibit 3.0, lines 160-66). Nicor maintains that short-term debt should be excluded from its capital structure. Nicor Gas Ex. 36.0, at 7-17. Nicor does suggest that, if short-term debt is to be included in its capital structure, no more than $36,625,000 of short-term debt should be included. *Id.* at lines 351-61.

Short-Term Debt Should Be Included in Nicor's Capital Structure for Ratemaking Purposes

In the direct testimony of Michael McNally, Staff presented evidence that short-term debt should be included in Nicor's capital structure for ratemaking purposes. Staff Ex. 5.0 lines 72-105. CUB and CCSAO believe that this is both reasonable and appropriate. CUB-CCSAO Ex. 3.0 line 82. In his direct testimony, CUB-CCSAO witness Thomas presented evidence that

Nicor's proposed capital structure "is unnecessarily equity heavy," and that "[s]etting rates based upon Nicor's proposed balance of equity capital will result in an increased rate of return for the company that will provide no benefit for regulated ratepayers." CUB-CCSAO Ex. 1.0 lines 122-25. This is inappropriate. Nicor's actual capitalization includes a significant portion of short-term debt. Nicor's actual capital structure, including short-term debt, includes the same dollar amount of equity as Nicor's proposed capital structure but in a smaller proportion to total capital, resulting in a reasonable ratemaking capital structure. CUB-CCSAO Ex. 3.0 lines 79-91.

In the direct testimony of Robert Mudra, Nicor proposed a capital structure that fails to recognize the Company's use of short-term debt. Nicor Gas Ex. 20B.1. Nicor uses short-term debt as a capital management tool to manage seasonal cash flow needs. Nicor argues that this short-term debt cannot finance rate base assets and is therefore solely a cash management tool for the company. Nicor Gas Ex. 20B, lines 406-34. This is simply not true. Staff witness McNally notes that capital is fungible, meaning that any one dollar of capital cannot be said to finance any individual project. Rather, all investment is financed in proportion to a company's total capitalization. Staff Ex. 5.0 line 74. Nicor acknowledged that the specific uses of its cash "can not be strictly defined." Staff Ex. 5.0 lines 77-81; MGM 3.01. Nicor also argues that its books do not contain an outstanding balance of short-term debt for several months out of the year and that this means that short-term debt does not support rate base. Nicor Gas Ex. 20B.0 lines 436-46. This is irrelevant and misleading. As witness McNally points out, the Commission previously rejected this flawed argument. Staff Ex. 5.0 lines 95-98; Commission Order, Docket No. 95-0079 at 49-51. Mr. McNally also demonstrated that the vast majority of the variability in Nicor Gas' short-term debt is explained by the variability in Nicor's working gas balances, which are included in rate base. Staff Ex. 5.0 lines 98-103; Staff Ex. 14.0 lines 82-85.

Failure to Recognize Nicor's Use of Short-Term Debt Will Result in Unreasonable Rates

There is no dispute that Nicor uses short-term debt in its operations. Mr. Thomas testified that using short-term debt is a prudent decision by management to lower costs and has allowed Nicor to operate efficiently for years. CUB-CCSAO Ex. 3.0 lines 94-95, 105-06; Nicor Gas Ex. 20A.0 lines 258-60. However, Nicor's proposed capital structure does not recognize the benefit of short-term debt and "fails to cover approximately 20.74% of its proposed rate base, contrary to the Company's claim that its proposed capital structure is Nicor's actual capital structure." CUB-CCSAO Ex. 3.0 lines 111-13. The Commission has previously found that a utility need not reconcile its rate base with its capital structure, however the large discrepancy between Nicor's requested capital structure and requested rate base certainly merits further investigation.

It is accepted practice in commercial relationships to evaluate the strength of a company based upon its actual capitalization, and there is no reason for the Commission to view Nicor Gas distribution operations any differently. Nicor Gas Exhibit 20A lines 170-83. Mr. McNally contends that the Commission should concern itself with the question of whether Nicor's actual capital structure, in its entirety, will allow access to capital at reasonable rates and on reasonable terms. Staff Ex. 5.0 lines 225-28. Credit ratings agencies such as Standard & Poors provide valuable information to investors concerning the financial health and risk profile of individual companies. Staff and CUB-CCSAO agree with Nicor that there is no bright line formula by which a given credit rating is determined. Staff Ex. 5.0, lines 233-36; CUB-CCSAO Ex. 3.0 line 209-11). However, both Staff and CUB-CCSAO recognize the value of utility benchmark values, or guidelines, published by S&P, and Mr. Thomas testifies, "These guidelines are

intended to reflect the expected future performance of similarly situated utilities and represent a reasonable and appropriate benchmark for capital structure comparisons." Staff Ex. 5.0 lines 233-39; CUB-CCSAO Ex. 3.0 lines 212-14; CUB-CCSAO Ex. 1.0 lines 136-44.

Nicor witness Hawley criticizes CUB-CCSAO and Staff use of S&P guidelines by claiming that credit rating is complex. Nicor Gas Ex. 20A lines 157-69. This is not a disputed fact. Mr. Hawley also argues that a capital structure containing a higher proportion of debt will place "downward pressure on Nicor Gas' ability to maintain its S&P AA rating and in fact could jeopardize the rating." *Id.* at lines 230-33. However, as Mr. Thomas notes, this is pure speculation; no party possibly could have any direct knowledge of how S&P might react to a Commission decision in this proceeding. CUB-CCSAO Ex. 3.0, lines 205-09. Given this fact, Mr. Thomas recommends that the best course of action available to the Commission is to rely on published S&P guidelines in determining the appropriateness a given capital structure for ratemaking purposes. *Id.* at lines 212-14. Mr. Thomas further notes that, a close comparison of Nicor's actual capital structure with the S&P guidelines reveals that the inclusion of short-term debt results in a capital structure that is within the range of S&P's expectations for similarly situated utilities. *Id.* at lines 83-85; Staff Ex. 5.0 lines 237-39.

The testimony of both Mr. Thomas and Mr. McNally demonstrates that the failure to include short-term debt in Nicor capital structure for ratemaking purposes results in an unreasonable capital structure. Both Mr. McNally and Mr. Thomas used the S&P corporate criteria guidelines to evaluate the reasonableness of Nicor's capital structure, and the only capital structure that falls within these guidelines is the capital structure that includes short-term debt. If the Commission fails to incorporate short-term debt, it will allow Nicor to earn a higher rate of

return than the actual cost that Nicor incurs in financing its rate base. This is unreasonable and unnecessary.

The Commission Should Adopt Staff's Proposed $177,608,285 Balance of Short-Term Debt

Mr. McNally calculated an average balance of short-term debt expected during the test year, adjusted to address double counting issues that were raised in Docket 95-0076. Staff Ex. 5.0 lines 106-26. Mr. McNally effectively demonstrated that $177,608,285 should be included in Nicor's capital structure for ratemaking purposes. Staff Ex. 5.2. Nicor disputed Mr. McNally's methodology and stated that if the Commission were to recognize that the additional rate base deductions that Staff supports were available to fund asset purchases, and that if only working gas balances are financed by short-term debt the balance of short term debt is around $36.6 million. Nicor Gas Ex. 20B.0 lines 719-28. However, Nicor has not presented sufficient evidence to demonstrate why the Commission should adjust Mr. McNally's recommendation. First, the additional rate base deductions supported by Staff will not be available to fund purchases during the test year. By the time the Commission issues its order in this proceeding, the test year will be over and Nicor likely already will have funded the items it proposes to recover in this proceeding. Second, as discussed above, Nicor has not demonstrated that short-term debt does not support rate-base and therefore cannot demonstrate that only working gas is financed by short-term debt. CUB-CCSAO recommend that the Commission recognize the $177,608,285 balance of short-term debt in Nicor's actual capital structure for ratemaking purposes. Overall, the Commission should reduce Nicor's revenue requirement by $13.8 million.

B. Adjustments to Capital Structure Component Balances

Staff adjusts all the components in its recommended capital structure to reflect the Commission's previously accepted methodology for calculating the allowance for funds used during construction ("AFUDC"), which assumes that short-term debt is the first source of funds financing construction-work-in-progress ("CWIP"). Staff Ex. 5.0, lines 106-26. The Company argues that such an adjustment is not necessary if short-term debt is excluded from the capital structure, and that this adjustment does not change the final rate of return. Nicor Gas Ex. 36.0 lines 465-66. However, for the sake of consistency, if the Commission concludes that short-term debt is appropriate to include in Nicor's ratemaking capital structure, it should adjust the capital structure as Staff recommends.

C. Cost of Short-Term Debt

The Company estimates the cost of short-term debt is 4.12%. Nicor Gas Ex. 36.0, line 378. The Company's estimate reflects a forecasted interest rate plus commitment fees. Staff estimates the Company's cost of short-term debt is 2.58%. Staff Ex. 5.0, lines 248-57. Staff's estimate is based on the current interest rate on commercial paper and does not reflect commitment fees. Staff bases its position on the Company's failure to establish the reasonableness of the commitment fees reflected in its short-term debt cost recommendation and, thus, Nicor should not be allowed to recover them through rates. Staff Ex. 14.0, lines 117-31. CUB-CCSAO adopted Staff's cost of short-term debt recommendation. CUB-CCSAO Ex. 3.0, lines 160-66.

Nicor failed to provide any support for the inclusion of commitment fees until Surrebuttal testimony, and then only produced a group of unreliable and unsubstantiated assertions. Nicor's arguments are premised on the claim that, absent bank commitment fees, its short-term debt

"would most likely be rated 'Not Prime' or would not be rated at all." Nicor Gas Ex. 36.0 lines 402-06 This claim is strikingly similar to the claims that Nicor made in response to the inclusion of Nicor's total debt, both short-term and long-term, in Nicor's ratemaking capital structure. Nicor Gas Ex. 20A.0 lines 230-233. Nicor has not demonstrated that commitment fees are necessary, only that Nicor believes that they are. The Commission should adopt the position advocated by Staff and should set rates accordingly. If the Commission does otherwise, Nicor will be over-earning by approximately $5.1 million.

D. Cost of Equity

Investors' decisions to invest in Nicor Gas depend on the return they expect to receive from their investment. If investors do not believe that they are receiving a fair return for the risk they assume by providing equity capital to Nicor Gas, they will invest elsewhere. Nicor witness Dr. Jeff Makholm presented testimony that investors require a 10.68% return on their investment. CUB-CCSAO presented evidence demonstrating that Dr. Makholm overstates the appropriate investor-required rate of return on Nicor's shareholder equity (ROE). CUB-CCSAO Ex. 3.01. Mr. Thomas recommends a 9.86% ROE based on a discounted cash flow analysis of a diverse sample of expected growth rates for a group of comparable companies and is an appropriate estimate of the investor-required rate of return on Nicor's outstanding shareholder equity. CUB-CCSAO Ex. 1.0 lines 248-258. Nicor Gas has a credit rating above that of comparable companies contained within this sample, so CUB-CCSAO's proposed ROE also includes a downward adjustment to recognize the different risk profiles of Nicor and the companies in the comparable sample. CUB-CCSAO Ex. 3.0 lines 269-97; CUB-CCSAO Ex. 3.01).

Dr. Makholm's Table 4 in Nicor Exhibit 37.0 identifies only three substantive disagreements with Mr. Thomas: 1.) Different growth rate estimates; 2.) The 23 basis point risk adjustment proposed by Mr. McNally and accepted by Mr. Thomas; and, 3.) Nicor's proposed flotation cost adjustment. This table does not acknowledge two areas of minor disagreement abandoned in Dr. Makholm's rebuttal testimony because of their small magnitude. The two areas include Mr. Thomas' retention growth estimate and the use of spot stock prices vs. quarterly average stock prices. Nicor Gas Ex. 37.0 lines 283-87.

CUB-CCSAO recommend an ROE in this proceeding near the bottom of the range of allowable rates of return for LDCs throughout the country as shown in Figure 1 on page 24 of Nicor Gas Exhibit 21.0. Since this table was published, Mr. Thomas updated his ROE estimate to reflect a quarterly Discounted Cash Flow analysis (DCF), consistent with the other parties to this proceeding, and to incorporate the risk adjustment proposed by Mr. McNally. These updates changed Mr. Thomas' ROE recommendation from 9.94% to 9.86%, which is still greater than the lowest ROE shown in Figure 1. CUB-CCSAO Exhibit 3.01. CUB-CCSAO recommend an ROE near the bottom of the allowed rates of return for other utilities across the nation for good reason. Nicor's own testimony (See Nicor Gas Ex. 2.0 lines 104-107) touts its position as the lowest cost provider in the state of Illinois which means that management has been effective in keeping costs down. Its outstanding AA credit rating further demonstrates that investors view Nicor favorably. Staff Ex. 5.0 lines 756-59. These factors demonstrate that Nicor is less risky than other companies in the industry. As Staff witness McNally notes investors require higher returns to accept greater exposure to risk. Staff Ex. 14.0 lines 497-98. Therefore, it is not surprising that Nicor's shareholders are entitled to a lower rate of return than other companies in the industry.

Growth Rate Forecasts

The analysis performed by Mr. Thomas utilizes growth rate forecasts from Valueline, Zack's, and Reuters along with a retention growth estimate. CUB-CCSAO Ex. 1.0 line 262-63. Mr. Thomas utilized multiple growth estimates in order to gain an accurate picture about what investors expect the growth potential of each individual security to be and to reflect the variety of information that is available to investors in the marketplace. *Id.* at lines 263-68.

Mr. Thomas and Dr. Makholm utilized the same sample of comparable utilities. However, as Staff witness McNally testifies, Dr. Makholm based his calculations on mismatched data from different time periods that produces a meaningless result in both his retention growth estimate and in his value line growth rates. Staff Ex. 5.0 lines 646-48, 737-41. As an example, in estimating his Valueline growth rates, Dr. Makholm chose to use the geometric average from 2003 because it resulted in the highest overall ROE. Staff Ex. 5.0 lines 732-34. Staff witness McNally testified that because of this, "the average growth rate for the entire sample, upon which Dr. Makholm's cost of equity estimate relies, is inflated." *Id.* at lines 739-41. The DCF analysis undertaken by Mr. Thomas is superior in that it utilizes corrected and updated growth rate forecasts from a diverse group of sources. CUB-CCSAO Ex. 1.0 lines 208-11.

Dr. Makholm originally raised an issue with respect to the retention growth rate estimate utilized by Mr. Thomas. Nicor Gas Ex. 21.0 Table 2 line 589. However, Dr. Makholm in rebuttal abandoned this concern and conceded that the Commission can accept Mr. Thomas' estimate. Nicor Gas Ex. 37.0 lines 283-287.

Sample Selection Criteria

In order to accurately estimate the ROE of Nicor Gas, it is necessary to identify a group of proxy firms with characteristics similar to those of Nicor's Gas Distribution Operations. CUB-CCSAO Ex. 1.0 lines 248-50. Mr. Thomas utilized the sample proposed by Nicor witness Makholm. Nicor Gas Ex. 4.0; CUB-CCSAO Ex. 1.0 lines 250-51. Mr. Thomas maintained that the selection criteria proposed by Dr. Makholm should identify companies that reasonably approximate the risk characteristics of Nicor's gas distribution operations. CUB-CCSAO Ex. 1.0 lines 252-54.

The disagreement on this issue concerns the proportion of each proxy firm's revenues from natural gas distribution operations in relation to each firm's total revenues. Dr. Makholm proposes criteria which excludes companies who earn less than 80% of their revenue from natural gas distribution operations. Nicor Gas Ex. 4.6. Staff utilized different criteria, which excluded companies earning less than 70% of their income from non-utility activities. Staff Ex. 5.0 lines 285-87. Mr. Thomas maintains that a higher threshold for income from non-utility activities is appropriate. However, Mr. Thomas indicated that there is no strong financial theory that dictates specific criteria. Transcript at 1245. Therefore, if the Commission determines that Dr. Makholm's sample is the most appropriate sample to use, then Mr. Thomas' proposed ROE should be adopted, as it utilizes consistent growth rates from a variety of sources to appropriately recognize the true investor required rate of return on common equity.

Stock Prices

Mr. Thomas utilized three-month average stock prices in order to balance the view that markets are efficient with the growing body of evidence that suggests that markets may not price securities appropriately in the short term. CUB-CCSAO Ex. 3.0 lines 264-68. Dr. Makholm

argued that past stock prices are "Useless to gauge investors current expectations." Nicor Gas Ex. 21.0 lines 453-54. This issue deals with the Efficient Market Hypotheses (EMH). The fundamental premise of relying on the EMH is that investors' expectations always lead to correct pricing. CUB-CCSAO Exhibit 3.0 lines 260-61. CUB-CCSAO presented evidence that, "when information is difficult to obtain, investors may tend to 'follow the herd' rather than invest according to substantive information they posses about the correct value of a company." CUB-CCSAO Ex. 3.0 lines 260-64. Mr. Thomas testified that using a 3-month average stock price is the most supportable approach to incorporate stock prices into a DCF analysis since evidence on the efficient market hypotheses seems contradictory. CUB-CCSAO Ex. 3.0 lines 264-68.

Dr. Makholm asserts a preference for spot closing stock prices adjusted to reflect the timing of dividends in relation to the Ex-Dividend date. Nicor Gas Ex. 4.0, lines 479-86. Mr. Thomas demonstrated that, in this proceeding, Dr. Makholm's choice of an adjusted spot stock price estimate is not significantly different than the three-month average historically utilized by Mr. Thomas. CUB-CCSAO Ex. 1.0 lines 309-11. Mr. Thomas' methodology is superior in that it reflects different views of what the actual stock price might be. *Id.* at lines 300-13. Dr. Makholm concedes that this issue is of minor importance in this case and not an issue reasonably worth contending here. Nicor Gas Exhibit 37.0 lines 84-86.

Downward Risk Adjustment

As Staff witness Mr. McNally testified, financial theory posits that investors require higher returns to accept greater exposure to risk. Conversely, the investor-required return is lower for investments with less exposure to risk. Mr. McNally proposed an adjustment that recognizes the relative credit ratings, a proxy for financial risk, of Nicor Gas and the samples of comparable companies utilized by the parties to this proceeding. Staff Ex. 5.0 lines 579-84.

Since these samples do not accurately reflect the financial risk level of Nicor Gas, an adjustment should be made. Staff Ex. 5.0 lines 570-72. CUB-CCSAO believe that the 23 basis point downward adjustment proposed by Staff witness McNally is reasonable and necessary. CUB-CCSAO Ex. 3.01; CUB-CCSAO Ex. 3.0 lines 280-83.

The 23 basis point adjustment proposed by Mr. McNally reflects the spread between A-rated and AA-rated 30-year utility debt yields. Staff Ex. 5.0, lines 587-88. This is consistent with the difference between the comparable sample utilized by Mr. Thomas and credit rating of Nicor Gas. CUB-CCSAO Ex. 3.01; CUB-CCSAO Ex. 3.0 lines 278-83). Mr. Thomas testified that "[T]he adjustment proposed by Mr. McNally should represent the MINIMUM reasonable adjustment to account for credit-rating difference." CUB-CCSAO Ex. 3.0 lines 290-294. Mr. McNally relied on a reasonable standard and the Commission should adopt it. *Id.* at lines 290-97). In previous cases, the Commission accepted equity risk adjustments made using the approach proposed by Mr. McNally. Staff Ex. 14.0 lines 490-92. This adjustment reduces Nicor's revenue requirement by $ 5.579 Million.

E. Flotation Costs

Nicor has proposed that the Commission incorporate an adjustment to recover stock issuance expenses that it claims have been previously unrecovered. Nicor Gas Ex. 4.0 lines 604-83. Nicor proposed to recover backwards-looking issuance costs dating as far back as 1961 and issued under a different name. CUB-CCSAO Ex. 3.04. It is inappropriate to incorporate these previously incurred costs into a forward-looking cost of capital, since they aren't anticipated to occur during the period in which the cost of capital would be in effect. CUB-CCSAO Ex. 1.0 lines 342-44. The Company indicated that it currently has no plans to issue additional equity.

Nicor Gas Ex. 3.0 lines 75-76. Clearly this is inappropriate and should not be allowed by the Commission. This adjustment reduces Nicor's revenue requirement by $ 970,239.

CONCLUSION

CUB-CCSAO presented evidence that demonstrated that Nicor Gas should be allowed to earn a 7.697% rate of return as follows:

	Capital ($000)	%	Cost	Weighted
Short Term Debt	177,608	13.38%	2.58%	0.35%
Long-term Debt	500,376	37.69%	6.72%	2.53%
Non Redeemable Preferred Stock	1,401	0.11%	4.77%	0.01%
Common Equity	648,156	48.82%	9.86%	4.81%
	1,327,541			7.697%

VII. COST OF SERVICE, RATE DESIGN, AND TARIFF TERMS AND CONDITIONS

Nicor Gas proposed a rate design that is reasonable despite its flawed methodology. Nicor ignores an entire body of existing economic literature and relies on seriously flawed cost allocation methods in determining a cost of service benchmark. CUB-CCSAO presented evidence disputing Nicor's reliance on marginal costs in determining class cost of service or individual rates. CUB-CCSAO also disputes Nicor's usage of a flawed coincident peak methodology that ignores the actual demands that customers make of Nicor's distribution system. However, CUB-CCSAO presents separate analysis supporting Nicor's rate design as it relates to residential customers. This rate design should be adjusted based on a clear set of guidelines once the Commission sets overall revenue requirement and billing determinants.

A. Cost Of Service Study

1. Marginal Cost Of Service Study

In its application, Nicor presented a Marginal Cost of Service Study (MCOSS) adjusted by the equal percentage of marginal cost method (EPMC) to determine class cost of service. Nicor Gas Ex. 17.0 lines 176-229; Nicor Gas Ex. 13.0. In rebuttal, Nicor modified its methodology to concede that revenue should be allocated to customer classes based on the revised Nicor Gas Embedded Cost of Service Study ("ECOSS"), but that tail block prices should be set according to marginal cost. Nicor Gas Ex. 35.0 lines 134-36.

A marginal cost study represents the cost of small changes in gas delivery service on a going forward basis. Nicor Gas Ex. 13.0 lines 241-42. The MCOSS presented by Nicor witness Dr. Hethie Parmesano purports to analyze the cost drivers for each component of Nicor Gas' distribution business. Nicor Gas Ex. 13.0 lines 257-61. CUB-CCSAO witness Thomas testified that there are significant flaws with Dr. Parmesano's study and that a marginal cost of service study is of little value to the Commission.

In fact, Staff, CUB-CCSAO, and IIEC all agree that the MCOSS is inappropriate to use in this proceeding. Even IIEC does not support the use of an MCOSS, despite the fact it allocates more cost to residential consumers and less to industrials and commercial consumers than an embedded cost of service study. IIEC Exhibit 1.0 lines 9-11. IIEC witness Dr. Alan Rosenberg notes that "[t]he use of a marginal cost study is a rarity in the natural gas industry," and that the Commission has used an embedded cost of service study (E-COSS) for rate design purposes for the past 20 years. IIEC Ex. 1.0 lines 15-18. Staff witness Mike Luth also testified that an MCOSS is inappropriate to use in this proceeding. Staff Ex. 7.0 lines 57-101. The Company

accepted this fact and agreed to rely on an embedded cost of service study for class cost of service determination and revenue allocation purposes. Nicor Gas Ex. 44.0 lines 109-21.

While Nicor concedes that revenue allocation should be based on an E-COSS, the Company maintains that the MCOSS should be utilized to determine the effective tail block rates. Nicor Gas Ex. 44.0 lines 407-17. There are three problems with this proposal: (1) Nicor has not demonstrated conclusively that marginal cost based pricing leads to efficiency, (2) Nicor has not demonstrated significant problems with the Commission's current practice of setting rates based on embedded costs or that rates based on the MCOSS are an improvement, and (3) The MCOSS proposed by Nicor suffers from serious flaws in methodology and logic.

Nicor Fails to Demonstrate that Marginal Cost Based Pricing Leads to Efficiency

Nicor's proposal to set rates based on marginal cost of service represents a radical shift in the way that natural gas rates have historically been set in Illinois. CUB-CCSAO Ex. 1.0 lines 588-91. While Nicor claims that "[e]conomists agree that marginal cost pricing results in an efficient allocation of resources, Nicor Gas Ex. 13.0 line 116, this is true only under the narrow set of circumstances that make up the theoretical construct of perfect competition. CUB-CCSAO Ex. 1.0 lines 514-38, quoting Dr. Buchanan.

Nicor's position is based primarily on speculation. Dr. Parmesano testified that Nicor Gas had not made estimates of the efficiency of its customers' gas consumption decisions under various pricing arrangements, had not computed its customers' demand elasticities for the services Nicor Gas provides, and had not estimated the welfare effects of various rate changes. Nicor Gas Ex. 30.0 lines 243-46. CUB-CCSAO asked Nicor for this crucial information in discovery and, as Mr. Thomas testified, "Absent such support the record in this proceeding does not support a finding by the Commission that setting prices at marginal cost is the most efficient

solution in the market for LDC services." CUB-CCSAO Ex. 1.0 lines 619-26. In discussing the efficient allocation of resources in the economy, Dr. Gordon admits, "[t]here certainly might be some consequences outside the sphere of consideration. However, in my judgment, those are very likely to be second order effects, i.e., small, and it's probably safe to ignore them for the purposes of regulating an industry." Transcript at 213. Mr. Thomas cited numerous examples of economic authorities that disagree with Dr. Gordon's assessment. Two examples include Nobel Prize-winning economist James M. Buchanan who stated that equalities between price and marginal cost have no relationship to allocational efficiency, and Dr. Alfred Kahn, who notes that the marginal cost pricing principle does not necessarily "provide a correct guide for pricing in individual markets or industries if it is not being followed uniformly throughout the economy. " CUB-CCSAO Ex. 1.0 lines 514-38, 555-84). Conversely, the only authority that Nicor cited is a 25-year-old study. Nicor Gas Ex. 19.0, fn 18) and could not be provided through discovery because "we couldn't get consent from the copyright holder to have it." Transcript at 196-97. Clearly Nicor has not met its burden of proof.

Nicor Has Not Demonstrated that the Commission should abandon its Current Practice of Setting Rates Based on Embedded Costs.

Existing rates are based on embedded cost, not on marginal costs. Nicor Gas Ex. 17.0 lines 565-566. Nicor has not explained why the Commission should deviate from this practice, nor has it demonstrated that MC-based pricing leads to allocative efficiency in LDC rate setting. CUB-CCSAO Ex. 3.0 lines 455-57; Staff Ex. 7.0 lines 64-67). Staff witness Luth maintains that "[s]ince the ECOSS is based primarily upon the allocation of the current costs to operate the utility's system by the current use of the utility's system, the E-COSS is the appropriate method to determine today's rates. Staff Ex. 16.0 lines 93-96. "Nicor has not shown that E-COSS rates

developed through use of an E-COSS are invalid. An E-COSS is an appropriate method to determine customer class revenue allocations." Staff Ex. 7.0 lines 64-67.

Nicor witness Dr. Parmesano claims that it is important to match the price signals consumer receive from the competitive commodity market with signal they receive from delivery service rates. Nicor Gas Ex. 13.0 lines 194-223. However, Dr. Parmesano's own testimony argues that "[t]he charges for gas delivery service will not affect the competitiveness of the gas supply business, so long as consumers pay the same for delivery–whether they purchase gas from the LDC or an alternative supplier." Nicor Gas Ex. 13.0 lines 195-97. Nicor has simply not demonstrated that its customers will benefit from a radical shift towards marginal cost based rate design. CUB-CCSAO Ex. 3.0 lines 403-504.

The Commission should be very cautious about changing ratesetting regimes without a significant showing of the benefits. CUB-CCSAO Ex. 1.0 lines 59-63. Rates set based solely upon Nicor's MCOSS method would "shift a higher percentage of costs to a flat-rated customer charge, there is very little change in the price of gas at the margin." CUB-CCSAO Ex. 1.0 lines 652-654. Such rates would also result in drastic rate increases to residential customers with very little change in the price signals residential customers would face in their decision to consume a little bit more, or a little bit less, at any time during the month. CUB-CCSAO Ex. 1.0 lines 661-65. Furthermore, "evidence indicates that average price may be more relevant to customer response than marginal price, at least in situations where a declining block rate structure is in place. *See*, Shin, Jeong-Shik (1985), "Perception of Price When Price Information is Costly: Evidence from Residential Electricity Demand," *Review of Economics and Statistics* 67(4): 591-98; CUB-CCSAO Exhibit 3.0 lines 464-68. Nicor has not met its burden of proof and accordingly, the Commission must reject Nicor's position.

The MCOSS Proposed by Nicor Suffers From Serious Flaws in Methodology and Logic.

In addition to being an inappropriate methodology, Nicor's proposed MCOSS suffers from serious flaws in methodology and logic. First, Dr. Parmesano utilizes an incremental cost approach in calculating marginal costs. Nicor Gas Ex. 13.0, lines 250-51. Since costs are derived on a per-customer basis, this approach applies the same cost to all customers. CUB-CCSAO Ex. 1.0 lines 670-73. However, in a perfectly competitive market, the true marginal cost would likely be customer specific. CUB-CCSAO Ex. 1.0 lines 673-74. Dr. Parmesano responded to this criticism by stating that "Customers are not charged the full cost of facilities when they are installed, rather they are allowed to pay the cost over time through rates." Nicor Gas Ex. 30.0 lines 360-67. This highlights the result driven nature of Dr. Parmesano's testimony. These costs are sunk and would not be considered in a perfectly competitive environment, which is the only environment in which marginal cost pricing can be expected to induce the efficiency that Nicor discusses. CUB-CCSAO Ex. 1.0 lines 514-38 quoting Dr. Buchanan.

Second, Nicor has not demonstrated why the use of whatever costs happen to be at a particular point in time, inflated to 2005, is an accurate representation of the costs that can be anticipated in 2005. CUB-CCSAO Ex. 1.0 lines 690-93. Nicor's only response to this criticism is Dr. Parmesano's statement that "Mr. Harms has informed me that the large increase from 2002 to 2003 may have been the result of a change in the way costs were allocated. Nicor Gas Ex. 30.0 lines 388-90. Mr. Harms himself did not testify to this issue and as such the only evidence Nicor presented is hearsay.

2. **Embedded Cost Of Service Study**

Nicor also presented an embedded cost of service study sponsored by Alan C. Heintz. Nicor Gas Ex. 14.0. The objective of performing an ECOSS is to determine the embedded costs that are attributable to each customer class. CUB-CCSAO Ex. 1.0 lines 380-82. Embedded costs are one standard to which rates have historically been compared. CUB-CCSAO Ex. 1.0 lines 382-83. The Commission has utilized this method for the past 20 years to determine class cost of service and revenue allocation. IIEC Ex. 1.0 lines 15-18. Nicor, Staff, and CUB-CCSAO presented E-COSS for the Commission's consideration.

The Commission should rely on the ECOSS presented in the Direct Testimony of Christopher C. Thomas for class cost of service and revenue allocation purposes. The ECOSSs proposed by both Staff and Nicor contain serious misallocations. CUB-CCSAO Ex. 1.0 lines 399-408. Specifically, both misallocate the costs of transmission plant and distribution plant, including distribution mains, and associated expenses (T&D costs). *Id*. at lines 399-401. Nicor's E-COSS relies on a flawed and unrealistic Modified Distribution Main (MDM) Study, and even the updated MDM presented by Staff witness Luth and incorporated into his E-COSS do not fix the problem. CUB-CCSAO Ex. 3.0 lines 633-34. The Commission should reject any study relying on the flawed coincident peak methodology.

a). Modified Distribution Mains Study (MDM)

Nicor proposed to allocate the cost of distribution mains based upon a Modified Distribution Mains (MDM) study. Nicor Gas Ex. 14.0 lines 267-72. Nicor refers to the MDM study as "an engineering analysis that determines the peak day flows for each size of distribution main in service and what percentage of those peak day flows is attributed to each customer rate

class." Nicor Gas Ex. 32.0 lines 118-20. The ECOSS allocates costs to classes based on peak day demands. Nicor Gas Ex. 14.0 lines 255-57. Mr. Thomas has testified that such a methodology "overallocates the costs of distribution mains to residential consumers and should be rejected by the Commission." CUB-CCSAO Ex. 1.0 lines 419-21.

Nicor's MDM study overallocates costs to residential consumers because it relies on Nicor's flawed logic regarding cost causation. The MDM study allocates costs based upon coincident peak usage, which is inappropriate as the next section of this brief will detail. CUB-CCSAO Ex. 3.0 lines 633-34. The Commission should rely only on accurate cost causation principles, and therefore should not rely on the Company's MDM to allocate any portion of service costs.

Apparently realizing the flaw in its logic, Nicor has agreed to accept an average and peak (A&P) methodology that incorporates the MDM study to estimate the peak portion of costs. Nicor Gas Ex. 44.0 lines 123-24. However, this is still unacceptable to CUB-CCSAO. Averaging the results of a cost study based on cost allocations grounded in cost causation (an A&P analysis) with cost study results that pretend that all delivery costs are incurred and caused by peak day demands only (Nicor's MDM) does not produce a reasonable estimate of allocated costs. CUB-CCSAO Ex. 3.0 lines 637-42. If the Commission believes that the coincident peak allocation methodology is inappropriate, then there is no need to utilize the MDM study for any purpose. *Id.* at lines 642-44.

Staff has argued that Nicor's proposed MDM is inappropriate. Mr. Luth demonstrated that the peak demands Nicor utilized in the MDM for Rates 1 and 4 are overstated relative to the other rate classes. Staff Ex. 16.0 lines 201-05. Mr. Luth has adjusted the MDM demand allocation factors to correct this inaccuracy. Staff Ex. 16.0 lines 163-66. Nevertheless, while

Mr. Luth's study fixes one problem with the MDM, it still relies on the same flawed coincident peak allocation methodology and remains inappropriate.

b). Coincident Peak (CP) Allocation Methodology

Nicor Gas originally proposed the MDM methodology, which allocates costs based on the CP methodology. Nicor Gas Ex. 14.0 lines 255-57. However, Nicor has since indicated that it is willing to accept Staff's A&P methodology in a revised ECOSS. Nicor Gas Ex. 42, line 59. "Nicor Gas is prepared to accept a revised version of its embedded cost of service study ("ECOSS") that incorporates Staff's Average and Peak ("A & P") methodology for certain demand cost allocations and also incorporates the unaltered Nicor Gas Modified Distribution Main ("MDM") study for allocating distribution mains-related costs." Nicor Gas Ex. 44.0 lines 33-37. CUB-CCSAO demonstrated that this approach does not produce a reasonable estimate of allocated costs and should not be used in this proceeding. CUB-CCSAO Ex. 3.0 lines 637-42.

Allocation is a critical aspect of an appropriately performed E-COSS, and an appropriate allocation needs to recognize that the system is designed to meet peak capacity but is utilized throughout the entire year. As the Commission concluded in Docket 94-0040, a utility cannot justify its transmission and distribution investment on demands for a single day. Final Order ICC Docket 94-0040 at 138-39; CUB-CCSAO Ex. 1.0 lines 434-38. This rationale still applies.

A gas distribution system has essentially two major functions, both of which are quite similar, yet distinct. Such a system must be sized to accommodate peak day demand, but it is used every day, which by definition includes low-demand days and all levels of demand in between low-demand days and peak days. Nicor's use of CP for certain costs measures only the demand on the system on peak days, and does not measure the use of the system on the vast majority of days other than peak days. Staff Exhibit 7.0 lines 106-12. Some customer classes

use the system more heavily throughout the year and Mr. Luth testified that they "should be expected to pay for the use of the system based, at least in part, on the use of the system throughout the year, rather than how the system is used on only a few days each year" (Staff Exhibit 16.0 lines 273-77. The CP methodology fails to recognize the fact that different customer classes place different demands on the system and should therefore be rejected.

Nicor's position that costs are caused based only on peak day demands is inconsistent with its own tariff, which states:

> GAS MAIN EXTENSION (C) General - Facilities will not be provided hereunder for any uneconomic extension, temporary business or business of doubtful permanency. For the purposes hereof, the term "uneconomic" shall mean any case where expected revenues make it doubtful that a reasonable return would be derived from the required investment. In such cases, the Customer or Subdivider may provide an additional deposit, over and above that provided for above, to make the required extension economic, as determined by the Company; provided, however, that this section shall not operate to deprive any Customer of his right to 100 feet of low pressure main, or 200 feet of high pressure main, as the case may be.

Nicor Gas Ex. 12B.1, page 51. The Company recognizes that mains are installed based upon factors other than demand on the peak day. According to Mr. Harms, investment in mains "…depends upon the revenue generated from that customer in comparison to the investment and the expenses that we expect." Transcript at 755. Given the actual tariff language filed by Nicor and interpreted by Mr. Harms, it is disingenuous to argue that the total annual usage of each customer is irrelevant. Accurate cost causation analysis would recognize that factors other than peak day demand cause costs. Mains are installed to meet varying demand throughout the year and Nicor's CP methodology simply fails to recognize this fact. CUB-CCSAO Ex. 3.0 lines 516-17. The Commission should reject any study relying on Nicor's CP methodology because it is inconsistent with accurate cost causation principles.

c). Average & Peak (A&P) Allocation Methodology

In virtually every LDC rate case in the past ten years, the Commission has utilized an Average and Peak (A&P) methodology for allocating T&D costs, and there is no reason for the Commission to modify its previously established policy. CUB-CCSAO Ex. 1.0 lines 450-60. As discussed in the previous section, a utility cannot justify its transmission and distribution investment on demands for a single day. Final Order, ICC Docket 94-0040 at 138-39. Consistent with accurate cost causation principles, the Commission cannot rely on any allocation methodology that ignores the actual demands placed on the system.

Mr. Thomas presented testimony on the appropriate A&P allocator for use in this proceeding on behalf of CUB-CCSAO and Mr. Luth presented similar testimony on behalf of Staff. The primary difference in the A&P allocation factor proposed by Mr. Luth and the one proposed by Mr. Thomas lies in the underlying data considered in their analyses. Mr. Luth used an A&P factor that is weighted according to "the percentage of the peak demand day that an average day represents." Staff Ex. 7.0 lines 114-16. Consistent with changes he proposed to Nicor's MDM study, Mr. Luth updated the peak demands for several customer classes in rebuttal testimony. He proposed a 26.76% A&P factor for use in this proceeding. Staff Ex. 16.0 lines 259-62. Mr. Thomas took a more detailed and complete look at the available data by examining both the daily average data and the aggregated monthly information. CUB-CCSAO Ex. 3.0 lines 588-602. Mr. Thomas's analysis indicates that mean weighting presents a skewed picture of the system load and results in an estimate of average that is skewed lower than it actually should be. *Id.* at lines 597-98. Mr. Thomas's analysis is the only analysis that examines the full scope of available data on customer usage and is therefore the most balanced option available for the Commission.

Mr. Thomas compared actual throughput for the 12-month period ending December 2004 with the average and coincident peak information utilized by Nicor's E-COSS in the creation of his A&P allocator. CUB-CCSAO Ex. 3.0 lines 585-96. The average of the total system throughput data is 45.44% of the peak month, while the daily average data is only 23.1% of the coincident peak data. Mr. Thomas's regression analysis indicates that the appropriate A&P allocation factor is 37.5%. *Id.* at lines 809-13. Thus 37.5% of costs should be allocated on the basis of average demand and the remaining 62.5% should be allocated based upon peak demands. Mr. Thomas' analysis presents an accurate picture of the data and is therefore an appropriate measure of the relative weighting between average and peak demands. *Id.* at lines 598-602.

Nicor criticizes Mr. Thomas's regression analysis. Mr. Heintz argues that since the R-squared of Mr. Thomas's analysis is low the entire analysis should be disregarded. Nicor Gas Ex. 42.0 lines 150-58. This criticism is misleading. R-squared is a measure of how much of the variation in throughout is explained by time. As Mr. Thomas explained, the fact that time does not explain the variation in throughput does not diminish the value of the analysis. CUB-CCSAO Ex. 3.0 lines 585-96.

Nicor also criticizes the fact that Mr. Thomas's regression analysis is organized such that July is the first month. Nicor Gas Ex. 42.0 lines 176-77. Once again, Nicor grasps at straws. Organizing the data such that July is the first month gives the data a relatively normal shape and is an accurate picture of how demand on the system is distributed. CUB-CCSAO Ex. 3.0 lines 552-555. In fact, *The Appropriate Use of Climatic Information in Illinois Natural Gas Utility Weather Normalization Techniques* (Referred to by Nicor witness Takle, Nicor Exhibit 16.0)

includes a figure (Figure 2, pg. 5) that organizes heating degree-day data for 83 years in exactly the same manner.

It is also clear that peak usage should be Nicor's actual throughput on the peak day. Nicor inappropriately considers only firm peak throughput on the peak day. CUB-CCSAO Ex. 1.0 line 416. On the peak day, interruptible customers still receive some level of gas service. These customers should be responsible for the costs they cause, but are not under the Company's study. *Id.* at lines 439-42. The amount of gas that flows to these customers on the peak day still places a demand on the system, and should therefore be recognized in allocating costs *Id.* at lines 443-46. The analysis presented by Mr. Thomas is the only analysis the uses the total volume of gas that flows through the system on the peak day, and accordingly is the only analysis the Commission can accept.

B. RATES, RIDERS, AND OTHER TERMS

Nicor concedes that revenue should be allocated to customer classes based on the ECOSS, but insists that the tail block prices should be set according to marginal cost. Nicor Gas Ex. 35.0 lines 134-36. CUB and CCSAO disagree with Nicor's reliance on the MCOSS in any form, yet believe that the Company's proposed rate design is reasonable. CUB-CCSAO Ex. 1.0 lines 699-701.

Nicor's proposed rate design constitutes a reasonable attempt to move toward a cost based rate standard. CUB-CCSAO Ex. 3.0 lines 358-63. It is reasonable because it satisfies three key objectives. First, the proposed rate structure is just and reasonable, in that it allows the company the opportunity to recover its prudently incurred costs. CUB-CCSAO Ex. 1.0 lines 734-36. Second, the rates encourage efficiency by employing a moderate increase over existing rates, in the tail block. CUB-CCSAO Ex. 1.0 lines 737-38. Third, the Company's proposal is an

appropriate, measured step towards a flat-rated commodity charge, which is easier to administer and easier for customers to factor into their consumption decisions. *Id.* at lines 739-41.

The Commission should be very clear in its order that it is not simply accepting Nicor's view that prices set at marginal costs provide appropriate pricing signals to the market. All of the parties, except Nicor, who submitted testimony on this issue agree that marginal cost-based pricing for natural gas distribution services is a dramatic departure from previous pricing practices in Illinois and is inappropriate. CUB-CCSAO Ex. 3.0 lines 481-486. Neither the ECOSS nor MCOSS supports a declining block rate structure. CUB-CCSAO Ex. 1.0 lines 766-767. There is no cost study in evidence that supports the idea that actual costs are different between the 50th and the 51st therm consumed during a given month. *Id.* at lines 771-73; Nicor Gas Ex. 30.0 lines 445-49. This supports movement towards a flat rated commodity charge that could be used to send clearer signals to consumers, since a declining block rates structure discourages conservation. While moving towards such a flat rated commodity charge to encourage efficiency is an important goal, it must be done gradually to reduce the rate shock that could occur among customers with different usage levels, i.e. space heat customers vs. cooking gas customers. CUB-CCSAO Ex. 1.0 line 745-48.

The Commission should be very careful in realigning interclass revenue structures and in setting rates, to avoid shifting undue cost burdens to residential consumers, who could be forced to choose between leaving the heat on and putting on a sweater. CUB-CCSAO Ex. 1.0 lines 720-44. Changes to the existing rate structure could easily result in inequities in the intra-class allocation of rates and have the potential to negatively impact some customers while other customers remain largely unaffected. CUB-CCSAO Ex. 1.0 lines 742-45. The Commission should be mindful of the impacts that its decisions have on customers with different usage

patterns and should ensure that any changes are made in a manner that limits unintended consequences, or rate shock, to particular customers. CUB-CCSAO Ex. 3.0 lines 688-93.

Nicor's proposed rate design is reasonable, but should be adjusted based upon a well-defined set of objectives. The Commission must determine a revenue requirement. CUB-CCSAO Ex. 1.0 lines 64-66. Once the Commission determines the appropriate revenue requirement, the interclass allocation proposed by the Company should be preserved, at least as it applies to residential consumers. The Commission should keep the second block and tail block rates for rate 1 at the levels proposed by the Company and allocate the remaining increase between the customer charges and the first block rates, utilizing the approved billing determinants. These changes will maintain consumption efficiency incentives embedded within Nicor's proposal, while preserving gradualism in the move towards a flat-rated demand charge. CUB-CCSAO Ex. 1.0 lines 753-61.

4. Rate 1

The residential rate structure proposed by Nicor is a reasonable compromise between cost reflection, feasibility, and gradualism. Nicor Gas Ex. 30.0 lines 34-35. The Company's proposal takes a stride towards cost-based rates, while employing gradualism to moderate the effect's increases. CUB-CCSAO Ex. 1.0 lines 710-13. CUB and CCSAO maintain that this is the most reasonable option available to the Commission.

Staff witness Luth presented the only other proposal for residential rate design. The Commission should reject Staff's proposed rate design. Mr. Luth failed to incorporate any degree of gradualism to limit the rate shock to residential customers, even though he acknowledges that it is a widely-recognized regulatory standard for determining rates. Transcript at 1319. In addition, Mr. Luth did not consider the effect that his rate design would

have on residential end users who use either significantly more than or significantly less than the average usage for each rate class. Transcript at 1319-20.

With regard to the claimed efficiency of Nicor's rate proposal, Nicor simply has not demonstrated that marginal cost-based rates will offer an improvement in efficiency. Evidence indicates that average price may be more relevant to customer response than marginal price, at least in situations where a declining block rate structure is in place. *See*, Shin, Jeong-Shik (1985), "Perception of Price When Price Information is Costly: Evidence from Residential Electricity Demand," *Review of Economics and Statistics* 67(4): 591-98, CUB-CCSAO Ex. 3.0 lines 464-68.

CONCLUSION

CUB-CCSAO support Nicor's proposed rate design, and encourage the Commission to adopt it. However, CUB-CCSAO encourage the Commission to raise the tail block rates to send signals to consumers concerning efficiency on the margin, without basing the adjustment on the Company's MCOSS. CUB-CCSAO Ex. 1.0 lines 764-66; CUB-CCSAO Ex. 3.0 lines 495-97.

15. ENERGY EFFICIENCY PROGRAMS

The Environmental Law and Policy Center (ELPC) submitted testimony proposing the Commission add funds to Nicor's rate request in order to fund energy efficiency ("EE") programs in Nicor's service territory. ELPC's witness, Martin Kushler, initially recommended funding programs in the amount of $38 million per year for five years, but noted that if the Commission is not willing to go to that level, that effective programs can be approved at $10 million per year. ELPC Ex. 1.0 lines 124-28. Mr. Kushler further recommended that the

Commission set up a collaborative process to design a portfolio of programs to best serve customers. ELPC Ex. 1.0 at lines 225-28.

CUB-CCSAO support funding energy efficiency programs and support the use of a collaborative process. However, we believe that funding these programs at the $10 million level is appropriate as a starting point.

As ELPC notes, Illinois residential, business and government consumers have been hard hit by dramatic natural gas commodity price increases over the past few years. ELPC Ex. 1.0 lines 52-53. This results in a tremendous dollar drain on the state's economy to pay for imported natural gas. According to Mr. Kushler, for every $1 million invested in natural gas energy efficiency programs, more than $2 million should be produced in avoided natural gas costs for Nicor ratepayers over the life of these measures. ELPC Ex. 1.0 lines 166-68.

Consistent with the testimony of CUB/CCSAO Witness Thomas, CUB/CCSAO believe that if implemented properly, these programs should in fact reduce the usage of gas at peak prices during the winter and produce substantial savings for customers. CUB/CCSAO Ex. 3.0 at 757-60. CUB-CCSAO supports Mr. Thomas' recommendation that the Commission start with the smaller $10 million initiative and increase funding as EE initiatives prove themselves successful in Nicor's service territory. *Id.*at lines 760-62. Simultaneously, the Commission should initiate a series of workshops allowing interested parties to participate and resulting in a recommended RFP process that includes clear project goals and guidelines. The working group should be given the express goal to reduce natural gas consumption in Nicor's service territory. *Id.* at lines 789-94. Independent program evaluation is crucial and should be included in any plan implementing EE. *Id.* at lines 784-85.

Nicor opposes the approval of funding for energy efficiency programs in this proceeding, but it fails to adequately explain or defend its position. Nicor's witness Val Jensen, who has consistently supported energy efficiency programs in the past (Tr. at 430), including a recent California program, now opposes the ELPC proposal in this proceeding. Before the California PUC, Mr. Jensen specifically testified, "energy efficiency is a valuable resource to meet customers' needs." Tr. at 432. In this proceeding, Mr. Jensen acknowledges that energy efficiency measures reduce consumers' consumption of gas during peak periods. Tr. at 423.

Additionally, Mr. Jensen opposes the collaborative process, asserting, "collaboratives serve more to advance the specific interests of participants than to produce the best practice programs." Nicor Ex. 33.0 at lines 128-30. However, when questioned about the motives of participants on cross, he provided no support for his assertions that ICC Staff, ELPC, CUB, Cook County and other consumer representatives would participate in such a process to promote their self interests. Tr. at 442-46. In fact, he acknowledged that it is possible to set up a collaborative with clear lines of authority that allow quick decisions and necessary adjustments to programs. Tr. at 441.

The nature of LDC regulation is such that Nicor's incentives as a profit maximizing entity are at odds with the goals of effectively run EE programs. Nicor's revenues are based upon the quantity of gas it delivers to customers and theoretically less usage means less revenue. CUB-CCSAO Exhibit 3.0 lines 765-69. It appears that Nicor's opposition to the energy efficiency funding is related to a concern that the company's revenues would be reduced.

While there are no guarantees that energy efficiency programs will fulfill their promise, the consumer and environmental groups in this proceeding all commit to seeing that programs are properly designed and implemented, and produce results. The funding from the program

comes not from the utility, but from the consumers who support this proposal and the consumers urge the Commission to approve ELPC's proposal at the $10 million level.

16. COMFORT GUARD

CUB-CCSAO attempted to create a record in this proceeding supporting the position that revenues derived from Nicor Services' sale of Comfort Guard and HVAC services should be attributed to Nicor Gas. Nicor Gas sold Comfort Guard and HVAC services under the Nicor Services name, but CUB-CCSAO attempted to submit evidence demonstrating that Nicor Gas employees actually sold and serviced these products and that the revenues derived from these products should be attributed to Nicor Gas for ratemaking purposes.

On May 23, the ALJs issued a ruling rejecting CUB-CCSAO's attempt to raise this issue in the current proceeding. The ruling rejected CUB-CCSAO's request to file additional testimony, stating that this docket "is not the appropriate forum for adjudication of this issue." ALJ Ruling May 23, 2005. Consistent with that broad premise, the Ruling also excluded data responses relating to this issue that CUB-CCSAO submitted for the record earlier in the hearing, as well as cross-examination related to the Comfort Guard and HVAC services issue. The Ruling concluded that CUB-CCSAO could pursue this issue in a separate filing. *Id.*

On May 24, CUB-CCSAO filed a Motion to Reconsider the ALJ's ruling, asserting that, at a minimum, the Commission should make the data responses and cross-examination relating to Comfort Guard and HVAC Services part of the record. Additionally, before the close of the hearing CUB-CCSAO made an offer of proof for the record, submitting a statement outlining the arguments that it would have made had it been permitted to do so.

At this time, the Commission has not yet ruled on CUB-CCSAO's Motion for Reconsideration and thus the data responses and cross-examination are not part of the record.

Thus, CUB-CCSAO are unable to argue this issue at this time, but intend to supplement this brief if the ALJ's ruling on the Motion for Reconsideration puts the data responses and cross-examination back in the record.

CONCLUSION

CUB-CCSAO and the Attorney General presented evidence demonstrating that the record does not support Nicor's request and that Nicor is over-earning by approximately $12.7 million. CUB-CCSAO recommend that the Commission place a portion of this over-earning into energy efficiency initiatives and that it refund Nicor's customers approximately $2.7 million. Additionally, Nicor's proposal to establish an uncollectibles expense tracking mechanism should be rejected. Further, CUB-CCSAO support Nicor's proposed rate design, and encourage the Commission to adopt it. However, CUB-CCSAO encourage the Commission to raise the tail block rates to encourage efficient consumption, without incorporating the Company's MCOSS.

Respectfully submitted,

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June 22, 2005