

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

NORTHERN ILLINOIS GAS COMPANY D/B/A	:	
NICOR GAS COMPANY	:	
	:	No. 04-0779
Proposed general increase in rates, and revisions to	:	
other terms and conditions of service.	:	

NORTHERN ILLINOIS GAS COMPANY'S
INITIAL POST-HEARING BRIEF

TABLE OF CONTENTS

	<u>Page</u>
SUMMARY	1
I. INTRODUCTION	11
A. Nature of Operations	11
B. Test Year	12
II. RATE BASE	13
Overview	13
Nicor Gas Rate Base Evidence “Road Map”	14
A. Uncontested Issues	18
B. Year-End or Average Rate Base Methodology	22
C. Utility Plant Balance	26
1. Staff’s Proposed Capital Expenditures Adjustment	26
2. The AG’s Proposed Net Capital Additions And 2004 Year-End Balance Adjustments	29
D. Accumulated Depreciation (Depreciation Reserve)	31
E. Daily Metering Project	31
F. Mainframe Project	33
G. Gas In Storage	34
H. Pension Asset	38
I. Section 263A	41
J. Deferred Taxes	44
K. Customer Deposits	44
L. Budget Payment Plan	45
M. Uncollectibles Reserve	46
1. Uncollectible Expense Tracker	47
N. Other	47
III. EXPENSES	47
Overview	47
Nicor Gas Operating Expense Evidence “Road Map”	48
A. Uncontested Issues	51
B. Depreciation Expense	53
C. Storage Gas Losses (2% Withdrawal Factor)	53
D. Industry Association Dues	55
E. Social and Service Club Dues	56
F. Office Supplies Expense	57
G. Branding Expense	58
H. Stock Option Expense	59

I.	Incentive Compensation	63
J.	Payroll Expense	67
K.	Payroll Tax	68
L.	Corporate Benefit Plan Expense	68
M.	Interest Expense on Customer Deposits	69
N.	Interest Synchronization	69
O.	Uncollectibles Expense	70
P.	Income Tax Expense	72
Q.	Rate Case Expense	73
R.	Gross Revenue Conversion Factor	74
S.	Other	75
IV.	WEATHER NORMALIZATION	75
V.	RATE OF RETURN	80
A.	Capital Structure (Inclusion of Short-Term Debt)	81
1.	Overall Rate of Return	81
2.	Short-Term Debt in Nicor Gas' Capital Structure	85
B.	Adjustments to Capital Structure Component Balances	93
C.	Cost of Short-Term Debt	94
D.	Cost of Equity	95
E.	Flotation Costs	101
VI.	COST OF SERVICE, RATE DESIGN, AND TARIFF TERMS AND CONDITIONS	102
	Overview	102
A.	Cost Of Service Study	105
1.	Marginal Cost Of Service Study	105
2.	Embedded Cost Of Service Study	108
a)	Modified Distribution Mains Study (MDM)	108
b)	Coincident Peak (CP) Allocation Methodology	109
c)	Average & Peak (A&P) Allocation Methodology	110
B.	Rates, Riders, and Other Terms	110
1.	Rate 5: Seasonal Use Service [uncontested]	110
2.	Rate 75: Seasonal Use Transportation Service [uncontested]	110
3.	Rider 6	110
a)	Allocation of Hub Expenses through Revenue Requirement; Hub Revenues	110
b)	Commodity Portion of Uncollectibles	112
c)	Commodity Portion of Gas Cost	113
d)	Gas Storage Losses (2% Withdrawal Factor)	113
e)	Working Capital on Gas Storage	113
4.	Rate 1	114
5.	Rate 4	117

6.	Elimination of Rate 81 – Energy Transportation; Elimination of Rate 11 - Energy Service	118
7.	Rate 21 – Interruptible Transport and Storage Service	119
8.	Rates 74, 76, 77	121
	a) Allocation	122
	(1) Storage Capacity Allocation	122
	(2) Storage Withdrawal Rights	125
	(3) Daily Delivery Algorithm/Weather Sensitivity	126
	(4) Maximum Daily Nomination	127
	(5) Intraday Nominations	129
	(6) Upstream Pipeline Capacity	130
	b) SBS Charge	130
	c) Cycling	131
	(1) Super-pooling	135
	d) Level of Rate Increase	135
9.	Rider 13 – Group Size Limitation	137
10.	Rider 16 (Customer Select) – Gas Management Issues	138
	a) Storage Capacity Allocation	139
	b) Storage Withdrawal Rights	140
	c) Daily Delivery Algorithm/Weather Sensitivity	140
	d) Monthly Balancing Tolerance/Penalty	141
	e) Access to Upstream Capacity / Elimination of Aggregation Balancing Service Charge	142
11.	Rider 25 – Demand Gas Costs	143
12.	Rider 12 – Environmental Cost Recovery	143
13.	Rider 7 – Local Government Compensation Adjustment; Rider 2	145
14.	Other Customer Select issues	147
	a) Billing and Gas Supply Administrative Costs	147
	b) Mailing List	148
	c) Customer Select Signup (Account and Meter Numbers)	148
15.	Energy Efficiency Programs	148
16.	Other	150
VII.	CONCLUSION	151

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Northern Illinois Gas Company d/b/a Nicor Gas Company (“Nicor Gas”), in accordance with the Administrative Law Judges’ (the “ALJs”) scheduling order of May 27, 2005, the order regarding the briefing outline of May 31, 2005, and 83 Illinois Administrative (“Ill. Admin.”) Code § 200.800, submits this Initial Post-Hearing Brief (“Initial Brief”).

SUMMARY¹

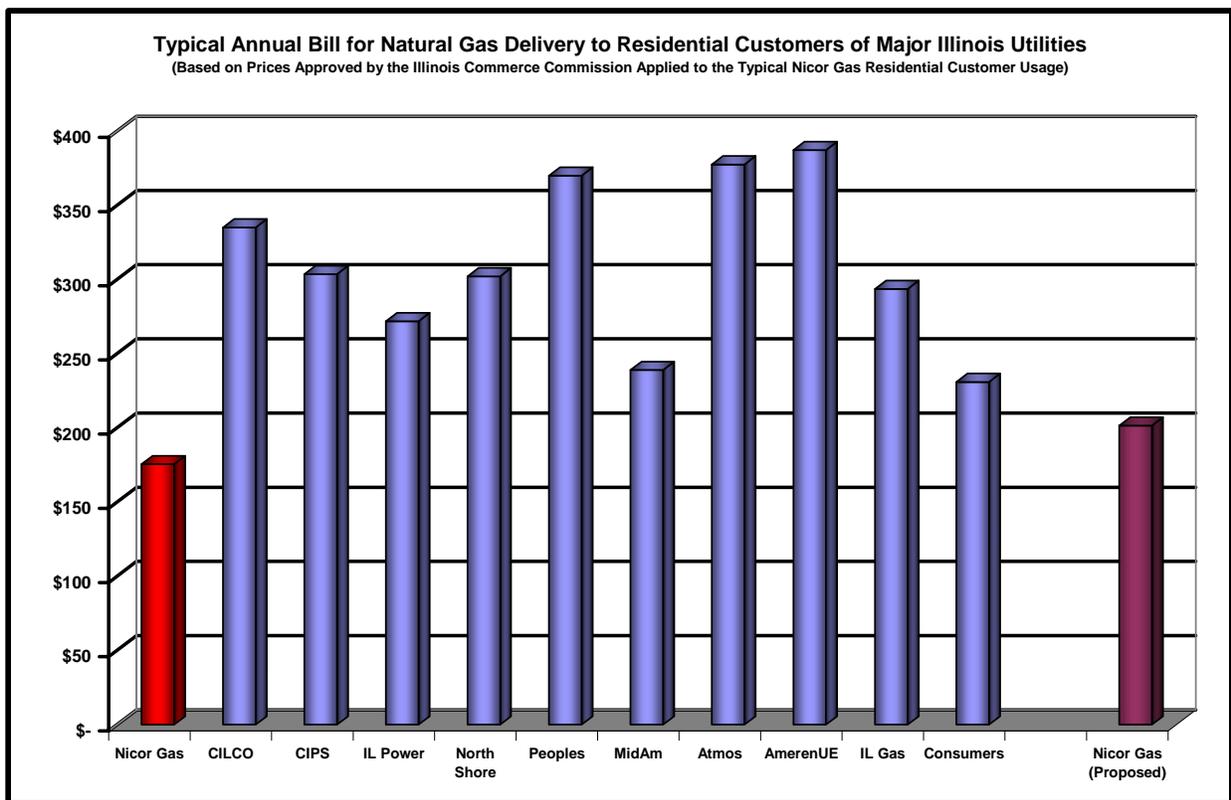
Before the Illinois Commerce Commission (the “ICC” or “Commission”) are tariffs embodying Nicor Gas’ first increase in gas distribution rates in nearly a decade. Nicor Gas seeks an increase in its base rate revenues, on a comparable basis, of \$77,573,000.² (Gorenz Rebuttal (“Reb.”), Nicor Gas Exhibit (“Ex.”) 26B.0, 5:107 – 111)³

¹ This Summary will introduce and summarize this Initial Brief and Nicor Gas’ request for rate relief. The Summary is intended to comply with 83 Ill. Admin. Code § 200.800(b)(3) and to supplement, rather than replace, the discussion of specific items called for by the ALJs’ order of May 31, 2005.

² Because Nicor Gas proposes that some of its revenues -- notably uncollectible gas costs less collected gross Hub revenues -- be collected through its Rider 6, Gas Supply Cost, those proposals, if approved, would result in the increase in base rates being only \$61,726,000. (Gorenz Reb., Nicor Gas Ex. 26B.0, 5:107-113) The total required revenues, of course, remain the same.

³ When citing pre-filed testimony in this Initial Brief, Nicor Gas has provided citations to the page number and line number(s) in the form of “page:line(s)” or “page:line – page:line”.

The case for this rate relief is straightforward. Since its rates were last set, Nicor Gas has invested approximately \$1.24 billion in new plant, began serving approximately 300,000 new customers, many in areas requiring new infrastructure, with flat sendout, and saw its unit operating costs inexorably rise. (E.g., O'Connor Reb., Nicor Gas Ex. 26A.0, 23:518 - 522; O'Connor Direct ("Dir."), Nicor Gas Ex. 1B.0, 8:190 - 9:235; O'Connor Reb., Nicor Gas Ex. 18B.0, 7:155 - 156; D'Alessandro Dir., Nicor Gas Ex. 5.0, 13:260 - 270; McCain Dir., Nicor Gas Ex. 6.0, 12:251 - 261) Throughout this period, Nicor Gas has provided high quality service, and has consistently maintained the lowest rates of any major gas distribution company in Illinois. (E.g., O'Connor Dir., Nicor Gas Ex. 1B.0, 14:364 - 369; Gordon Dir., Nicor Gas Ex. 2.0, 12:215 - 13:246 (the final column depicts Nicor Gas' initial request for rate relief))



Moreover, even if the entire proposed rate increase is approved, Nicor Gas' customers will continue to enjoy the lowest gas distribution rates of any major Illinois local distribution

company (“LDC”), just as they have for years. (*E.g.*, O’Connor Dir., Nicor Gas Ex. 1B.0, 14:364 – 369; Gordon Dir., Nicor Gas Ex. 2.0, 12:218 – 13:222) Residential base rates, in particular, will increase only 10.41%. (Nicor Gas Ex. 44.7) The effect on an average residential customer’s total bill is an increase of only 2.34%. (*Id.*) No matter how measured, Nicor Gas’ proposed increase in residential bills is much less than inflation, and much less than the increases in prices of other essential goods and services since the 1995 Rate Case.⁴ (Gordon Dir., Nicor Gas Ex. 2.0, 5:108 – 111, 6:147 – 13:232)

Although modest in its effect on customers, the evidence shows that the proposed rate relief is critical if Nicor Gas is to recover its costs and earn an appropriate rate of return on its investments comparable to what the market requires of other gas LDCs in the United States. Growing investments, a growing service territory, flat sendout, and rising costs have outstripped Nicor Gas’ decade-old rates. In 2004, Nicor Gas earned net operating income of \$96,300,440, which is \$6,651,560 less than was forecasted when this case was filed (O’Connor Reb., Nicor Gas Ex. 26A.0, 16:344 – 353), and which is \$36,450,560 less than the \$132,751,000 allowed in the 1995 Rate Case. *In re Northern Illinois Gas Co.*, Docket 95-0219, 1996 Ill. PUC Lexis 204 at *157 (Order April 3, 1996). Moreover, even that depressed level of income includes income from Hub operations that will no longer be available to Nicor Gas, as discussed below. In the 2005 test year, operating income is forecast to fall to only \$84,043,000, or \$48,708,000 less than currently allowed. (Nicor Gas Ex. 26B.1, Schedule A-2) The resulting test year revenue deficiency is a staggering \$77,573,000. (*Id.*) This financial performance is depicted below.

⁴ *In re Northern Illinois Gas Co.*, Docket 95-0219, 1996 Ill. PUC Lexis 204 (Order April 3, 1996) (the “1995 Rate Case”).

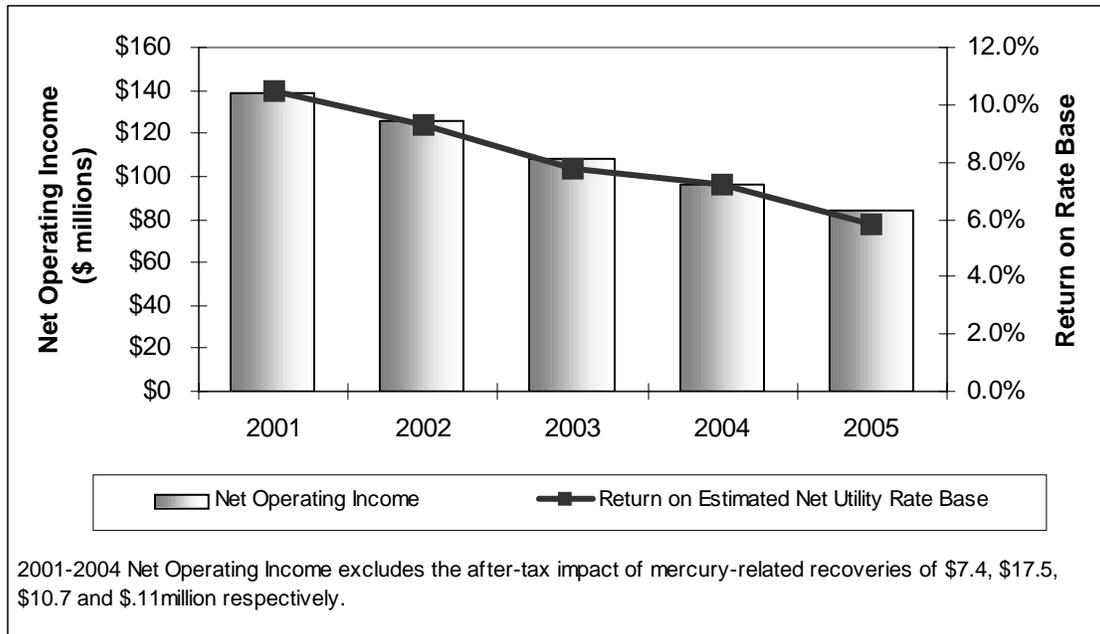


Figure 1: Operating Income and Earnings Trend, 2001 through 2005⁵

This type of financial performance simply cannot be sustained by an independent, financially sound utility; nor is it in the public interest. (*E.g.*, O'Connor Dir., Nicor Gas Ex. 1B.0, 7:177 – 8:189; Gordon Dir., Nicor Gas Ex. 2.0, 17:310 – 322) It should be emphasized that Nicor Gas' rate request will not increase its allowed earnings (net operating income); its proposed earnings of \$130,130,000 will actually be slightly lower than that approved in the 1995 Rate Case. (*E.g.*, Nicor Gas Ex. 26B.1, Revised Schedule C-1) Rather, it will permit Nicor Gas the opportunity to restore its performance to historical, healthy levels commensurate with recovery of its costs and a fair return on its investments. Conversely, if Nicor Gas' request is denied or reduced in material amount, it will be left with earnings far below the level allowed in the 1995 Rate Case, and will simply be denied the opportunity to recover its costs and to earn a

⁵ Figure 1 is the same as Figure 1 that appears in the direct testimony of Richard Hawley, C.P.A. (Nicor Gas Ex. 1A.0, 7:175), except that the 2004 forecasted figure has been replaced by the actual 2004 figure provided in the rebuttal testimony of Gerald O'Connor, FCCA (Nicor Gas Ex. 26A.0, 16:344-353), and the 2005 data has been updated to reflect the newer data reported in Nicor Gas Ex. 26B.1 at Revised Schedule A-2.

fair return on its investments. (O’Conner Surrebuttal (“Sur.”), Nicor Gas Ex. 34.0, 22:488 – 504; Hawley Dir., Nicor Gas Ex. 3A, 12:255 – 259; Mudra Reb., Nicor Gas Ex. 20B.0, 13:312 – 315)

No part of the evidentiary record justifies denying Nicor Gas that opportunity. No party challenges the quality of Nicor Gas’ service, the appropriateness or cost of its plant investments (with one very small exception), its commitment to cost containment, or its singular efficiency. Indeed, as noted above, Nicor Gas has remained the lowest cost and lowest rate major LDC in Illinois, and it will continue to be the lowest cost and lowest rate major LDC in Illinois if every penny of its rate request is approved.

Nonetheless, parties propose to leave Nicor Gas with much less. The ICC’s Staff (“Staff”) proposes allowing Nicor Gas a base rate increase that it characterizes as \$38,885,000. (Struck Reb., Staff Ex. 10.0 Revised, Schedule 10.01 Revised, page 1) Staff’s proposal is actually far more draconian, as most of Staff’s calculated “increase” actually represents only transfers of revenues to base rates from Rider 6. On a comparable basis, Staff would allow a real revenue increase of only \$17,921,000 (*Id.*)⁶ Moreover, Nicor Gas could expect to actually recover \$8,435,000 less than that increase if Staff’s recommended position on billing determinants -- requiring use of an inaccurate 30-year weather normalization period -- were to be accepted, as discussed further below. Net of this effect, Staff actually proposes an increase of only \$9,486,000. Thus, under Staff’s proposals, Nicor Gas could expect to earn approximately \$39,222,000 less than was allowed in the 1995 Rate Case, and less even than in 2004. That would be an unjust and unreasonable result. It would leave Nicor Gas financially wounded.

⁶ This figure is the remainder after subtracting from \$38,885,000 the grossed-up \$13,061,000 impact of Staff’s proposal and proposed \$12,879,000 figure (incorrect) re the 2% withdrawal factor and the grossed-up \$7,903,000 impact of Staff’s position re the inclusion of gross Hub revenues of \$7,790,000 in Rider 6, discussed in Sections III(C) and VI(B)(3)(a) of this Initial Brief.

(E.g., O'Connor Dir., Nicor Gas Ex. 1B.0, 7:177 – 8:189; Gordon Dir., Nicor Gas Ex. 2.0, 17:310 – 322)

As is discussed below, the inadequate base rate revenues proposed by Staff flow directly from Staff's proposing, among other things:

- Unjust and unrealistic rates of return. Staff proposes that Nicor Gas be allowed a return on equity that the evidence shows is lower than that awarded to any other LDC in the United States in the two preceding calendar years (2004 and 2005 to date). Staff urges that all of Nicor Gas' short-term debt be added to its capital structure, even though that is unwarranted and contrary to past practice and Commission decisions concerning this very debt. Staff also urges that this debt be included at an artificially low cost that completely ignores Nicor Gas' commitment fees. *See* Section V of this Initial Brief.
- An unjust and arbitrary period for rate base measurement. Nicor Gas has submitted overwhelming, uncontradicted, evidence that its forecasted rate base as of December 31, 2005, is representative of its rate base during the period in which the rates to be set in this case will be in effect. Nonetheless, Staff proposes to use only Nicor Gas' average 2005 rate base, effectively excluding over \$40 million of investments which have occurred before or during this year or will occur by the end of the year, and that are prudent, reasonable, and needed to provide service during the test year and beyond. *See* Section II(B) of this Initial Brief.
- A further unjust and arbitrary reduction of capital expenditures. Staff proposes to reduce Nicor Gas' net plant by another nearly \$9 million based on a specious averaging methodology of capital budget variances in which nearly 90% of the result is attributable to a unique and non-recurring capital budget variance level that occurred in 1998. *See* Section II(C)(1) of this Initial Brief.
- An unjust and inconsistent treatment of an important financial asset. Staff proposes to deny over \$100 million of Nicor Gas' net rate base based on the theory that ratepayers funded the net pension asset created by contributions made by Nicor Gas. This theory ignores, among other things, that during the same period in which Staff claims ratepayers were paying too much through rates for pension expense, Nicor Gas was experiencing a revenue deficiency as established in the 1995 Rate Case. Moreover, ratepayers have had the benefit of a pension credit against other operating expenses of \$62.2 million since the 1995 Rate Case until the rates to be set here go into effect. Staff's theory is inconsistent with the treatment of utility plant, and is inconsistently and unfairly coupled with Staff's insistence that ratepayers continue to receive a pension credit against other operating expenses. *See* Section II(H) of this Initial Brief.
- An unjust and ill-conceived disallowance of a portion of Nicor Gas employees' total compensation. Staff proposes to disallow over \$6 million in labor costs

associated with Nicor Gas' incentive compensation programs. Without either background or experience in human resources management, or any empirical analysis of compensation costs, Staff claims that these employee expenses do not benefit ratepayers. Nicor Gas showed that it follows a long-established total compensation approach that: (1) has been and is developed and implemented with the assistance of analyses, data, and recommendations from leading outside experts; (2) considers overall employee compensation as well as its components; and (3) seeks overall to pay employees at the median -- the "50th percentile" -- of the applicable labor market, in order to best balance the objectives of obtaining a sufficient, qualified work force while controlling costs. The record shows that Nicor Gas' total compensation approach, including the payment of incentive compensation, benefits ratepayers. *See* Section III(I) of this Initial Brief.

In addition, Staff urges the Commission to ignore the absolutely undisputed evidence of both the statistical superiority of 10-year versus 30-year weather normalization and the science of regional climate change, and to establish base rate charges as if there had been no such evidence submitted. Literally every shred of evidence in the record proves that winter weather, which in Nicor Gas' territory is critical to gas throughput, has become systematically warmer. (*E.g.*, O'Connor Dir., Nicor Gas Ex. 1B.0, 8:205 – 207, 15:389 – 401; Herrera Dir., Nicor Gas Ex. 15.0, 1:20 – 2:25, 2:29 – 10:172; Nicor Gas Exs. 15.2 – 15.7; Takle Dir., Nicor Gas Ex. 16.0, *passim*) Literally every shred of evidence in the record proves that a ten year period is a statistically more accurate predictor of future weather, and the sound choice scientifically. (*E.g.*, Herrera Dir., Nicor Gas Ex. 15.0, 4:67 – 68; Takle Dir., Nicor Gas Ex. 16.0, 5:94 – 96) It is clear that Nicor Gas' 10-year weather normalization period is authorized by law and complies with all Commission rules. *See* Section IV of this Initial Brief. Moreover, Staff's proposal of an inaccurate weather normalization period can be expected annually to deny Nicor Gas recovery of \$5,465,000 - \$8,435,000 of its revenue requirement, depending on the rate design used. (Harms Reb., Nicor Gas Ex. 32.0, 41:880 – 889; Harms Sur., Nicor Gas Ex. 44.0, 28:627 – 629) There is, in short, no lawful excuse to disregard the uncontradicted evidence and impose a 30-year

normalization period that the evidence shows is inaccurate and is expected to unjustly cause Nicor Gas to under-recover the revenue requirement ultimately approved by the Commission.

Intervenors the Citizens Utility Board (“CUB”), the Cook County States Attorney’s Office (“CCSAO”), and the Office of the Attorney General of the State of Illinois (the “AG”) (collectively referred to herein as “GCI”), in combination, argue that Nicor Gas is somehow actually over-earning and, therefore, that its base rates should be cut. (Effron Dir., AG Ex. 1.0, 3:21 – 4:8; Effron Reb., AG Ex. 1.3, 23 :2 – 17)⁷ As the evidence shows, GCI’s position rests on fanciful constructs such as treating Nicor Gas’ shareholders’ investment in approximately \$107 million in working gas as a \$66 million, or even a \$75 million, liability. *See, e.g.*, the Overview subsection and subsection “G” of Section II of this Initial Brief. While their arguments suffer from numerous particular grievous flaws, their cumulative impacts lead to overall figures that are simply divorced from reality. Nicor Gas has operated efficiently, managed its costs well, invested heavily, served an increasing number of customers, and seen its costs escalate, and beginning in 2002, faced plummeting earnings. Those facts are undeniably established by the evidence -- and they are equally undeniably inconsistent with a claim that Nicor Gas’ base rates should be cut further.

⁷ CUB/CCSAO filed joint testimony. The AG filed separate testimony. However, the AG’s witness, at the direction of the AG’s counsel, included in his revenue requirement testimony and Schedules the impact of the rate of return and all but one of the revenue requirement adjustments proposed by CUB/CCSAO’s witnesses, the exception being the “uncollectibles reserve” adjustment discussed in subsection II(M) of this Initial Brief, even though the AG’s witnesses’ testimony did not provide any independent support for any of the CUB/CCSAO proposals. (*E.g.*, Gorenz Reb., Nicor Gas Ex. 26B.0, 53:1187 – 1195 (citing the AG’s witness’ response to a data request); Effron, Tr. 1133 – 1135, 1167 – 1168, 1169 – 1170) The “GCI” position referred to in certain of Nicor Gas’ rebuttal and surrebuttal testimony and herein reflects the positions taken by the AG adopting CUB/CCSAO positions, i.e., it reflects the combined impacts of their revenue requirement positions, except for CUB/CCSAO’s proposed uncollectibles reserve adjustment. Thus, as with the testimony, for consistency, Nicor Gas’ references to a “GCI” position herein omit the net impact of CUB/CCSAO’s proposed uncollectibles reserve adjustment.

Nicor Gas' proposed approaches to allocation of its revenue requirement to customer classes (rate designations) and to rate design are supported by some intervenors but are opposed by Staff and some other intervenors in various respects. Nicor Gas has concluded that for purposes of this case, in order to narrow the issues, it is willing to accept the determination of the allocation of its revenue requirement to customer classes based on the use of a revised version of its embedded cost of service study ("ECOSS"), employing the Average and Peak ("A&P") method including its Modified Distribution Main ("MDM") study, subject to the moderation of the rate increase in relation to its Rate 1, Residential Service, that is discussed primarily in the Overview subsection and subsections "A(1)", "A(2)", "B(4)", and "B(5)" of Section VI of this Initial Brief. (Harms Sur., Nicor Gas Ex. 44.0, 2:32 – 37, 5:109 – 6:116, 11:226 – 12:249; Nicor Gas Ex. 44.2, 44.3; Nicor Gas Ex. 42.1) Nicor Gas remains unwilling, however, to accept Staff's ECOSS, which makes arbitrary and unsubstantiated changes to peak day usage by class and inappropriately modifies the MDM study, and which, contrary to Staff's claim, is not consistent with the ICC's ruling in the 1995 Rate Case. (*Id.* at 2:37 – 3:53, 6:122 – 10:225, 11:238 – 12:249) Nicor Gas' compromise proposal is consistent with the evidentiary record and should be approved. Use of Staff's ECOSS, however, would be erroneous.

Nicor Gas proposed a sound rate design, which the evidence continues to support. Nicor Gas' proposal to set charges to collect the allocated revenue requirements based on marginal cost principles, especially in the setting of tail block charges for multi-blocked rates and in customer charges other than the Rate 1 customer charge, is well-founded, consistent with efficient ratemaking, balanced, and should be approved. (*E.g.*, Harms Sur., Nicor Gas Ex. 44.0, 3:56 – 4:75, 12:251 – 12:266; Nicor Gas Ex. 44.4, pages 9 – 14)

Nicor Gas also proposes both to recover uncollectible gas costs through its Rider 6 and to pass collected Hub gross revenues through Rider 6 as a partial offset (with Hub expenses collected in base rates), in response to which other parties have taken inconsistent supporting and opposing positions. Both proposals are amply supported by the evidence and should be approved, as is discussed in Sections II(O) and VI(B)(3) of this Initial Brief. The commodity-related portion of those uncollectibles expenses falls within both the statutory and regulatory rules governing the purchased gas adjustment (“PGA”) mechanism and Rider 6, 220 ILCS 5/9-220; 83 Ill. Admin. Code Part 525, and inclusion is just and reasonable for both Nicor Gas and its customers. Also, uncollectibles expenses independently meet the established criteria for a rider. While Nicor Gas believes it has properly allocated these credits and costs among customer groups, in any event, Nicor Gas’ proposed revenue treatment of commodity-related uncollectibles expense, collected Hub gross revenues, and Hub expenses should be accepted.

It should be noted that various Staff and intervenor proposals relating to Nicor Gas’ rate design and Rider 6 not only are unwarranted, but would unnecessarily increase Nicor Gas’ financial risks, by further jeopardizing the recovery of its revenue requirement in various respects, increasing the weather sensitivity of its base rates, and increasing its as well as its customers’ exposure to increased natural gas price volatility. (O’Connor Sur., Nicor Gas Ex. 34.0, 2:27 – 30, 7:160 – 10:226)

Finally, the evidence supports Nicor Gas’ proposals, not only with respect to cost allocations but also as to operational concerns and the need to manage on-system and upstream storage to efficiently operate the system. Various intervenors argue not only for a variety of different allocations of costs but also for other revisions to terms and conditions of service that reflect their own parochial interests. Each class of customer desires an allocation of distribution

costs, storage capacity, and the cost of storage, for example, that favors its own situation. The facts support Nicor Gas' proposals, and those proposals should be approved.

The foregoing issues, in greater detail, as well as all the other issues that are pending in this Docket, are addressed in this Initial Brief at the designated portions of the outline.

In sum, the Commission should approve Nicor Gas' proposed tariffs, subject to the proposed revisions that it has made or accepted as discussed in its rebuttal and surrebuttal testimony and exhibits and herein. The determination of the issues in this case must be consistent with law and based exclusively on the evidence in the record. 220 ILCS 5/10-103, 10-201(e)(iv); *Business and Professional People for the Public Interest v. Illinois Commerce Comm'n*, 136 Ill. 2d 192, 201, 227, 555 N.E.2d 693, 697, 709 (1989). The rates to be set in this case must be just and reasonable for Nicor Gas, its stockholders, and its customers. 220 ILCS 5/9-201(c); *Business and Professional People for the Pub. Interest v. Illinois Commerce Comm'n*, 146 Ill. 2d 175, 208, 585 N.E.2d 1032, 1045 (1991). Nicor Gas clearly has presented much more than a *prima facie* case, and not only has met, but has far exceeded, its burden of proof that its proposed tariffs, as revised, are just and reasonable. 220 ILCS 5/9-201(c); *Illinois Bell Tel. Co., v. Illinois Commerce Comm'n*, 327 Ill. App. 3d 768, 776, 762 N.E.2d 1117, 1123-1124 (3d Dist. 2002); *City of Chicago v. People of Cook County*, 133 Ill. App. 3d 435, 442-443, 478 N.E.2d 1369, 1375 (1st Dist. 1985). They should be approved.

I. INTRODUCTION

A. Nature of Operations

Nicor Gas is a natural gas LDC that serves a territory of approximately 17,000 square miles, that includes much of north and north-central Illinois, excluding the City of Chicago and certain suburbs served by affiliates of Peoples Energy. (McCain Dir., Nicor Gas Ex. 6.0, 3:49 –

59) By the end of the 2005 test year, Nicor Gas will be serving approximately 2,140,000 customers, of which approximately 1,950,000 will be residential users, and approximately 190,000 will be commercial, industrial, and other non-residential users. (*Id.* at 3:56 – 59) Nicor Gas is an Illinois utility regulated by the ICC and, to a lesser extent, the U.S. Department of Transportation, and the Federal Energy Regulatory Commission (“FERC”). (*Id.* at 3:50 – 53) Under its Illinois-jurisdictional tariffs, Nicor Gas provides sales service (*i.e.*, service that involves both the transportation of gas to the end user and the sales of the gas itself) and transportation services (*i.e.*, service that principally involves the movement and delivery of gas and, only incidentally if at all, the sale of gas itself). (*Id.* at 3:59 – 63)

To serve those customers and provide those services, Nicor Gas operates and maintains eight aquifer gas storage fields to provide supply flexibility and certainty, improve the reliability of deliveries, and mitigate the risks associated with seasonal price movements, among other things, and a system of natural gas distribution and transmission assets that allow Nicor Gas to take delivery of gas from interstate pipelines, move company-owned gas and gas owned by customers to and from Nicor Gas’ storage fields, move gas between and within the major areas of Nicor Gas’ service territory, control the flows of that gas, and, finally, reduce the pressure of that gas so that it may flow on local distribution gas mains and pipes. (McCain Dir., Nicor Gas Ex. 6.0, 3:64 – 4:75; Bartlett Dir., Nicor Gas Ex. 8.0, 4:77 – 87) Without these storage, transmission, and distribution facilities, Nicor Gas could not safely, efficiently, and reliably meet the service needs of its retail sales and transportation customers. (*Id.*)

B. Test Year

The Commission should approve Nicor Gas’ proposed forecasted 2005 test year. Nicor Gas presented uncontradicted evidence that its proposed forecasted 2005 test year is an

appropriate test year, and that it is the test year that best reflects, within the regulatory options available, the conditions and costs of Nicor Gas during the period in which the rates to be set will be in effect. (O'Connor Dir., Nicor Gas Ex. 1B.0, 4:79 – 97; Gordon Dir., Nicor Gas Ex. 2.0, 34:692 – 35:709; O'Connor Dir., Nicor Gas Ex. 11A.0, 1:16 – 18, 5:98 – 6:121) Neither Staff nor any intervenor presented any testimony proposing or supporting use of a different test year. (O'Connor Reb., Nicor Gas Ex. 26A.0, 2:35 – 39)

II. RATE BASE

Overview

The Commission should approve Nicor Gas' revised proposed net rate base of \$1,441,082,000 (*e.g.*, Nicor Gas Ex. 26B.1 at Revised Schedule B-1),⁸ for two overall reasons:

- First, Nicor Gas' extensive supporting evidence for its revised net rate base figure establishes fully and in detail the grounds for both the total amount and its components. The vast majority of that evidence is uncontradicted, and it is the most thorough, accurate, consistent, and reasonable evidence on this subject in the record. A summary "road map" to Nicor Gas' rate base evidence is set forth below in this Overview subsection of this Section II of this Initial Brief.
- Second, Staff and GCI,⁹ the only other parties to submit evidence on the subject of rate base, have presented no valid grounds for any reductions. Their respective proposed adjustments are selective, arbitrary, unwarranted, and inconsistent, as is discussed in subsections "B" through "M" of this Section II.

⁸ The figure of \$1,441,082,000 does not reflect an inadvertent understatement of net rate base by \$104,000. (Gorenz Reb., Nicor Gas Ex. 26B.0, 7:37 footnote 1)

⁹ The term "GCI" is defined in the Summary of this Initial Brief.

Nicor Gas Rate Base Evidence “Road Map”

Nicor Gas, in its direct case, submitted a wealth of evidence in support of its rate base. Nicor Gas presented a proposed net rate base of \$1,450,781,000, including detailed calculations and supporting Schedules. (*E.g.*, Gorenz Dir., Nicor Gas Ex. 11B.0, 3:55 – 58, 14:314 – 15:329; Nicor Gas Ex. 11B.1 at Schedules B-1, B-1.1, B-1.2, B-1.3, B-1.4, B-1.5, B-1.6, B-2, B-2.1, B-2.2, B-2.3, B-6, B-8, B-8.1, B-9, B-13, and B-14 (copies of selected key Nicor Gas “Schedule Bs”, the rate base schedules, filed as part of its submission under 83 Ill. Admin. Code Part 285 (“Part 285”)). Nicor Gas also presented detailed discussion of the processes by which it developed its capital budget and its forecast for 2005, which included its calculation of its proposed net rate base, and established that its forecasted financial statements and its summary of the assumptions underlying its forecast were examined by an independent Certified Public Accountant (“C.P.A.”), Deloitte & Touche LLP, in accordance with the requirements of 83 Ill. Admin. Code § 285.7010, and filed under Part 285. (*E.g.*, Gorenz Dir., Nicor Gas Ex. 11B.0, 7:142 – 9:203, 10:220 – 13:287, 16:354 – 17:365; D’Alessandro Dir., Nicor Gas Ex. 5.0, 12:238 – 250; McCain Dir., Nicor Gas Ex. 6.0, 11:240 – 12:250, 20:432 – 21:444)¹⁰

Nicor Gas presented the direct testimony of eight witnesses who supported in detail the proposed rate base and/or components thereof. (D’Alessandro Dir., Nicor Gas Ex. 5.0, 1:7 – 10, 2:25 – 30, 3:47 – 16:327; Nicor Gas Ex. 5.1 (Schedule F-4 of Nicor Gas’ submission under Part 285, 83 Ill. Admin. Code § 285.6100, regarding the largest additions to plant in service since Nicor Gas’ last general rate case); McCain Dir., Nicor Gas Ex. 6.0, 1:7 – 8, 1:10 – 16, 2:24 – 26, 10:213 – 21:455; Suppes Dir., Nicor Gas Ex. 7.0, 1:7 – 2:33, 3:55 – 63, 3:66 – 5:116, 6:125 –

¹⁰ Indeed, no Staff or intervenor witness presented any general criticism of how Nicor Gas developed its forecast. (Gorenz Reb., Nicor Gas Ex. 26B.0, 2:43-45, 10:208-217; Gorenz Sur., Nicor Gas Ex. 41.0, 7:141-151)

133, 8:157 – 9:181, 10:223 – 11:236, 12:256 – 267, 13:269 – 283, 16:338 – 23:500; Bartlett Dir., Nicor Gas Ex. 8.0, 1:21 – 26, 2:34 – 36, 4:77 – 87, 30:662 – 666, 31:685 – 39:860; Nicor Gas Ex. 8.3; Bacidore Dir., Nicor Gas Ex. 9.0, 1:8 – 12, 1:19 – 2:24, 13:290 – 15:323, 15:325 – 16:335, 17:355 – 360; J. Madziarczyk Dir., Nicor Gas Ex. 10.0, 1:12 – 20, 3:45 – 8:163; O’Connor Dir., Nicor Gas Ex. 11A.0, 2:45 – 49, 6:132 – 7:140, 14:314 – 16:345, 18:390 – 394, 19:402 – 20:447, 21:458 – 22:472, 22:480 – 23:510; and Gorenz Dir., Nicor Gas Ex. 11B.0, 1:9 – 14, 1:15, 1:19 – 3:58, 3:69 – 78, 6:124 – 9:203, 10:220 – 13:287, 14:314 – 15 – 329, 16:347 – 18 – 401, 20:448 – 22:479, 23:511 – 26:573; and Nicor Gas Ex. 11B.1, at Schedules B-1, B-1.1, B-1.2, B-1.3, B-1.4, B-1.5, B-1.6, B-2, B-2.1, B-2.2, B-2.3, B-6, B-8, B-8.1, B-9, B-13, and B-14, respectively) (*See also* Hawley Dir., Nicor Gas Ex. 1A.0, 6:164 – 169 (overview); O’Connor Dir., Nicor Gas Ex. 1B.0, 5:114 – 121, 9:236 – 10:281 (overview)) That direct testimony supports all elements of the “Schedule Bs”. Moreover, the direct testimony of four witnesses includes detailed support of each project in Schedule F-4. (D’Alessandro Dir., Nicor Gas Ex. 5.0, 11:230 – 237, 12:251 – 16:327; Nicor Gas Ex. 5.1; McCain Dir., Nicor Gas Ex. 6.0, 12:251 – 20:431; Suppes Dir., Nicor Gas Ex. 7.0, 16:338 – 22:500; Bartlett Dir., Nicor Gas Ex. 8.0, 32:705 – 38:837)¹¹

Nicor Gas also submitted rebuttal and surrebuttal evidence in support of its rate base. Nicor Gas, in its rebuttal testimony, presented and supported a revised proposed net rate base of \$1,441,082,000, including detailed calculations and supporting Schedules. (*E.g.*, Gorenz Reb.,

¹¹ Nicor Gas also provided extensive additional documentary and informational support for its proposed net rate base in its Part 285 submission. (*E.g.*, O’Connor Dir., Nicor Gas Ex. 1B.0, 21:579-582) For example, the work papers to Schedule G-1, 83 Ill. Admin. Code § 285.7005, include, among other things, Nicor Gas’ month-by-month capital budgets for 2002 through 2005, broken down into approximately 50 categories of spending, and Nicor Gas’ 55-page, single-spaced, detailed “2005 Budget Process Documentation” document. (*E.g.*, Gorenz Reb., Nicor Gas Ex. 11B.0, 12:268 - 13:271; Effron, Tr. 1149) For another example, Schedule G-5, 83 Ill. Admin Code § 285.7025, sets forth the earlier-referenced summary of assumptions used in the 2005 test year forecast. (AG Ex. 11 (Schedule G-5); Gorenz Reb., Nicor Gas Ex. 11B.0, 13:271-272)

Nicor Gas Ex. 26B.0, 6:114 – 118, 7:137 and footnote 1, 22:481 – 484; Nicor Gas Ex. 26B.1 at Revised Schedules B-1, B-2; O’Connor Reb., Nicor Gas Ex. 26A.0, 22:485 – 23:499)

There are only two differences between Nicor Gas’ original proposed net rate base of \$1,450,781,000 and its revised proposed net rate base of \$1,441,082,000. First, Nicor Gas corrected its figure for Accumulated Deferred Income Taxes (“ADIT”). (Gorenz. Reb., Nicor Gas Ex. 26B.0, 61:384; Nicor Gas Ex. 26B.1 at Revised Schedules B-1, B-2, and Schedule 1.02; O’Connor Reb., Nicor Gas Ex. 26A.0, 28:621 – 622, 62:1392 – 1396) Second, Nicor Gas updated its figures for the Gas in Storage rate base addition, and the associated adjustment to that figure, for changes in the price of natural gas as of February 7, 2005, the date as of which Staff chose to propose to update Nicor Gas’ rate of return. (Gorenz Reb., Nicor Gas Ex. 26B.0, 17:381 – 18:384, 43:952 – 957, 53:1196 – 1202; Nicor Gas Ex. 26B.1 at Revised Schedules B-1, B-2, and Schedule 1.01)

Nicor Gas, in its rebuttal, presented the testimony of five witnesses who supported in detail the revised proposed net rate base and/or components thereof. (O’Connor Reb., Nicor Gas Ex. 18B.0, 2:29 – 38, 3:51 – 4:87, 5:109 – 111, 5:112 – 6:123, 8:170 – 9:197, 11:231 – 13:282; D’Alessandro Reb., Nicor Gas Ex. 22.0, 1:7 – 5:111; Suppes Reb., Nicor Gas Ex. 23.0, 1:18 – 3:69; Nicor Gas Ex. 23.1; Bartlett Reb., Nicor Gas Ex. 24.0, 1:4 – 9, 2:38 – 7:146; O’Connor Reb., Nicor Gas Ex. 26A.0, *passim* (see, essentially, pages 1 to 73, other than portions stricken through and allocated to Nicor Gas Ex. 26B.0); Gorenz Reb., Nicor Gas Ex. 26B.0, *passim* (see, essentially, pages 1 to 73, other than portions stricken through and allocated to Nicor Gas Ex. 26A.0); Nicor Gas Ex. 26B.1 at Revised Schedules B–1, B-2, and Schedules 1.01, 1.02; Nicor Gas Ex. 26B.2 at Schedules 1.02, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11; Nicor Gas Ex, 26B.3 at Staff data request responses Nicor-SAS.2.12, Nicor-LAP.2.04; Nicor Gas Ex. 26B.4 at AG data

request responses Nicor-AG-2.05, Nicor-AG-2.06, Nicor-AG-2.07, Nicor-AG-2.09, Nicor-AG-2.10, Nicor-AG-2.11, Nicor-AG-2.12)

Finally, Nicor Gas, in its surrebuttal testimony, continued to support the revised proposed net rate base that it had presented in rebuttal. Nicor Gas presented the testimony of four witnesses who supported in detail the proposed rate base and/or components thereof. (O'Connor Sur., Nicor Gas Ex. 34.0, *passim*; Suppes Sur., Nicor Gas Ex. 38.0, 1:7 – 3:63; Bartlett Sur., Nicor Gas Ex. 39.0, 4:84 – 6:114; Gorenz Sur., Nicor Gas Ex. 41.0, *passim* through page 20)

Nicor Gas' revised net rate base of \$1,441,082,000 is reasonable in light of the fact that the Commission approved a net rate base of \$1,372,815,000 in Nicor Gas' last general rate case. *In re Northern Illinois Gas Co.*, Docket 95-0219, 1996 Ill. PUC Lexis 204 at ** 32, 156 – 157 (Finding 10) and Appendix at Schedules 1, 2, 3 (Order April 3, 1996). The fact that Nicor Gas is seeking a modestly higher net rate base than that approved in its last general rate case makes sense in light of its total capital expenditures since the last case, and their steadily increasing level. It is uncontested that Nicor Gas has invested roughly \$1.24 billion in capital projects since its last general rate case; that its gross plant, net plant, capital expenditures, and net capital additions have increased every year since 2000, and are forecasted to do so again in 2005; and that its 2005 capital expenditures now are forecasted to be \$1,500,000 over the 2005 budget level included in its original forecast, as is discussed further in subsections "B" and "C" of this Section II. (*E.g.*, O'Connor Reb., Nicor Gas Ex. 26A.0, 24:518 – 519; Nicor Gas Ex. 48; Gorenz Reb., Nicor Gas Ex. 26B.0, 14:300 – 309; Struck, Tr. 959 – 965, 969, 993 – 994) It also is uncontested that Nicor Gas' capital costs of providing adequate, safe, and reliable tariffed services have increased, despite its effective cost-control programs. (*E.g.*, Hawley Dir., Nicor

Gas Ex. 1A.0, 9:190 – 204, 9:212 – 10:235; O’Connor Reb., Nicor Gas Ex. 18B.0, 5:108 – 6:123; O’Connor Sur., Nicor Gas Ex. 34.0, 2:48 – 51, 5:121 – 127)

In summary, Nicor Gas’ revised proposed net rate base of \$1,441,082,000 is supported by thorough and proper budgeting and forecasting processes as is shown by overwhelming evidence, and its revised figure is reasonable when viewed in light of the figure approved in Nicor Gas’ last rate case, its steadily increasing capital expenditures, its increased capital needs in order to provide tariffed services, and its effective increase in ADIT discussed in subsection “I”. Staff’s and GCI’s respective proposed rate base adjustments are without merit. Nicor Gas’ revised figure should be approved.¹²

A. Uncontested Issues

The following facts regarding Nicor Gas’ overall costs of providing adequate, safe, and reliable tariffed services, including both capital costs and operating expenses, are uncontested:

- Nicor Gas has consistently performed at a high level of cost efficiency relative to other Illinois gas utilities. (*E.g.*, Gordon Dir., Nicor Gas Ex. 2.0, 9:173 – 183; *see also* Hawley Dir., Nicor Gas Ex. 1A.0, 6:166 – 174; O’Connor Reb., Nicor Gas Ex. 18B.0, 4:91 – 5:123; Gordon Reb., Nicor Gas Ex. 19.0, 17:395 – 18:412; O’Connor Sur., Nicor Gas Ex. 34.0, 2:441 – 43)

¹² Please note that if the Commission were to adopt any other party’s proposed adjustments to any revenue requirement items based on periods and dates prior to the 2005 test year, such as proposed adjustments based on balances as of December 31, 2004, then the Gas in Storage addition and the adjustment, discussed in subsection “G” of this Section II, appropriately, and in fairness, should be calculated as of March 31, 2005, as \$109,964,000 and \$20,911,000, respectively. (*E.g.*, Gorenz Reb., Nicor Gas Ex. 26B.0, 17:374 - 20:442; Nicor Gas Ex. 26B.2 at Schedule 2) That would increase net rate base accordingly.

- Nicor Gas also has performed at a higher level of efficiency than its peer national group of gas utilities. (*E.g.*, Gordon Dir., Nicor Gas Ex. 2.0, 9:173 – 183; Gordon Reb., Nicor Gas Ex. 19.0, 17:395 – 18:412)
- Nicor Gas currently has the lowest rates for gas delivery of any major Illinois gas utility. (*E.g.*, Gordon Dir., Nicor Gas Ex. 2.0, 9:173 – 183; *see also* Hawley Dir., Nicor Gas Ex. 1A.0, 6:166 – 174; O’Connor Reb., Nicor Gas Ex. 18A.0, 4:95 – 100; O’Connor Sur., Nicor Gas Ex. 34.0, 2:44 – 47)
- Nicor Gas’ low service costs have allowed it to offer very low delivery rates for over a decade. (*E.g.*, Gordon Dir., Nicor Gas Ex. 2.0, 9:173 – 183)
- Nicor Gas will continue to have the lowest delivery charges of any major Illinois gas utility if its proposed rates are allowed to go into effect. (*E.g.*, Gordon Dir., Nicor Gas Ex. 2.0, 31:618 – 629)
- Nicor Gas’ proposed revenue requirement includes no costs or recoveries for its Mercury Inspection and Repair Program. (*E.g.*, D’Alessandro Dir., Nicor Gas Ex. 5.0, 20:414 – 417; Gorenz Dir., Nicor Gas Ex. 11B.0, 24:534 – 25:539, 25:548 – 26:561; Nicor Gas Ex. 11B.1 at Schedules B-1, B-2, B-2.1)

The following additional facts regarding Nicor Gas’ rate base, in particular, also are uncontested:

- Nicor Gas is permitted under the ICC’s rules to propose use of an end-of-year rate base with its forecast test year in this rate case. (*E.g.*, O’Connor Reb., Nicor Gas Ex. 26A.0, 25:552 – 555, 29:644 – 30:656)
- Nicor Gas has invested roughly \$1.24 billion in capital projects since its last general rate case. (*E.g.*, O’Connor Reb., Nicor Gas Ex. 26A.0, 24:518 – 519)

- Nicor Gas’ gross plant, net plant, capital expenditures, and net capital additions have increased every year since 2000, and are forecasted to do so again in 2005. (*E.g.*, O’Connor Reb., Nicor Gas Ex. 26A.0, 24:518 – 519; Nicor Gas Ex. 48; Gorenz Reb., Nicor Gas Ex. 26B.0, 14:300 – 309; Struck, Tr. 959 – 965, 969, 993 – 994)
- Nicor Gas’ 2005 capital expenditures now are forecasted to be \$1,500,000 over the 2005 budget level included in its original forecast. (*E.g.*, Gorenz Reb., Nicor Gas Ex. 26B.0, 14:300 – 309)
- Nicor Gas’ capital costs of providing adequate, safe, and reliable tariffed services have increased, despite its effective cost-control programs. (*E.g.*, Hawley Dir., Nicor Gas Ex. 1A.0, 9:190 – 204, 9:212 – 10:235; O’Connor Reb., Nicor Gas Ex. 18B.0, 5:108 – 6:123; O’Connor Sur., Nicor Gas Ex. 34.0, 2:48 – 51, 5:121 – 127)
- Nicor Gas’ proposed rate base includes 18 capital projects that qualify under Schedule F-4 of Part 285 as major additions to Gross Utility Plant since its last general rate case -- each of these projects is prudent, reasonable, and used and useful in providing tariffed services, and the costs of each of these projects are prudent and reasonable.¹³ (*E.g.*, D’Alessandro Dir., Nicor Gas Ex. 5.0, 11:230 – 237, 12:251 – 16:327; Nicor Gas Ex. 5.1; McCain Dir., Nicor Gas Ex. 6.0, 12:251 – 20:431; Suppes Dir., Nicor Gas Ex. 7.0, 16:338 – 22:500; Bartlett Dir.,

¹³ Staff contests \$389,000 of the costs of one of these 18 projects, and \$522,000 of the costs of another of these 18 projects, on (invalid) grounds that do not call into question the prudence and reasonableness of these costs, as is discussed in subsections “E” and “F” of this Section II.

Nicor Gas Ex. 8.0, 32:705 – 38:837; *see also, e.g.,* O’Connor Reb., Nicor Gas Ex. 26A.0, 27:600 – 606)

- Nicor Gas’ deduction from rate base (Gross Utility Plant) as a result of its proposed updates of service pipe extension charges should be \$12,000. (*E.g.,* Gorenz Dir., Nicor Gas Ex. 11B.0, 26:569 – 573; Nicor Gas Ex. 11B.1 at Schedules B-1, B-2, B-2.3)
- Nicor Gas’ addition to rate base for Materials and Supplies should be \$4,313,000. (*E.g.,* Gorenz Dir., Nicor Gas Ex. 11B.0, 18:390 – 394, 21:448 – 454; Nicor Gas Ex. 11B.1 at Schedule B-1)¹⁴
- Nicor Gas’ deduction from rate base for the Reserve for Injuries and Damages should be \$1,597,000. (*E.g.,* Gorenz Dir., Nicor Gas Ex. 11B.0, 21:458 – 468, 24:534 – 25:539; Nicor Gas Ex. 11B.1 at Schedule B-1)
- Nicor Gas’ net rate base in this Docket would be \$66,469,557 higher than what it now is proposing were it not for Nicor Gas’ election in 2003 under Section 263A of the Internal Revenue Code (“IRC”), as is discussed further in subsection “I” of this Section II.

¹⁴ Staff, in its direct testimony, proposed adjustments to five rate base items -- Materials and Supplies, Customer Deposits, Budget Payment Plan, Regulatory Tax Liability, and the Reserve for Injuries and Damages -- that it withdrew in rebuttal, one of which adjustments (the first) would have increased rate base, and three of which (the second, third, and fifth) would have decreased net rate base (the fourth had no net impact, the sum of all five was a net decrease). (Ebrey Dir., Staff Ex. 2.0, 3:44-54, 4:71 - 6:111 and Schedules 2.01, 2.03, 2.04, 2.05, 2.06; Ebrey Reb. Staff Ex. 11.0 Revised, 3:53 - 4:65)

B. Year-End or Average Rate Base Methodology¹⁵

Nicor Gas has referenced in the Overview subsection, above, its comprehensive, careful budgeting and forecasting processes for the 2005 test year, including the calculation of its net rate base, as is supported by an extensive body of testimony and exhibits. Nicor Gas also noted the absence of any evidence presenting any general criticism of how it developed its forecast.

Nicor Gas' proposed net rate base is based on its forecast of all components of its rate base as of December 31, 2005, except for the three rate base items that it calculated based on its forecast of the 13 month average ending on that date, i.e., Materials and Supplies, Gas in Storage, and the Budget Payment Plan. (*E.g.*, Gorenz Dir., Nicor Gas Ex. 11B.0, 16:354 – 357, 17:366 – 372, 21:458 – 68; Nicor Gas Ex. 11B.1 at Schedule B-1; O'Connor, Nicor Gas Ex. 11A.0, 19:402 – 413) As previously noted, it is uncontested that, under the Commission's rules, Nicor Gas is permitted to propose an end-of-year rate base with its forecast test year in this rate case. (*E.g.*, O'Connor Reb., Nicor Gas Ex. 26A.0, 25:552 – 555, 29:644 – 30:656) Moreover, Staff agrees that it is appropriate to calculate those three items based on a 13 month average. (*E.g.*, Struck Dir., Staff Ex. 1.0, 7:124 – 127; Struck, Tr. 954 – 955)

Despite the foregoing, Staff witness Mr. Struck proposes that the Commission base the determination of all rate base items, except for the three items calculated using a 13 month average, based not on the forecast as of December 31, 2005, but on the average of the forecasts as of December 31, 2004, and December 31, 2005, resulting in a proposed downward rate base

¹⁵ Based on the ALJs' order of May 31, 2005, establishing the briefing outline, the ruling regarding submission of proposed orders, and the nature of the issues in this rate case, Nicor Gas' understanding and belief is that it is not appropriate to attempt to divide the discussion of the issues into separate subsections for statements of facts and arguments as forth in the ALJs' order of January 14, 2005, and that to attempt to do so would require this Initial Brief to be very substantially longer, with extensive repetition. Nicor Gas has provided appropriate and extensive record and legal citations for its statements, organized by issue as provided in the order of May 31, 2005. Nicor Gas believes that this structure provides the clearest presentation of the issues. Also, Nicor Gas' proposed order will reflect the parties' respective factual positions with appropriate citations.

adjustment of \$40,069,000.¹⁶ (Struck Dir., Staff Ex. 1.0, 6:114 – 9:179 and Schedule 1.08; Struck Reb., Staff Ex. 10.0 Revised, 6:102 – 21:406 and Schedule 10.08 Revised and Attachments A and B) Mr. Struck’s proposed “average rate base” adjustment is just plain wrong, for several reasons.

First, Staff’s proposed adjustment by its very nature inherently denies recovery of substantial prudent and reasonable costs that Nicor Gas already has incurred or will incur this year that are used and useful in order to provide adequate, safe, and reliable tariffed services to customers this year and going forward. (O’Connor Reb., Nicor Gas Ex. 26A.0, 25:548 – 551, 26:563 – 28:643; O’Connor Sur., Nicor Gas Ex. 34.0, 12:281 – 285, 13:297 – 305)

Staff’s proposed adjustment directly denies recovery of \$17,537,000 of net plant. (Struck Reb., Staff Ex. 10.0 Revised, Schedule 10.08 Revised) \$16,700,000 of that \$17,537,000 is attributable to Staff’s methodology’s effectively allowing Nicor Gas to recover only one half of the 2005 capital costs of the capital projects on Schedule F-4. (O’Connor Reb., Nicor Gas Ex. 26B.0, 28:610 – 613) As noted earlier, it is an uncontested fact that the Nicor Gas capital projects on Schedule F-4 of Part 285 are prudent, reasonable, and used and useful in providing tariffed services, and that the costs of each of these projects are prudent and reasonable.¹⁷ (*E.g.*, D’Alessandro Dir., Nicor Gas Ex. 5.0, 11:230 – 237, 12:251 – 16:327; Nicor Gas Ex. 5.1;

¹⁶ The figure of \$40,069,000 for Staff’s proposed “average rate base” adjustment is the impact of the proposed adjustment on net rate base. Staff in its revised rebuttal testimony presented final calculations of this and each of its other proposed rate base adjustments, including their impacts on the Accumulated Reserve for Depreciation and Amortization (the “Depreciation Reserve”), ADIT, and depreciation expense. (Struck Reb., Staff Ex. 10.0 Revised, Schedules 10.01 Revised through 10.08 Revised) While none of Staff’s proposed rate base adjustments is warranted, Nicor Gas does not contest Staff’s computation as the amounts of these adjustments, including their impacts on the Depreciation Reserve, ADIT, and depreciation expense, except for one error discussed in subsection “J” of this Section II. For that reason, Nicor Gas, in the remainder of this Section II, in discussing this and each of Staff’s other proposed rate base adjustments, will reference only the impact on net rate base.

¹⁷ See *supra* note 8 and subsections “E” and “F” of this Section II.

McCain Dir., Nicor Gas Ex. 6.0, 12:251 – 20:431; Suppes Dir., Nicor Gas Ex. 7.0, 16:338 – 22:500; Bartlett Dir., Nicor Gas Ex. 8.0, 32:705 – 38:837; *see also, e.g.*, O’Connor Reb., Nicor Gas Ex. 26A.0, 27:600 – 606) The remaining \$837,000 of net plant that Mr. Struck’s proposed adjustment would directly deny the recovery of also has not been questioned as to its prudence, reasonableness, or used and usefulness.

Staff’s proposed adjustment indirectly denies recovery of another \$22,532,000 of net plant, because the remainder of the proposed adjustment is due entirely to an increase in ADIT that is subtracted from net plant in calculating net rate base. (O’Connor Reb., Nicor Gas Ex. 26A.0, 28:614 – 29:635; Struck Reb., Staff Ex. 10.0 Revised, Schedule 10.08 Revised; *see also* Struck, Tr. 965 – 966, 975) That \$22,532,000 of net plant that is being deducted also has not been questioned as to its prudence, reasonableness, or used and usefulness.

It should be noted that that increase in ADIT is in turn due entirely to the fact that Mr. Struck’s methodology has the unreasonable effect of disallowing half of the impact of Nicor Gas’ estimated resolution of the IRS review relating to the election under Section 263A of the IRC. (O’Connor Reb., Nicor Gas Ex. 26A.0, 28:614 – 29:635) Nicor Gas’ inclusion of the entire amount of the estimated resolution in its rate base is fully warranted, as is discussed in subsection “I” of this Section II.

Mr. Struck asserts that his methodology does not disallow particular rate base items (Struck Reb., Staff Ex. 10.0 Revised, 6:118), but that, in a sense, is the very problem with his approach -- it identifies no rate base item that is imprudent, unreasonable, or unnecessary, and yet it has the effect of disallowing prudent, reasonable, and necessary items. (O’Connor Sur., Nicor Gas Ex. 34.0, 13:297 – 305)

Second, as noted above, it is uncontested that Nicor Gas, under the Commission's rules, is permitted to propose using, end-of-year rate base with its 2005 forecast test year. Indeed, Mr. Struck agrees. (Struck Reb., Staff Ex. 10.0 Revised, 8:145 – 150)

Third, because the rates to be set in this case likely will go into effect in early or mid-October 2005 and likely will remain in effect for at least some years, it is illogical and unfair to chose to calculate these rate base items based on an average of their balances as of the ends of 2004 and 2005. (O'Connor Reb., Nicor Gas Ex. 26A.0, 25:556 – 559, 30:657 – 32:707; O'Connor Sur., Nicor Gas Ex. 34.0, 12:277 – 281) Nicor Gas' end-of-year rate base methodology both logically and in fact leads to a result that is more representative, than the arbitrarily reduced net rate base that results from Mr. Struck's methodology, of the net rate base that Nicor Gas will have during the period in which the rates to be set in this case will be in effect. (O'Connor Reb., Nicor Gas Ex. 26A.0, 25:556 – 559, 30:657 – 32:707; D'Alessandro Reb., Nicor Gas Ex. 22.0, 5:99 – 111; O'Connor Sur., Nicor Gas Ex. 34.0, 12:277 – 281, 14:317 – 16:360) Neither Staff nor any other party has presented any evidence contrary to Nicor Gas' evidence that Nicor Gas' revised proposed net rate base is in fact more representative of Nicor Gas' net rate base going forward.

Indeed, as noted earlier, it is uncontested that Nicor Gas has invested roughly \$1.24 billion in capital projects since its last general rate case; that its gross plant, net plant, capital expenditures, and net capital additions have increased every year since 2000, and are forecasted to do so again in 2005; and that its 2005 capital expenditures now are forecasted to be \$1,500,000 over the 2005 budget level included in its original forecast. (E.g., O'Connor Reb., Nicor Gas Ex. 26A.0, 24:518 – 519; Nicor Gas Ex. 48; Gorenz Reb., Nicor Gas Ex. 26B.0, 14:300 – 309; Struck, Tr. 959-965, 969, 993-994)

Finally, Mr. Struck's average rate base methodology is arbitrary and is not supported by any analysis of the rate base components at issue other than his simple averaging methodology itself. (O'Connor Reb., Nicor Gas Ex. 26A.0, 25:560 – 562, 32:708 – 34:768; O'Connor Sur., Nicor Gas Ex. 34.0, 13:294 – 296, 13:309 – 16:360) Mr. Struck's argument that his methodology leads to "better matching" of rate base with test year operating expenses is unclear in its meaning, fails to identify any actual purpose served by such "better matching", and "proves too much" because it applies equally to historical test year cases where the Commission routinely approves end-of-year rate bases. (O'Connor Reb., Nicor Gas Ex. 26.0, 32:708 – 33:726; O'Connor Sur., Nicor Gas Ex. 34.0, 15:340 – 16:360) Mr. Struck's "better matching" argument simply is incorrect, in any event, because his methodology has no variable for when investment occurs during the test year. (*See Struck*, Tr. 955 – 957) Mr. Struck's proposed average rate base adjustment is without merit and should be rejected.

C. Utility Plant Balance

1. Staff's Proposed Capital Expenditures Adjustment

Staff witness Mr. Griffin, based on a raw simple average of Nicor Gas' capital budget versus actual capital expenditure variances, expressed as percentages, from 1998 to 2003, has proposed a 3.3% reduction to budgeted capital expenditures for each of 2004 and 2005, which would result in a downward adjustment to net plant, and thus to net rate base, of \$8,742,000. (Griffin Dir., Staff Ex. 4.0, 3:47 – 4:68 Corrected and Schedule 4.01; Struck Reb., Staff Ex. 10.0 Revised, Schedules 10.01 and 10.04 Revised) Mr. Griffin's proposed adjustment suffers from numerous fundamental defects.

Nicor Gas presented detailed rebuttal testimony on why Mr. Griffin's proposal is inappropriate and unreliable from both a budgeting and forecasting perspective and from an

operational perspective. (D'Alessandro Reb., Nicor Gas Ex. 22.0, 1:21 – 4:75; Gorenz Reb., Nicor Gas Ex. 26B.0, 35:783 – 790, 36:793 – 36:804) Mr. Griffin's rebuttal ignored most of the points made on these subjects, and presented no meaningful or reasonable response to the rest. (See Griffin Reb., Staff Ex. 13.0, 2:21 – 3:50) Moreover, he stated that he is not suggesting that Nicor Gas make any changes to its forecasting procedure for capital expenditures. (*Id.* at 2:28 – 29)

Nicor Gas also demonstrated in its rebuttal testimony that Mr. Griffin's proposal is arbitrary and ignores the relevant facts regarding the variances on which his methodology is based. (Gorenz Reb., Nicor Gas Ex. 26B.0, 35:790 – 36:792, 36:805 – 38:485; Nicor Gas Ex. 26B.2, Schedule 3.0) Nicor Gas pointed out that, had Mr. Griffin chosen a five, four, three, or two year average, then his methodology would have produced a much smaller proposed disallowance or would have supported an increase to Nicor Gas' plant balance. (Gorenz Reb., Nicor Gas Ex. 26B.0, 36:807 – 37: 818) Nicor Gas also demonstrated that, if Mr. Griffin's methodology were to be adjusted for two atypical significant mid-year project cancellations in 1998 and 2002, then it also would support an increase to Nicor Gas' plant balance. (*Id.* at 37:819 – 38:845) Mr. Griffin's 1998 data point alone, which was not adjusted for the 1998 cancellation, causes 87.94% of his proposed adjustment. (See Griffin Dir., Staff Ex. 4.0, Schedule 4.08) Mr. Griffin's rebuttal, on these points, too, presented no meaningful or reasonable response. (See Griffin Reb., Staff Ex. 13.0, 3:41 – 4:67) Mr. Griffin's rebuttal essentially seemed to take the position that no facts other than his six data points are relevant, because it is the purpose of his adjustment to do nothing more or less than determine the raw simple average of Nicor Gas' capital budget versus actual capital expenditure variances,

expressed as percentages, from 1998 to 2003. (*See* Griffin Reb., Staff Ex. 13.0, 3:41 – 4:67) That only confirms the capricious nature of his approach.

Nicor Gas’ rebuttal testimony also pointed out that its 2005 capital expenditures currently are forecasted to exceed its budgeted capital expenditures by \$1,500,000. (Gorenz Reb., Nicor Gas Ex. 26B.0, 13:288 – 14:309; *see also* D’Alessandro Reb., Nicor Gas Ex. 22.0, 4:70 – 75) Mr. Griffin’s rebuttal ignored that point.

Nicor Gas’ surrebuttal testimony also catalogued in detail numerous fundamental flaws of Mr. Griffin’s proposed adjustment. (Gorenz Sur., Nicor Gas Ex. 41.0, 9:180 – 12:249)

Finally, Mr. Griffin on cross-examination made many admissions that further confirmed and illustrated that his adjustment is arbitrary and has no valid basis.

- Mr. Griffin confirmed the randomness of the inquiry underlying his selection of a six year data set starting in 1998. (Griffin, Tr. 1095 and Nicor Gas Ex. 51; *see also* Griffin Reb., Staff Ex. 13.0, 4:57 – 59)
- He acknowledged that his methodology weighted all years from 1998 to 2003 equally, and was not weighted for dollar amounts. (Griffin, Tr. 1100 – 1101)
- He agreed that his 1998 data point showed a variance more than twice as high as that in any other year. (Griffin, Tr. 1101 – 1102)
- Mr. Griffin, when asked to confirm that his methodology placed zero weight on Nicor Gas’ forecasted capital additions for 2004 and 2005, responded: “Well, of course, that’s the point.” (Griffin, Tr. 1095)
- Mr. Griffin repeatedly sought to rationalize his admitted failure to investigate and consider the causes of the variances underlying his proposed adjustments, but his

rationalizations were unreasonable, as well as contrary to his response to a data request. (Griffin, Tr. 1102 – 1106 and Nicor Gas Ex. 53)

- He agreed that his testimony contains no data regarding Nicor Gas' capital needs. (Griffin, Tr. 1108 – 1109)
- Finally, he agreed that if he had chosen a five, four, three, or two year average, then his methodology would have produced a much smaller proposed disallowance or would have resulted in a positive average. (Griffin, Tr. 1109 – 1110 and Nicor Gas Ex. 54)

Mr. Griffin's proposed adjustment should be rejected.

2. The AG's Proposed Net Capital Additions And 2004 Year-End Balance Adjustments

AG witness Mr. Effron proposes to use an average of Nicor Gas' net plant additions in the years 2002, 2003, and 2004, and to substitute the actual 2004 year-end total plant balance for the forecasted 2004 year-end total plant balance, together resulting in a proposed downward adjustment of \$14,196,000 to net plant and, thus to net rate base.¹⁸ (Effron Dir., AG Ex. 1.0, 4:12 – 6:18 and Schedules B and B-1) Mr. Effron's proposed adjustments are without merit.

Mr. Effron's proposed net capital additions adjustment suffers from much the same flaws as Mr. Griffin's proposed capital expenditures adjustment, discussed in the previous subsection, from both a budgeting and forecasting perspective and an operational perspective, is arbitrary, and ignores the impacts of any infrequent and non-recurring events, including the 2002 variance noted earlier in relation to Mr. Griffin's proposed adjustment. (D'Alessandro Reb., Nicor Gas

¹⁸ Mr. Effron addressed the impacts of his proposed adjustments on the Depreciation Reserve and depreciation expense but appears not to have addressed the impacts on ADIT.

Ex. 22.0, 4:77 – 5:97; Gorenz Reb., Nicor Gas Ex. 26B.0, 38:846 – 862; Nicor Gas Ex. 26B.4 at the AG’s responses to data requests Nicor-AG-2.05, 2.06, and 2.07; Gorenz Sur., Nicor Gas Ex. 41.0, 12:250 – 13:270)

Mr. Effron’s assertion that Nicor Gas has done little “to explain the reasons for the increase it is forecasting for 2005” (Effron Reb., AG Ex. 1.3, 7:12–13) is nonsense, as is shown not only by Nicor Gas’ evidence but also by Mr. Effron’s admissions. (*E.g.*, Gorenz Dir., 7:142 – 9:203, 10:220 – 11:245; Gorenz Reb., Nicor Gas Ex. 26.0, 12:261 – 13:272, 38:850 – 854; Gorenz Sur., Nicor Gas Ex. 41.0, 12:258 – 264; Effron, Tr. 1147 – 1149) Mr. Effron has acknowledged that his claim of a “demonstrated tendency” of Nicor Gas to overestimate capital additions (Effron Reb., AG Ex. 1.3, 7:13 – 14) relies entirely upon Mr. Griffin’s proposed capital expenditures adjustment (Effron, Tr. 1149 – 1150), which has been shown, above, not to support any such conclusion. Mr. Effron also acknowledged that his proposed adjustment used a level of net capital additions lower than the actual level for the two most recent years in his three year average, 2002 and 2003, although he sought to minimize this fact. (Effron Reb., AG Ex. 1.3, 7:18 – 8:14) Mr. Effron’s proposed net capital additions adjustment should be rejected.

Mr. Effron’s 2004 year-end plant balances adjustment also is without merit. As Nicor Gas has explained, in detail, Mr. Effron has presented no valid grounds for rejecting Nicor Gas’ forecasted plant balances as of December 31, 2005, based on the actual plant balance as of December 31, 2004. (O’Connor Reb., Nicor Gas Ex. 26A.0, 15:332 – 16:343, 16:354 – 17:364, 38:863 – 40:891; *see also* O’Connor Reb., Nicor Gas Ex. 26A.0, and Gorenz Reb., Nicor Gas Ex. 26B.0, in combination, at 10:208 – 20:442, regarding how Nicor Gas approached its review of its forecast in light of Staff’s and GCI’s proposed adjustments and updated data) His 2004 year-end plant balances adjustment also should be rejected.

D. Accumulated Depreciation (Depreciation Reserve)

Nicor Gas has correctly calculated its Depreciation Reserve as of December 31, 2005. (E.g., Gorenz Dir., Nicor Gas Ex. 11B.0, 17:367 – 372; Nicor Gas Ex. 11B.1 at Schedule B-6; Gorenz Reb., Nicor Gas Ex. 26B.0, 41:922 – 928)

Staff witness Mr. Griffin’s proposed adjustment to decrease the Depreciation Reserve by \$562,000, and thus to increase net rate base by the same amount, is derivative of his three proposed plant adjustments. (Griffin, Staff Ex. 4.0, 6:125 – 131; Griffin, Staff Ex. 13.0, 6:100 – 106 and Schedule 13.01) Those three plant adjustments are without merit, as shown in subsections “C(1)”, “E”, and “F” of this Section II, and accordingly, those adjustments and the derivative adjustment to the Depreciation Reserve should be rejected.

AG witness Mr. Effron’s proposed adjustment to increase the Depreciation Reserve by \$12,097,000, and thus to decrease net rate base by the same amount, is derivative of his proposed net capital additions and 2004 year-end plant balances adjustments, a parallel use of his three year averaging methodology from the former adjustment as to certain other depreciation, and a parallel use of his 2004 year-end balance methodology from the latter adjustment as to the Depreciation Reserve. (Effron Dir., AG Ex. 1.0, 6:21 – 8:6 and Schedule B-2) Those adjustments, and those methodologies, are without merit, as discussed in subsection “C(2)” of this Section II, and accordingly those adjustments and the derivative and parallel adjustments to the Depreciation Reserve should be rejected.

E. Daily Metering Project

Nicor Gas has included in its rate base the capital costs associated with its Daily Metering Project, which involved Nicor Gas’ provision of daily metering for transportation customers selecting variable backup, and which is one of the projects on Schedule F-4. (Suppes Dir., Nicor

Gas Ex. 7.0, 16:351 – 17:374; Nicor Gas Ex. 5.1) The project, which went into service over the period between 1995 and 1997, is prudent, reasonable, and used and useful, and its costs are prudent and reasonable. (*Id.*; Suppes Reb., Nicor Gas Ex. 23.0, 1:18 – 2:27)

Staff witness Mr. Griffin has proposed disallowing \$389,000 from net rate base on the theory that Nicor Gas violated its own budgeting policy, as to approvals for upward cost variances of at least \$200,000, with respect to the project in the amount of \$389,000. (Griffin Dir., Staff Ex. 4.0, 4:69 – 6:106) There is no merit to Mr. Griffin’s claim. To begin with, even if Mr. Griffin were right about his personal reading of the Nicor Gas policy on which he relies, but which he did not attach to his testimony, that would not be a basis for disallowing prudent and reasonable costs of a prudent, reasonable, and used and useful project. (Suppes Reb., Nicor Gas Ex. 23.0, 1:18 – 2:53; Suppes Sur., Nicor Gas Ex. 38.0, 1:14 – 2:48) In any event, Mr. Griffin is wrong. Nicor Gas completed the project within the authorized budget, and it was in fact \$131,000 under budget when overheads are excluded, as they should be and are under Nicor Gas’ written policies and its long-established, consistent practices. (Suppes Reb., Nicor Gas Ex. 23.0, 2:28 – 3:53; Suppes Sur., Nicor Gas Ex. 38.0, 1:14 – 3:48) Nicor Gas’ practice of separating direct costs and overhead costs is consistent with its capital budgeting process work papers and with the policy that Mr. Griffin cites, and Mr. Griffin acknowledges that Nicor Gas’ practice is, and historically has been, consistent with its interpretation of that policy. (Suppes Reb., Nicor Gas Ex. 23.0, 2:28 – 3:53; Suppes Sur., Nicor Gas Ex. 38.0, 2:23 – 44; Griffin Reb., Staff Ex. 13.0, 4:73) It is simply arbitrary and unreasonable for Mr. Griffin to insist on his personal reading of the policy in the face of its language, Nicor Gas’ capital budgeting process work papers, and Nicor Gas’ consistent current and past interpretations over many years of the

policy on which he relies. (Suppes Reb., Nicor Gas Ex. 23.0, 2:28 – 3:53; Suppes Sur., Nicor Gas Ex. 38.0, 2:23 – 44) Mr. Griffin’s proposed adjustment should be rejected.

F. Mainframe Project

Nicor Gas has included in 2005 rate base \$4,700,000 in capital costs for the Mainframe Project, which involved replacement of Nicor Gas’ 1992 mainframe computer. (Suppes Dir., Nicor Gas Ex. 7.0, 17:375 – 18:390; Nicor Gas Ex. 5.1) The project, which is a 2005 project, is prudent, reasonable, and used and useful, and its costs are prudent and reasonable. (*Id.*)

Staff witness Mr. Griffin has proposed disallowing \$522,000 from 2005 net rate base stemming from an early purchase discount associated with this project obtained in late 2004. (Griffin Dir., Staff Ex. 4.0, 6:107 – 113 and Schedule 4.03) Mr. Griffin’s proposal should not be adopted. Nicor Gas has discussed in the Overview subsection and in subsections “B” and “C(1)” of this Section II the extensive evidence in support of its forecasting process, and the fact that no Staff or intervenor witness has identified any general criticism of the forecasting process. Mr. Griffin’s identification of one instance in 2004 where Nicor Gas realized an early purchase discount that resulted in a specific project being under budget does not justify a corresponding reduction in Nicor Gas’ forecasted December 31, 2005, Gross Utility Plant balance. (Suppes Reb., Nicor Gas Ex. 23.0, 3:55 – 4:69; Suppes Sur., Nicor Gas Ex. 38.0, 3:50 – 63) Indeed, Mr. Griffin’s testimony did not present any analysis of whether any other project on Schedule F-4, or any other 2005 project, was above, at, or under budget. As noted earlier, it is uncontested that Nicor Gas’ 2005 capital expenditures currently are forecasted to exceed its budgeted capital expenditures by \$1,500,000. (Gorenz Reb., Nicor Gas Ex. 26B.0, 13:288 – 14:309; *see also* D’Alessandro Reb., Nicor Gas Ex. 22.0, 4:70 – 75) Mr. Griffin’s proposed adjustment should be rejected.

G. Gas In Storage

Nicor Gas correctly calculated the Gas in Storage addition to rate base as \$106,867,000, and the adjustment related to a proposed rate design change as \$18,453,000, both updated for changes in the price of natural gas as of February 7, 2005, the date as of which Staff chose to propose to update Nicor Gas' rate of return. (*E.g.*, Gorenz Dir., Nicor Gas Ex. 11B.0, 18:395 – 401; Nicor Gas Ex. 11B.1 at Schedules B.1, B-1.1; Gorenz Reb., Nicor Gas Ex. 26B.0, 17:374 – 20:442, 43:952 – 957; Nicor Gas Ex. 26B1 at Revised Schedules B-1, B-2) Staff, which originally proposed an adjustment to the Gas in Storage addition, withdrew that proposal and now accepts Nicor Gas' updated figures for both the addition and the adjustment. (Maple Reb., Staff Ex. 15.0, 1:11 – 2:28; Struck Reb., Staff Ex. 10.0 Revised, Schedule 10.03 Revised)

1. 13 Month Average For Computing Gas In Storage

Nicor Gas used a 13 month average to calculate the Gas in Storage addition to rate base, originally \$98,724,000, and updated in rebuttal to \$106,867,000. (Gorenz Dir., Nicor Gas Ex. 11B.0, 18:390 – 401; Nicor Gas Ex. 11B.1 at Schedule B-1; Gorenz Reb., Nicor Gas Ex. 26B.0, 45:1011 – 46: 1018, 53:1196 – 54:1202; Nicor Gas Ex. 26B.1 at Revised Schedule B-1 and Schedule 1.01) Staff accepts both this methodology and the updated figure. (*E.g.*, Struck Reb., Staff Ex. 10.0 Revised, Schedules 10.03 Revised, 10.08 Revised)

CUB/CCSAO witness Mr. Mierzwa, however, has proposed using a 12 month average instead, which would reduce the Gas in Storage addition by \$11,469,000.¹⁹ (Mierzwa,

¹⁹ Please note that Mr. Mierzwa's three proposed adjustments to the Gas in Storage addition, discussed in this and the next two subsections, in combination would reduce it by a total of \$164,776,891, approximately 167% of what Nicor Gas originally proposed. (Mierzwa Dir., CUB/CCSAO Ex. 2.0, 13:289-291; CUB/CCSAO Ex. 2.1) The figure of \$11,469,000 that appears above is Nicor Gas' current interpretation of the portion of the aggregate \$164,776,891 that is attributable to this adjustment, a separate figure is not expressly broken out by Mr. Mierzwa's testimony and schedules. The same is true of the figure of \$57,999,286 that Nicor Gas identifies below with regard to the third adjustment.

CUB/CCSAO Ex. 2.0, 11:242 – 243, 12:276 – 284) Mr. Mierzwa’s proposal is specious. The 13 month averaging methodology is appropriate, is more accurate than a 12 month average, and is the same method used and approved by the Commission in Nicor Gas’ last general rate case and in numerous other proceedings. (Gorenz Dir., Nicor Gas Ex. 11B.0, 18:390 – 401; Gorenz Reb., Nicor Gas Ex. 26B.0, 45:1011 – 46:1018, 47:1046 – 1047, 51:1148 – 52:1164; Gorenz Sur., Nicor Gas Ex. 41.0, 16:343 – 352) A 13 month average is more representative of the average balance for an entire calendar year, as it better approximates the daily balances of each day of that year, while a 12 month average approximates only the average of each daily balance from January 31 to December 31 and thus improperly ignores the opening balance of the year. (Gorenz Reb., Nicor Gas Ex. 26B.0, 51:1153 – 52:1159; Gorenz Sur., Nicor Gas Ex. 41.0, 16:346 – 352) Moreover, Mr. Mierzwa’s proposal is selective and unfair, because if he had extended his 12 month average methodology to Materials and Supplies, and Budget Payment Plan Balances, which he did not do, net rate base would increase by about \$4,336,000. (Gorenz Sur., Nicor Gas Ex. 41.0, 17:353 – 361) Mr. Mierzwa’s proposal should be rejected.

2. Gas In Storage - LIFO

Nicor Gas’s calculation of the Gas in Storage addition to rate base reflects that its inventory is recorded at historical cost on a last-in, first-out (“LIFO”) basis. (Gorenz Dir., Nicor Gas Ex. 11B.0, 18:390 – 401)

Please also note that AG witness Mr. Effron, who included those three proposed adjustments in his proposed revenue requirement schedules, repeatedly confirmed that his testimony provided no independent support for those adjustments. (*E.g.*, Gorenz Reb., Nicor Gas Ex. 26B.0, 53:1187-1195 (quoting Mr. Effron’s response to Nicor Gas data request Nicor-AG-2.09); Effron, Tr. 1133, 1134, 1135, 1167-1168, 1169-1170)) Mr. Effron, in rebuttal, arbitrarily increased the total amount of Mr. Mierzwa’s three adjustments by \$8,619,000, but he admitted that that was done solely to increase that amount to offset the \$8,619,000 increase in the Gas in Storage addition that resulted from the update Nicor Gas presented in rebuttal, so as to achieve the same desired result that Mr. Mierzwa had presented in his direct testimony; the increase in the proposed adjustments has no actual basis in the evidence. (*See* Effron, Tr. 1130-1131)

CUB/CCSAO witness Mr. Mierzwa has proposed to reduce the Gas in Storage addition by another \$95,308,248, claiming that it was unreasonable for Nicor Gas to have liquidated certain low-cost Gas in Storage inventory while its Gas Cost Performance Program (“GCPP”) was in effect. (Mierzwa Dir., CUB/CCSAO Ex. 2.0, *passim*; CUB/CCSAO Ex. 2.1) Mr. Mierzwa’s proposal should be rejected, for several reasons.

Mr. Mierzwa’s proposed adjustment is without merit because: (1) this rate case is not the proper forum for evaluating Nicor Gas’ decisions under the GCPP, as the Commission is already evaluating them in *Illinois Commerce Comm’n v. Northern Illinois Gas Co.*, Docket 02-0067 Consolidated (“Cons.”), and any relief deemed appropriate by the Commission can be effectuated in that proceeding (and no such relief would warrant a change here); (2) in contrast, any inappropriate disallowance in this Docket cannot be rectified in that or any other proceeding; (3) all appropriate accounting adjustment to Nicor Gas’ LIFO inventory as a consequence of the GCPP have been reflected in Nicor Gas’ restated and independently audited financial statements for the years that the GCPP was in effect. (Gorenz Reb., Nicor Gas Ex. 26B.0, 46:1027 – 1034, 47:1057 – 49:1097; Gorenz Sur., Nicor Gas Ex. 41.0, 15:309 – 327) In addition, Mr. Mierzwa’s calculation of \$95,308,248, which he has proposed to deduct from the year-end inventory balance, is incorrect even based on his spurious theory; the “correct” amount would be \$12,988,874 (Gorenz Reb., Nicor Gas Ex. 26B.0, 49:1085 – 1097), a difference that speaks to the lack of credibility of the underlying position. Indeed, Mr. Mierzwa did not challenge that correction, but rather only sought to deflect attention from it by referring to his two other proposed Gas in Storage adjustments. (Mierzwa Reb., CUB/CCSAO Ex. 4.0, 4:81 – 84) Mr. Mierzwa’s proposed adjustment should be rejected.

3. Valuation of Gas in Storage

CUB/CCSAO witness Mr. Mierzwa also has proposed to reduce the Gas in Storage addition to rate base by another \$57,999,286 to account for what he asserts to be a beneficial cash flow advantage to Nicor Gas. (Mierzwa Dir., CUB/CCSAO Ex. 2.0, 11:238 – 242, 11:245 – 274) Mr. Mierzwa’s proposed adjustment is nonsense. His assertion simply does not reflect economic reality, and it is wrong from an accounting perspective as well. (Gorenz Reb., Nicor Gas Ex. 26B.0, 49:1098 – 51:1147; Gorenz Sur., Nicor Gas Ex. 41.0, 15:328 – 16:342) For example, as to economic reality:

At the beginning of a calendar year, Nicor Gas has a large Gas in Storage balance. This gas would have been purchased and paid for by Nicor Gas at current market prices during the preceding summer and fall for injection into storage. The carrying cost of that gas is borne by Nicor Gas until the winter withdrawal season. While Mr. Mierzwa is correct that current market prices are substantially higher than the prices of older LIFO layers, that argument has no bearing on the real cash flow implications of storage operations for Nicor Gas.

(Gorenz Reb., Nicor Gas Ex. 26B.0, 49:1107 – 50:1113) Mr. Mierzwa’s proposed adjustment should be rejected.

4. Gas in Storage – Reduction in Transportation Customer Volumes

Nicor Gas has proposed to decrease the capacity of storage allocated to transportation customers from 26 to 23 times the Maximum Daily Contract Quantity (“MDCQ”), as is discussed in subsection “B(8)(a)(1)” of Section VI of this Initial Brief. If approved, that would result in a \$18,453,000 increase to net rate base (updated rebuttal figure) to reflect the increased volume of Gas in Storage that Nicor Gas will be responsible for filling. (Gorenz Dir., Nicor Gas Ex. 11B.0, 26:562 – 568; Gorenz Reb., Nicor Gas Ex. 26B.0, 53:1196 – 54:1202; Nicor Gas Ex. 26B.1 at Schedules B-1 and 1.01) Although the rate design change is at issue, no party

contests that computation. Nicor Gas' inclusion of this amount in its net rate base should be approved.

H. Pension Asset

Nicor Gas has forecast a prepaid pension balance of \$186,882,000, from which \$75,156,000 (corrected figure) in associated ADIT has been deducted, resulting in a net pension asset of \$111,726,000 being included in net rate base. (O'Connor Dir., Nicor Gas Ex. 11A.0, 19:402 – 20:447; O'Connor Reb., Nicor Gas Ex. 26A.0, 61:1362 – 1366) Nicor Gas appropriately included the net pension asset in net rate base.

The net pension asset reflects investments made by the Company in a pension trust in compliance with its obligations under its pension plan (defined benefit plan) applicable to eligible former employees (retirees) and eligible current employees hired before January 1998. That plan is "frozen", but it still applies to those employees. The Company's undertaking of those obligations, and its past and continuing compliance with them, was and is prudent and reasonable as a matter of human resources policy, and in the interests of ratepayers, as discussed in the direct testimony of Rebecca Bacidore (Nicor Gas Ex. 9.0). The pension plan currently is, and in 2005 is projected to be, "overfunded", but the Company cannot withdraw, and does not have the use of, any "overfunded" amounts. Thus, while the pension asset is not gas plant such as pipe or meters or the like, it nonetheless is an asset on the balance sheet, and it reflects payments made into the trust by the Company and the value of the resulting assets in the trust as they change over time, payments that benefited and continue to benefit ratepayers. While pension expense was a component of approved operating expenses in the years leading up to the Company's last general rate case, customers did not pay a separate charge or a segregated portion of any charge that directly funded or was tied to the pension asset. Customers did not fund the pension asset any more than they funded any particular item of gas plant. The ICC, in its Order in the Company's last general rate case, ICC Docket No. 95-0219, rejected the inclusion of the then-forecasted net pension asset in Nicor Gas' proposed net rate base. The Company is of the view that approval of recovery in this case is warranted, notwithstanding the prior Order's disallowance. Moreover, we note that the ICC, in that Order, with little explanation, also imposed an annual pension credit to operating expenses. The credit on the books was, and still is, an accounting accrual, not cash, and it did not and does not serve to reduce the Company's other operating expenses. Thus, for nearly a decade, customers have not paid anything towards the pension asset and, instead, have enjoyed a substantial reduction in charges, one that in our view was and is not warranted, due to the "overfunded" pension plan. The Company's proposed total

and base rate revenue requirements, in light of the prior Order, nonetheless credit the 2005 forecasted level of the accrual against operating expenses, even though the credit is not justified. We believe that the Company's inclusion of the net pension asset in net rate base, therefore, is appropriate.

(O'Connor Dir., Nicor Gas Ex. 11A.0, 19:417 – 20:447)

Staff witness Ms. Pugh and AG witness Mr. Effron have proposed disallowing from rate base the entire amount of the net pension asset (Staff's proposed adjustment is somewhat smaller due to coordination with its proposed "average rate base" adjustment to avoid double-counting). (Pugh Dir., Staff Ex. 3.0, 2:36 – 4:73; Effron Dir., AG Ex. 1.0, 9:11 – 11:11) Their claim that ratepayers, before Nicor Gas' last general rate case, "funded" the net pension asset is incorrect.

It is not the case, as Ms. Pugh's argument seems to suggest, although Ms. Pugh presumably would disclaim such an interpretation, that Nicor Gas had an actual charge to ratepayers for pension expenses, or that any funds paid by ratepayers on any charge were tied as such to pension expenses. In a rate case, any approved pension expenses, like any other approved OO&M expenses, are summed and allocated to ratepayers through general charges based on the approved rate design. The payments made into the pension trust were made by Nicor Gas, not customers. Customers did not fund the pension asset any more than they funded any particular distribution main on the Nicor Gas system.

Moreover, Ms. Pugh's theory amounts to a novel form of retroactive ratemaking combined with single issue ratemaking, and it exhibits the problems of both. She, in essence, is contending that too much of one type of OO&M expense -- pension expense -- was approved prior to the last Nicor Gas general rate case, with that "too much" being determined by her, with hindsight, based on the subsequent performance of the pension trust, and that customers, therefore, funded the pension asset. That is improper. Even if a retrospective analysis were appropriate, then in order for Ms. Pugh's theory to have any logic to it, and to be fair, she would have to show that there were not offsetting shortfalls in the amounts recovered by Nicor Gas for other operating expenses. If Nicor Gas were under-recovering its other operating expenses, then Ms. Pugh could not logically or fairly strip out this one category of operating expense, say too much of this one category of operating expense was recovered, and then say that that "excess" funded the pension asset. Ms. Pugh has not presented, however, and cannot present, any such analysis. The Commission found in Nicor Gas' last general rate case, ICC Docket 95-0219, that Nicor Gas was experiencing a revenue deficiency of \$33,732,000. That fact simply cannot be squared with the notion that ratepayers before that case were paying "excess" amounts that funded the pension trust.

(O'Connor Reb., Nicor Gas Ex. 26A.0, 55:1238 – 56:1262; *see also id.* at 54:1219 – 1223, 57:1268 – 1279; O'Connor Sur., Nicor Gas Ex. 34.0, 19:436 – 20:462)

Staff's and the AG's citation of the ruling on this issue in Nicor Gas' last general rate case does not warrant a disallowance of the net pension asset in the instant Docket, and it is undercut by the extreme inconsistency that Staff has exhibited in this Docket regarding the relevance of, and weight to be given to, ICC Orders in the last rate case and in other Dockets. (O'Connor Reb., Nicor Gas Ex. 26A.0, 57:1280 – 58:1305; O'Connor Sur., Nicor Gas Ex. 34.0, 21:467 – 469)

Moreover, Staff's and the AG's position is invalid, or at least very incomplete, overstated, and unfair, because they fail to take into account that the rates set in Nicor Gas' last rate case included an annual pension credit to ratepayers of \$6,550,000, which means that ratepayers will have benefited by a rate reduction of approximately \$62,200,000 (not escalated for inflation) from the last rate case to when the rates to be set in this case go into effect, and that the rates proposed in Nicor Gas' direct case in this Docket include an annual pension credit to ratepayers of \$3,486,000. (O'Connor Reb., Nicor Gas Ex. 26B.0, 54:1219 – 1223, 57:1268 – 1279, 58:1306 – 60:1344; O'Connor Sur., Nicor Gas Ex. 34.0, 20:454 – 462)

Even if the Commission were to find that some of the net pension asset should be disallowed, Nicor Gas still should be allowed to include in its net rate base the net amount of \$67,900,000 by which the net pension asset has increased since the last general rate case, because customers have not "funded" the net pension asset, but rather had the benefit of it through the pension credit, during this period, or, alternatively, the net amount of \$62,200,000 referenced above. (O'Connor Sur., Nicor Gas Ex. 34.0, 20:454 – 21:466)

Moreover, if Commission ultimately found that any or all of the net pension asset should be disallowed, then the pension credit should not be deducted from Nicor Gas' operating expenses in computing its revenue requirement. There simply is no valid basis for the deduction to begin with, not least because it is an accounting accrual, not actual funds, and it does not offset other operating expenses or provide a means to pay them, and the deduction is even more baseless and unfair if any or all of the net pension asset is disallowed. (Bacidore Dir., Nicor Gas Ex. 9.0, 17:355 – 18:373; O'Connor Reb., Nicor Gas Ex. 26B.0, 58:1306 – 60:1344; O'Connor Sur., Nicor Gas Ex. 34.0, 21:470 – 481)

Nicor Gas should be allowed to include the net pension asset in its rate base. In the alternative, Nicor Gas should be allowed to include the net amount of \$67,900,000 or \$62,200,000, and the pension credit, which has no basis in any event, should not be deducted from operating expenses in computing the revenue requirement.

I. Section 263A

In 2003 (in its 2002 federal tax return), Nicor Gas elected to change its overhead capitalization method under Section 263A of the IRC. (O'Connor Dir., Nicor Gas Ex. 11B.0, 22:485 – 490) The election is a timing item, i.e., it defers taxes. (*Id.* at 23:503 – 505; Effron, Tr. 1138 – 1139) The election benefited customers, as discussed below. The net impact of the election as of December 31, 2004, was an increase in ADIT of \$133,032,557. (*E.g.*, O'Connor Sur., Nicor Gas Ex. 34.0, 23:523 – 530; Effron, Tr. 1140)

Nicor Gas' revised proposed net rate base includes a (corrected) reduction of ADIT of \$66,563,000 based on its estimated resolution of the IRS review of the election under Section 263A. (*E.g.*, O'Connor Dir., Nicor Gas Ex. 11A.0, 22:485 – 23:510; O'Connor Reb., Nicor Gas Ex. 26A.0, 62:1392 – 63:1407; Effron, Tr. 1138) Staff accepts the inclusion of the

estimated resolution, although Staff's proposed "average rate base" adjustment would inappropriately and unfairly eliminate 50% of its impact, as is discussed in subsection "B" of this Section II. The inclusion of the entire estimated resolution is appropriate.

We wish to note that the ADIT figure reflects what the Company believes is a reasonable estimate (one included in its forecast) for ratemaking purposes of the outcome of the current review by the Internal Revenue Service (the "IRS") of Nicor Gas' accounting methodology change regarding its overhead capitalization method, pursuant to Section 263A of the federal Internal Revenue Code, elected as part of its federal income tax return for the 2002 tax year. Many other utilities across the country also made similar elections under Section 263A. The IRS, therefore, is also looking at this same issue in regard to Nicor Gas and many other utilities around the nation. Nicor Gas also recognizes that Section 263A issues are an industry-wide issue being reviewed by the IRS at a national level. Nicor Gas believes its tax filing position was and is appropriate and consistent with federal tax law and regulations. The Company recognizes, however, that a final IRS review will involve interpretation of tax laws, as well as computational issues. While the Company forecast reflects its belief that it will prevail on the issues in principle, there is a real possibility that we could lose, or settle, some of the tax impact. Therefore, Nicor Gas has adjusted its forecasted test year federal and state deferred taxes by \$84.9 million, which represents approximately half of the filed tax position. Nicor Gas' forecasted ADIT thus reflects a reasonable estimate of the most likely outcome based on available data and the current status, given the uncertainties surrounding the subject. We believe this approach is reasonable. Tax deferrals from timing items (such as Nicor Gas' Section 263A election) can reduce customers' rates via a reduction in the Company's financing costs. There is a benefit to ratepayers from the position Nicor Gas took in its 2002 tax return and now the ICC should approve Nicor Gas' approach, which balances the risks between the utility and ratepayers. To do otherwise, we submit, would likely have a chilling effect on utilities trying to optimize tax positions, and that would be detrimental for ratepayers by ultimately leading to higher rates.

(O'Connor Dir., Nicor Gas Ex. 11A.0, 22:485 – 23:510) (referring to the earlier uncorrected amount of the estimated resolution)

It is an uncontested fact that Nicor Gas' revised proposed net rate base in the instant Docket would be \$66,469,557 higher were it not for the election, i.e., the \$133,032,557 impact of the election as of December 31, 2004, less the \$66,563,000 estimated resolution, referenced

above.²⁰ (*See also, e.g.,* Effron, Tr. 1143) It would not be just and reasonable, nor would it be good policy, as noted above, for the Commission to accept the reduction of rate base by the entire impact of the Section 263A election before the resolution of that election while rejecting the expected resolution of that election.

AG witness Mr. Effron, while taking full advantage of an ADIT figure that reflects the election in making his net rate base proposal, nonetheless opposes the reflection of the estimated resolution of in Nicor Gas net rate base as “speculative”, although he also suggests an alternative partial (capped) “hold harmless” proposal. (Effron Dir., AG Ex. 1.0, 12:10 – 14:3) Mr. Effron’s objection is without merit.

Mr. Effron’s criticism not only is wrong, it is inexplicable. Mr. Effron fails to mention, much less address, the information and documentation supplied by Nicor Gas in discovery that addresses the basis of the estimate. In its confidential original and corrected responses to AG data request 1.20, served on January 24, and February 24, 2005, respectively, Nicor Gas provided its revised (updated and corrected) calculation of the estimate (the revision relied on by Ms. Ebrey, as referenced above), a narrative explanation of the basis of the revised estimate, and a copy of an October 29, 2003, internal confidential Nicor Gas Memorandum explaining and supporting in a detailed manner the calculation of the original estimate. Mr. Effron, in his response to a Nicor Gas data request that referenced Mr. Effron’s direct testimony on this subject (Nicor-AG-2.10), confirmed that at the time when he prepared his direct testimony, he had read all of Nicor Gas’ responses to the AG’s data requests on this subject.

Moreover, while Mr. Effron goes on to quote Nicor Gas’ acknowledgement in Schedule G-7 of its filing under Part 285 of the Commission’s Rules that the resolution date and its amount, if any, are uncertain at this time (AG Ex. 1.0, page 13, lines 4-7), he fails to mention, much less address, the fact that the original estimate was reflected in the forecasted financial statements that were submitted as Schedules G-15 through G-18 of the Part 285 filing, which were prepared in accordance with the Guide for Prospective Financial Information of the American Institute of Certified Public Accountants as required by Section 285.7010 of Part 285. The revision of the figure, again, has been fully explained in discovery and, as noted above, Staff has accepted the

²⁰ The figure above actually is an understatement of how much the net rate base would be higher, because the impact of the election is increasing this year, but, for simplicity’s sake, Nicor Gas is not factoring in that increase.

revision, subject to the impact of Mr. Struck's proposed average rate base disallowance.

(O'Connor Reb., Nicor Gas Ex. 26A.0, 63:1413 – 64:1434; *see also* O'Connor Sur., Nicor Gas Ex. 34.0, 23:523 – 24: 541) Mr. Effron's alternative proposal is an incomplete and unfair substitute for allowing Nicor Gas to include the estimated resolution in its net rate base, and is problematic in other respects. (O'Connor Reb., Nicor Gas Ex. 26A.0, 64:1435 – 67:1512) Mr. Effron's proposed adjustment should be rejected.

J. Deferred Taxes

The "average rate base", plant balance, Daily Metering Project, Mainframe Project, net pension asset, and Section 263A issues each involve ADIT amounts. Please see subsections "B", "C", "E", "F", "H", and "I" of this Section II. Nicor Gas does not believe that those issues, and their ADIT impacts, require further discussion here.

Staff has made an error of inadvertently including an increase to ADIT of \$1,590,000 in its rate base calculations, thereby incorrectly reducing net rate base by the same amount. (*See* Struck Reb., Staff Ex. 10.0 Revised, Schedule 10.04, page 1, column (h), line 14) That figure appears in a column relating to the Depreciation Reserve, and has no relation to that column or to the Staff Schedule cited as the basis for that column. The figure appears to be a duplication, with a transposition error, of an ADIT figure of \$1,509,000 that appears in the next active column. (*See id.* at page 2, column (k), line 14) The erroneous figure obviously should be rejected.

K. Customer Deposits

Nicor Gas properly calculated the Customer Deposits subtraction from rate base, based on its forecast as of December 31, 2005, as \$23,711,000. (Gorenz Dir., Nicor Gas Ex. 11B.0, 23:511 – 515; Nicor Gas Ex. 11B.1 at Schedules B-1, B-13) Had Nicor Gas used a 13 month average based on its forecast for the period ending December 31, 2005, the figure would only

have been \$21,189,000. (Nicor Gas Ex. 11B.1 at Schedule B-13) *See, e.g., In re Central Illinois Public Service Co.*, Docket 02-0798 Cons., 2003 Ill. PUC Lexis 824 at *68 (Order Oct. 22, 2003) (approving Staff witness Ms. Ebrey's proposal to use a 13 month average for customer deposits). Staff initially proposed to increase the figure to \$25,485,000 based on replacing Nicor Gas' forecast as of December 31, 2005, with a 13 month average based on actuals through December 31, 2004, but later withdrew its proposal and accepted Nicor Gas' figure (as part of the withdrawal of several adjustments, some favoring Nicor Gas, some not, for the stated reason of narrowing the issues). (Ebrey Dir., Staff Ex. 2.0, 4:71 – 5:79 and Schedules 2.01, 2.03, 2.04, 2.05, 2.06; Ebrey Reb., Staff Ex. 11.0, 3:53 – 4:65)

AG witness Mr. Effron has proposed, selectively, to revise the figure to \$27,259,000 based on the actual balance as of December 31, 2004. (Effron Dir., AG Ex. 1.0, 14:6 – 15:20). As was discussed with regard to Mr. Effron's proposed adjustment to Gross Utility Plant based on the actual balance as of December 31, 2004, addressed in subsection "C(2)" of this Section II, Mr. Effron has shown no valid basis for rejecting Nicor Gas' forecast as of December 31, 2005, based on an updated figure as of December 31, 2004. Mr. Effron's proposed adjustment should be rejected.

L. Budget Payment Plan

Nicor Gas properly calculated the Budget Payment Plan Balances subtraction from rate base, based on its forecasted 13 month average through December 31, 2005, as \$60,965,000. (Gorenz Dir., Nicor Gas Ex. 11B.0, 24:516 – 523; Nicor Gas Ex. 11B.1 at Schedules B-1, B-14) Staff initially proposed to increase the figure to \$82,506,000 based on replacing Nicor Gas' forecast as of December 31, 2005, with a 13 month average based on actuals through December 31, 2004, but later withdrew its proposal and accepted Nicor Gas' figure (as part of

the withdrawal of several adjustments, some favoring Nicor Gas, some not, for the stated reason of narrowing the issues). (Ebrey Dir., Staff Ex. 2.0, 5:81 – 91 and Schedule 2.04; Ebrey Reb., Staff Ex. 11.0, 3:58 – 4:65)

AG witness Mr. Effron originally proposed, selectively, to change the figure to \$84,417,000 based on a 13 month average that uses the actual balance for the last day of December 31, 2004, the forecasted balances for the last days of January to March 2005, and the actual balances for the last days April to December 2004. (Effron Dir., AG Ex. 1.0, 15:23 – 17:21 and Schedule B-4) He later proposed, selectively, in rebuttal to change the figure to \$83,427,000 based on a 12 month average that uses the actual balances for the last days of April 2004 to March 2005. (Effron Reb., AG Ex. 1.3, 15:2 – 16:15 and Schedule B-4) Mr. Effron’s proposed adjustment, original or revised, is without merit. His proposed adjustment is selective and provides no sufficient basis for rejecting the methodology used in Nicor Gas’ forecast, as demonstrated in the highly detailed evidence that Nicor Gas has presented on this subject. (O’Connor Reb., Nicor Gas Ex. 26A.0, 70:1571 – 73:1638; *see also* O’Connor Sur., Nicor Gas Ex. 34.0, 26:586 – 591) His proposed adjustment should be rejected.

M. Uncollectibles Reserve

CUB/CCSAO witness Mr. Mierzwa has presented the novel contention that the “uncollectibles reserve” should be treated as a rate base deduction, proposing a deduction of \$24,185,247 from net rate base. (Mierzwa Dir., CUB/CCSAO Ex. 2.0, 4:80 – 81, 4:89 – 90, 15:326 – 16:356; CUB/CCSAO Ex. 2.2) Mr. Mierzwa’s proposed adjustment is specious. Both Nicor Gas and Staff agree that the “uncollectibles reserve”, which is not cash but rather is an accounting accrual, is not a ratepayer supplied source of funds, and that the proposed adjustment

should be rejected. (Struck Reb., Staff Ex. 10.0, 25:502 – 26:516; Gorenz Reb., Nicor Gas Ex. 26B.0, 74:1657 – 1670; Gorenz Sur., Nicor Gas Ex. 41.0, 18:386 – 20:423)

1. Uncollectible Expense Tracker

Please see the Overview subsection and subsections “B(3)(a)” and “B(3)(b)” of Section VI of this Initial Brief.

N. Other

Nicor Gas at this time has not identified any other item to be addressed in this Section II.

III. EXPENSES

Overview

The Commission should approve Nicor Gas’ revised proposed base rate operating expenses (not including net operating income), after adjustments and including income taxes, of \$453,456,000 (*e.g.*, Nicor Gas Ex. 26B.1 at Revised Schedule C-1), for two overall reasons:

- First, Nicor Gas’ extensive supporting evidence for its revised base rate operating expenses figure establishes fully and in detail the grounds for both the total amount and its components. The vast majority of that evidence is uncontradicted, and it is the most thorough, accurate, consistent, and reasonable evidence on this subject in the record. A summary “road map” to Nicor Gas’ operating expense evidence is set forth below in this Overview subsection of this Section III of this Initial Brief.
- Second, Staff and the AG, the only other parties to submit evidence on the subject of operating expenses, have presented no valid grounds for any reductions. Their respective proposed adjustments are selective, arbitrary, unwarranted, and inconsistent, as is discussed in subsections “B” through “R” of this Section III.

Nicor Gas Operating Expense Evidence “Road Map”

Nicor Gas, in its direct case, submitted a wealth of evidence in support of its base rate operating expenses. Nicor Gas presented proposed base rate operating expenses of \$452,641,000, after adjustments and assuming income taxes calculated on a post-adjustment basis, setting aside the adjusted figure of \$1,675,017,000 for Cost of Gas (and environmental cost recovery), and assuming the inclusion of commodity-related uncollectibles expenses and net collected Hub revenues in Rider 6 rather than base rates, consisting of: (1) \$222,876,000 for Other Operation and Maintenance (“OO&M”) expenses, (2) \$154,700,000 for depreciation and amortization expenses, (3) \$19,399,000 for taxes, other than income taxes; and (4) \$55,666,000 for income taxes (net), including detailed calculations and supporting Schedules. (*E.g.*, Gorenz Dir., Nicor Gas Ex. 11B.0, 30:661 – 664; Nicor Gas Ex. 11B.1 at Schedules C-1, C-2, C-2.1, C-2.2, C-2.3, C-2.4, C-2.5, C-11.3, C-12, C-18 (copies of selected key Nicor Gas “Schedule Cs”, the operating expenses schedules, filed as part of its submission under Part 285)) Nicor Gas also presented detailed discussion of the processes by which it developed its operating expense budget and its forecast for 2005, which included its calculation of its base rate operating expenses, and, as noted previously, established that its forecasted financial statements and its summary of the assumptions underlying its forecast were examined by an independent C.P.A., Deloitte & Touche LLP, in accordance with the requirements of 83 Ill. Admin. Code § 285.7010, and filed under Part 285. (*E.g.*, Gorenz Dir., Nicor Gas Ex. 11B.0, 7:142 – 10:219, 11:231 – 13:287)

Nicor Gas presented the direct testimony of eight witnesses who supported in detail the proposed base rate operating expenses and/or components thereof. (D’Alessandro Dir., Nicor Gas Ex. 5.0, 1:11 – 14, 2:28 – 30, 16:328 – 21:452; McCain Dir., Nicor Gas Ex. 6.0, 1:7 – 10,

1:21 – 23, 2:27 – 30, 3:49 – 10:211, 21:457 – 22:477; Suppes Dir., Nicor Gas Ex. 7.0, 1:7 – 2:33, 3:55 – 63, 3:66 – 73, 6:117 – 123, 9:182 – 10:220, 11:238 – 12:267, 12:284 – 16:336, 16:338 – 23:500; Bartlett Dir., Nicor Gas Ex. 8.0, 1:21 – 26, 30:662 – 31:684; Nicor Gas Ex. 8.3; Bacidore Dir., Nicor Gas Ex. 9.0, 1:8 – 2:24, 3:47 – 18:373; J. Madziarczyk Dir., Nicor Gas Ex. 10.0, 1:12 – 20, 3:45 – 8:163; O’Connor Dir., Nicor Gas Ex. 11A.0, 2:45 – 49, 6:132 – 7:140; and Gorenz Dir., Nicor Gas Ex. 11B.0, 1:9 – 14, 1:15, 1:19 – 3:54, 3:59 – 78, 6:124 – 10:219, 11:231 – 13:287, 26:574 – 30:664, 31:680 – 683; and Nicor Gas Ex. 11B.1, at Schedules C-1, C-2, C-2.1, C-2.2, C-2.3, C-2.4, C-2.5, C-11.3, C-12, and C-18, respectively) (See also Hawley Dir., Nicor Gas Ex. 1A.0, 6:164 – 167 (overview); O’Connor Dir., Nicor Gas Ex. 1B.0, 5:122 – 130, 8:192 – 9:235 (overview)) That direct testimony supports all elements of the “Schedule Cs”.

Nicor Gas also submitted rebuttal and surrebuttal evidence in support of its base rate operating expenses. Nicor Gas, in its rebuttal testimony, presented and supported a revised proposed base rate operating expenses figure of \$453,456,000, after adjustments and assuming income taxes calculated on a post-adjustment basis, setting aside the adjusted figure of \$1,675,017,000 for Cost of Gas (and environmental cost recovery), and assuming the inclusion of commodity-related uncollectibles expenses and gross collected Hub revenues in Rider 6 rather than base rates, consisting of: (1) \$224,973,000 for OO&M expenses (revised), (2) \$154,700,000 for depreciation and amortization expenses (unchanged), (3) \$19,399,000 for taxes, other than income taxes (unchanged); and (4) \$52,163,000 for income taxes (net) (revised solely to reflect the revised net operating income figure), including detailed calculations and supporting Schedules. (E.g., Gorenz Reb., Nicor Gas Ex. 26B.0, 74:1673 – 1679; Nicor Gas Ex. 26B.1 at Revised Schedules C-1, C-2)

Nicor Gas, in its rebuttal, presented the testimony of four witnesses who supported in detail the proposed base rate operating expenses and/or components thereof. (Suppes Reb., Nicor Gas Ex. 23.0, 4:71 – 10:206; Bacidore Reb., Nicor Gas Ex. 25.0, *passim*; O’Connor Reb., Nicor Gas Ex. 26A.0, 1:16 – 2:32, 2:40 – 45, 3:50 – 53, 3:55 – 60, 5:102 – 105, 9:194 – 10:204, 10:218 – 223, 11:233 – 238, 12:247 – 255, 15:332 – 17:364; and Gorenz Dir., Nicor Gas Ex. 26B.0, 1:7 – 2:32, 2:40 – 3:49, 6:119 – 128, 11:239 – 246, 12:261 – 15:331, 17:365 – 20:442, 74:1672 – 85:1926, 87:1962 – 88:1979, 89:1999 – 90:2016; Nicor Gas Ex. 26B.1, at Schedules C-1, C-2, C-2.1, C-2.2, C-2.3, C-2.4, C-2.5, C-11.3, C-12, and C-18, respectively)

Finally, Nicor Gas, in its surrebuttal testimony, continued to support the revised proposed base rate operating expenses that it had presented in rebuttal. Nicor Gas presented the testimony of four witnesses who supported in detail the proposed base rate operating expenses and/or components thereof. (O’Connor Sur., Nicor Gas Ex. 34.0, 2:48 – 51, 5:124 – 127, 16:362 – 18:406, 24:543 – 552; Suppes Sur., Nicor Gas Ex. 38.0, 3:65 – 6:120; Bacidore Sur., Nicor Gas Ex. 40.0, *passim*; and Gorenz Sur., Nicor Gas Ex. 41.0, 1:18 – 4:69, 4:74 – 83, 20:439 – 30:646, 30:655 – 31:670)

Nicor Gas’ revised proposed base rate operating expenses of \$453,456,000, and in particular, its revised OO&M expenses figure of \$224,973,000 (*e.g.*, Nicor Gas Ex. 26B.1 at Revised Schedule C-1), are reasonable.²¹ Nicor Gas’ revised figure is reasonable because it is founded on its comprehensive, careful budgeting and forecasting processes for the 2005 test year, including the calculation of its base rate operating expenses, as is shown in the extensive evidence cited above. Indeed, as previously noted, no Staff or intervenor witness presented any

²¹ The remaining elements of the calculation of base rate operating expenses are derivative of the parties’ positions on rate base and rate of return issues, and are not the subject of any “independent” proposed adjustments.

general criticism of how Nicor Gas developed its forecast. (Gorenz Reb., Nicor Gas Ex. 26B.0, 2:43 – 45, 10:208 – 217; Gorenz Sur., Nicor Gas Ex. 41.0, 7:141 – 151) Nicor Gas’ revised figures are consistent with the uncontested facts regarding its inexorable increases in its base rate operating expenses, despite its effective cost-control measures. Staff’s and GCI’s respective proposed operating expense adjustments and their cumulative impacts are not reasonable. Nicor Gas’ revised figure should be approved.²²

A. Uncontested Issues

Please see subsection “A” of Section II for certain facts regarding Nicor Gas’ overall costs of providing adequate, safe, and reliable tariffed services, including both capital costs and operating expenses, that are uncontested.

The following additional facts regarding Nicor Gas’ base rate operating expenses, in particular, also are uncontested:

- The rate of increase in certain key costs of Nicor Gas, such as employee benefits, natural gas (for company use and its effects on uncollectibles expenses), pipeline safety, security, and corporate governance compliance, have far surpassed the overall consumer price inflation rate. (*E.g.*, Gordon Dir., Nicor Gas Ex. 2.0, 21:401 – 22:428)

²² Please note that if the Commission were to adopt any other party’s proposed adjustments to any revenue requirement items based on periods and dates prior to the 2005 test year, such as proposed adjustments based on balances as of December 31, 2004, then the 2% withdrawal factor expenses and uncollectibles expenses figures, discussed in subsections “C” and “O” of this Section III, appropriately, and in fairness, should be set based on their respective increased figures as of March 31, 2005. (*E.g.*, Gorenz Reb., Nicor Gas Ex. 26B.0, 17:374 - 20:442; Nicor Gas Ex. 26B.2 at Schedule 2) That would increase base rate operating expenses accordingly.

- Those cost increases have affected not only Nicor Gas, but also other LDCs and companies throughout the last decade. (*E.g.*, Gordon Dir., Nicor Gas Ex. 2.0, 1:14 – 15)
- Nicor Gas has forecast test year collected Hub gross revenues of \$7,790,000,²³ less administrative expenses of \$1,079,000 for a net \$6,711,000. (*E.g.*, J. Gorenz Dir., Nicor Gas Ex. 11B.0, 2:30 – 31 (net Hub revenues forecast of \$6,711,000); J. Gorenz Reb., Nicor Gas Ex. 26B.0, 85:1948 – 86:1950) (Hub administration expenses forecast of \$1,079,000)) No Staff or intervenor witness has contested those figures.
- Nicor Gas has forecast \$4,340,000 in test year Transmission expenses. (*E.g.*, Nicor Gas Ex. 11B.1 at Schedule C-1) No Staff or intervenor witness has contested that figure.
- Nicor Gas has forecast \$51,282,000 in test year Distribution expenses. (*E.g.*, Nicor Gas Ex. 11B.1 at Schedule C-1) No Staff or intervenor witness has contested that figure.
- Nicor Gas has forecast \$474,000 in test year expenses associated with Customer Service and Information. (*E.g.*, Nicor Gas Ex. 11B.1 at Schedule C-1) No Staff or intervenor witness has contested that figure.
- Nicor Gas has forecast \$11,979,000 in test year expenses for Injury and Damages. (*E.g.*, Pugh Dir., Staff Ex. 3.0, Schedule 3.08) No Staff or intervenor witness now contests that figure.

²³ The figure of \$7,790,000 does not include the forecasted gross Hub revenues of \$2,172,000 already included in Rider 6 under existing rates, which are not a contested topic in this case. (Nicor Gas Ex. 26B.1 at Schedule 1.07)

- Nicor Gas has forecast a rate case expense figure of \$3,575,000. (*E.g.*, Nicor Gas Ex. 11B.1 at Schedule C–1 (figure of \$715,000, representing proposed amortization of five years)) No Staff or intervenor witness has contested that figure, although the amortization period is contested, as discussed in subsection “Q” of this Section III.
- Nicor Gas’ 2005 OO&M expenses, depreciation expenses, and taxes other than income taxes are “on track” as of March 31, 2005, i.e., consistent with its 2005 budgets and forecast, with OO&M expenses now forecasted to exceed the budget by roughly \$500,000, except for concerns about upward impacts of changes in the price of natural gas. (Gorenz Reb., Nicor Gas Ex. 26B.0, 2:45 – 3:49, 11:242–245, 13:288 – 15:331)

B. Depreciation Expense

Nicor Gas has correctly forecasted \$154,700,000 in test year Depreciation Expense. (*E.g.*, Gorenz Dir., Nicor Gas Ex. 11B.0, 28:602 – 610, 28:621 – 29:627) The adjustments proposed by Staff and GCI relating to depreciation expense relate solely to their proposed adjustments to plant discussed in subsections “B” and “C” of Section II of this Initial Brief, which have been shown there to be without merit. There are no “independent” proposed adjustments relating to Depreciation Expense. Nicor Gas’ figure should be approved.

C. Storage Gas Losses (2% Withdrawal Factor)

Nicor Gas currently recovers the 2% withdrawal factor from sales customers through Rider 6, Gas Supply Cost, and from transportation customers through the lost and unaccounted for adjustment, as it has done for decades. (Harms Reb., Nicor Gas Ex. 27B.0, 7:145 – 150; Harms Sur., Nicor Gas Ex. 44.0, 14:309 – 15:316) Although Staff originally made a different

proposal, Staff's final proposal on this subject, as Nicor Gas understands it, is to move to base rates the expenses associated with the 2% withdrawal factor as to sales customers, while to continue to permit Nicor Gas to recover the expenses associated with the 2% withdrawal factor through the lost and unaccounted for adjustment as to transportation customers. (Pretrial Memorandum of the Staff of the Illinois Commerce Commission, pages 15-16)

Nicor Gas believes, given the volatility of these expenses, that the most efficient method of reflecting the expenses associated with the 2% withdrawal factor is to continue Nicor Gas' current process of passing the costs through the Gas Supply Cost to sales customers and through the lost and unaccounted for adjustment to transportation customers -- the net impact is recovery of current costs from both sales and transportation customers on a current basis. (Harms Reb., Nicor Gas Ex. 27B.0, 7:145 – 155; Harms Sur., Nicor Gas Ex. 44.0, 14:309 – 15:330; Gorenz Reb. 26B.0, 75:1701 – 76:1713; Gorenz Sur., Nicor Ex. 41.0, 21:456 – 465) The Commission, therefore, should approve and retain Nicor Gas' current method of handling the 2% withdrawal factor.

If Staff's original proposal, now withdrawn, of moving all expenses of the 2% withdrawal factor to base rates, as to both sales customers and transportation customers were to be adopted, then the correct amount of the adjustment to base rates would be an increase in operating expenses of \$16,347,000. (*E.g.*, Gorenz Sur., Nicor Gas Ex. 41.0, 22:466 – 469)

If Staff's final proposal of moving all expenses of the 2% withdrawal factor as to sales customers only to base rates, and permitting Nicor Gas to continue to recover the 2% withdrawal factor as to transportation customers through the lost and unaccounted for factor, were to be adopted, then the correct amount of the adjustment to base rates would be an increase in

operating expenses of \$16,347,000 times 61%, or \$9,971,670. (*E.g.*, Gorenz Sur., Nicor Gas Ex. 41.0, 22:470 – 473)

Please note that Staff’s final revised revenue requirement Schedules show a figure of \$12,879,000. (*E.g.*, Struck Reb., Staff Ex. 10.0 Revised, Schedule 10.01 Revised, page 1, column (c), line 8, and Schedule 10.02 Revised, page 1, column (f), line 8) Nicor Gas believes that to be an error. The figure of \$12,879,000 is too low for Staff’s original proposal, and too high for Staff’s final proposal, as stated above.

In addition, if the Commission were to adopt Staff’s final proposal, then customers served under Rider 25, Firm Transportation Service, and Customer Select customers should receive a credit to their delivery charges. (Harms Sur., Nicor Gas Ex. 44.0, 15:328 – 330) Based on the characteristics of its Rate 4, General Service, and Rate 6, Large General Service, Nicor Gas believes that the appropriate credit would be \$0.0032 for Rate 4 and \$0.0011 for Rate 6, multiplied by the customer-owned terms that they would use in the billing month. (Harms Sur., Nicor Gas Ex. 44.0, 34:767 – 35:777) Nicor Gas would need to modify Rider 25 to incorporate this credit. (*Id.* at 35:776 – 777) In this scenario, Customer Select customers should also receive a credit of \$0.0032. (*Id.* at 35:777 – 779)

The Commission should approve Nicor Gas’ current, and long-established, method of handling the 2% withdrawal factor. If the Commission were to adopt Staff’s final proposal, however, then base rate operating expenses should be modified as stated above, and Nicor Gas should be directed to modify its tariffs accordingly in its compliance filing.

D. Industry Association Dues

Staff witness Ms. Pugh proposes the disallowance of \$93,000 of dues paid to fifteen “industry associations” of which Nicor Gas is a member, based on her assertion that the dues are

for promotional or goodwill purposes. (Pugh Dir., Staff Ex. 3.0, 15:343 – 18:374; Pugh Reb., Staff Ex. 12.0, 17:265 – 18:285) These expenses, however, are not for promotional or goodwill purposes; rather, Nicor Gas participates in these industry associations in order to better serve its customers and, as such, these expenditures are properly recovered. (Suppes Reb., Nicor Gas Ex. 23.0, 6:127 – 8:162; Nicor Gas Exs. 23.2, 23.3; Suppes Sur., Nicor Ex. 38.0, 4:86 – 5:110) Moreover, Ms. Pugh has distorted the meaning of goodwill or institutional advertising, which is defined as “... any advertising either on a local or national basis designed primarily to bring the utility’s name before the general public in such a way as to improve the image of the utility or to promote controversial issues for the utility or the industry.” 220 ILCS 5/9–225(1)(d). Nicor Gas’ expenditures on industry associations dues do not fall within that legal definition of goodwill or institutional advertising. The Commission should deny Staff’s proposal to disallow Nicor Gas’ industry association dues.

E. Social and Service Club Dues

Staff Witness Ms. Pugh also has proposed the disallowance of \$85,000 of dues paid to “social and service club[s]”, based on her assertion that participation in such groups is a promotional and goodwill practice. (Pugh Dir., Staff Ex. 3.0, 17:378 – 18:397; Pugh Reb., Staff Ex. 12.0, 20:417 – 423) Nicor Gas participates in these social and service clubs, however, to benefit the community and to better service customers. (Suppes Reb., Nicor Ex. 23.0, 6:127 – 8:162; Suppes Sur., Nicor Gas Ex. 38.0, 4:86 – 5:110) Also, again, Ms. Pugh has distorted the meaning of goodwill or institutional advertising, as discussed in the previous subsection. Nicor Gas’ expenditures on social and service club dues do not fall within that legal definition of goodwill or institutional advertising. The Commission should deny Staff’s proposal to disallow Nicor Gas’ “social and service club” dues.

F. Office Supplies and Expenses

AG witness Mr. Effron has proposed a \$5,067,000 reduction in Account 921, Office Supplies and Expenses, based on his escalation of the 2003 figure and his review of the figure from 2004. (Effron Dir., AG Ex. 1.0, 26:1 – 22; 27:1 – 17; Effron Reb., AG Ex. 1.3, 18:3 – 19:16) He asserts that these expenses are inflation driven and should only moderately rise. (Effron Dir., AG Ex. 1.0, 26:1 – 22; 27:1 – 17) His proposal is without merit.

Nicor Gas' test year OO&M budget was developed from the bottom up, requiring preparers to build from the lowest level of detail, and using exhaustive, formal processes with multiple steps and reviews. (*E.g.*, Gorenz Dir., Nicor Gas Ex. 11B.0, 7:142 – 10:219; Gorenz Reb., Nicor Gas Ex. 26B.0, 81:1834 – 82:1843; Gorenz Sur., Nicor Gas Ex. 41.0, 24:528 – 25:539) The costs charged to Account 921 are or will be prudently and reasonably incurred and include necessary items such as telephone, office supplies, and general and administrative rental expense. (Gorenz Reb., Nicor Gas Ex. 26B.0, 81:1834 – 82:1843; Gorenz Sur., Nicor Gas Ex. 41.0, 24:528 – 25:539)

Mr. Effron's characterization of the Office Supplies and Expenses as being inflation driven is inaccurate. The Office Supplies and Expenses include items which vary widely such as information technology ("IT") costs, cost allocations from Nicor Inc. for items such as risk management and oversight activities and "Sarbanes-Oxley Act" compliance, and costs stemming from FERC regulation. (Gorenz Reb., Nicor Gas Ex. 26B.0, 82:1857 – 83:1878; AG Ex. 7)

Finally, Mr. Effron's proposal ignores the uncontested fact that Nicor Gas' 2005 OO&M expenses are "on track" as of March 31, 2005, i.e., consistent with its 2005 budgets and forecast, with OO&M expenses now forecasted to exceed the budget by roughly \$500,000, except for concerns about upward impacts of changes in the price of natural gas. (Gorenz Reb., Nicor Gas

Ex. 26B.0, 2:45 – 3:49, 11:242 – 245, 13:288 – 15:331) There is no valid basis for selectively disallowing one component of OO&M expenses, as Mr. Effron proposes in this circumstance. The Commission should deny the AG’s proposed disallowance related to Nicor Gas’ Office Supplies and Expenses.

G. Branding Expense

AG witness Mr. Effron in his direct testimony suggested disallowing \$340,000 in operating expenses associated with “branding”, asserting that these expenses, which reflect Nicor Gas’ allocated share of expenditures by its parent, Nicor Inc., are designed to improve the corporate image and reputation of Nicor Inc. (Effron Dir., AG Ex. 1.0, 28:4 – 11, Schedule C-2) Contrary to Mr. Effron’s suggestion, this budget item is not merely advertising for Nicor Gas’ parent, but provides clear and tangible benefits to Nicor Gas’ customers. (Suppes Reb., Nicor Gas Ex. 23.0, 8:173 – 177) The amount allocated to Nicor Gas, which constitutes roughly 39% of the total, is based upon the proportional benefit that its customers receive from the dollars spent by Nicor Inc., as is determined using a two-factor formula as required by the ICC-approved Operating Agreement. (*Id.* at 8:170 – 10:206; Suppes Sur., Nicor Gas Ex. 38.0, 6:112 – 120) One of the principal ways in which these funds are used is to inform and educate customers and the community on important issues, such as gas cost, financial assistance, and safety. (C. Suppes Reb., Nicor Ex. 23.0, 9:184 – 193)

Although Mr. Effron continued to include this proposed disallowance in his rebuttal testimony schedules (Effron Reb., AG Ex. 1.3, Schedule C-2), he did not even mention it, much less seek to defend it, in his rebuttal testimony narrative, and those schedules provide no support for it. The Commission should deny the AG’s proposed disallowance.

H. Stock Option Expense

The AG's Mr. Efron has proposed to disallow \$891,000 in operating expenses associated with employee stock options, asserting that these expenses do not benefit ratepayers. (Efron Dir., AG Ex. 1.0, 23:19–22, 24:3 – 11, Schedule C-2) In rebuttal testimony, Staff's Ms. Pugh joined with Mr. Efron and also proposed to disallow these expenses. (Pugh Reb., Staff Ex. 12.0, 24:502 – 25:521, Schedule 12.06) Mr. Efron and Ms. Pugh also each propose slightly different disallowances of incentive compensation expenses, as is discussed in subsection "I" of this Section III. Mr. Efron further proposes a disallowance of corporate benefit plan expenses, in which Ms. Pugh has not joined, as is addressed in subsection "L" of this Section III. None of those adjustments are warranted, for the reasons discussed here and in subsections "I" and "L". On the subject of employee compensation, Mr. Efron and Ms. Pugh go one worse than mistaking the trees for the forest, they focus on two or three trees and pretend there is no forest. That simply does not serve the interests of customers.

Mr. Efron and Ms. Pugh have no backgrounds in human resources management. (Efron Dir., AG Ex. 1.0, 1:9 – 2:18; Pugh Dir., Staff Ex. 3.0, 1:5 – 12; Pugh, Tr. 1033) Mr. Efron could not, and did not, offer any expert opinion on how human resources management should be conducted. Ms. Pugh acknowledged that she did not offer any expert opinion on any question of how to manage human resources. (Pugh, Tr. 1033)

In contrast, Nicor Gas witness Ms. Bacidore is Nicor Gas' Assistant Vice President of Human Resources. (Bacidore Dir., Nicor Gas Ex. 9.0, 1:5 – 6) Ms. Bacidore has extensive experience, as well as formal training, in human resources management. (*Id.* at 2:26 – 45) She has extensive knowledge of Nicor Gas' "total compensation" approach to employee compensation, the details thereof, how it is developed and implemented, and the reasons for that

approach. (*Id.* at *passim*; Bacidore Reb., Nicor Gas Ex. 25.0, *passim*, Bacidore Sur., Nicor Gas Ex. 40.0, *passim*)

“People who are deciding where to work and on what terms, and current employees when contemplating their career objectives, status, and possible alternatives, do not wear blinders, they consider the total compensation and benefits package, as well as whatever else matters to them.” (Bacidore Dir., Nicor Gas Ex. 9.0, 6:129 – 132)

Nicor Gas accordingly follows a “total compensation” approach to employee compensation that: (1) has been and is developed and implemented on an ongoing basis with the assistance of analyses, data, and recommendations from leading outside experts; (2) considers overall employee compensation as well as its components; and (3) seeks overall to pay employees at the median -- the “50th percentile” -- of the applicable labor market, in order to best balance the objectives of obtaining a sufficient, qualified work force while controlling costs. (*E.g.*, Bacidore Dir., Nicor Gas Ex. 9.0, 9:189 – 10:199; Bacidore Reb., Nicor Gas Ex. 25.0, 3:52 – 6:126, 8:158 – 10:207; Bacidore Sur., Nicor Gas Ex. 40.0, 2:28 – 5:92, 5:106 – 6:117)

As Ms. Bacidore has summarized this approach:

Nicor Gas has a long-established total cash compensation philosophy, which it has followed, of rewarding professional employees with base pay and annual incentive opportunities in order to be competitively positioned within our industry. In order to achieve this goal, Nicor Gas targets professional employees at a “50th percentile” level, i.e., at the median of the relevant labor market. That policy is prudent and reasonable, because it enables Nicor Gas to offer a pay package that is compelling enough to attract, motivate, and retain a skilled, stable workforce that provides high quality service to Nicor Gas’ customers while also enabling Nicor Gas to remain a low-cost natural gas distribution company.

(Bacidore Reb., Nicor Gas Ex. 25.0, 3:52 – 60)

As she further has explained:

Q. What do you mean when you say that Nicor Gas has a total cash compensation policy of paying at a “50th percentile” level, i.e., at the median of the relevant labor market?

- A. Nicor Gas reviews the available data and seeks to structure its total cash compensation packages such that employees' total cash compensation is at the median of the relevant labor market. By total cash compensation, I mean base salary plus incentive elements. Nicor Gas consults with Towers Perrin, an experienced outside human resources consulting firm, for validation of our assumptions.
- Q. What are the reasons for Nicor Gas' policy of setting total cash compensation at the median of the relevant labor market?
- A. Nicor Gas seeks to provide safe and reliable service in a cost-effective manner, while respecting the need to provide a fair rate of return of and on investment. Nicor Gas hypothetically could pay total compensation well above market in the hopes that this would result in an extraordinarily high level of customer service, but that would sacrifice the objective of providing cost-effective service. Nicor Gas also hypothetically could offer total compensation well below market to drive down its costs and rates, but this would lead to losing qualified employees, understaffing, and/or hiring unqualified employees. The goal, obviously, is to balance the competing objectives in a prudent and reasonable manner. Achieving that balance is consistent with Nicor Gas' corporate philosophy. Nicor Gas, in part because it is a regulated utility, is naturally more conservative than some other organizations, and is focused on controlling costs, while maintaining exceptional service. Providing a total cash compensation package targeted at the median of the relevant labor market is consistent with Nicor Gas' goals, and benefits ratepayers.
- Q. How does Nicor Gas determine that it is setting total compensation for officers at the median of the relevant labor market?
- A. For officers, Nicor Gas engages the services of Towers Perrin to annually review the total cash compensation (base salary and annual incentives) for each officer compared to comparable positions in the energy and general industries. Exceptions are for positions specific to the energy industry, which are compared only to the energy industry compensation rates. Market reference points for each position are targeted to approximately the 50th percentile (median) of similarly sized companies. Towers Perrin conducts a thorough analysis of each position and then aggregates data to create an overall variance comparing Nicor Gas to the market data median rates. From there, Nicor Gas can determine how its total cash compensation compares to the market on an aggregate officer group basis.
- Q. How does Nicor Gas determine the appropriate total cash compensation for other management employees?
- A. Nicor Gas evaluates the median total cash compensation for other management employees on an on-going basis, as needed, using a similar

process to that used by Towers Perrin to assess Nicor Gas' total cash compensation packages for officers. As Nicor Gas replaces a job, adds a new job, or changes its organizational structure, Nicor Gas analyzes relevant survey data that has been compiled and validated by the largest consulting companies, in addition to internal equity considerations, assessing total cash compensation packages for the same or similar jobs.

Each year, nationally recognized professional survey houses compile information throughout corporate America, with detailed information. The results are published on an annual basis, and used throughout human resources organizations nationwide. Through various subscriptions, Nicor Gas receives the results of a number of surveys, including one published by the American Gas Association. In this manner, Nicor Gas can assess the total cash compensation package for a particular position. In the event that the surveys do not provide sufficient data for a particular opening, Nicor Gas contracts with a consulting company such as Towers Perrin to assess market data for that specific position, just as we do for Nicor Gas' officer positions. Just as Nicor Gas assesses a position as compared to the relevant labor market, Nicor Gas reviews comparable jobs within the organization to ensure that parity exists among the same or similar jobs, a process that is known in the human resources domain as "internal equity".

(Bacidore Reb., Nicor Gas Ex. 25.0, 4:71 – 6:126)

Mr. Efron's proposal, in which Ms. Pugh has joined, selectively and inappropriately focuses on a single element of the total compensation package, while ignoring the adverse impacts on customers of driving down total compensation. (Bacidore Reb., Nicor Gas Ex. 25.0, 2:29 – 31, 13:271 – 279; Bacidore Sur., Nicor Gas Ex. 40.0, 7:143 – 155) "[T]his approach continues to suffer from the flaw that it views one element of employees' compensation in isolation. Stock option expense is but one element of the total compensation package, which benefits ratepayers. Mr. Efron cannot 'pick off' stock option expenses, without leaving total compensation below that which is in customers' interest." (Bacidore Sur., Nicor Gas Ex. 40.0, 7:150 – 155) As is discussed further in the next subsection, if, in order to get total compensation back to the 50th percentile if a particular form of compensation is disallowed and eliminated, Nicor Gas raises other elements of the total compensation package, then Mr. Efron's and Ms. Pugh's position does nothing whatsoever to reduce total operating expenses, and serves no

purpose other than to interfere with Nicor Gas and its outside experts' best judgment about how best to craft the elements of that package. The Commission should reject the proposal to disallow Nicor Gas' employee stock options expenses.

I. Incentive Compensation

Staff witness Ms. Pugh has proposed to disallow \$6,089,000 in incentive compensation expenses, asserting that such costs do not benefit ratepayers. (Pugh Dir., Staff Ex. 3.0, 4:77 – 8:161, Schedule 3.08; Pugh Reb., Staff Ex. 12.0, 7:130 – 10:213, Schedule 12.02) AG witness Mr. Effron has proposed a similar disallowance. (Effron Dir., AG Ex. 1.0, 22:6 – 16, Schedule C-2.1) Their proposals are without merit and should be rejected.

As is discussed in the previous subsection, Ms. Pugh and Mr. Effron lack credentials to offer expert opinion on how to manage human resources. Even more importantly, as also is discussed in the previous subsection, Ms. Pugh and Ms. Effron simply have failed to come to grips with the facts that potential and existing employees in making decisions about their careers consider total compensation, and that Nicor Gas accordingly follows a long-established total compensation approach to employee compensation that: (1) has been and is developed and implemented on an ongoing basis with the assistance of analyses, data, and recommendations from leading outside experts; (2) considers overall employee compensation as well as its components; and (3) seeks overall to pay employees at the median -- the "50th percentile" -- of the applicable labor market, in order to best balance the objectives of obtaining a sufficient, qualified work force while controlling costs.

Moreover, there is not, and there cannot be, any argument that it is imprudent or unreasonable for Nicor Gas to pay incentive compensation, or that the amount that Nicor Gas pays is excessive, given the evidence in this case. Indeed, the evidence is uncontradicted that it

is common for employers in the utility industry to pay incentive compensation, and that Nicor Gas' incentive compensation programs are low in amounts when compared to the incentive compensation packages of other utilities, both in terms of potential dollar value payout and in terms of percentage of incentive compensation as compared to the total compensation package. (*E.g.*, Bacidore Reb., Nicor Gas Ex. 25.0, 6:127 – 7:144)

In any event, Ms. Bacidore in her rebuttal, and again in her surrebuttal, refuted Ms. Pugh's and Mr. Effron's proposed disallowances of incentive compensation expenses and their underlying assertions, at great length and in great detail. (Bacidore Reb., Nicor Gas Ex. 25.0, 1:13 – 20, 3:45 – 11:242; Bacidore Sur., Nicor Gas Ex. 40.0 1:13 – 6:120) For example, Ms. Bacidore, in her rebuttal, pointed out the following:

Ms. Pugh's and Mr. Effron's respective proposed adjustments to disallow Nicor Gas' recovery of incentive compensation costs should be rejected. Their proposals are not valid, instead, they are arbitrary, and they are not in the interests of customers. They are contrary to best and common practices, they serve no valid purpose, and they ultimately would negatively impact Nicor Gas' ability to attract, motivate, and retain a quality work force and/or require commensurate increases in other labor costs. Disallowing incentive compensation ultimately is a "lose-lose" proposition for Nicor Gas and its customers.

(Bacidore Reb., Nicor Gas Ex. 25.0, 1:13 – 20)

- Q. Ms. Pugh, in her testimony, expresses the view that tying the funding of incentive compensation to the financial performance of Nicor Gas benefits shareholders, and not ratepayers. Is that an accurate conclusion?
- A. No. Nicor Gas' incentive compensation programs benefit ratepayers as well as Nicor Gas. Through its incentive compensation programs, as part of its total compensation package, Nicor Gas is able to attract a skilled, knowledgeable workforce while holding down costs to ratepayers. Moreover, given Nicor Gas' total compensation approach, incentive compensation costs commensurately reduce other compensation costs. In addition, I discussed in my direct testimony other reasons that tying the programs to a net income trigger benefits customers.
- Q. What would be the results of a decrease in funding for Nicor Gas' incentive compensation programs?

- A. A decrease in the level of funding for the incentive compensation programs would harm ratepayers, in both the long run and in the near term. As I indicated in my direct testimony, prospective and current employees make employment decisions based in large part upon total cash compensation. If Nicor Gas were forced to eliminate or reduce its incentive compensation programs, then it would have to increase other aspects of its total compensation package commensurately in order to maintain its competitiveness as an employer within the industry and to continue to attract a skilled work force. That would result in higher direct payroll costs. The increase would have to match the decrease in expected incentive compensation payouts, in order to keep total compensation at the 50th percentile -- median -- level of the relevant labor market. If Nicor Gas let its total compensation slip due to the elimination of incentive compensation, then over time the results would be losing qualified employees and failing to attract qualified employees, leading either to understaffing or to the attraction and retention of employees who do not have the skill sets to provide the same level of adequate, safe, reliable, and cost-efficient service. Furthermore, training new employees requires expending considerable resources. More turnover means more training costs.
- Q. Does Ms. Pugh's testimony take into account the effect that reducing incentive compensation would have on the remaining components of total compensation?
- A. No. Nicor Gas data request 2.11 to Ms. Pugh asked: "Has Ms. Pugh or any other Staff witness analyzed whether, if Nicor Gas terminated its incentive compensation plans, it would be required to increase other forms of compensation in order to be able to retain and attract qualified employees? If so, please provide such analysis, including its methodology, data, and results." Ms. Pugh answered: "No. Further, Nicor has not provided such analysis either." (As noted earlier, a copy of said data request response is attached hereto as Nicor Gas Ex. 25.2.) The first part of her answer -- "No" -- demonstrates that Ms. Pugh's analysis is fatally flawed. She simply does not know whether reducing incentive compensation would lead to offsetting increases in other forms of compensation or, to put it the other way around, she simply does not know whether paying incentive compensation leads to offsetting reductions of other compensation expenses. The second part of her answer, which was gratuitous, is mistaken. I discussed this very point -- the "total compensation" point -- in my direct testimony. (Nicor Gas Ex. 9.0, pages 6, 9-10.) As I explained further, above, Nicor Gas has determined that, as part of its philosophy of implementing cost-effect strategies, which is one the keys to success for a regulated utility, it needs to pay total compensation at the "50th percentile" -- median -- level in order to retain and attract a qualified work force. Nicor Gas' conclusion that reducing incentive compensation will require offsetting increases in other

compensation is in fact based on analysis, notwithstanding Ms. Pugh's volunteered assertion to the contrary.

- Q. Does Mr. Effron's testimony take into account the effect that reducing incentive compensation would have on the remaining components of total compensation?
- A. No. His testimony suffers from the same fatal flaw on that score (as well as others) as does Ms. Pugh's testimony.
- Q. Is there any reason of which you are aware that the reductions in other compensation expenses that follow from paying incentive compensation do not or should not "count" as a benefit to customers?
- A. No. While it is not entirely clear, Mr. Effron, and possibly Ms. Pugh, seems to proceed from the premise that only reductions of other types of expenses "count". That makes no sense from the perspective of customers. Setting aside rate design issues, which are not relevant here, customers are not better or worse off, when rates are being set, because a reduction in operating expenses involves one category of costs and not another. In this context, a dollar is a dollar.

(Bacidore Reb., Nicor Gas Ex. 25.0, 7:145 – 10:207)

In contrast, Ms. Pugh and Mr. Effron in their respective rebuttals stuck to their trees and ignored the forest, presenting no facts that rebut Ms. Bacidore's points regarding Nicor Gas' total compensation approach, and the imprudence and illogic of proposing to disallow incentive compensation without regard for those points. (*See* Pugh Reb., Staff Ex. 12.0, 7:128 – 10:213; Effron Reb., AG Ex. 1.3, 20:5 – 21:2)

The cross-examinations of Ms. Pugh and Mr. Effron showed that their positions on the subject of incentive compensation (as well as other employee compensation) fundamentally are completely illogical, for they have no true relationship to the total amount of operating expenses for employee compensation, and instead, they simply seek to punish Nicor Gas for choosing incentive compensation as one of the elements of the total compensation package, without regard for the real world consequences of doing so. (*See* Pugh, Tr. 1033 – 1044; Effron, Tr. 1157 – 1167) Moreover, Mr. Effron acknowledged that just because an incentive compensation

program has financial goals does not necessarily mean that it benefits only stockholders, and that if a incentive compensation program is tied to cost reductions that benefit customers, then it is reasonable to include the program' expenses in the revenue requirement. (Effron, Tr. 1164 – 1167)

Ms. Pugh also points to the fact that the Commission has disallowed incentive compensation expenses in several other Dockets, but that does not warrant disallowing Nicor Gas' incentive compensation expenses. "The issue should be decided based on the record in this Docket. Moreover, while the Commission has denied incentive compensation program costs in some Dockets, it has approved it in others, including Nicor Gas' last general rate case, ICC Docket 95-0219, and, more recently, ICC Dockets 03-0403, 02-0690, and 01-0423. *In re Consumers Illinois Water Co.*, Docket 03-0403, page 12 (Order April 13, 2004; *In re Illinois-American Water Co.*, Docket 02-0690, pages 17-19 (Order August 12, 2003); *In re Commonwealth Edison Co.*, Docket 01-0423, pages 109-111 (Interim Order April 1, 2002), and pages 120-122 (Order March 28, 2003). Toting up the Orders, however, is not the point. The point is that Nicor Gas has shown in this Docket that its costs should be allowed." (Bacidore Reb., Nicor Gas Ex. 25.0, 11:234 – 242) (emphasis in original) The fact is that the total compensation Nicor Gas has paid has resulted in one of the most cost-efficient gas utilities in the country. Ms. Pugh's and Mr. Effron's proposed disallowances should be rejected.

J. Payroll Expense

AG witness Mr. Effron proposes a revised reduction to payroll expense of \$502,000 included in OO&M expenses based on his assertions relating to employee headcounts. (Effron Reb., AG Ex. 1.3, 20:5 – 13) Mr. Effron's proposed adjustment is erroneous and unwarranted, for numerous reasons. His assertions relating to employee headcounts are misguided and do not

support his proposed adjustment, he has shown no valid reason for rejecting Nicor Gas' forecast, and Nicor Gas' 2005 operating expenses are "on track", with OO&M expenses now forecasted to be roughly \$500,000 over budget. (Bacidore Reb., Nicor Gas Ex. 25.0, 1:21 – 2:28, 11:244 – 12:269; Nicor Gas Ex. 25.1; Bacidore Sur., Nicor Gas Ex. 40.0, 6:122 – 7:141; Gorenz Reb., Nicor Gas Ex. 26B.0, 2:45 – 3:49, 11:242 – 245, 13:288 – 15:331; Gorenz Sur., Nicor Gas Ex. 41.0, 29:642 – 30:646) Mr. Effron's proposed adjustment should be rejected.

K. Payroll Tax

Staff's and the AG's respective proposed adjustments to Nicor Gas' forecasted payroll taxes are derivative of Staff's and the AG's respective proposed adjustments relating to incentive compensation and payroll expenses, discussed in subsections "I" and "J" of this Section III. There are no "independent" payroll tax issues. Because those proposed adjustments are without merit and should be rejected, as discussed in those subsections, the associated payroll tax expense impacts should be rejected as well.

L. Corporate Benefit Plan Expense

AG witness Mr. Effron has proposed a disallowance of half of Nicor Gas' corporate benefit plan expense, to reduce these expenses by \$1,103,000, which reflects the forecast increase in such expenses over 2004. (Effron Dir., AG Ex. 1.0, 24:13 – 21, 27:3 – 8, Schedule C-2) His proposal is based on the assumption that Nicor Gas will only pay out 50% of the 2005 forecast expense based on the 2003 data. (Effron Dir., AG Ex. 1.0, 27:3 – 8) This proposed disallowance is yet another inappropriate attempt to make a selective update of Nicor Gas' test year forecast, which Nicor Gas properly assembled through the work of a great number of trained people, and which Nicor Gas has shown, with uncontradicted evidence, to be on track, with OO&M expenses now forecasted to be roughly \$500,000 over budget. (Bacidore Reb.,

Nicor Gas Ex. 25.0, 13:284 – 292; Bacidore Sur., Nicor Gas Ex. 40.0, 7:157 – 8:167; Gorenz Reb., Nicor Gas Ex. 26B.0, 2:45 – 3:49, 11:242 – 245, 13:288 – 15:331) In effect, the AG’s proposal would require Nicor Gas to inappropriately budget for less than 100% of the corporate benefit plan expense, an action that would send a negative message to both the employees and the financial community. (Bacidore Reb., Nicor Gas Ex. 25.0, 14:294 – 297) The Commission should reject the proposed disallowance.

M. Interest Expense on Customer Deposits

Nicor Gas has forecast \$314,000 in interest expense related to customer deposits. (Nicor Gas Ex. 11B.1 at Schedule B-13) AG witness Mr. Effron has proposed an upward adjustment of \$477,000 to reflect 2004 year-end numbers. (Effron Reb., AG Ex. 1.3, Schedule C-2) That adjustment should not be adopted. As discussed in several previous subsections of this Initial Brief, such as subsection “B(2)” of Section II, it is inappropriate to make selective adjustments to Nicor Gas’ carefully and thoroughly developed 2005 budget and forecast simply to reflect 2004 year-end numbers. (*See also, e.g.,* O’Connor Sur., Nicor Gas Ex. 34.0, 26:586 – 591) Mr. Effron’s proposed adjustment should be rejected.

N. Interest Synchronization

Nicor Gas has proposed an interest expense component of \$42,080,000. (Nicor Gas Ex. 26B.1 at Schedule 1.03) The interest expense is computed by multiplying its revised proposed net rate base, \$1,441,082,000, by its weighted cost of debt, 2.92%. (*Id.*) Staff witness Mr. Struck has proposed an interest expense of \$36,367,000. (Struck Reb., Staff Ex. 10.0 Revised, Schedule 10.05 Revised) His proposal differs due to his use of Staff’s proposed net rate base of \$1,289,611,000 and its proposed cost of debt of 2.82% (*Id.*), which are refuted in Sections II and V of this Initial Brief, respectively. Mr. Struck’s proposed adjustments should be

rejected. (*See also* Gorenz Reb., Nicor Gas Ex. 26B.0, 88:1974 – 1979; Gorenz Sur., Nicor Gas Ex. 41.0, 28:614 – 620)

AG witness Mr. Effron has proposed an interest expense of \$29,399,000 with a corresponding tax impact of \$926,000 for state taxes and \$4,114,000 for federal taxes. (Effron Reb., AG Ex. 1.3, Schedule C-5) His proposal, too, is derivative of GCI’s proposed net rate base and CUB/CCSAO’s proposed cost of debt (*Id.*), which are refuted in Sections II and V, respectively. His proposed adjustments should be rejected.

O. Uncollectibles Expense

Nicor Gas has proposed to include the gas cost (commodity-related) portion of uncollectibles expenses in Rider 6. That proposal is discussed in the Overview subsection and subsections “B(3)(a)” and “B(3)(b)” of Section VI of this Initial Brief

The total amount of uncollectibles originally proposed by Nicor Gas (the relevant update is discussed below) to be included in its base rate operating expenses, based on its careful and thorough forecast, was \$30,355,000. (*E.g.*, Suppes Dir., Nicor Gas Ex. 7.0, 9:190 – 10:214; Nicor Gas Ex. 11B.1, at Schedules C-1, C-2.1, C-2.2) Of that amount, \$20,216,000 is attributable to the commodity portion -- that determination was based on a careful calculation, using valid statistical sampling procedures, of a 66.6% portion being attributable to the commodity, as is discussed further in the Overview subsection and subsections “B(3)(a)” and “B(3)(b)” of Section VI. (*E.g.*, O’Connor Dir., Nicor Ex. 12A.0, 29:642 – 653; Herrera Dir., Nicor Ex. 15.0, 10:174 – 11:191; Nicor Gas Ex. 11B.1 at Schedule C-2.2)

The conservatively updated figures for the total amount of uncollectibles expenses and the commodity portion presented in Nicor Gas’ rebuttal testimony are \$35,162,000 and \$23,417,000, respectively, based on an updated uncollectibles loss factor of 1.40% that may still

be too low and the 66.6% allocation. (Suppes Reb., Nicor Gas Ex. 23.0, 4:71 – 6:114; Gorenz Reb., Nicor Gas Ex. 26B.0, 17:374 – 20:442, 78:1761 – 81:815; Nicor Gas Ex. 26B1 at Schedules C-1, C-2, 1.04; Nicor Gas Ex. 26B.2 at Schedules 1.0, 1.01) Staff witness Mr. Struck has accepted Nicor Gas' use of the updated uncollectibles loss factor of 1.40%. (*E.g.*, Struck Reb., Staff Ex. 10.0 Revised, Schedule 10.09 Revised; Gorenz Sur., Nicor Ex. 41.0, 24:523-524)

AG witness Mr. Effron has contested the updated uncollectibles loss factor of 1.40%. (Effron Reb., AG Ex. 1.3, 17:1–23) He proposes the use of a loss ratio significantly lower than the loss ratio that Nicor Gas will experience during the test year, asserting that the loss ratio should be 1.30% based on historical averages. (Effron Reb., AG Ex. 1.3, 17:9 – 23) However, Mr. Effron's proposal is flawed in that it does not recognize the significant increases in uncollectibles expenses which Nicor Gas has experienced and is continuing to experience and is a factually incorrect historical computation. Mr. Effron's calculation is flawed in at least two fundamental respects: (1) it relies on historical averages to predict future uncollectibles expenses when the historical data indicated that uncollectibles are trending upwards; (2) Mr. Effron compares projected net charge-offs to current revenues to determine the uncollectibles ratio. (Gorenz Sur., Nicor Gas Ex. 41.0, 22:484 – 487) The reliance on an historical average is inappropriate as evidenced by the upward trend in uncollectibles discussed by Nicor Gas witness Ms. Suppes. (*E.g.*, Suppes Reb., Nicor Gas Ex. 23.0, 4:77 – 5:93; Suppes Sur., Nicor Gas Ex. 38.0, 3:65 – 4:80) Because uncollectibles are trending upward, an historical average will represent a lower uncollectibles level than would be expected based on the trend. Mr. Effron's use of current revenues to determine the uncollectibles ratios of historical uncollectibles levels is inappropriate. Nicor Gas witness Mr. Gorenz has illustrated that projected net charge-offs track most closely with revenues eight months earlier. (Gorenz Reb., Nicor Gas Ex. 26B.0, 80:1792 –

1798) Comparison of projected net charge-offs to current revenues results in an under representation of the true uncollectibles ratio. In fact, Nicor Gas experienced a 1.40% uncollectibles expense ratio for the first quarter of 2005 and began the second quarter of 2005 experiencing a 1.45% uncollectibles expense ratio. (Gorenz Sur., Nicor Gas Ex. 41.0, 23:508 – 24:514) Nicor Gas' update should be approved, because Nicor Gas has demonstrated the continuing upward trend in uncollectibles expense and has shown that this trend is expected to continue. A 1.40% uncollectibles ratio, as used by Nicor Gas and Staff, more accurately reflects the test year uncollectibles ratio Nicor Gas is experiencing and will experience going forward. The Commission should adopt Nicor Gas' and Staff's use of the 1.40% uncollectibles ratio in this proceeding.

Thus, if the Commission does not accept Nicor Gas' proposal to include commodity-related uncollectibles expenses in Rider 6, the amount of uncollectibles expenses that should be included in its base rate operating expenses is \$35,162,000. If the Commission accepts Nicor Gas' proposal, however, then the amount of uncollectibles expenses that should be included in its base rate operating expenses is \$11,745,000.

P. Income Tax Expense

Nicor Gas's revised proposed figure for income taxes is \$52,163,000, which is derivative of its revised proposed net operating income figure of \$130,130,000 and the applicable income tax rates. (E.g., Gorenz Reb., Nicor Gas Ex. 26B.0, 3:63 – 67, 6:119 – 124, 74:1672 – 75:1680) Staff's and GCI's proposed adjustments relating to income taxes are entirely derivative of their proposed adjustments to net rate base, operating expenses, and the rate of return, which have been shown to be without merit in Sections II, III, and V of this Initial Brief. There are no

“independent” proposed adjustments relating to income taxes. Nicor Gas’ revised figure should be approved.

Q. Rate Case Expense

Nicor Gas’ proposed rate case expense amount of \$3,575,000 is uncontested, as noted earlier. The only dispute on this subject is the amortization period.

Nicor Gas has conservatively proposed a five year amortization period based on the prevailing circumstances, the approval of a five year period for this purpose in its last general rate case, Docket 95-0219, and Commission Orders in other recent rate cases. (O’Connor Reb., Nicor Gas Ex. 26A.0, 20:674 – 676, 58:1291 – 1293; Gorenz Reb., Nicor Gas Ex. 26B.0, 83:1879 – 84:1904) Nicor Gas’ understanding is that the Commission in recent cases (from 2000 to date) consistently has approved or imposed rate case expense amortization periods of five years or less, and that Staff has not proposed a period of longer than five years. (Nicor Gas Ex. 26B.3 at Staff data request responses Nicor-TEE.2.03 through Nicor-TEE.206) *See, e.g., In re South Beloit Water, Gas and Electric Co., et al.*, Docket 03-0676 Cons., page 6 (Order Oct. 6, 2004); *In re Cedar Bluff Utilities, Inc., et al.*, Docket 03-0398 Cons., page 7 (Order April 7, 2004); *In re Central Illinois Public Service Co., et al.*, Docket 02-0798, page 57 Cons. (Order Oct. 22, 2003); *In re Central Illinois Light Co.*, Docket 02-0837, page 23 (Order Oct. 17, 2003); *In re Illinois Power Co.*, Docket 01-0432, page 27 (Order March 28, 2002); *In re Commonwealth Edison Co.*, Docket 01-0423, page 111 (Interim Order April 1, 2002) and page 122 (Order March 28, 2003); *In re Consumers Gas Co.*, Docket 00-0575, page 5 (Order June 27, 2001); *In re Sundale Utilities, Inc.*, Docket 00-0513 Cons., page 7 (Order March 27, 2001); *In re Consumers Illinois Water Co., et al.*, Docket 00-0337, page 6 Cons. (Order Jan. 31, 2001); *In re United Cities Gas Co.*, Docket 00-0228, page 5 (Order Oct. 18, 2000).

Staff nonetheless has argued for an eight year amortization period in this case. (Ebrey Dir., Staff Ex. 2.0, 7:115 – 124) Ms. Ebrey bases her proposal solely on the (rounded) average of years between Nicor Gas rate cases over the 23 year period from 1981 to 2004. (Ebrey Dir., Staff Ex. 2.0, 7:115 – 124) Staff's approach also is inconsistent and selective, in terms of the minimal regard shown here for prior Commission Orders involving Nicor Gas and other utilities versus the great weight placed by Staff on Commission Orders on other subjects. (O'Connor Reb., Nicor Gas Ex. 26B.0, 57:1280 – 58:1305; O'Connor Sur., Nicor Gas Ex. 34.0, 10:229 – 11:250) More importantly, Staff's assumption that an eight year period is reasonable based on past experience cannot be squared with Staff's approaches to determination of net rate base, base rate operating expenses, weather normalization, the rate of return, and rate design discussed in Sections II through V of this Initial Brief, which work to incorrectly reduce Nicor Gas' revenue requirement, as well as its opportunity to recover that revenue requirement, through its base rates, leaving Nicor Gas in an unsustainable position. The Commission should approve Nicor Gas' conservative and reasonable proposal for a five year amortization period for rate case expenses.

R. Gross Revenue Conversion Factor

Nicor Gas has used a revised gross revenue conversion factor of 1.683178 with an uncollectibles loss factor of 1.40%. (Gorenz Reb., Nicor Gas Ex. 26B.0, 89:1999 – 90:2016; Nicor Gas Ex. 26B.1 at Schedule A-2.1) Staff's Mr. Struck has proposed substantially the same gross revenue conversion factor (with a minor difference due to rounding) of 1.683179 with the same uncollectibles loss factor of 1.40%. (Struck Reb., Staff Ex. 10.0 Revised, 5:92 – 100 and Schedule 10.07)

The AG's Mr. Effron, however, has proposed a lower gross revenue conversion factor of 1.681472, due to his proposed use of a 1.30% uncollectibles loss factor rather than the 1.40%

figure calculated by Nicor Gas and accepted by Staff. (Effron Reb., AG Ex. 1.3, 17:1 – 23) As is discussed in subsection “O” of this Section III, the loss factor employed by Mr. Effron is inappropriate and does not reflect current loss experience, while the 1.40% figure is correct, if not too low. The Commission should adopt the gross revenue conversion factor calculated by Nicor Gas, which includes the uncollectibles loss factor supported by Staff.

S. Other

Nicor Gas at this time has not identified any other item to be addressed in this Section III.

IV. WEATHER NORMALIZATION

Nicor Gas’ gas deliveries, and therefore revenues, are highly dependent on weather. A comparison of Nicor Gas’ sendout of gas with the key weather statistic reflecting use of gas for space heating, the “heating degree day,” reveals a close correlation between cold temperatures and gas deliveries.²⁴ Similarly, over the course of a winter, a colder winter results in more, and a warmer winter results in less deliveries. Weather normalization is a method of predicting expected weather for a utility’s service area and building it into the rates. (O’Connor Dir., Nicor Gas Ex. 1B) No party disputes this, or disputes the concept that weather normalization is appropriate for setting Nicor Gas’ rates.

The dispute centers on the calculation of the normal weather – – the predicted number of heating degree days – – that Nicor Gas can expect. In a number of rate cases, including Nicor Gas’ 1995 Rate Case, the Commission approved weather normalization based on a thirty-year average of heating degree day statistics. Nicor Gas has proposed here that the normal weather be

²⁴ A heating degree day is sometimes abbreviated HDD. The number of HDDs is the number of degrees Fahrenheit that the actual mean daily temperature is below 65 degrees Fahrenheit. (Takle Dir., Nicor Gas Ex. 16.0, 5:102 – 6:114)

the average of the actual annual heating degree days experienced over the most recent ten calendar years prior to the filing of this rate case. Nicor Gas proved, based on an analysis of the statistics over the past 75 years, that compared to using an average of the past thirty years, an average of the past ten years will more accurately predict the heating degree days over the period of time that Nicor Gas' proposed rates are expected to be in effect. Nicor Gas presented the testimony of Dr. Cesar Herrera, an expert in statistics, who analyzed how predictive a ten-year average is compared to a thirty-year average. He found that the ten-year average is significantly more accurate in predicting future heating degree days. (Herrera Dir., Nicor Gas Ex. 15.0, 8:132 – 9:145) No party questioned this analysis or Dr. Herrera's testimony.

Moreover, Nicor Gas proved that the winter climate in its service territory has begun to warm, and is expected to continue to do so over the next several years. A climate scientist, Prof. Eugene Takle, showed that Dr. Herrera's statistical results are consistent with the current scientific consensus on climate change. (Takle Dir., Nicor Gas Ex. 16.0, 28:609 – 613) The changing climate makes a shorter averaging period more accurate than a longer period, which has many years of data from the less relevant colder regime. (*Id.* at 28:600 – 608; *see also* Herrera Dir., Nicor Gas Ex. 15.0, page 8, Figure 3) Again, no party contested Professor Takle's conclusions.

The effect of using an appropriate weather normalization period is not trivial; it is essential if Nicor Gas' rates are to be fair. The ten-year average of heating degree days is 5,830 per year. (Herrera Dir., Nicor Gas Ex. 15.0, 9:Table 2) The thirty-year average is 6,072 HDDs per year. Setting the gas deliveries based on the higher 6,072 HDD level will cause Nicor Gas' rates for recovering the allowed base rate revenue requirement to be set too low for the number of heating degree days that the record proves Nicor Gas' service territory is likely to experience.

Thus, when the weather is, in fact, warmer than the 6,072 HDD per year level, incorrectly setting the normalization number at 6,072 HDD will cause Nicor Gas to under-earn \$5,465,000 - \$8,435,000, depending on the rate design used. (Harms Reb., Nicor Gas Ex. 32.0, 41:878 – 891; Harms Sur., Nicor Gas Ex. 44.0, 28:627 – 629) Staff agrees that the Commission should not set Nicor Gas’ rates in a manner that does not give Nicor Gas a fair chance to earn its revenue requirement. (Beyer, Tr. 838 – 839) In fact, Mr. Beyer agreed that it would be wrong for the Commission to purposely award a utility rates under which it would not be expected to recover its revenue requirement. (*Id.*, Tr. 839)

Although the facts are uncontested, Staff nonetheless requests the Commission to ignore the record and use the less accurate thirty-year average. Staff’s reasoning can be fairly characterized as “but we’ve always done it that way.” The Commission, however, is not bound by its prior decisions; the Commission has the power to deal with each situation before it regardless of how it may have dealt previously with a similar or the same situation. *Citizens Utility Board v. Illinois Commerce Comm’n*, 291 Ill. App. 3d 300; 307, 683 N.E.2d 938, 945 (1st Dist. 1997); *City of Chicago v. Illinois Commerce Comm’n*, 133 Ill. App. 3d 435, 440, 478 N.E.2d 1369, 1373 (1st Dist. 1985). The Commission’s decision must be based on its findings and analysis in this Docket. *E.g.*, 220 ILCS 5/10-201(e)(iii). Yet, Staff offered no proof at all that a thirty-year average outperformed a ten-year average in predicting future deliveries, or even that a thirty-year average was scientifically or statistically sound. Staff’s only witness was not a scientist, nor a statistician, nor an engineer. (Beyer, Tr. 834) And yet, Staff’s witness agreed that scientists, statisticians, and utility engineers were the types of experts that one would trust on these issues (Beyer, Tr. 842 – 843), and that is the type of evidence Nicor Gas presented. As Professor Takle explained, if the Commission chooses to impose the thirty-year average on Nicor

Gas for the sake of tradition and uniformity, it will be at the expense of scientific validity. (Takle Reb., Nicor Gas Ex. 29.0, 1:14 – 19)

Staff's position is that the appropriate forum to address weather averaging is a new rulemaking. This is incorrect. There has never been a rulemaking on this issue, and the Commission has no rules on weather normalization, or rules that prevent a utility from proposing any particular normalization period. (Nicor Gas Exs. 28.2, 28.3; Beyer, Tr. 847 – 848) Yet the Commission has approved different periods for normalization of weather, storm damage expenses, and amortization of rate case expenses in utility rate cases based on the facts presented in each specific case. (Beyer, Tr. 848 – 849; Nicor Gas Exs. 28.7, 28.8) Because many of the cases considering weather normalization have used a thirty-year average, Staff concludes that, although there is no promulgated rule, there is a "practice." (Beyer Dir., Staff Ex. 9.0, 2:34 – 40) As described by Nicor Gas' witness Myra Karegianes, a former general counsel of the Commission and an expert on Commission procedure, the Commission decides cases based on facts, and does not allow a practice that is not a promulgated rule to trump the evidence in the record of a specific case. (Karegianes Reb., Nicor Gas Ex. 28.0, 8:167 – 172) This is how the Commission has decided this issue in the past, and that is all that Nicor Gas asks here: a decision based on the evidence in the record before it.

Here, Staff's use of the thirty-year average is based solely on Mr. Beyer's testimony, which does not present any actual evidence to support the thirty-year average. (Luth, Tr. 1353 – 1354) Having offered no evidence to contradict Nicor Gas' evidence, Staff in effect is asking the Commission to ignore the testimony of Dr. Herrera and Professor Takle. That would be improper: the Commission, in a contested rate case, must apply the law governing uncontradicted evidence. The Supreme Court of Illinois has held that: "Where the testimony of a

witness is neither contradicted, either by positive testimony or by circumstances, nor inherently improbable, and the witness has not been impeached, that testimony cannot be disregarded by the trier of fact.” *Bazydlo v. Volant*, 164 Ill. 2d 207, 215, 647 N.E.2d 273, 277 (1995). The courts have applied to administrative agencies the law governing uncontradicted evidence. For example, the Appellate Court has held: “While an administrative agency's findings of fact are considered prima facie correct, they must still be based on the evidence, and the agency as fact finder simply cannot disregard the testimony of an unimpeached witness where the testimony is uncontradicted and is not inherently improbable.” *Thigpen v. Retirement Board of Fireman's Annuity and Benefit Fund of Chicago*, 317 Ill. App. 3d 1010, 1021, 741 N.E.2d 276, 284 – 85 (1st Dist. 2000) (citing *Trahraeg Holding Corp. v. Property Tax Appeal Board*, 204 Ill. App. 3d 41, 44, 561 N.E.2d 1298, 1300 (2d Dist. 1990)). This comports with Staff witness Gene Beyer’s view of proper Commission policy: he agreed that “it would be wrong for the Commission to reduce a utility's revenue requirement or refuse to allow it to effect tariffs that will permit it to recover a revenue requirement based on evidence that's not part of the record in the rate case.” (Beyer, Tr. 840)

Moreover, Staff’s position is inexplicable. Staff has never instituted, proposed, or otherwise advocated a rulemaking on this issue. Although Nicor Gas advised Staff of its proposed weather normalization calculation before it filed its revised tariffs (Beyer, Tr. 851), Staff made no move toward a rulemaking. (*Id.*) After Nicor Gas filed its direct testimony spelling out exactly why it was using a ten-year average, Staff did not seek a rulemaking. Similarly, Staff did not commence a rulemaking during the fifteen years following a report from the Illinois Department of Energy and Natural Resources back in 1990 entitled *The Appropriate Use of Climatic Information in Illinois Natural-Gas Utility Weather-Normalization Techniques*.

(See Nicor Gas Ex. 28.1) This government report was discussed in Professor Takle's direct testimony (cited in Nicor Gas Ex. 16.2; discussed by Takle Dir., Nicor Gas Ex. 16.0, 24:525 – 27:591) in November, but as late as the hearings in May 2005, Staff's witness on this issue had yet to look at it. (Beyer, Tr. 849 – 850) Mr. Luth, who testified on the billing determinants, had not looked at it either. (Luth, Tr. 1354)

In any event, the purpose and necessity of Staff's preferred rulemaking proceeding is far from clear. Mr. Beyer expressed the opinion, as a non-scientist, that a rulemaking would allow the Commission to set an averaging period that took into account the climate in all parts of the State, and that considered cooling degree days as well as the heating season. Professor Takle, the scientist, suggested that such a broad rule might not be scientifically valid (Takle Reb., Nicor Gas Ex. 29.0, 3:54–60), and Nicor Gas put evidence into this record demonstrating a more accurate averaging period specifically applicable to Nicor Gas. And that is the only evidence in the record on which the Commission can base its decision.

V. RATE OF RETURN

Nicor Gas is entitled to a fair and reasonable rate of return. It is Nicor Gas' right, and critical to the continued performance of its duties as a utility. The United States Supreme Court articulated this standard more than sixty years ago:

...the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital.

(*Federal Power Commission et al. v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) (emphasis added)) In practical terms, a fair and reasonable return is one that is sufficient to attract investors to Nicor Gas in competition with other LDCs and other unrelated investments.

As shown in this Section V below, the record establishes that Nicor Gas' proposed rate of return is the only proposal that meets those standards. The alternative rates of return suggested by Staff and GCI do not even come close. Fundamentally, these alternatives are contrary to the evidence. Their flaws are, in the main, not complex or arcane matters of economics, statistics, or corporate finance theory. Nor do they stem from a difference of opinion, or the exercise of judgment. The errors underlying Staff's and GCI's proposals are factual, plain from the record, and underscore that their proposals are not just and reasonable rates of return. In contrast, Nicor Gas' proposed rate of return is well supported and should be accepted by the Commission.

A. Capital Structure (Inclusion of Short Term Debt)

1. Overall Rate of Return

Nicor Gas seeks a 9.03% overall rate of return on its net rate base. (Mudra Reb., Nicor Gas Ex. 20B.0, 4:91 – 92; Mudra Sur., Nicor Gas Ex. 36.0, 25:541 – 542) This is a reasonable and modest return, falling well within the range of returns allowed to other LDCs, both nationally and in Illinois. (Gordon Dir., Nicor Gas Ex. 2.0, 5:104 – 107) It is derived mathematically from Nicor Gas' actual embedded cost of long-term debt, its actual embedded cost of non-redeemable preferred stock, and its calculated annual rate of return on common equity. (Mudra Sur., Nicor Gas Ex. 36.0, 25:542 – 544) No party any longer contests the costs of Nicor Gas' long-term debt or preferred stock, and, as shown below, the 10.82% return on equity that Nicor Gas is using -- calculated with DCF and CAPM methods long accepted and used in Illinois, and based on a sample most closely comparable to Nicor Gas -- is appropriate. The proposed rate of return is based upon an end-of-test-year capital structure, which by the time of the hearing also was undisputed. (*See* Nicor Gas Ex. 20B.1) The proposed structure appropriately excludes Nicor Gas' short-term debt, consistent with past Commission orders

concerning that debt, as well as with investors' continued recognition that such debt is used, when it is used at all, to manage seasonal cash flow, not to finance the firm on an ongoing basis. (Hawley Reb., Nicor Gas Ex. 20A.0, 43:994 – 44:1006; Mudra Sur., Nicor Gas Ex. 36.0, 8:166 – 171, 9:191 – 193, 11:231 – 239) Also consistent with Commission standards, Nicor Gas seeks to recover its actual and previously unrecovered equity issuance or “flotation” costs. At the same time, Nicor Gas does not propose any novel adders, equity incentives, or special “factors” in its overall rate of return. The derivation of Nicor Gas’ proposed rate of return is summarized in the following table (Nicor Gas Ex. 20B.1, page 1):

Test Year: 12 Months Ended 12/31/05					
December 31, 2005					
Class of Capital (A)	Amount ⁽¹⁾ (\$000) (B)	Percent of Total (C)	Percent Cost (D)	Cost Reference (E)	Weighted Cost (F) = (C X D)
Long-term Debt ⁽³⁾	\$ 500,376	43.51 %	6.72 %	D-3	2.92 %
Non-redeemable Preferred Stock	1,401	0.12	4.77	D-4	0.01
Common Equity	<u>648,156</u>	<u>56.37</u>	10.82 ⁽²⁾	D-6	<u>6.10</u>
Total Capital	\$ <u>1,149,933</u>	<u>100.00 %</u>			<u>9.03 %</u>

⁽¹⁾ 2005 Forecasted year-end capital structure.

⁽²⁾ Revised cost of common equity requested in this filing.

⁽³⁾ Including redeemable preferred stock and long-term debt due within one year.

Staff and GCI nonetheless each argue for significantly lower rates of return: Staff, 7.55%, and GCI, 7.69%. (McNally Reb., Staff Ex. 14.0, 8:152 – 9:154; Staff Ex. 14.1; Thomas Reb., CUB/CCSAO Ex. 3.0, 2:16 – 23, 15:319 – 326) As shown below, these efforts to lower Nicor Gas’ overall return are based on arguments that are contrary to the record. In sum, Staff’s proposed rate of return rests mainly on: (1) the insistent claim that Nicor Gas’ return on equity should be pegged to that of a dissimilar group of companies that no longer meets Mr. McNally’s own already relaxed sample criteria and on the decision – which flows from the use of that non-comparable sample – to depress Nicor Gas’ return on equity even further to compensate for the

difference between Nicor Gas and the flawed sample; (2) the claim that all of Nicor Gas' short-term debt should be included in the capital structure at an artificially low rate, when in fact it is not appropriate to include any such debt; and (3) the simple refusal to accept Nicor Gas' evidence of its common equity flotation costs despite the indisputable competence of that evidence and the complete absence of evidence to the contrary. (Mudra Sur., Nicor Gas Ex. 36.0, 4:84 – 6:109) GCI adopts Staff's results-oriented position on short-term debt, and also proposes to ignore Nicor Gas' unrecovered flotation costs. (Thomas Reb., CUB/CCSAO Ex. 3.0, 5:79 – 91, 14:303 – 15:314) And while GCI witness Christopher Thomas uses, and acknowledges the propriety of, the sample proposed by Dr. Makhholm and Nicor Gas, GCI proposes a flawed means of calculating returns on equity. (Thomas Dir., CUB/CCSAO Ex. 1.0, 11:214 – 15:313; Thomas Reb., CUB/CCSAO Ex. 3.0, 13:278 – 279)

Although technical issues, such as estimation of the correct DCF growth rate, remain, it is the foregoing issues that constitute the core of the dispute. (*See* Mudra Sur., Nicor Gas Ex. 36.0, 4:84 – 6:115; Nicor Gas Ex. 36.1) The numerical significance of Staff's various positions is shown in following table (Nicor Gas Ex. 36.1):

**Contested Cost of Capital Issues
and their Effect on Rate of Return**

Cost of Equity Effects:	<u>Basis Point Reduction in Rate of Return</u>	<u>Annual Reduction in Revenue Requirements ⁽¹⁾</u>	
Choice of Gas Sample	25	\$6.1	
Growth Rate	15	\$3.6	
McNally 23 bp Risk Adjustment	14	\$3.4	
Other	<u>16</u>	<u>\$3.9</u>	
Total	70	\$17.0	MM/year
 Short-term Debt Effects:			
Cost of Short-term Debt	21	\$5.1	
Magnitude of Short-term Debt	<u>57</u>	<u>\$13.8</u>	
Total	78	\$18.9	MM/year
 Grand Total Cost of Capital Effects: ⁽²⁾	 148	 \$35.9	 MM/year

⁽¹⁾ Based on Nicor Gas' proposed net utility rate base of \$1,441,082,000 and the gross revenue conversion factor of 1.683178.

⁽²⁾ Nicor Gas's requested rate of return of 9.03% - Staff's proposed 7.55% ROR = 1.48% or 148 bps

Of these issues, the only significant one affecting capital structure relates to short-term debt, which is discussed in Section V.A.2, below. In the event that the Commission includes any short-term debt in Nicor Gas' capital structure -- which it should not do -- the amount of short-term debt included, even under Staff's flawed theory, should not exceed the maximum amount that could have funded the purchase of gas in storage, which is the only identified rate base asset that Staff claims has any relationship to short-term debt. Nor can the cost of Nicor Gas' short-term debt be reasonably set below its actual cost. (Mudra Reb., Nicor Gas Ex. 20B.0, 32:730 – 742; Mudra Sur., Nicor Gas Ex. 36.0, 25:550 – 553) These assumptions result in Nicor Gas'

being allowed an 8.88% overall annual rate of return (Mudra Sur., Nicor Gas Ex. 36.0, 25:549 – 550; Nicor Gas Ex. 36.2), still far above that proposed by Staff.

Aside from their particular flaws, the returns proposed by Staff and GCI are not reasonable overall. Such proposals would leave Nicor Gas with a rate of return at the very bottom of recent rates of return set for any gas LDC in the entire United States, and would relegate Nicor Gas to earning a level of net income far below that currently and historically allowed by the Commission and reflected in its financial expectations. (Mudra Sur., Nicor Gas Ex. 36.0, 25:560 – 563) There is no basis in reality or in the record for such treatment. In fact, the rates of return proposed by Staff and GCI are so extreme that they could preclude Nicor Gas from protecting its sound financial ratings, or from adequately funding its operations and meeting investor expectations. (Mudra Sur., Nicor Gas Ex. 36.0, 25:564 – 566)

Thus, for several reasons, both specific and overall, the Commission should accept the reasonable, well supported rate of return proposed by Nicor Gas, and should reject the deeply flawed and wholly unrealistic ones suggested by Staff and GCI.

2. Short-Term Debt in Nicor Gas' Capital Structure

Nicor Gas proposes to use its actual test-year capital structure to establish its overall rate of return. (Hawley Dir., Nicor Gas Ex. 3A.0, 5:100 – 108, 7:133 – 145) This proposal is not controversial in itself, but (as noted above) Staff and GCI are attempting to add short-term debt to that structure, even though such debt has no place in it. These attempts should be rejected. The Commission should, as it has in the past, approve Nicor Gas' capital structure without such debt.

Fundamentally, Nicor Gas does not use any short-term debt to provide a permanent source of capital for long-term assets. (Hawley Dir., Nicor Gas Ex. 3A.0, 5:110 – 6:117)

Rather, as extensive, and in this respect uncontradicted, testimony makes clear, Nicor Gas uses such debt – which comprises temporary, seasonal, short-term commercial paper borrowings – to manage cash requirements and meet seasonal cash flow needs. (Hawley Dir., Nicor Gas Ex. 3A.0, 5:110 – 6:117; Mudra Reb., Nicor Gas Ex. 20B.0, 18:408 – 19:446; Mudra Sur., Nicor Gas Ex. 36.0, 7:135 – 136, 8:159 – 167) These uses are evidenced by, among other things, Nicor Gas’ history of typically not having short-term debt outstanding year-around, as well as its forecast of being out of short-term debt for several months during the test year. (Hawley Dir., Nicor Gas Ex. 3A.0, 6:114 – 117; Mudra Reb., Nicor Gas Ex. 20B.0, 18:411 – 425; Mudra Sur., Nicor Gas Ex. 36.0, 8:172 – 176, 10:215 – 219)

Specifically, the undisputed record shows that Nicor Gas has not had any commercial paper outstanding for, on average, 58 days per year over the last six years, and in three of those years, it did not issue any short-term debt for 99 days or more. (Mudra Sur., Nicor Gas Ex. 36.0, 8:172 – 174) The record further shows, again without contest, that in 2005 specifically, Nicor Gas reached a zero short-term debt balance on March 10, 2005, is not currently expected to issue short-term debt until the third quarter of 2005, more than four months later, and as of May 13, 2005, had not used any short-term debt for 64 days (and counting). (Mudra Sur., Nicor Gas Ex. 36.0, 8:174 – 9:178)

Moreover, this issue is not driven solely by corporate finance theory. Like all questions of affording a fair overall return, it is also about how investors see Nicor Gas and about how Nicor Gas can be allowed an economic return to support its activities going forward long-term. The record is clear and uncontradicted that investors understand that Nicor Gas’ rate base investments, including its 13-month average balance of gas in storage, are long-term investments, and are not financed with short-term debt. (Mudra Sur., Nicor Gas Ex. 36.0,

9:195 – 198) Rather, as the undisputed evidence also shows, investors view Nicor Gas’ use of such debt as an effective means of cash management, not as a permanent part of its capital structure. (Mudra Sur., Nicor Gas Ex. 36.0, 8:168 – 170) These distinctions are critical, because investors demand returns based on how Nicor Gas is actually financed over the long term, and establishing a fair rate of return requires the application of Nicor Gas’ long-term cost of capital to its long-term investment in rate base. (Mudra Sur., Nicor Gas Ex. 36.0, 9:180 – 182) Ignoring these distinctions, and thus including short-term debt as part of long-term financing, would substantially impede Nicor Gas’ ability to earn such a fair return. (Mudra Sur., Nicor Gas Ex. 36.0, 9:182 – 186)

Some parties have tried to blur this distinction, claiming that Nicor Gas uses short-term debt as part of the capital from which it “supports” rate base and, therefore, that such debt should be included in the capital structure for ratemaking purposes. (McNally Reb., Staff Ex. 14.0, 4:65 – 72) This attempted blurring should be rejected. It apparently stems from the misguided notion that phrases such as “supports rate base” and “funds rate base” should be viewed in the context of physically tracing the funding sources from which on idealized fungible dollar of capital could theoretically come on any given day. (Mudra Sur., Nicor Gas Ex. 36.0, 9:195 – 10:200) Such an attempt to “trace” individual dollars of capital from source to use is not only imprecise and fruitless (*see* Mudra Sur., Nicor Gas Ex. 36.0, 15:320 – 321), but also irrelevant. The important issue is how Nicor Gas’ rate base is financed. (Mudra Sur., Nicor Gas Ex. 36.0, 10:200 – 201) As the record clearly demonstrates, Nicor Gas finances its rate base from a base level of long-term, permanent sources of capital with a stable structure, not with short-term debt. (Mudra Sur., Nicor Gas Ex. 36.0, 10:203 – 204) That Nicor Gas uses short-term debt on a temporary basis, for only parts of the year, as almost all businesses do, does not imply that such

debt is used for long-term capitalization or rate base. (Mudra Sur., Nicor Gas Ex. 36.0, 10:206 – 208)

The inherent fungibility of cash, while unassailable, does not change this analysis at all. The record is clear that Nicor Gas is out of short-term debt for substantial portions of the year, that it eliminates its short-term debt balances as soon as its receipts allow (not based on whether it is buying or selling gas or any other asset), and that short-term debt is simply the last source to which Nicor Gas will turn if, and only if, additional cash is needed for temporary or seasonal requirements. (*E.g.*, Mudra Sur., Nicor Gas Ex. 36.0, 10:215 – 219) It is therefore not surprising that seasonally variable assets or liabilities (whether in rate base or not) such as gas in storage appear to correlate with Nicor Gas' seasonal short-term borrowings, if one applies particular lags and adjustments. After all, Nicor Gas has clearly stated from the start that it uses short-term debt as a seasonal cash management tool. But, that does not mean that Nicor Gas' short-term debt is viewed either by its investors or by its management as financing Nicor Gas, or its rate base. Such a view would be inconsistent with Nicor Gas' actual practices in managing its long-term capital structure. (Mudra Sur., Nicor Gas Ex. 36.0, 10:220 – 226)

With respect to gas in storage, in particular, the market expects and demands that Nicor Gas earn a long-term return commensurate with its long-term average investment in that asset. (Mudra Sur., Nicor Gas Ex. 36.0, 10:220 – 11:228) This market behavior makes sense, given that seasonally-variable gas in storage balances go hand in hand with Nicor Gas' very long-term investment in its aquifer storage fields. (Mudra Reb., Nicor Gas Ex. 20B.0, 29:660 – 664) Those fields are useful assets because they can store gas, and used because every year, they do. (Mudra Reb., Nicor Gas Ex. 20B.0, 29:660 – 666) Investors know it will be that way, long-term. (Mudra Reb., Nicor Gas Ex. 20B.0, 29:660 – 661) That these long-term assets store seasonally-

varying amounts of gas hardly changes this fact; indeed, it is exactly what investors expect. (Mudra Reb., Nicor Gas Ex. 20B.0, 29:661 – 666) The notion that Nicor Gas should earn only a short-term return on this asset is thus inconsistent with their expectations. (Mudra Reb., Nicor Gas Ex. 20B.0, 29:666-669)

The accounting treatment of gas in storage further supports this analysis. This asset is accounted for on a LIFO layer basis, and therefore reflects gas that was stored from one to many years ago. (*See* Gorenz Reb., Nicor Gas Ex. 26B.0, 45:995 – 47:1045) Treating this asset as a purely short-term asset would not be consistent with such accounting.

The evidence shows that improper inclusion of short-term debt in Nicor Gas' capital structure would have several other harmful effects, as well. For instance, short-term interest risk and variability would be unfairly introduced into Nicor Gas' rate of return, and Nicor Gas' ability to attract adequate levels of capital in the future would be impeded. (Mudra Sur., Nicor Ex. 36.0, 9:180 – 186) Including short-term debt also would send irrational economic and financial signals to other utilities that do not actually rely on such debt as a source of long-term financing, and would encourage them to hold excess long-term debt or common equity, which in turn would drive up the cost of capital and thereby increase those firms' financial risk and reduce their financial flexibility. (Mudra Sur., Nicor Ex. 36.0, 11:242 – 12:250)

For the Commission, there is nothing novel in excluding short-term debt from Nicor Gas' capital structure. In fact, it would be novel to include it. The Commission has already evaluated the exact same debt in the exact same circumstances with the exact same purposes for the exact same utility, and has rightly approved that exclusion. For instance, as the record shows -- without any dispute whatsoever -- in the 1995 Rate Case: Nicor Gas had the same need to respond to daily and seasonal cash flow requirements, including gas costs, with revenues and

other available sources of funds; short-term borrowing was used on the same basis as it is today; and Nicor Gas paid off that debt with the same regularity. (Mudra Sur., Nicor Gas Ex. 36.0, 13:282 – 291) Given this exact replication, the Commission should easily conclude here, as it did in the 1995 Rate Case, that short-term debt should be excluded from Nicor Gas’ capital structure. *In re Northern Illinois Gas Co.*, Docket 95-0219, 1996 Ill. PUC Lexis 204 at *83 (Order April 3, 1996). Such a result likewise would be consistent with the Commission’s Order in Nicor Gas’ 1987 rate case, which also approved a capital structure without short-term debt. *In re Northern Illinois Gas Co.*, Docket 87–0032, 1987 Ill. PUC Lexis 37 at *13 (Order Jan. 27, 1987).

Moreover, the Commission has already determined that Nicor Gas’ gas in storage – the sole identified asset that Staff claims could be related to short-term debt – does not alter this analysis. In setting the avoided carrying costs of this asset in 2002, the Commission determined that such costs were based on the long-term cost of capital approved in the 1995 Rate Case, not on the cost of short-term debt. *In re Citizens Utility Board et al.*, Docket 00-0620 Cons., 2002 Ill. PUC Lexis 16 at *40 (Order on Rehearing Jan. 3, 2002). In fact, Staff argued in that case that storage gas was not financed by short-term debt. *Id.* at *35 Mr. McNally does not and cannot reconcile that position – or the Commission’s ruling, setting the carrying charge based on the 1995 cost of capital that expressly excludes short-term debt – with his position in this case.

Nor can Mr. McNally reconcile his position here with Staff’s support of the exclusion of short-term debt from Nicor Gas’ capital structure in the 1995 Rate Case. *In re Northern Illinois Gas Co.*, Docket 95-0219, 1996 Ill. PUC Lexis 204 at *82 – 83 (Order April 3, 1996). Indeed, as Mr. McNally acknowledged, Staff in that case -- like Nicor Gas in this case -- argued that “the Company’s short-term debt [should] be excluded because the Company does not use its

short-term debt to finance long-term investments, but instead uses it to meet seasonal cash requirements.” *Id.* at *83 (emphasis added); *see* McNally, Tr. 920:10 – 18. Given that the record in this proceeding shows precisely the same situation, Staff’s 180-degree turnaround on this issue is neither explicable nor justified. In these circumstances, where the Commission has determined the general issue of excluding Nicor Gas’ short-term debt from its capital structure, as well as the specific issue of treating Nicor Gas’ gas in storage as not being supported by such debt – and Staff has heretofore supported those determinations – there is simply no reason for the Commission to revisit such issues again in this proceeding.

Moreover, including short-term debt would also have a radical and unfair impact. Staff’s proposal to include \$177.6 million of commercial paper at 2.58% would reduce Nicor Gas’ revenue requirement by \$18.9 million (assuming Nicor Gas’ proposed rate base) when, again, there has been no change in the use of commercial paper as a temporary cash management tool. (Mudra Sur., Nicor Gas Ex. 36.0, 14:293 – 297) In these circumstances, the Commission can and should easily follow its repeated rulings excluding short-term debt from Nicor Gas’ capital structure, and thus should accept the capital structure that Nicor Gas is proposing.

The Commission also should reject Staff’s suggestion that Part 285 of Title 83 somehow mandates a different result. Fundamentally, Part 285 sets out requirements for information that the utility must provide at the time of filing; it does not establish substantive law or rules of decision. 83 Ill. Admin. Code Part 285. There is no legal basis for Mr. McNally’s assertion that Part 285 requires inclusion of short-term debt in capital structure absent a certain showing. (McNally, Tr. 915:5 – 15, 924:16 – 926:6)

Staff’s own inconsistency on this account is noteworthy. For example, when discussing a separate issue of record retention during the hearings, Staff witness Thomas Griffin testified that

Part 285 establishes filing requirements and does not preclude parties from using different or additional data or adjustments for ratemaking purposes. (Griffin, Tr. 1097:22 – 1098:20) Moreover, with respect to flotation costs, Nicor Gas has provided all of the data required by Part 285 (in addition to its sworn testimony), yet Mr. McNally continues to assert that additional evidence is required. (McNally Reb., Staff Ex. 14.0, 9:156 – 10:187)

The Commission should consider the more general implications of forcing short-term debt into Nicor Gas' capital structure. If the Commission holds that Nicor Gas' capital structure must include short-term debt because of cash fungibility, despite the evidence that Nicor Gas uses such debt solely for cash management purposes, then it should expect that every utility using any short-term debt balance, for whatever purpose, will be put in the same position.

Indeed, this is another reason why including short-term debt in the capital structure is so unjust to Nicor Gas. Nicor Gas has been consistent in excluding short-term debt, regardless of whether such exclusion hurts it (as it did in 1987) or helps it (as it does in this case). (Hawley Dir., Nicor Gas Ex. 3A.0, 5:109 – 6:117; Mudra Reb., Nicor Gas Ex. 20B.0, 11:267 – 30:684) Staff, on the other hand, has been inconsistent, apparently choosing whatever position lowers Nicor Gas' rate of return. Thus, despite the fact that there has been no change in the nature or uses of Nicor Gas' short-term debt, Staff supported a capital structure that did not include such debt in 1987 and rejected the use of such debt in computing carrying costs in 2002, yet seeks to include it here in setting base rates. *In Re Northern Illinois Gas Co.*, Docket 87-0032, 1988 Ill. PUC Lexis 37 at *11 (Order Jan. 20, 1988); *In re Citizens Utility Board et al.*, Docket 00-0620 Cons., 2002 Ill. PUC Lexis 16 at *34 (Order on Rehearing Jan. 3, 2002). The Commission should reject such an apparently results-driven approach, and instead base its decision on the clear record of evidence and its own clear prior decisions regarding this very debt.

Finally, in the event that the Commission determines that at least some amount of short-term debt does belong in Nicor Gas' capital structure, that amount should be calculated assuming that Nicor Gas uses all available sources of cash before issuing short-term debt to cover cash flow relating to gas in storage. (Mudra Sur., Nicor Gas Ex. 36.0, 16:353 – 357) Such a method of calculation would at least be consistent with Staff's own view of gas in storage. (Mudra Sur., Nicor Gas Ex. 36.0, 16:353 – 357) Using this approach, the Commission, if it decides to include short-term debt in Nicor Gas' capital structure, should impute no more than \$28 million to \$36 million of that debt, depending on the final cost of gas in storage determined in this case. (Mudra Sur., Nicor Gas Ex. 36.0, 16:357 – 17:360; Nicor Gas Ex. 36.2)

B. Adjustments to Capital Structure Component Balances

The Commission should adopt the actual forecast book-value weighted capital structure balances that Nicor Gas proposes in Nicor Gas Ex. 20B.1.²⁵ Staff and CUB/CCSAO have accepted Nicor Gas' proposed end-of-test-year capital structure, and the parties have resolved any differences concerning Nicor Gas' embedded cost of long term debt. (Mudra Sur., Nicor Gas Ex. 36.0, 20:448 – 21:451)

Still, Staff witness Mr. McNally's proposed component balance does not appear to have used year-end book values. (Mudra Sur., Nicor Gas Ex. 36.0, 20:448 – 21:451) Mr. McNally instead inappropriately deducted \$18.6 million from the end-of-test-year book balance of long-term debt due to retired debt issues that are not part of the year-end test year capital structure. (Mudra Sur., Nicor Gas Ex. 36.0, 21:451 – 456) The proposed balance thus does not reflect Nicor Gas' actual forecast capital structure weighting and is not needed.

²⁵ Alternatively, if short-term debt is included in the capital structure, the Commission should use the actual book value balances shown in Nicor Gas Ex. 36.2.

Mr. McNally also inappropriately reduced the actual book balances for long-term debt, common equity and preferred stock by a total of \$7.9 million based on the average CWIP balance accruing AFUDC. (Mudra Sur., Nicor Gas Ex. 36.0, 21:457 – 459) This adjustment is unnecessary where – like here – there is no short-term debt in the capital structure, as the component ratios will be unchanged by the proportionate adjustment. (Mudra Sur., Nicor Gas Ex. 36.0, 21:459 – 461)

Accordingly, the Commission should adopt Nicor Gas' undisputed, actual forecast book-value weighted capital structure balances.

C. Cost of Short-Term Debt

While no short-term debt should be included in Nicor Gas' capital structure, if the Commission decides otherwise, short-term debt should only be included at its actual cost of 4.12%. (Mudra Sur., Nicor Gas Ex. 36.0, 17:364 – 378) The components of that cost include both the direct interest costs and the cost of bank commitment fees to support that debt. (Mudra Sur., Nicor Gas Ex. 36.0, 17:365 – 366) These fees are reasonable and necessary. (Mudra Sur., Nicor Gas Ex. 36.0, 17:363 – 20:433)

By contrast, the Commission should reject the 2.58% cost of short-term debt proposed by Staff and supported by CUB/CCSAO. As the record clearly shows, their proposed figure distorts this cost on multiple grounds. For instance, Staff's methodology was inferior to that used by Nicor Gas. Mr. McNally simply used an annualized daily spot rate, taken on February 7, 2005, as the proxy to set the direct interest cost. (Mudra Sur., Nicor Gas Ex. 36.0, 17:367 – 371) Nicor Gas, on the other hand, established 2005-year costs by using as a proxy a broad set of independent forecasts of the Federal Funds Rate, from three independent sources: The Northern Trust Company, Mesirov Financial, and BMO Financial. (Mudra Sur., Nicor Gas Ex. 36.0,

17:367 – 371) Mr. McNally’s approach also did not use the time-weighted rate format outlined by the Commission on Schedule D-2. (Mudra Sur., Nicor Gas Ex. 36.0, 17:381 – 18:382) In addition, Mr. McNally’s approach ignored Nicor Gas’ actual forecast 2005 short-term balances. (Mudra Sur., Nicor Gas Ex. 36.0, 18:382 – 383)

Mr. McNally’s analysis also inappropriately excluded the necessary commitment fees supporting short term-debt. Substantial, undisputed evidence demonstrates that Nicor Gas’ commitment fees are necessary and reasonable. (Mudra Sur., Nicor Gas Ex. 36.0, 18:394 – 20:433) Among other things, in response to conditions that Mr. McNally proposed for Nicor Gas to demonstrate such reasonableness, Nicor Gas presented uncontested evidence that (1) despite Nicor Gas’ strong credit profile, the use of credit facilities was required to avoid increased borrowing costs, (2) Nicor Gas has done extensive research to ensure that its commitment fees were reasonable and (3) year-around commitment fees are reasonable and necessary to guarantee the flexibility and availability of short-term debt required by Nicor Gas. (Mudra Sur., Nicor Gas Ex. 36.0, 18:394 – 20:429)

D. Cost of Equity

Nicor Gas proposes a rate of return on equity (“ROE”) of 10.82%. (Makhholm Reb., Nicor Gas Ex. 21.0, 1:14-19) The record shows that this ROE is fair and reasonable and should be accepted by the Commission. This rate was based on appropriate and updated inputs, and calculated by averaging the results of two widely accepted methods, the discounted cash flow (“DCF”) and the capital asset pricing model (“CAPM”) methodologies. (Hawley Reb., Nicor Gas Ex. 20A.0, 38:853 – 855) In using this approach, Nicor Gas paralleled the method used by Staff’s Mr. McNally, who also computed an ROE by averaging DCF and CAPM calculations

and employed a quarterly version of the DCF model. (Hawley Reb., Nicor Gas Ex. 20A.0, 38:855 – 856)

Nicor Gas' proposed ROE of 10.82% is the average of the results of the DCF analysis conducted by outside expert, Dr. Jeff Makhholm, which estimated a 10.68% ROE, and his CAPM analysis, which estimated a 10.95% ROE. (Makhholm Reb., Nicor Gas Ex. 21.0, 1:14 – 19) The record shows that Nicor Gas' analysis was based on a sound group of comparable companies both when initially chosen and using the latest data available. That sample group, developed by Dr. Makhholm, consisted of six publicly-traded companies that face business risks similar to those facing Nicor Gas' utility operations, and that have stock price and dividend payment data that can be readily applied to the DCF model. (Makhholm Dir., Nicor Gas Ex. 4.0, 20:400 – 22:442) For purposes of this analysis, companies with similar business risks were defined by Dr. Makhholm as those that derive at least 80 percent of their operating revenues from regulated utility operations (Nicor Inc. derived approximately 88 percent of its revenues from Nicor Gas' utility operations) and operate as a regulated gas distribution utility. (Makhholm Dir., Nicor Gas Ex. 4.0, 20:414 – 419; Nicor Gas Ex. 4.5) Then, to ensure that the proxy group consisted only of companies with reliable data, only those companies that did not have existing financial concerns about future dividends and that were not known to be potentially involved in mergers or acquisitions were selected. (Makhholm Dir., Nicor Ex. 4.0, 21:431 – 434) After application of these multiple criteria, the resultant group of companies was closely comparable to Nicor Gas. (See Makhholm Dir., Nicor Gas Ex. 4.0, 21:439 – 22:442)

This close comparability is critical because, as all parties acknowledge, Nicor Gas' ROE cannot be measured directly. (Makhholm Dir., Nicor Gas Ex. 4.0, 12:244 – 246), and thus a proxy that fairly represents the activities and risks of Nicor Gas must be used. As the Commission is

being asked to set Nicor Gas' ROE based on that proxy, every care should be taken to make that group as fair as possible. Otherwise, even a perfect calculation of ROE is only a perfect calculation of another company's ROE and assigning it to Nicor Gas is arbitrary.

As discussed above, Nicor Gas took the proper steps to develop a closely comparable proxy group, and verified that that group continued to remain valid as newer data became available. The record further demonstrates that Nicor Gas used proper data for current stock prices, current annual dividends, and estimated dividend growth rates, and included a proper adjustment for selling and issuance costs. (Makholm Dir., Nicor Gas Ex. 4.0, 23:469 – 34:683) The record also shows that Nicor Gas even updated its cost of equity to reflect new data. (Hawley Reb., Nicor Gas Ex. 20A.0, 38:857 – 869) Thus, in light of the record, Nicor Gas' proposed ROE is fair and reasonable, and should be accepted by the Commission.

In stark contrast, Mr. McNally made several fundamental and numerically critical errors in generating his proposed ROE of 9.54%. The first, and key, flaw is that his group of proxy companies is not, in fact, fairly comparable. Mr. McNally's original search used inappropriately relaxed criteria for selecting comparable companies, requiring that only 70% of their operating revenues be derived from regulated utility operations. (McNally Dir., Staff Ex. 5.0, 14:285 – 287; Makholm Sur., Nicor Gas Ex. 37.0, 6:136 – 140) But, what is even more prejudicial is that Mr. McNally continued to use that group, even after newer data conclusively demonstrated that fully half of the companies included no longer met even his relaxed criteria. (Makholm Sur., Nicor Gas Ex. 37.0, 2:25 – 28) The result, not surprisingly, is that his proxy group utterly failed to meet its primary objective — namely, reflecting Nicor Gas' risks. (*See* Makholm Sur., Nicor Gas Ex. 37.0, 5:112, 6:147 – 149)

The unsuitability of Mr. McNally's sample is not a question for arcane dispute, or one on which witnesses' respective judgments control. The characteristics of the various sample companies are facts, plain in the record, and the conclusions they reveal about Mr. McNally's proposed proxy group are unavoidable. Moreover, the critical importance of a having comparable proxy group is clear -- and hard to overstate. The proxy group must be like the utility if the return calculated for the proxy is to be a fair return for the utility. A flawed sample like Mr. McNally's, even using a perfect mathematical model, will not set a just and reasonable rate of return for Nicor Gas because the model will be measuring the required return of some other, hypothetical, company with far more activity in unregulated businesses. Indeed, on multiple grounds -- including predominant activities, revenues from utility functions, and risk profiles -- the record is clear that Nicor Gas' proxy group is far superior to Mr. McNally's. (McNally Dir., Staff Ex. 5.0, 14:285 -- 287; Makholm Sur., Nicor Gas Ex. 37.0, 2:25 -- 28, 5:112, 6:147 -- 149; Tr. 1244:21 -- 1245:10) Even CUB/CCSAO witness Mr. Thomas accepted Nicor Gas' group for his own ROE calculation, noting the reasonableness of "Dr. Makholm's selection criteria." (Tr. 1244:21 -- 1245:10) In short, Nicor Gas proposed a closely matched sample; Mr. McNally did not.

Not only is Mr. McNally's proxy group invalid, but it is the use of that invalid group that leads Mr. McNally to compound his error by proposing a 23-basis point adjustment to compensate for non-comparability between the risk profile of the proxy group and that of Nicor Gas. (Makholm Reb., Nicor Gas Ex. 21.0, 5:119 -- 123; 8:224 -- 9:259) This adjustment is unwarranted for two independent reasons. First and foremost, it would be unnecessary -- even under Mr. McNally's approach -- if a comparable proxy group was used. The record shows that when the risk profile, for example, of Nicor Gas' proxy group is compared to the risk profile of

Nicor Gas, there is no significant difference and no adjustment required. (Makholm Reb., Nicor Gas Ex. 21.0, 4:103 – 5:131, 6:160 – 8:223; Makholm Sur., Nicor Gas Ex. 37.0, 5:101 – 109, 9:212 – 216) Indeed, the record demonstrates further that the risk comparison driving Mr. McNally’s proposed adjustment rests on the inclusion of very sample companies that the newest data show fail Mr. McNally’s own relaxed 70% test and should be excluded. (Makholm Sur., Nicor Gas Ex. 37.0, 3:62 – 64) Thus, Mr. McNally’s proposed adjustment actually underscores just how incomparable his proxy group is.

Second, regardless of the proxy group used, Mr. McNally’s proposed adjustment should be rejected because it improperly mixes debt and equity risks. The risk profiles are based on debt yields, which are not connected to rates of return on equity. As Dr. Makholm noted, this is not an “apples-to-oranges” problem, but rather a “fruits-to-vegetables” one: “Equity and debt are very different financial securities – the difference between the bond yield of AA and A rated bonds has nothing to do with differences in equity risk of comparing a proxy group to a single firm.” (Makholm Reb., Nicor Gas Ex. 21.0, 9:260 – 10:268) Given these fundamental distinctions between equity and debt, nothing in either financial theory or practice justifies this adjustment. (See Makholm Reb., Nicor Gas Ex. 21.0, 10:269 – 279)

Beyond using an improper proxy group and suggesting an unjustified adjustment, Mr. McNally also makes a number of errors regarding the growth rate for his DCF analysis. For instance, he uses only a single growth rate source, missing probably the most widely used and most highly regarded source used in utility rate cases source – *The Value Line Investment Survey*. (Makholm Reb., Nicor Gas Ex. 21.0, 11:311 – 314) This omission alone drives Mr. McNally’s cost of equity down by 54 basis points. (Makholm Reb., Nicor Gas Ex. 21.0, 12:319 – 321) In contrast, Dr. Makholm’s growth rate is derived from multiple separate, credible, and

complementary sources, including *The Value Line Investment Survey* just mentioned. (Makholm Dir., Nicor Gas Ex. 4.0, 27:542 – 30:603) The inappropriateness of Mr. McNally’s approach is compounded by his introduction of a second, subjective growth rate into his DCF analysis, which he does by selecting, by hand, the “next” dividend payment for his proxy group companies before allowing the base growth rate to take over. (McNally Dir., Staff Ex. 5.0, 16:316 – 18:371)

Mr. McNally also errs by failing to include Nicor Gas’ flotation costs. (Makholm Reb., Nicor Gas Ex. 21.0, 11:292 – 295) This issue is discussed in more detail in Section V.E. below.

CUB/CCSAO witness Mr. Thomas also attempted to estimate Nicor Gas’ ROE, which produced a result of 10.09%. (Thomas Dir., CUB/CCSAO Ex. 1.0, 15:316 – 321; Makholm Sur., Nicor Gas Ex. 37.0, 12: Table 4) His analysis, however, suffers from several flaws. For instance, although Mr. Thomas accepted Nicor Gas’ proxy group, he nonetheless adopted without analysis the unwarranted 23-basis point adjustment proposed by Mr. McNally, which was premised on the risk profiles of Mr. McNally’s proxy group. (Makholm Sur., Nicor Gas Ex. 37.0, 4:86 – 88) In addition, Mr. Thomas, like Mr. McNally, also erroneously fails to include flotation costs. (Makholm Sur., Nicor Gas Ex. 37.0, 12: Table 4)

In sum, Nicor Gas proposes a return on equity calculated in accordance with accepted methodologies, using the most recent data in the record, and without reliance on subjective adjustments. Unlike the estimates proposed by Staff and GCI that would push Nicor Gas’ ROE well below its peers (and in Staff’s case, below the result any other recent gas case in the nation), it is a fair and just ROE that will permit Nicor Gas to attract the required capital at reasonable cost. The Commission should adopt Nicor Gas’ proposed ROE, and should reject those proposed by Messrs. McNally and Thomas.

E. Flotation Costs

Nicor Gas proposes to recover its unrecovered selling and issuance costs (“flotation costs”) identified in Nicor Gas Ex. 3.4. The record shows that these costs have not been recovered before, and were for utility purposes. (Mudra Sur., Nicor Gas Ex. 36.0, 22:475 – 24:524; Mudra Reb., Nicor Gas Ex. 20B.0, 40:906 – 42:974) The Commission has previously held that where issuance costs have been incurred but not recovered, an adjustment to cost of equity is necessary to provide a fair return on issuance costs because “if these costs are not recovered in the Company’s allowed rate of return, its investors will not have a fair opportunity to earn their required rate of return.” *In re Iowa-Illinois Gas & Electric Co.*, Docket 92-0292 Cons., 1993 Ill. PUC Lexis 245 at *127 (Order July 21, 1993). As a result, they should be accepted by the Commission.

The undisputed evidence in the record includes sworn testimony based on the witnesses’ review of Nicor Gas’ audited books and records, original equity issuance documents, rate filings made with the Commission, annual reports to the Commission, and the Commission’s own rate orders demonstrating that Nicor Gas has incurred issuance costs and that those costs have not been recovered. (Mudra Reb., Nicor Gas Ex. 20B.0, 39:899 – 41:930; Mudra Sur., Nicor Gas Ex. 36.0, 23:506 – 24:524) There is simply not a shred of evidence in the record to the contrary.

Nonetheless, Mr. McNally continues to assert that Nicor Gas “failed to demonstrate either that the remaining costs it seeks to recover through rates were incurred for the benefit of Nicor Gas utility operations or that those costs remain unrecovered.” (McNally Reb., Staff Ex. 14.0, 9:161 – 163) This assertion simply has no basis in the record. Mr. McNally cannot dispute that Nicor Gas’ testimony and exhibits are proper evidence. He cannot dispute that they have been properly admitted as such. His continued assertion that Nicor Gas has not proven its claim

simply ignores that evidence. Indeed, his testimony on cross-examination makes clear that what Mr. McNally repeatedly terms “assertions” are actually sworn testimony and competent evidence. (Tr. 938:13 – 940:10)

The Commission, in a contested rate case, must apply the law governing uncontradicted evidence. Please see the discussion of this legal issue in Section IV of this Initial Brief.

Likewise, Mr. McNally’s observation that two issuances were made by “Nicor Inc.” (McNally Reb., Staff Ex. 14.0, 10:180 – 181) is immaterial because Nicor Gas is only seeking to recover the percentage flotation cost applicable to Nicor Gas’ equity capital. There is no doubt that the equity contribution to Nicor Gas was used for utility purposes. (Mudra Sur., Nicor Gas Ex. 36.0, 22:490 – 23:494) These issuances by Nicor Gas’ holding company properly establish the historical percentage and issuance cost for equity capital used by Nicor Gas. (Mudra Sur., Nicor Gas Ex. 36.0, 22:490 – 23:494)

In the face of the substantial evidence presented by Nicor Gas demonstrating that issuance costs have been incurred for utility purposes and have not been recovered, and the complete lack of any evidence to the contrary, the Commission should follow its precedent and allow the flotation cost adjustment proposed by Nicor Gas.

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

Overview

Nicor Gas, at every step of this case, has sought to present and support proposed revised and new tariffs and tariff provisions, including rate designs, charges, and other terms and conditions, that are just and reasonable for customers and the utility. Nicor Gas has laid out its proposals, and the supporting evidence, in great detail in its testimony and exhibits. Nicor Gas’ proposals, as revised in its rebuttal and surrebuttal testimony and exhibits, should be approved.

Nicor Gas presented and supported proposals relating to base rate revenue requirement allocation, rate designs, and those charges that are designed to collect its base rate revenue requirement primarily through the testimony of Mr. Harms, Dr. Gordon, Dr. Parmesano, and Mr. Heintz. (Nicor Gas Exs. 17.0, 2.0, 13.0, 14.0, 19.0, 30.0, 31.0, 32.0, 44.0, 35.0) Nicor Gas presented and supported proposals relating to storage and supply operations primarily through the testimony of Mr. Bartlett. (Nicor Gas Exs. 8.0, 24.0, 39.0) Finally, Nicor Gas presented and supported other tariff-related proposals primarily through the testimony of Mr. O'Connor and Mr. Harms. (Nicor Gas Exs. 12A.0, 12B.0, 27A.0, 27B.0, 34.0)²⁶

Nicor Gas' proposed approaches to allocation of its revenue requirement to customer classes (rate designations) and to rate design are supported by some intervenors but are opposed by Staff and some other intervenors in various respects. Nicor Gas has concluded that for purposes of this case, in order to narrow the issues, it is willing to accept the determination of its revenue requirement allocation to customer classes (rate designations) based on the use of a revised version of its embedded cost of service study (ECOSS) employing the Average and Peak method including the Modified Distribution Main (MDM) study, subject to the moderation of the rate increase in relation to its Rate 1, Residential Service, as is discussed primarily in subsections "A(1)", "A(2)", "B(4)", and "B(5)" of this Section VI of this Initial Brief. (Harms Sur., Nicor Gas Ex. 44.0, 2:32 – 37, 5:109 – 116, 11:226 – 12:249; Nicor Gas Ex. 44.2, 44.3; Nicor Gas Ex. 42.1) Nicor Gas cannot accept use of Staff's ECOSS for this purpose, however, because it makes arbitrary and unsubstantiated changes to peak day usage by class and inappropriately modifies the MDM study, plus, contrary to Staff's claim, it is not consistent with

²⁶ The demarcations identified in this paragraph are not, in all instances, perfect dividing lines, because of the interrelationships of some issues.

the ICC's ruling in the 1995 Rate Case. (*Id.* at 2:37 – 3:53, 5:122 – 10:225, 11:238 – 12:249) Nicor Gas' compromise proposal is consistent with the evidence and should be approved. Use of Staff's ECOSS, however, would be erroneous. This subject is discussed further in subsections "A(1)" and "A(2)" of this Section VI.

Nicor Gas's proposed rate design is sound and amply justified. Nicor Gas' proposal to set charges to collect the allocated revenue requirement based on marginal cost principles, especially in the setting of tail block charges for multi-blocked rates and in customer charges other than the Rate 1 customer charge, is well-supported, consistent with efficient ratemaking, balanced, and should be approved. (Harms Sur., Nicor Gas Ex. 44.0, 3:56 – 4:75, 12:251 – 12:266; Nicor Gas Ex. 44.4, pages 9–14) This subject also is discussed further in subsections "A(1)", "A(2)", "B(4)", and "B(5)" of this Section VI.

Nicor Gas' proposal to collect commodity-related uncollectibles expenses through its Rider 6, as well as its revised proposal to pass collected Hub gross revenues through Rider 6 as a partial offset (with Hub expenses collected in base rates), which are supported and opposed by various parties in differing respects, are fully supported by the evidence and should be approved. The commodity-related portion of uncollectibles expenses fall within both the statutory and regulatory rules governing Rider 6, i.e., Section 9-220 of the Public Utilities Act, 220 ILCS 5/9-220, and 83 Ill. Admin. Code Part 525, and use of the PGA mechanism for such expenses is just and reasonable for both Nicor Gas and customers. Also, uncollectibles expenses independently meet the established criteria for a rider. While Nicor Gas believes it has properly allocated these credits and costs among customer groups, in any event, Nicor Gas' proposed revenue treatment of commodity-related uncollectibles expense, collected Hub gross revenues,

and Hub expenses should be approved. Those subjects, in particular, are discussed in subsection “B(3)” of this Section VI.

The evidence also supports Nicor Gas’ proposals with respect to operational concerns and the need to maintain on-system and upstream storage adequate to efficiently operate the system, and those proposals should be approved. Various intervenors urge various changes that are to their particular advantage, but those proposals, to the extent that they depart from Nicor Gas’ proposals, as revised in its rebuttal and surrebuttal testimony and exhibits, are without merit. Those subjects are discussed in detail in various subsections of subsection “B” of this Section VI.

A. Cost Of Service Study

1. Marginal Cost Of Service Study

Nicor Gas, in its direct case, presented a detailed marginal cost of service study (“MCOSS”). (Parmesano Dir., Nicor Gas Ex. 13.0, *passim*; Nicor Gas Ex. 13.1 (the MCOSS)) The other parties have identified only one small error in the MCOSS, which Nicor Gas has acknowledged and corrected. (Parmesano Reb., Nicor Gas Ex. 30.0, 17:394 – 19:405)

Nicor Gas in its direct case, presented substantial evidence in support of both: (1) use of the MCOSS and the Equalized Percentage of Marginal Cost (“EPMC”) method, with moderation (discussed further below), for the purpose of allocating the base rate revenue requirement among the customer classes (rate designations); and (2) use of the MCOSS in rate design, especially in the setting of tail block charges for multi-blocked rates and in customer charges other than the Rate 1 customer charge. (Parmesano Dir., Nicor Gas Ex. 13.0, *passim*; Gordon Dir., Nicor Gas Ex. 2.0, 3:65 – 5:99, 35:711 – 39:807; Harms Dir., Nicor Gas Ex. 17.0, *passim*) Nicor Gas, in its rebuttal and surrebuttal testimony, presented additional substantial evidence in support of both of those positions, although in its surrebuttal, in order to narrow the issues, it indicated its

willingness for purposes of this case to accept a different approach on the former position, as noted earlier and discussed further below and in the following subsection. (Parmesano Reb., Nicor Gas Ex. 30.0, *passim*; Gordon Reb., Nicor Gas Ex. 19.0, 2:27 – 30, 3:58 – 60, 16:358 – 21:426; Gordon Sur., Nicor Gas Ex. 35.0, 1:25 – 2:50, 5:131 – 8:180); Harms Reb., Nicor Gas Ex. 32.0, 3:55 – 61, 5:94 – 20:423; Harms Sur., Nicor Gas Ex. 44.0, 2:30 – 3:66, 5:109 – 16:362)

Business Energy Alliance and Resources, LLC (“BEAR”) witness Ms. Hilton submitted direct testimony supporting Nicor Gas’ proposed moderated use of the MCOSS and the EPMC method in relation to the allocation of the revenue requirement and its proposed use of the MCOSS in relation to rate design. (Hilton, BEAR Ex. 1, page 2 (not line numbered)) (She did not submit rebuttal testimony.)

CUB/CCSAO witness Mr. Thomas in direct and rebuttal testimony was generally supportive of Nicor Gas’ proposals relating to allocation of the revenue requirement and rate design, although he expressed reservations about marginal cost theory and further movements toward marginal cost ratemaking. (Thomas Dir., CUB/CCSAO Ex. 1.0, 4:54 – 63, 24:506 – 26:591, 28:629 – 639, 30:667 – 31:693; Thomas Reb., CUB/CCSAO Ex. 3.0, 19:403 – 23:504)

Staff witness Mr. Luth and Illinois Industrial Energy Consumers (“IIEC”) witness Dr. Rosenberg in direct and rebuttal testimony have opposed Nicor Gas’ use of the MCOSS and the EPMC method, with moderation, in relation to allocation of the revenue requirement and use of the MCOSS in relation to rate design, although Mr. Luth and Dr. Rosenberg differ on which ECOSS should be used in their place. (Luth Dir., Staff Ex. 7.0, *passim*; Luth Reb., Staff Ex. 16.0, *passim*; Rosenberg Dir., IIEC Ex. 1.0, *passim*; Rosenberg Reb., IIEC Ex. 2.0, *passim*)

The use of the MCOSS and the EPMC method, with moderation, is appropriate in relation to allocation of the revenue requirement to customer classes (rate designations);

however, as noted earlier, for the purposes of this case, Nicor Gas is willing to accept the concept of use of an ECOSS, if properly calculated, for the purposes of revenue requirement allocation. (Harms Sur., Nicor Gas Ex. 44.0, 2:32 – 37, 5:109 – 6:116, 11:226 – 12:249; Nicor Gas Ex. 44.2, 44.3; Nicor Gas Ex. 42.1) The subject of the ECOSS is discussed further in the following subsection of this Section VI.

Marginal cost principles nonetheless should be applied to Nicor Gas' rate design, especially in the setting of tail block charges for multi-blocked rates and in customer charges other than the Rate 1 customer charge. (Harms Dir., Nicor Gas Ex. 17.0, 17:373 – 18:382, 20:427 – 21:468, 22:483 – 23:492; Harms Sur., Nicor Gas Ex. 44.0, 3:67 – 4:75, 19:407–417, 20:435 – 441, 21:464 – 471, 22:488 – 495, 24:539 – 25:550; Parmesano Dir., Nicor Gas Ex. 13.0, 2:42 – 46, 3:70 – 72, 28:569 – 571; Parmesano Reb., Nicor Gas Ex. 30.0, 5:79 – 81, 5:87 – 90, 5:94 – 6:100, 6:117 – 7:129, 20:438 – 21:452; Gordon Reb., Nicor Gas Ex. 19.0, 20:450 – 21:464; Gordon Sur., Nicor Gas Ex. 35.0, 1:29 – 2:34, 5:133 – 6:140) As Dr. Gordon has stated: “Absent first-best marginal cost prices, which cannot be implemented for Nicor Gas, Nicor Gas' proposal to utilize marginal cost pricing of tail block units is appropriate and supports the movement toward efficient price signals. Pricing marginal units (i.e., those units where customers are most likely to be consuming) at marginal cost provides appropriate price signals in the range of consumption.” (Gordon Sur., Nicor Gas Ex. 35.0, 1:29 – 2:34) Nicor Gas' revised proposal, as presented in its surrebuttal testimony, should be approved.

2. Embedded Cost Of Service Study

a. Modified Distribution Mains Study (MDM)

Distribution mains are the largest element of Nicor Gas' gross and net plant. (*E.g.*, Nicor Gas Ex. 14.1 at Schedule G, page 9) Nicor Gas' MDM study is an engineering study that assigns distribution mains-related costs to its customer classes based on cost-causation:

The results of the MDM study are used in the ECOSS to allocate distribution mains-related costs to the customer classes. In general, the MDM study is 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. The study was done in the same manner as the previous study approved by the Commission in Nicor Gas' last general rate case and simply updates the information since the previous study because Nicor Gas has added a substantial number of customers since then.

Specifically, Nicor Gas determined the allocation among customer rate classes in the following manner. First, Nicor Gas generated a random sample of Rate 1 (residential) customers and another random sample of Rates 4 and 74 (small non-residential) customers. Nicor Gas researched each customer in each of the two random samples to determine the customer's peak day use and the size of distribution main from which the customer was receiving service. Next, for Nicor Gas' largest customers (Rates 6, 7, 17 (Contract Services), 76, 77 and 81), we reviewed each customer to determine the same information. The result of this engineering analysis is a table that provides the use of each size of distribution main on a peak day by rate classification.

Implicit in this analysis is that natural gas is delivered by Nicor Gas from larger diameter mains to smaller diameter mains. That is, a 36 inch distribution main delivers gas to smaller sized mains such as 30 inch or 24 inch, not the other way around. Because gas flows from larger sized to smaller sized mains, the analysis, starting with the peak day flows in order of largest main sizes first, makes it possible to progress down to smaller main sizes and thereby determine what percentage of total peak day flow by rate class is attributable to each main size.

(Harms Reb., Nicor Gas Ex. 32.0, 6:117 – 7:140) No party has presented any opposing engineering study regarding Nicor Gas' distribution mains.

The detailed evidence from both Nicor Gas and IIEC shows that Nicor Gas' Modified Distribution Main study is the most accurate means to assign distribution mains-related costs.

(Heintz Dir., Nicor Gas Ex. 14.0, 13:249 – 257; Harms Reb., Nicor Gas Ex. 32.0, 2:27 – 32,

3:58 – 62, 4:69 – 72, 5:99 – 11:227, 12:237 – 13:251, 18:375 – 379; Nicor Gas Ex. 31.1; Heintz Reb., Nicor Gas Ex. 31.0, 7:140 – 9:183; Rosenberg Reb., IIEC Ex. 2, 2:5 – 6, 3:9 – 8:9; Harms Sur., Nicor Gas Ex. 44.0, 2:30 – 3:48, 5:109 – 7:152, 9:201 – 12:249; Heintz Sur., Nicor Gas Ex. 42.0, 4:67 – 69, 6:112 – 117) While Staff and CUB/CCSAO propose that the MDM study be modified, or not reflected at all, in the ECOSS in this case, respectively, they have identified no error in the MDM study nor any valid ground for doing anything other than fully reflecting the MDM study, in its unmodified form, in the ECOSS.

The Commission should approve Nicor Gas' MDM study in this case, just as it did in its last general rate case, not because the Commission did so in the last case, but because that is the only determination that is consistent with the evidence. *In re Northern Illinois Gas Co.* Docket 95-0219, 1996 Ill. PUC Lexis 204 at ** 104, 109 – 110 (Order April 3, 1996).

b. Coincident Peak (CP) Allocation Methodology

The detailed evidence from both Nicor Gas and IIEC shows that the Coincident Peak methodology is the most accurate methodology for assigning transmission and distribution plant costs not assigned by Nicor Gas' MDM study. (Heintz Dir., Nicor Gas Ex. 14.0, 14:272 – 15:291; Harms Dir., Nicor Gas Ex. 17.0, 26:565 – 573; Heintz Reb., Nicor Gas Ex. 31.0, 2:29 – 7:139; Nicor Gas Ex. 31.1; Harms Reb., Nicor Gas Ex. 32.0, 3:58 – 62, 5:109 – 6:133; Rosenberg Reb., IIEC Ex. 2,2:7 – 8, 6:4 – 8:9; Heintz Sur., Nicor Gas Ex. 42.0, 3:57 – 59, 8:143 – 10:183; Harms Sur., Nicor Gas Ex. 44.0, 2:49 – 53)

As previously stated, Nicor Gas, for purposes of this case, in order to narrow the issues, nonetheless is willing to accept the use of a revised version of its embedded cost of service study, based on the Average and Peak method, but including the Modified Distribution Main study, to determine its revenue requirement allocation to customer classes (rate designations). (Harms

Sur., Nicor Gas Ex. 44.0, 2:32 – 41, 5:109 – 6:116, 11:226 – 12:249; Nicor Gas Ex. 44.2, 44.3; Nicor Gas Ex. 42.1) Nicor Gas cannot accept use of Staff’s ECOSS for this purpose, because it makes arbitrary and unsubstantiated changes to peak day usage by class and inappropriately modifies the MDM study, plus, contrary to Staff’s claim, it is not consistent with the ICC’s ruling in the 1995 Rate Case. (*Id.* at 2:37 – 3:53, 5:122 – 10:225, 11:238 – 12:249)

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

Please see the preceding subsection.

B. Rates, Riders, and Other Terms

1. Rate 5: Seasonal Use Service [uncontested]

BEAR has proposed a new Rate 5, Seasonal Use Service, which would be available to non-residential customers with minimal peak winter usage. (Hilton Dir., BEAR Ex. 1, *passim*, and Schedule BJH-1) No Nicor Gas, Staff, or other intervenor witness has contested this proposal.

2. Rate 75: Seasonal Use Transportation Service [uncontested]

BEAR has proposed a new Rate 75, Seasonal Use Transportation Service, which concerns non-residential customers with minimal peak winter usage. (Hilton Dir., BEAR Ex. 1, *passim*, and Schedule BJH-1) No Nicor Gas, Staff, or other intervenor witness has contested this proposal.

3. Rider 6

a. Allocation of Hub Expenses Through Revenue Requirement; Hub Revenues

Nicor Gas initially proposed that net collected Hub revenues should be credited to customers through Rider 6, as a partial offset to Nicor Gas’ proposal to include

commodity-related uncollectibles expenses in Rider 6, as is discussed in this and the next subsection of this Initial Brief. (*E.g.*, Bartlett Dir., Nicor Gas Ex. 8.0, 1:12–15, 4:93 – 96, 11:252 – 15:329)

Nicor Gas and Staff witness Mr. Borden since have agreed that gross revenues from Hub services collected by Nicor Gas should be credited to customers through Rider 6, and that the administration fees associated with these revenues, which have been forecast at \$1,079,000 in 2005, should be recovered as operating expenses through base rates. (*E.g.*, Borden Dir., Staff Ex. 8.0, 3:40 – 4:61; Bartlett Reb., Nicor Gas Ex. 24.0, 7:148 – 159) Nicor Gas continues to propose that commodity-related uncollectibles expenses should be included in Rider 6, as discussed in the next subsection.

IIEC witness Dr. Rosenberg objected to the credit of collected Hub revenues through Rider 6, arguing that transportation customers should share in these revenues. (Rosenberg, IIEC Ex. 1, 21:9 – 22) Vanguard witness Mr. Anderson, in passing, expressed a similar view. (Anderson Dir., Vanguard Ex. 1, 9:3 – 9) Their positions are not warranted. (Bartlett Reb., Nicor Gas Ex. 24.0, 13:276 – 291; Bartlett Sur., Nicor Gas Ex. 39.0, 6:131 – 7:153; Bartlett, Tr. 538 – 539) Among other things, as Mr. Bartlett has explained:

Regardless, in my opinion, Hub revenues should be a credit to the cost of gas, which is primarily recovered through sales customers. The bulk of Nicor Gas' purchased assets are used for two purposes, to: (1) supply gas for sales customers, and (2) support and operate the system for the benefit of all customers. However, for all intents and purposes, these costs are recovered from sales customers. Moreover, in my view, the position and obligations of transportation customers, that operate within very flexible tariff provisions, are fundamentally different than the position and obligations of sales customers that pick up all direct and incidental gas costs necessary to operate the system. Since the sales customers bear the residual costs of operating the system, it is my opinion that it is equitable that they receive relief through the Hub credit made possible because of the system.

(Bartlett Reb., Nicor Gas Ex. 24.0, 13:280 – 291) This methodology also simplifies the associated accounting, including the variable nature of Hub revenues. (Bartlett Dir., Nicor Gas Ex. 8.0, 13:296 – 14:305) Nicor Gas’ revised proposal should be adopted.

b. Commodity Portion of Uncollectibles

Nicor Gas proposes to recover commodity-related uncollectibles expenses in Rider 6, subject to the partial offset relating to collected Hub revenues discussed in the previous subsection. (*E.g.*, O’Connor Dir., Nicor Gas Ex. 12A.0, 25:551 – 30:664; Bartlett Dir., Nicor Gas Ex. 8.0, 11:252 – 12–265, 14:306 – 314) Nicor Gas, in its direct case, presented both the grounds for this proposal as well as documentation of the statistical analysis performed using valid statistical sampling procedures to split commodity-related uncollectibles expenses from other uncollectibles expenses, which yielded a figure of 66.6% as the commodity-related portion. (*E.g.*, O’Connor Dir., Nicor Gas Ex. 12A.0, 25:551 – 30:664; Herrera Dir., Nicor Ex. 15.0, 10:174 – 11:191) The Retail Gas Suppliers and DRI support this proposal (White Reb., Retail Gas Suppliers Ex. 1.0, 22:546 – 23:564; Crist Dir., DRI Ex. 1, 4:1, 17:7 – 20), while Staff and CUB/CCSAO have expressed their opposition to it (Struck Dir., Staff Ex. 1.0, 11:210 – 224; Mierzwa Dir., CUB/CCSAO Ex. 2.0, 13:294 – 14:312).

Staff’s and CUB/CCSAO’s objections to Nicor Gas’ proposal, including Staff’s objections based on 83 Ill. Admin. Code Part 525, are without merit. The purchased gas adjustment clause provided for in Rider 6 and Part 525 is based on Section 9-220 of the Public Utilities Act, 220 ILCS 5/9-220. Section 9-220(a) provides in part: “Annually, the Commission shall initiate public hearings to determine whether the clauses reflect actual costs of fuel, gas, power, or coal transportation purchased to determine whether such purchases were prudent, and to reconcile any amounts collected with the actual costs of fuel, power, gas, or coal

transportation prudently purchased.” 220 ILCS 5/9-220(a) (emphasis added). Including Nicor Gas’ commodity-related uncollectibles expenses in Rider 6 would improve the accuracy of the PGA reconciliation mechanism by providing a more accurate determination of Nicor Gas’ actual costs and the amounts collected relating to the cost of gas, is consistent with Part 525, and is in the interests of customers as well as Nicor Gas. (*E.g.*, O’Connor Reb., Nicor Gas Ex. 27A.0, 4:80 – 5:107, 6:129–139; O’Connor Sur., Nicor Gas Ex. 34.0, 16:362 – 17:389) Moreover, Nicor Gas’ commodity-related uncollectibles expenses also independently meet the criteria for a rider, given their amount, drivers, and volatility. (*E.g.*, O’Connor Dir., Nicor Gas Ex. 12A.0, 25:564 – 27:619)

Staff’s related, alternative proposal that a recalculation of the split between commodity-related from other uncollectibles expenses should occur each year also is without merit. (*E.g.*, O’Connor Reb., Nicor Gas Ex. 27A.0, 5:108 – 117; O’Connor Sur., Nicor Gas Ex. 34.0, 17:390 – 18:406). Nicor Gas’ proposal should be approved.

c. Commodity Portion of Gas Cost

Please see the preceding subsection.

d. Gas Storage Losses (2% Withdrawal Factor)

Please see subsection “C” of Section III of this Initial Brief.

e. Working Capital on Gas Storage

DRI has proposed to modify Rider 6 to permit collection of carrying charges on gas in storage. (Crist Dir., DRI Ex. 1.0, 18:13 – 20) Staff withdrew its support for that proposal, finding it not to be needed. (Borden, Tr. 1048) Nicor Gas also believes that this proposal is unnecessary, as such an adjustment as already been made.

Customer Select customers are already receiving a credit, determined by the Commission in *In re Citizen's Utility Board, et al.*, Docket 00-0620 Cons., 2002 Ill. PUC Lexis 16 at **70-71 (Order on Rehearing Jan. 3, 2002), to account for working capital on gas in storage. As such, the working capital on gas storage inventory should not even be an issue for any Customer Select suppliers, such as DRI. (Harms Sur., Nicor Gas Ex. 44.0, 31:695 – 33:748) As a result of Docket 00-0620 Cons., Nicor Gas has adjusted its administrative account charge from \$1.03 to \$0.59 to provide a credit of \$0.44 per month per account for the gas storage inventory working capital. *In re Citizen's Utility Board*, Docket 00-0620 Cons., 2002 Ill. PUC Lexis 16 at *70-71, Appendix A (Order on Rehearing Jan. 3, 2002). DRI's proposal would, in effect, result in a double counting of working capital on gas in storage. This double counting will cause retail sales customers to subsidize Customer Select customers, clearly not a result which should be allowed. If the Commission decides to adopt DRI's proposal, then the Commission should also recognize the double-counting of the credit and increase the Customer Select monthly Account Charge from \$0.59 to \$1.03. Absent an increase in Customer Select administrative charges for the lower gas storage inventory costs – which Mr. Crist has not proposed – no changes are needed to the accounting of gas storage inventory. (Harms Sur., Nicor Gas Ex. 44.0, 31:695 – 33:748) The Commission should reject DRI's proposal to provide an additional credit for carrying charges on gas in storage.

4. Rate 1

Nicor Gas serves approximately 1,950,000 residential customers under Rate 1. (*E.g.*, McCain Dir., Nicor Gas Ex. 6.0, 3:58) Nicor Gas consistently and appropriately has proposed to moderate the impact of its proposed rate increase on Rate 1 customers. As Nicor Gas' Manager of Rate Research, Mr. Harms (now retired), explained in his direct testimony:

The proposed rate design draws on the MCOSS and the EPMC method in setting customer charges in non-residential rates and in setting the volumetric distribution charges of the “tail” blocks in Rate 1 and the non-residential rates. Focusing on the tail blocks makes sense, because that tends to be where customers consume on the margin.

The Company sought to ameliorate the impacts of the MCOSS and the EPMC method, however, by limiting the increase in the portion of its base rate revenue requirement that would be allocated to Rate 1 customers to less than Rate 1’s revenue deficiency. The Company also moderated the relative increase in the Rate 1 customer charge, meaning that the existing charge of \$6.00 is proposed to increase only to \$8.40, discussed further below. The foregoing results in somewhat higher volumetric distribution charges than the MCOSS otherwise would indicate in the first (or only) or lower blocks in Rate 1 and as well as the non-residential rates, i.e., Rates 4 and 74, Rates 6 and 76, and Rates 7 and 77.

The proposed rate design, in comparison to the existing rates, recovers more of the Company’s fixed costs through its fixed charges, by which I mean the customer charges. The proposed approach is preferable to the existing approach because the Company’s recovery of its total fixed costs should not be dependent, or at least should be much less dependent, on the weather and other variable factors that can impact usage.

- Q. Given the proposed base rate revenue requirement of \$587,416,000, how were charges for Rate 1 determined?
- A. First, the customer charge for Rate 1, which currently is set at \$6.00, was limited to an increase of 40%, or a proposed charge of \$8.40, as noted earlier. The Company believes that the 40% figure is an appropriate balance -- a moderation of the MCOSS and the EPMC method -- given that the overall increase in the Rate 1 revenue requirement is somewhat less than required by the MCOSS and the EPMC method (as well as the ECOSS). In addition both the MCOSS and the EPMC method and ECOSS supported even higher levels for the Rate 1 customer charge. Coincidentally, that moderation results in preserving the Company position of having the lowest residential customer charge of the major Illinois gas utilities. Second, the tail-block charge for use over 50 therms was set at the marginal cost of service of \$0.0519. The remaining amount of the Rate 1 base rate revenue requirement was then spread over the first two blocks on a cents per therm basis which achieved the allocated revenue requirement. The Company used this method so as to prevent residential customers from bearing the entirety of the base rate revenue requirement increase. The proposed charges in Rate 1 instead allow the Company the opportunity to recover approximately 67%

(\$55,563,000/\$83,308,000) of the revenue deficiency. The Company believes that that is an appropriate balance -- moderation -- given that Rate 1 base rate revenues under existing rates recover approximately 64% (\$322,467,000/\$504,108,000) of base rate revenues, while the MCOSS and the EPMC method (and the ECOSS) indicate that Rate 1 should recover over 70% of the base rate revenue requirement.

(Harms Dir., Nicor Gas Ex. 17.0, 18:375 – 18:396, 20:427 – 21:448) CUB/CCSAO generally supports Nicor Gas' proposed rate design, including its approach to moderation of the Rate 1 increase. (*E.g.*, Thomas Dir., CUB/CCSAO Ex. 1.0, 4:64 – 66, 31:696 – 701; Joint Pretrial Memorandum of the Cook County State's Attorney's Office and the Citizens Utility Board, pages 14 – 15) BEAR also supports Nicor Gas' proposed rate design, including its approach to moderation of the Rate 1 increase. (Hilton Dir., BEAR Ex. 1, page 2 (not line-numbered))

Staff's and IIEC's respective proposals to use an ECOSS, without any such moderation, to allocate revenues among the customer classes (rates) would lead, given Nicor Gas' revised proposed revenue requirement, to a significantly larger increase in the portion of the revenue requirement allocated to Rate 1, which Nicor Gas does not believe to be appropriate. (*E.g.*, Harms Reb., Nicor Gas Ex. 32.0, 16:328 – 19:390)

Nicor Gas has proposed to retain the three block declining rate design for Rate 1 that was approved in Nicor Gas' last general rate case. Nicor Gas proposes to set the tail block of that design in accordance with marginal cost principles, as discussed in subsections "A(1)" and "A(2)" of this Section VI. Staff witness Mr. Luth has proposed that Rate 1 have a two-step declining block rate that is for all intents and purposes a single flat rate. (Staff Revised Ex. 16.6, page 1) Mr. Luth's proposal should be rejected as it has no justification in economic theory, provides poor price signals to customers, would make Nicor Gas' proposed rates and customers' bills more weather-sensitive (including higher bills in the winter), and would leave Nicor Gas with a huge risk of under-recovery of its allowed revenue requirement. (Harms Reb., Nicor Gas

Ex. 32.0, 22:459 – 24:393, 25:535 – 27:570; Harms Sur., Nicor Gas Ex. 44.0, 3:67 – 4:75, 19:407 – 21:463) Nicor Gas’ proposed design of the Rate 1 blocks should be approved.

Finally, AG witness Mr. Effron proposes to alter the billing determinants for Rate 1. (Effron Dir., AG Ex. 1.0, 18:11 – 19:19) That proposal, which presents no valid basis for rejection of Nicor Gas’ detailed and careful forecasting, is without merit and should be rejected. (Harms Reb., Nicor Gas Ex. 32.0, 41:892 – 42:904; Harms Sur., Nicor Gas Ex. 44.0, 29:640 – 651)

5. Rate 4

Nicor Gas appropriately developed its proposed rate design for Rate 4. Mr. Harms, in his direct testimony, gave this overview of how the rate design for Rate 4 was developed in the context of the rate design for all non-residential rates.

The proposed non-residential rates were developed following a similar process. First, after limiting the Rate 1 increase, as discussed above, the remaining revenue requirements for each of the non-residential companion rates was based on the MCOSS using the EPMC method as shown on Nicor Gas Exs. 17.1 and 17.2. The Company combined the revenue requirements for each of the companion rates in order to maintain revenue indifference when customers switch between the rates. The exception to this was Rate 77 where the Company applied the same percent increase to non-customer charge revenues as Rate 6 and 76 received, in order to maintain a consistent differential between Rate 76 and Rate 77. These two rates serve over 200 of the Company’s largest customers and it was important to limit the unanticipated possibility of rate switching. As such, Rates 4 and 74 were developed together. Similarly, Rate 77 was included with Rates 6 and 76. Second, the monthly customer charges and tail block rates or single commodity rate were set at or near the appropriate marginal cost value. Third, any remaining revenue requirements were allocated to the remaining blocks, and allocated on a cents per therm basis. Finally, an adjustment was made to reflect the storage banking service revenues that the companion transportation rates are designed to recover. The base rate revenues generated from the foregoing process were then compared to the required revenues and any necessary adjustments made for the difference was allocated on a cents per therm basis to both the sales and transportation rate.

The proposed rate design preserves the relationships between the charges in “companion” sales and transportation rates. That is desirable, as discussed earlier,

because, otherwise, eligible customers are given unnecessary incentives or disincentives for switching between these rates when their charges are not consistent.

(Harms Dir., Nicor Gas Ex. 17.0, 21:450 – 22:472)

Staff's proposals relating to the rate design of Rate 4 are inappropriate both because they fail to recognize and take into account that Rate 4 is a companion rate with Rate 74 and their rate designs must be coordinated to avoid creating artificial incentives for switching from one rate to the other, and because Staff's proposal to alter the block structure suffers from the same serious flaws that afflict Staff's proposal to change the block structure of Rate 1, discussed in the preceding subsection. (Harms Reb., Nicor Gas Ex. 32.0, 21:432 – 23:493, 28:610 – 31:665; Harms Sur., Nicor Gas Ex. 44.0, 22:483 – 495) The Commission should approve Nicor Gas proposed rate design for Rate 4, coordinated with its proposed rate design for Rate 74.

**6. Elimination of Rate 81 - Energy Transportation;
Elimination of Rate 11 - Energy Service**

Nicor Gas proposes to eliminate Rate 11 and Rate 81, which are special sales and transportation rates applicable to gas used as fuel for producing electricity for the customer's use, or for co-generation. (Harms Dir., Nicor Gas Ex. 12B.0, 12:274 – 13:277) These rates have been in the process of being phased-out for many years, since Nicor Gas' 1995 Rate Case, and no new customers have been permitted to use these rates since that time. (Harms Dir., Nicor Gas Ex. 12B.0, 13:282 – 283) It is now time to eliminate these rates. No party has opposed the elimination of Rate 11, but the elimination of Rate 81 is opposed by one party, Constellation New Energy – Gas Division ("CNE").

Rates 11 and 81 were developed as promotional rates to encourage on-site generators to use natural gas. The promotional nature of the rates meant that customers under these rates made a lower contribution to fixed costs than similar customers not eligible for these rates. (Harms

Dir., Nicor Gas Ex. 12B.0, 13:290 - 297) They were, in other words, subsidized rates. While this made sense originally, it no longer does, as gas costs are higher and electric rates and reliability are more stable. (Harms Dir., Nicor Gas Ex. 12B.0, 14:298 - 304) Going forward, the 55 active accounts on Rate 11 and the 32 active accounts on Rate 81 should be charged rates based on the cost of service to similarly situated customers. (*Id.*)

The effect on the customers that will lose these rates is not severe. Migrating customers to other applicable rates would result in decreased charges to more than 50 customers, and increased charges to 36 customers, all other things being equal. (Harms Dir., Nicor Gas Ex. 12B.0, 14:307 – 314) For those 36 customers likely to experience increased charges, the average increase is about 6.7% for Rate 11 customers and 3.4% for Rate 81 customers (before the proposed rate increases and including the cost of gas). (*Id.*) This shows that the increases in charges found by CNE witness John Oroni (Oroni Dir., CNE Ex. 1.0, 10:185 – 190), are primarily attributable to increases in other rates, not the switch from Rate 81. Going forward, self-generation and co-generation customers should pay rates that cover costs like other customers.

7. Rate 21 – Interruptible Transport and Storage Service

The Hub, despite its name, is not an actual physical location or piece of equipment, but a collection of storage and transportation services that Nicor Gas provides transportation customers, local distribution companies, and others, on an interruptible basis only. (Bartlett, Tr. 507) As explained by Nicor Gas witness Mr. Bartlett, Hub services promote efficiency, allow flexibility, and provide a more liquid market for trading gas supplies. While Nicor Gas' Hub is not unique in the industry, it is one of the larger hubs in the region. Interstate services are offered pursuant to an operating statement on file with FERC, while intrastate services are

offered pursuant to Rate 21, Intrastate Transportation and Storage Services. (Bartlett Dir., Nicor Gas Ex. 8.0, 5:100 – 8:172)

Nicor Gas proposes to amend Rate 21 to effect three changes: (1) to allow for loans as, or as part of, intrastate transactions, (2) to remove the current 120-day limit on intrastate transactions and no longer specify a one-year maximum contract length, and (3) to permit Nicor Gas to offer “priority interruptible” services. These changes will make Nicor Gas’ intrastate Hub services similar to those offered under the Company’s FERC tariffs. (Bartlett Dir., Nicor Gas Ex. 8.0, 15:332 – 342)

The only issues which gave Staff concerns were the removal of the 120-day duration and the lack of a maximum length of the master contracts.²⁷ These concerns are unfounded. Currently, transactions longer than 120 days are permitted under Nicor Gas’ FERC tariff, and there is a demand for such services. (Bartlett Reb., Nicor Gas Ex. 24.0, 9:205 – 10:207) Some of these transactions will likely occur under Rate 21, instead of the FERC tariff, if Nicor Gas’ proposed tariff is approved. (Bartlett Reb., Nicor Gas Ex. 24.0, 10:216 – 11:230)

Moreover, the length of time the master contracts stay in force does not increase any risk to Nicor Gas or its customers. (Bartlett Reb., Nicor Gas Ex. 24.0, 12:252 – 254) The master contract with a Hub customer specifies the commercial terms for the Hub services, such as specifying the service that the customer will use, and is meant to cover all of the customer’s Hub transactions. (*Id.* at 11:245 – 12:251) A longer term for the master agreement will lessen Nicor

²⁷ Nicor Gas initially proposed to sell firm Hub services if they would not prejudice other customers. Staff opposes this change, and Nicor Gas agreed to withdraw its proposal. (Bartlett Reb., Nicor Gas Ex. 24.0, 9:194-201) Initially, Staff also objected to expanding the Hub services to include loans (Borden Dir., Staff Ex. 8.0, 4:62 – 5:78), but subsequently objected only to the elimination of the 120 day limit on loans. (Borden Reb., Staff Ex. 17.0, 18:367-373)

Gas' administrative burden, but does not imply that individual Hub transactions themselves will have long terms. (*Id.*)

The changes to Rate 21 are reasonable and should be approved. Increased flexibility of the Hub benefits those who use it, and, as Hub revenues will be credited to the sales customers, all customers will benefit. Because Hub services are provided on an interruptible basis, providing these services will not affect customers negatively. (Bartlett, Tr. 466 – 467; *see* Borden, Tr. 1080)

8. Rates 74, 76, 77

Rates 74, 76, and 77 are Nicor Gas' tariffs for transportation service. (Nicor Gas Ex. 12B.1, Sheets 18–27)²⁸ Transportation customers purchase their own gas, and can purchase storage service on the Nicor Gas system. The basic thread of Nicor Gas' proposed changes to these tariffs, and the transportation customers' objections to those changes, is how much flexibility and freedom the transportation customers should have using the Nicor Gas system, and the resulting costs.

Naturally, the transportation customers want more storage capacity, fewer restrictions on using it, no responsibility for helping achieve overall system objectives, and lower charges. The Commission needs to keep in mind that many of these issues are zero-sum: flexibility given to one class of customers may cause costs or loss of flexibility for other customers. (Bartlett Sur., Nicor Gas Ex. 39.0, 3:56 – 64; *see also* Borden, Tr. 1083 – 1084) And, despite their complaints, its bears emphasis that transportation customers have a great deal of flexibility, both now and after Nicor Gas' proposed changes. As one example, the former full-time position of one of the

²⁸ Nicor Gas has discussed the proper allocation of the revenue requirement to, and the proper rate design of, its three sets of companion sales and transportation rates, Rates 4 and 74, 6 and 76, and 7 and 77, in the Overview subsection and subsections "A(1)", "A(2)", "B(4)", and "B(5)" of this Section VI.

witnesses was to “manage the storage asset” his employer created from the existing tariffed storage rights of a group of transportation customers on Nicor Gas’ system. (Anderson, Vanguard Ex. 1, 1:14 – 2:1) These customers are finding so much flexibility that they can – – and do – – operate their service rights on Nicor Gas’ system as if it were their very own “storage asset.” (Anderson, Tr. 1211–1212)

a) Allocation

(1) Storage Capacity Allocation

Storage Banking Service, typically called SBS, is a service offered to transportation customers which allows them to serve all or part of their demands from supplies of gas that they have previously stored in Nicor Gas’ storage fields. In addition, when transportation customers’ deliveries in a day exceed demand, they may store the excess gas in Nicor Gas’ fields. Each eligible customer has the right to elect for an annual period the amount of SBS it wishes to take, up to a certain guaranteed amount. (Bartlett Dir., Nicor Gas Ex. 8.0, 21:470 – 479)

The amount of SBS to which each transportation customer is entitled has been calculated as a function of Nicor Gas’ seasonal storage cycling plan and an allocation among these customers based on each individual customer’s Maximum Daily Contract Quantity (MDCQ). The MDCQ is the maximum amount of gas that the customer can require Nicor Gas to deliver on a given day. (Bartlett Dir., Nicor Gas Ex. 8.0, 22:486 – 490) Nicor Gas used the formula approved in the Company’s last rate case, Docket 95-0219, to determine the allocation of SBS: the estimated amount of gas to be cycled during a year, divided by the estimated peak day sendout for the entire system. (Bartlett Dir., Nicor Gas Ex. 8.0, 22:480 – 491) This calculation, presented in Nicor Gas Ex. 8.1, results in an SBS allocation of 23 times a customer’s MDCQ. This update is reflected in Nicor Gas’ proposed Terms & Conditions dealing with transportation

services (Nicor Gas Ex. 12.1, Sheet 46), SBS and Firm Backup Service (Sheet No. 49), and SBS and FBS Selections (Sheet No. 50.1) A conforming change is also proposed to the level of storage allocated to each Customer Select Group under Rider 16 (Sheet No. 75.7).

There was general agreement among the witnesses and parties as to the use of the methodology from Nicor Gas' last rate case. There was also agreement as to the denominator in the calculation: Nicor Gas' peak day sendout is approximately 52,580,000 therms. (Nicor Gas Ex. 8.1; Harms Sur., Nicor Gas Ex. 44.0, 7:153 – 159) It was suggested, however, by some witnesses that Nicor Gas should use a higher numerator to reflect more gas that Nicor Gas could, in theory, draw out of storage. (Rosenberg, IIEC/CNE Jt. Ex. 1, 10:9 – 18; White, RGS Ex. 1.0, 11:297 – 12:305) Nicor Gas used 120 Bcf, which represents the amount of gas that Nicor Gas expects to cycle in a year. (Bartlett Dir., Nicor Gas Ex. 8.0, 22:480 – 491) Dr. Rosenberg, testifying on behalf of IIEC and CNE, opined that Nicor Gas should use a figure of 149.74 Bcf, which represents the sum of non-coincident capacity of Nicor Gas' eight storage fields. (Rosenberg, IIEC/CNE Jt. Ex. 1, 10:10 – 11) A number of other witnesses, also testifying on behalf of transportation customers or Customer Select suppliers, agreed. (Oroni, CNE Ex. 1, 5:89 – 95; Crist Dir., DRI Ex. 1, 12:9 – 15)

Using 149.74 Bcf for the storage allocation numerator would be incorrect. First, 149.74 Bcf is the non-coincident capacity – the total working gas of each storage field, even though they reach their maximum capacity level on different days. (Bartlett Reb., Nicor Gas Ex. 24.0, 14:315 – 317) It does not represent the capacity of the system as a whole at any particular time. (Bartlett Reb., Nicor Gas Ex. 24.0, 15:320; see also Anderson, Tr. 1209 – 1210) Accordingly,

even if one were to use total working gas, instead of estimated gas actually cycled, one should use the coincident maximum volume. (Borden, Tr. 1083) That would be 132 Bcf in 2004.²⁹

Total working gas, even the coincident total, is not, however, the correct figure. Total working gas is an amount which, in theory, Nicor Gas could draw out of its fields and reinject over the course of a year under ideal conditions. (Bartlett Reb., Nicor Gas Ex. 24.0, 15:326 – 328) One of those ideal conditions is that Nicor Gas would be able to draw its working gas down to zero before beginning to inject gas to meet its requirements for the following season. This is something that Nicor Gas cannot prudently do, any more than a prudent driver would keep driving until running out of gas before filling up. (*Id.* at 15:331 – 335)

The ability to deliver gas at a given rate is directly related to the amount of gas in the fields. (Borden, Tr. 1080) Nicor Gas must maintain its maximum deliverability from storage of 2.5 Bcf in a single day, as late as January 20 of the season. (Bartlett Sur., Nicor Gas Ex. 39.0, 10:201) After that, Nicor Gas can begin to let withdrawals overtake injections, but must be able to meet other, lower deliverability targets, some coming as late as mid-March. This is illustrated graphically on Nicor Gas Ex. 39.2. Accordingly, in order to meet its required working gas targets late in the withdrawal season, Nicor Gas will always have some gas left “in the tank” when it comes time to begin injecting for the following season. (Bartlett Reb., Nicor Gas Ex. 24.0, 15:328 – 335; Bartlett Sur., Nicor Gas Ex. 39.0, 13:269 – 284 and Nicor Gas Ex. 39.2)

²⁹ Mr. Borden, testifying for Staff, agreed that coincident maximum is the appropriate figure. He asserted that a better estimate of coincident working gas was higher than 132 Bcf, but his figures are actually relatively consistent with those presented by Mr. Bartlett for Nicor Gas. Mr. Borden calculated averages of the last three, five, and ten years. (Borden Reb., Staff Ex. 17.0, 11:220-221) In his prefiled testimony, however, Mr. Borden had not subtracted 7 Bcf from his averages to take Nicor Gas’ reclassification into account. (Borden, Tr. 1082-1083) When corrected for the reclassification, these averages would be 136, 138, and 133 Bcf. (Bartlett Sur., Nicor Gas Ex. 39.0, 11:220-223)

Significantly, transportation customers do not have to worry about these cycling issues. Transportation customers are free to withdraw all their gas before Nicor Gas' design day (January 20), refill their storage, and withdraw it all again by April 1. They do not need to consider the necessary reservoir pressures to achieve a target deliverability, and do not face a reduction in the amount of gas they can withdraw, so long as they have gas in storage. (Bartlett Reb., Nicor Gas Ex. 24.0, 16:347 – 354)

Because the 120 Bcf figure used by Nicor Gas best represents the actual amount of gas that Nicor Gas will cycle in a given year, it is the most appropriate figure for the storage allocation. That calculation results in a storage capacity allocation of 23 times a customer's MDCQ. (Nicor Gas Ex. 8.1)

(2) **Storage Withdrawal Rights**

Nicor Gas' proposed rates impose withdrawal limitations on an Operational Flow Order (OFO) Shortage Day or Critical Day. (Nicor Gas Ex. 12B.1, Sheet No. 21) This is done for two reasons. First, Nicor Gas' storage assets have a finite amount of withdrawals that can take place on any one day. (Bartlett Reb., Nicor Gas Ex. 8.0, 22:492 – 499) If Nicor Gas is to be able to serve all customers, it cannot allow unlimited storage withdrawals on a Critical Day or an OFO Shortage Day. Second, Critical Days and OFO Shortage Days require careful planning. Large and unpredictable storage withdrawals by SBS customers could cause demand to exceed Nicor Gas' physical maximum daily withdrawal capacity. (*Id.*) In addition, customers representing roughly one-third of Nicor Gas' demand have no direct physical access to storage and are served directly from pipeline deliveries. (Bartlett Reb., Nicor Gas Ex. 8.0, 22:500 – 23:505) If these customers deliver no gas to the city gate and are not served from storage, rather than shut these customers off, Nicor Gas must provide gas for these customers. (*Id.*) Therefore, to serve all

customers on an OFO Shortage Day or Critical Day without undue cost shifting, it is important that customer access to storage reflects Nicor Gas' overall capabilities.

Accordingly, using the same methodology as approved in its last rate case, Nicor Gas updated the calculation using its current operating conditions and capabilities. (Nicor Gas Ex. 8.2) As reflected in proposed tariff sheets 74, 76, and 77 (Nicor Gas Ex. 12.1, Sheet Nos. 21, 24, and 27) and Rider 13 (Sheet No. 72), Nicor Gas proposes to decrease the cap on permitted withdrawals on a Critical Day or OFO Shortage Day from 0.023 times the customer's selected SBS capacity to 0.021 times that capacity.

While it might be an overstatement to say that there was agreement on this reduction, no party offered a specific or reasoned objection. Staff supports Nicor Gas' proposal. (Borden Dir., Staff Ex. 8.0, 9:162 – 10:181) Dr. Rosenberg, testifying on behalf of IIEC and CNE, offered conditional support. (Rosenberg Reb., IIEC/CNE Jt. Ex. 2, 13:11 – 17) The Retail Gas Suppliers opposed the reduction for the reason that it used the 120 Bcf amount cycled, rather than a higher number, which is discussed in the immediately preceding section. (White Reb., RGS Ex. 1.0, 31:744 – 747) (In any event, using a denominator larger than 120 Bcf would reduce the storage withdrawal rights further.) Messrs. Crist, Oroni, and Anderson did not specifically object to the reduction.

Given the evidence supporting the 120 Bcf figure Nicor Gas used in both Nicor Gas Exs. 8.1 and 8.2, and the previously approved methodology, the reduction from 2.3% to 2.1% of a customer's total storage is reasonable. It should be approved.

(3) Daily Delivery Algorithm / Weather Sensitivity

The issue of Nicor Gas' daily delivery algorithm and weather sensitivity is discussed below in subsection B(10)(c) of this Section VI.

(4) Maximum Daily Nomination

Nicor Gas proposes that maximum daily nominations by transportation customers during the heating season be reduced from twice the customer's MDCQ to simply the customer's MDCQ. (Harms Dir., Nicor Gas Ex. 12B.0, 23:512 – 515) The daily nomination is the amount of gas a transportation customer can deliver to Nicor Gas' system to be used by the customer or added to its storage balance. The basic principle underlying the change is that winter injections run counter to Nicor Gas' overall objectives to cycle its fields. (Harms Dir., Nicor Gas Ex. 12B.0, 23:514 – 515) Staff agreed with Nicor Gas' proposal (Borden Dir., Staff Ex. 8.0, 12:226 – 229), but IIEC expressed the unsurprising view that transportation customers would rather have more flexibility, not less. (Rosenberg, IIEC Ex. 2, 24: 15 – 20, 25:2 – 8)

First, allowing transportation customers to nominate their entire MDCQ during the winter continues to provide excellent flexibility for customers. (Bartlett Reb., Nicor Gas Ex. 24.0, 27:615 – 616) The MDCQ is not the average daily use, but the maximum volume a customer is expected to use on a single day in the year. (Bartlett Sur., Nicor Gas Ex. 39.0, 24:510 – 511) So, since a customer is not using its MDCQ every day, all transportation customers will have the flexibility to do some re-injection into storage in the winter. Indeed, it is more flexibility than Nicor Gas' system actually has: the system equivalent of all customers' MDCQ is its worst case “design day,” and Nicor Gas cannot actually inject its full design day amount of gas on any day of the year, let alone a day in the withdrawal season. (Bartlett Reb., Nicor Gas Ex. 24.0, 27:617 – 28:618) The extreme flexibility currently in place for one segment of customers runs directly counter to Nicor Gas' goal of cycling its storage as a whole. (Bartlett Reb., Nicor Gas Ex. 24.0, 28:631 – 634)

Dr. Rosenberg suggests that Nicor Gas should not be restricting gas flow into the system during the cold months when gas use is at its highest. (Rosenberg Reb., IIEC Ex. 2, 25:7 – 8) Based on experience running the storage fields, however, Nicor Gas’ proposed limits will not reduce gas deliveries to the system on cold days when Nicor Gas needs it most. When cold weather occurs or is forecast, prices begin going up, and customers reduce their deliveries; logically, they do not pursue additional purchases of high-priced gas. (Bartlett Reb., Nicor Gas Ex. 24.0, 28:626 – 634) As noted above, since the limit is set at the maximum daily usage, not average use or actual use, some re-injection will be possible. The implication by Dr. Rosenberg (IIEC Ex. 2, 22:4 – 16) and Mr. White (RGS Ex. 1.0, 17:424 – 427) that Nicor Gas is preventing winter injections is not the case. (Bartlett Sur., Nicor Gas Ex. 39.0, 24:511 – 516)

Mr. White, testifying on behalf of the RGS, claims that Nicor Gas’ proposal “discriminates” against transportation customers because Nicor Gas injects gas into storage during the winter to restore performance. (White Reb., RGS Ex. 1.0, 17:428 – 429) There is no discrimination. Storage fields cannot perform at peak withdrawal rates continuously. Withdrawals at high rates impact subsequent days, and Nicor Gas may need to re-inject gas to be able to meet demand for all customers, including transportation customers. (Bartlett Sur., Nicor Gas Ex. 39.0, 24:522 – 526) Transportation customers need not be concerned with operational performance of Nicor Gas’ fields, and their daily withdrawal rights remain the same regardless of the decline in the actual withdrawal capabilities as inventory is withdrawn. (Bartlett Sur., Nicor Gas Ex. 39.0, 24:527 – 530) In any event, as mentioned above, transportation customers will have significant flexibility to re-inject gas during the withdrawal season.

(5) **Intraday Nominations**

Nicor Gas, under most conditions, accepts nominations by transportation customers once per day. CNE would rather see Nicor Gas accept amended nominations during the course of a day. (Oroni Dir., CNE Ex. 1.0, 11:221 – 13:258) Mr. Oroni stated that the North American Energy Standards Board (NAESB) standards allow intraday nominations.

First, CNE's proposal is not relevant to any rate sheet that Nicor Gas has proposed to amend, so there are no tariff sheets currently suspended and before the Commission for decision on this issue. It is therefore not appropriate to consider Mr. Oroni's suggestion, absent proof that Nicor Gas' currently filed tariff is unjust and unreasonable. CNE has not suggested any tariff language for the Commission to adopt. Moreover, adopting such a proposal is not practical until Nicor Gas has in place the systems that would be necessary to implement this; Nicor Gas does not have those systems. (Bartlett Sur., Nicor Gas Ex. 39.0, 3:52 – 55)

Second, the NAESB guidelines are written for, and applicable to, interstate pipeline transactions, not local distribution companies. (Bartlett Reb., Nicor Gas Ex. 24.0, 35:792 – 797) Nicor Gas does follow the NAESB standards to the extent required for the efficient coordination with interstate pipelines or gas suppliers. (*Id.*) Nicor Gas is under no obligation, by regulation or by the NAESB standards themselves, to operate under all their provisions. (*Id.*)

Third, as Mr. Oroni admitted, in judging tariffs, one needs to look at the rules of a utility as a whole, because each tariff has numerous provisions, and some provisions may be favorable in one area and other provisions may be less favorable. (Oroni, Tr. 1177 – 1178) An example is contained in Mr. Oroni's own testimony, in which he listed utilities that allow intraday nominations. (Oroni, CNE Ex. 2.0, 14:280 – 15:294) However, when the actual tariffs of one of

these utilities was examined, it was revealed that the utility requires suppliers to match deliveries on a daily basis, making intraday nomination more appropriate. (Tr. 1180 – 1181)

Fourth, Nicor Gas does allow the intraday amendment of nominations at the only time it would likely be of significant use to a marketer: during a Critical Day or OFO Shortage Day, including over a weekend. (Bartlett Reb., Nicor Gas Ex. 24.0, 36:800 – 808) In the real world, customers served under Nicor Gas’ flexible tariffs have little reason to need to change a nomination over the course of a single day, absent severe weather. (*Id.*) Under other conditions, when NAESB type nominations are not available, an unexpected increase or decrease in customer usage would simply be met by Nicor Gas out of the customer’s storage on a real-time, no-notice basis. (Bartlett Reb., Nicor Gas Ex. 24.0, 37:822 – 828) Accordingly, there is no real need for intraday nominations on Nicor Gas’ system, Nicor Gas has proposed no such changes, and the Commission should not order it to do so.

(6) Upstream Pipeline Capacity

The issue of upstream capacity is raised solely by DRI, and is therefore addressed below in subsection “B(10)(e)” of this Section VI.

(b) SBS Charge

Transportation customers may select, within limits, a level of Storage Banking Service (SBS), and pay a separate charge for that service. Nicor Gas derives the SBS charge by taking the cost of storage, as developed by its ECOSS, subtracting the cost related to top gas (since transportation customers supply their own gas), and dividing by the amount of gas that Nicor Gas expects to cycle (inject and withdraw) in a season. No witness disputed that this was conceptually a valid calculation. (*See, e.g.,* Rosenberg, IIEC Ex. 1, 32:4 – 7) Nicor Gas’ calculation results in an SBS charge of \$0.0038 per therm.

Accordingly, the only issue is using the correct numerator and denominator in the calculation. IIEC argues that Nicor Gas did two things wrong in selecting the numbers for its calculation. First, IIEC argues that Nicor Gas should have credited Hub revenues to the cost number in the numerator. (Rosenberg, IIEC Ex. 1.0, 32:9 – 10) IIEC is incorrect, for the reasons described in subsection “B(3)(a)” of this Section VI. Second, IIEC claims that Nicor Gas should have used, rather than the 120 Bcf figure for expected gas cycled, total non-coincident maximum top gas. Again, IIEC is incorrect, as described in subsection “B(8)(a)(1)” of this Section VI. Staff witness Mr. Luth calculated the SBS charge using the same methodology as Nicor Gas, although he used different numbers. Mr. Luth used Staff’s calculation of storage costs, but did not use Staff’s calculation of cycled gas. (Harms Sur., Nicor Gas Ex. 44.0, 26:588 – 27:594) If he had, his calculated SBS storage charge would have matched Nicor Gas’. (*Id.*) Accordingly, Nicor Gas’ calculation of the SBS charge is appropriate, and should be approved.

(c) **Cycling**

Cycling is a critically important part of managing gas storage fields. Underground aquifer fields, including all the gas storage fields owned by Nicor Gas, physically require that gas be seasonally cycled – that is, that gas be injected to near capacity and then drawn down each year. Failure to properly cycle the storage fields would lead to loss of capability in the short run, and possibly, in the long run as well. (Bartlett Dir., Nicor Gas Ex. 8.0, 25:557 – 566)

Under the current regime, in which there are no cycling targets for transportation customers, it is entirely possible, and even likely, that individual customers will actually work against Nicor Gas’ attempts to cycle its storage fields seasonally. With no responsibility for helping to achieve a seasonal cycle, transportation customers have used their complete freedom of injections and withdrawals in ways that are detrimental to maintaining the operational

integrity of the fields and forced the utility to work harder to keep its fields performing. To the extent that end use transportation customers elect to withdraw and inject gas in a manner inconsistent with the physical requirements of the fields, Nicor Gas and its customers must either suffer a degradation of this valuable asset, or Nicor Gas must alter its own purchasing to compensate. (Bartlett Dir., Nicor Gas Ex. 8.0, 25:567 – 579)

As Dr. Rosenberg recognized, for Nicor Gas to compensate for the actions of the transportation customers when those actions run counter to the required cycling of the fields, Nicor Gas must deviate from its own planned purchases. (IIEC/CNE Jt. Ex. 1, 6:8 – 14) What everyone prefers to do, of course, is to purchase gas at the lowest cost it can. So, the transportation customers effectively force Nicor Gas to alter its purchases, even if it results in added costs – purchases when the price is high, or scaling back purchases even though the price is low. These costs are borne by the sales customers, even though seasonal cycling is a necessary action that benefits all customers on the Nicor Gas system. (Bartlett Sur., Nicor Gas Ex. 39.0, 21:452 – 456)

It is not hard to see how this counter-cycling behavior could occur. A customer with the flexibility to buy and store will want to buy and store when the price is low, and use stored gas when the price is higher. This can and does lead to withdrawals and injections that hinder Nicor Gas' efforts to conduct an orderly seasonal cycling of the fields. Despite what one might expect -- buy and store gas in the summer when it's relatively inexpensive, and withdraw from storage in the winter when the price is higher (see Rosenberg, IIEC/CNE Jt. Ex. 1, 5:9 – 17) -- real world examples tell a different story. In the summer of 2004, prices were expected to go down, and transportation customers held off on their purchases for injection into storage. Nicor Gas, in order to get the storage fields' inventory up to the required operational levels, had to act, despite

the price level of gas, to acquire the needed gas. Then, in late summer, expectations changed, and higher prices were predicted. Transportation customers began increasing injections aggressively, filling storage capacity in October that Nicor Gas had filled earlier in the summer. To accommodate this late surge in injections, Nicor Gas was forced to reduce its own purchases, contrary to what it would want to do, based on price expectations. (Bartlett Reb., Nicor Gas Ex. 24.0, 24:527 – 25:554)

Mr. Bartlett gave another example. On March 31, 2005, at the end of the withdrawal season, the transportation customers as a whole had storage inventories of over 19 Bcf, or almost 55% of their subscribed storage capacity. Shortly thereafter, as Nicor Gas had changed its storage fields to begin injections to meet next winter's demand, transportation customers had, in the aggregate, made net withdrawals of over 1 Bcf over the first 10 days of April. (Bartlett Sur., Nicor Gas Ex. 39.0, 23:488 – 497)

Accordingly, Nicor Gas proposes to establish seasonal cycling targets for the use of gas storage by end use transportation customers. Specifically, Nicor Gas proposes that failure to bring stored gas levels to at least 90% by November 1 would result in reduction of Critical Day and OFO Shortage Day withdrawal capability, and failure to reduce balances to 10% or less of the maximum inventory level by April 1 would result in a reduction in the customer's daily summer injection rights. (Nicor Gas Ex. 12B.1, Sheet 50)

Nicor Gas' decision to begin encouraging some cycling discipline is understandably not popular among transportation customers. But the fact is that transportation customers will still enjoy substantial flexibility, since they still do not need to worry about Nicor Gas' deliverability requirements. A transportation customer can draw its entire storage down to zero during the winter season, fill it back up, and suffer no consequences so long as it draws down to 10% before

April 1. (Bartlett Reb., Nicor Gas Ex. 24.0, 16:348 – 354) Moreover, Nicor Gas’ proposal affects the withdrawal rights of customers not meeting the cycling targets only on OFO Shortage Days or Critical Days, which occur infrequently; customers otherwise retain full flexibility.

One argument from the transportation customers is that Nicor Gas itself does not meet the cycling targets it wants to set, particularly the April 1 inventory target of 10%. (Oroni Reb., CNE Ex. 2, 17:341 – 346) This argument misses a couple of important points. First, it is not appropriate to look at the total volume of working gas that Nicor Gas cycles, because, as discussed in subsection B(8)(a)(1) of this Section VI, Nicor Gas prudently does not cycle every therm of its working gas. And, accordingly, Nicor Gas bases its storage allocation on the amount of gas that Nicor Gas plans to cycle. Transportation customers do not have operational reasons to leave behind a certain amount of working gas. (Bartlett Reb., Nicor Gas Ex. 24.0, 19:428 – 20:446; Bartlett Sur., Nicor Gas Ex. 39.0, 20:421 – 28) Second, the system-wide minimum gas storage level is not an accurate indication of Nicor Gas’ cycling. Nicor Gas’ fields do not reach their minimum level all at the same time, so that on any particular day, the system-wide level may not reflect the minimum for a particular field. (Bartlett, Tr. 474)

The arguments made by the intervenors, and picked up in part by Staff, that there are various operational things Nicor Gas could do to cycle its fields even with the transportation customers continuing to work against it, ignore the cost of these solutions and who incurs that cost. Some of these possible “solutions” would work, such as using excess inventory in storage to meet system supplies prior to the injection season (Borden Reb., Staff Ex. 17.0, 13:252 – 256). As Dr. Rosenberg says, Nicor Gas is “physically capable” of cycling its fields even without the proposed incentives, and points out that Nicor Gas has been able to do its cycling in the past while letting transportation customers do as they please. (Rosenberg Dir., IIEC/CNE Jt. Ex. 1,

6:1 – 7) That’s quite true, but misses the point: who should bear the cost of this cycling when Nicor Gas is forced to take actions to get it done? As Dr. Rosenberg admits, Nicor Gas accomplishes this by “adjusting its own purchase patterns in response to transportation usage.” (Rosenberg Dir., IIEC/CNE Jt. Ex. 1, 6:8 – 14) These costs of operating the system and compensating for the actions of the transportation customers fall primarily on the sales customers. (Bartlett Reb., Nicor Gas Ex. 24.0, 22:491 – 494) Since all customers ultimately have an interest in the proper functioning of the storage fields, Nicor Gas’ proposed cycling merely spreads this responsibility equitably among the customer classes.

(1) Super-pooling

CNE proposes that Nicor Gas allow “super-pooling” of storage volumes for all groups of customers under common management of the same supplier in determining overall compliance with target cycling levels. (Oroni Reb., CNE Ex. 2.0, p. 21:435 – 443, 28:596 – 29:608) CNE argues that the proposed super pools will not affect sales customers or operation capabilities. Nicor Gas does not support this proposal. Balancing for each individual group will result in increased incentives for the supplier to meet the cycling requirements and better conformance to the cycling requirements. (Harms Sur., Nicor Gas Ex. 44.0, 41:920 – 922) It would provide a benefit to all customers that suppliers meet the cycling requirements at the group level, not groups of groups. (*Id.* at 41:922 – 924) If super-pooling were allowed, the appropriate cycling targets for the groups might need to be adjusted. (Harms, Tr. 719)

(d) Level of Rate Increase

As discussed in the Summary of this Initial Brief, Nicor Gas is currently experiencing a \$61,726,000 revenue requirement shortfall, assuming its proposed rate design changes relating to Rider 6, or \$77,573,000 without them, and thus Nicor Gas is proposing an increase in the

revenue requirement in this proceeding. (*E.g.*, Gorenz Reb., Nicor Gas Ex. 26B.0, 5:107 – 113) As discussed in that Summary, and in the Overview subsection and subsections “A(1)”, “A(2)”, “B(4)”, and “B(5)” of this Section VI, Nicor Gas has proposed to allocate costs to customer classes (rate designations) to more accurately reflect the cost of servicing those customers, subject to the rate design objectives discussed in its testimony and herein, and this necessitates an increase in various rates, including those for transportation customers, i.e., Rates 74, 76, and 77.

CNE has opposed the increase to transportation rates as being too great from a policy standpoint. (Oroni Reb., CNE 2.0, p. 3:48 – 4:82) While unable to cite to any specific revenue requirement item as unnecessary or imprudent, CNE argues that it would be unfair for the transportation customers to be burdened with such a large increase in rates. CNE witness Mr. Oroni took particular exception with Staff’s original proposed embedded cost of service study. (Oroni Reb., CNE 2.0, p. 5: 90 – 94, 32:686 – 33:694) IIEC witness Dr. Rosenberg has also taken issue with the level of rate increase for transportation customers, but from a cost of service standpoint, in regard to both Nicor Gas and Staff proposals, especially the latter. (Rosenberg Dir., IIEC Ex. 1.0, p. 24:10 – 27:25; Rosenberg Reb., IIEC Ex. 2.0, 23:17 – 24:10) Dr. Rosenberg’s recommendations regarding the cost of service studies and rate design are discussed in the Overview subsection and subsections “A(1)” and “A(2)” of this Section VI.

Nicor Gas agrees with CNE that the impact of any rate increase should be given some consideration once the proper revenue requirement has been determined. In fact, that is precisely what Nicor Gas has proposed in its rate design in this proceeding. Starting with a properly constructed ECOSS, Nicor Gas would still limit the increase to Rate 1, Residential Service, as it originally proposed and supported by Nicor Gas’ direct, rebuttal, and surrebuttal testimonies, as discussed above in greater detail in the Overview subsection and subsections “A(1)”, “A(2)”,

“B(4)”, and “B(5)” of this Section VI. In brief, as Mr. Harms’ analysis shows, to get to equalized rates of return would require residential customer rates (Rate 1) to increase by about \$76 million even though Nicor Gas’ requested total increase is \$77,573,000. (Harms Sur., Nicor Gas Ex. 44.0, 12:255 – 260) Nicor Gas is proposing to limit the residential class rate increase to about \$55.6 million or 72% of the approved residential class base rate increase. (Harms Sur., Nicor Gas Ex. 44.0, 3:56 – 58, 12:260 – 262) Nicor Gas further proposes that the total remaining revenue requirement, which would include the remaining \$22.0 million revenue increase, be allocated proportionally to the non-residential classes based on the results of the ECOSS (excluding Rates 17 and 19 which have individual contract services). (Harms Sur., Nicor Gas Ex. 44.0, 12:261 – 266) This results in an increase of about 17.2% in base rates for residential customers and 13.1% for commercial and industrial customers. (Harms Sur., Nicor Gas Ex. 44.0, 12:261 – 266)

IIEC’s proposal would result in approximately a greater than \$76 million increase to residential customers and in total a decrease for commercial and industrial customers. (IIEC Ex. 1, Schedule 9) The Commission should adopt Nicor Gas’ proposed rate increases for transportation customers rather than accept IIEC’s proposal to place more than the entire revenue requirement increase burden upon residential customers. CNE’s objections also are without merit.

9. Rider 13 – Group Size Limitation

Marketers often group transportation customers together. Nicor Gas’ Sheet No. 71, Rider 13, states that each group shall be limited to 50 accounts. This is done for ease of administration, because larger groups can be difficult to administer. (Oroni Dir., CNE Ex. 1.0,

Attachment D) CNE would like the group size limit eliminated. (Oroni Dir., CNE Ex. 1.0, 13:264 – 14:280)

Nicor Gas' 50-account group limit is reasonable. Suppliers frequently change the make-up of their groups as customers move into and out of groups. This requires close attention from Nicor Gas, as all customers in a group are billed at the same time. Any billing errors impact several different customers. Expanding groups beyond 50 accounts increases the potential of billing errors for the group, and increases administrative costs. (Harms Reb., Nicor Gas Ex. 27A.0, 15:320 – 329) While Mr. Oroni, testifying on behalf of CNE, named several utilities that did not put a size limit on groups, he could not say how many transportation customers these utilities had compared to Nicor Gas. (Oroni, Tr. 1182)

10. Rider 16 (Customer Select) – Gas Management Issues

Customer Select supplier DRI proposed a number of sweeping changes to provide Customer Select suppliers with additional flexibility. Nicor believes that it would be a mistake to rush to adopt such proposals. There needs to be equitable balancing among transportation customers, Customer Select customers, and the remaining sales customers. Rules governing Customer Select should be carefully written to enable the program to expand without causing cost shifts to other classes of customers, or to create operational problems. (Bartlett Sur., Nicor Gas Ex. 39.0, 28:613 – 618) At worst, failure to create an expandable program could lead to a significant number of Operational Flow Orders. (Bartlett Sur., Nicor Gas Ex. 39.0, 28:618 – 620) The changes suggested by DRI are so significant that they really should be handled outside this proceeding, as numerous Customer Select issues already have been. (Bartlett Sur., Nicor Gas Ex. 39.0, 28:620 – 622; Crist Tr. 1202 – 1203) Staff also counseled caution. (Borden Reb., Staff Ex. 17.0, 7:130 – 8:138)

(a) **Storage Capacity Allocation**

Storage capacity is discussed above with regard to the arguments of transportation customers, in subsection “B(8)(a)(1)” of this Section VI. However, DRI witness James Crist did not accept, as did the other parties, the formula for allocating storage capacity that the Commission approved in Nicor Gas’ previous rate case. Rather, he made an alternate proposal which is addressed here. Mr. Crist proposed that Customer Select customers should be allocated 38% of their annual requirements in Nicor Gas’ on-system storage capacity. (Crist Dir., DRI Ex. 1, 13:7 – 20)

Mr. Crist’s proposal must be rejected. DRI is attempting to obtain an allocation that is clearly out of proportion to other customers on the Nicor Gas system. Nicor Gas’ annual sendout is approximately 500 Bcf. Applying Mr. Crist’s 38% figure across the board to the entire sendout, it would call for 190 Bcf in allocated storage, which all parties agree is more on-system storage capacity than Nicor Gas has. (Bartlett Reb., Nicor Gas Ex. 24.0, 34:763 – 772) This indicates that Mr. Crist is laying claim to more than a fair share.

Mr. Crist attached some draft rules that cover on-system storage assignment, based on another LDC’s rules, which Mr. Crist believed were more favorable to DRI than Nicor Gas’ rules. (Crist, DRI Ex. 2, Attachment JLC 2.1) On cross-examination, it was revealed that Mr. Crist had modeled his rules on those of Dominion East Ohio, an affiliate of DRI. (Crist, Tr. 1199 – 1200) Nicor Gas suggests that it would be preferable to address proposed rules in a separate Illinois proceeding, rather than adopt the rules applicable to an Ohio LDC and its affiliate.

(b) Storage Withdrawal Rights

This issue is discussed above, as to transportation customers, in subsection “B(8)(a)(2)” of this Section VI. Nicor Gas’ arguments on storage withdrawal rights for transportation customers apply equally to the arguments regarding Customer Select.

(c) Daily Delivery Algorithm/Weather Sensitivity

DRI proposes, as a less desired alternative to full control over a portion of Nicor Gas’ on-system storage and upstream capacities, that the daily delivery obligation be dampened by removing the temperature factor from the models. (Crist Dir., DRI Ex. 1, 11:18 – 12:7) Nicor Gas does not support this proposal in this Docket.

Staff witness David Borden, while agreeing with Nicor Gas’ change in the tolerance level at month-end, suggests an additional change in the daily deliveries to Customer Select suppliers. Mr. Borden suggested that the level of withdrawals automatically change with the weather on a daily basis. (Borden, Staff Ex. 8.0, 15:302 – 306) Mr. Borden reported that this procedure, which came out of a collaborative process and is used for Peoples Gas’ small volume transportation customers, might work for Nicor Gas’ Customer Select program. (*Id.* at 14:272 – 275)

Nicor Gas has not proposed any tariff sheets that alter its existing algorithm, and therefore there are no tariff sheets currently suspended and before the Commission for decision on this issue. It is therefore not appropriate to consider Mr. Borden’s suggestion, absent proof that Nicor Gas’ currently filed tariff is unjust and unreasonable. As Mr. Borden noted, the changes to the Peoples Gas tariffs came at the end of a collaborative process involving the utility and affected customers. Nicor Gas has engaged in similar processes, including a process that led to changes to its Customer Select tariffs in advance of tariffs this past winter season. Nicor Gas

Amendments to Rider 16, ICC Docket 04-0511 (Sept. 9, 2004). An important change such as the altering of the algorithm should only be done deliberately, and with the input of affected customers.

This is particularly true in light of the fact that the Peoples Gas program to which Mr. Borden cites has only about 12,000 customers, less than 5,000 of which are residential. (Bartlett Reb., Nicor Gas Ex. 24.0, 31:685 – 688) The Nicor Gas Customer Select program is much larger, both in number of customers and geographically, and should therefore be treated with appropriate care. (*See* Borden, Tr. 1085 – 1086) Nicor Gas should not be ordered to adopt a new scheme based on the record before the Commission in this Docket.

(d) **Monthly Balancing Tolerance/Penalty**

Nicor Gas proposes to increase from 2% to 5% the tolerance level applicable at month-end to the variation between required deliveries for the month and actual deliveries nominated by the supplier. (Nicor Gas Ex. 12B.1, Sheet 75.5; Bartlett Dir., Nicor Gas Ex. 8.0, 28:625 – 29:632) DRI proposes to increase the tolerance to infinity. (Crist Dir., DRI Ex. 1, 10:25 – 26) The current Customer Select program provides significant marketer discretion to vary on a daily basis from the daily nomination requirements, and would get greater flexibility from the increase in the month-end tolerance, DRI's request is not appropriate. Under Nicor Gas' proposal, while a supplier cannot under-deliver at the maximum limit for every single day of the month (DRI's proposal, apparently), a supplier could under-deliver at the maximum level for at least 15 days without a penalty. (Bartlett Reb., Nicor Gas Ex. 24.0, 33:731 – 738) That is reasonable, providing flexibility without abuse.³⁰

³⁰ RGS witness Mr. White also complained about the 10% daily and 5% month-end tolerances, calling them a "double penalty." It is no such thing, and indeed the daily and month-end tolerances were introduced in the same

(e) **Access to Upstream Capacity /
Elimination of Aggregation
Balancing Service Charge**

Upstream capacity means the storage assets and transportation capacity on interstate pipelines for which Nicor Gas has contracted to maintain flexibility. Currently, Nicor Gas uses the upstream capacity it leases on interstate pipelines for the benefit of all customers to operate the system effectively and efficiently, and charges Customer Select suppliers a fair share of the cost of such contracts. (Bartlett Reb., Nicor Gas Ex. 24.0, 33:740 – 749) DRI asks the Commission to grant all Customer Select suppliers the right to demand an assignment from Nicor Gas of portions of the upstream capacity Nicor Gas leases. (Crist, DRI Ex. 1, 14:15 – 21) Mr. Crist suggests that Nicor Gas should release to Customer Select suppliers storage capacity on a yearly basis, and transportation capacity on a monthly basis. (*Id.*) In return, Mr. Crist says that DRI would be willing to provide additional gas deliveries on critical days and/or during peak periods. (Crist, DRI Ex. 1, 16:9 – 13) RGS says they would prefer this arrangement as well. (White Reb., RGS Ex. 1.0, 16:393 – 404)

Nicor Gas contracts for upstream capacity subject to FERC rules and upstream pipeline tariffs. The terms and conditions of those contracts are within the jurisdiction of the FERC, and it is not clear that the rights DRI and RGS seek are within the power of the Commission to grant them. Indeed, the FERC rules and FERC–jurisdictional interstate pipeline tariffs, which Nicor Gas must follow, contain provisions that govern capacity releases (assignments), and generally restrict discriminatory releases. (Bartlett Sur., Nicor Gas Ex. 39.0, 29:627 – 642) DRI and RGS appear to be asking for preferential options to obtain certain of Nicor Gas’ rights. Mr. Crist and

tariff filing in March 2002 (although the original month-end tolerance was only 2%). (Bartlett Sur., Nicor Gas Ex. 39.0, 22:480-486)

Mr. White do not explain how their proposals to give Customer Select suppliers an option on Nicor Gas' leased capacity would satisfy these restrictions. Therefore, the Commission should not entertain these sweeping proposals to completely transform the Customer Select program without significantly more information, and without a demonstration that the rights transferred from Nicor Gas to the Customer Select suppliers will not be illegal, or detrimental to other customer classes. (See Bartlett Sur., ComEd Ex. 39.0, 28:613 – 622)

11. Rider 25 – Demand Gas Costs

Rider 25 provides 100% backup service to transportation customers that choose this option. (Nicor Gas Ex. 12B.1, Sheets 76 – 78) In other words, at any time transportation customers taking Rider 25 service can provide none of their own gas, and instead obtain all of their gas needs from Nicor Gas' system supplies. Rider 25 customers are required to pay their share of firm interstate pipeline capacity and leased storage costs. (Harms Dir., Nicor Gas Ex. 12B.0, 7:156 – 163) Customers are billed based on their MDCQ. (Nicor Gas Ex. 12B.1, Sheet 76) Nicor Gas' on-system storage can provide 47% of the customer's MDCQ, with pipelines providing the other 53%. (Harms Dir., Nicor Gas Ex. 12B.0, 7:165 – 8:172) Accordingly, Rider 25 customers are required to pay pipeline costs – the Demand Gas Costs – for 53% of the MDCQ to receive 100% backup service. (Harms Reb., Nicor Gas Ex. 27B.0, 15:333 – 342) This is fair, and no witness disputed this charge.

12. Rider 12 – Environmental Cost Recovery

Nicor Gas has proposed to change certain language in its Rider 12, Environmental Cost Recovery. (Harms Dir., Nicor Gas Ex. 12B.0, 35:777 – 36:815, Nicor Gas Ex. 12B.2, pages 88 – 90) More specifically, Nicor Gas has proposed three changes regarding Rider 12: (1) to change the basis for the interest component from Nicor Gas' after tax costs of capital to the short term

interest rate determined annually by the Commission, (2) to add language to allow the recovery of research and development (“R&D”) costs associated with environmental remediation, and (3) to add language to allow recovery of certain costs relating to “Manufactured Gas Operations” that the Commission has permitted to be recovered by other gas utilities with environmental cost recovery tariffs. (Harms Dir., Nicor Gas Ex. 12B.0, 35:777 – 36:815)

Staff has agreed with Nicor Gas’ first point, setting the interest component. (Ebrey Dir., Staff Ex. 2.0, 16:318 – 326) Staff has taken exception, however, to the other two proposals to change the language of Rider 12, based on Staff witness Ms. Ebrey’s interpretation of the activities presently included within the scope of Rider 12. (Ebrey Dir., Staff Ex. 2.0, 10:189 – 16:326)

As to the first of these two changes that have not been accepted by Ms. Ebrey, certain incremental R&D expenses fall within the purpose of Rider 12 and should be recoverable based on existing tariff language. In fact, R&D costs associated with manufactured gas plants (“MGPs”) appear to be within the scope of Rider 12 already. Regardless, Nicor Gas’ proposed revision would make clear that those and certain other R&D expenses are includable. Ms. Ebrey’s position also should be rejected as being inconsistent with the Commission’s decision in granting MGPs cost recovery riders.

As to the second of these two changes, Nicor Gas has proposed to add to Rider 12 the words “Manufactured Gas Operations” into the definition of “Environmental Activities”. This minor change has the effect of giving Nicor gas comparable recovery of costs associated with manufactured gas plants as has been allowed to other utilities. (Harms Sur. Nicor Gas Ex. 44.0 39:878 – 40:394) Ms. Ebrey has objected to this proposal, claiming that it will be confusing. This objection, however, is not warranted. In comparing Nicor Gas’ MGP recovery rider with

similar riders of other Illinois utilities, it appears that such other companies are able to recover costs relating to MGP operations that are other than remediation costs; Nicor Gas simply desires the same treatment.

The Commission should approve Nicor Gas' proposal to set the interest rate as agreed by Staff and to amend Rider 12 to include for recovery of certain costs related to environmental remediation research and development and manufactured gas operations.

13. Rider 7 – Local Government Compensation Adjustment; Rider 2

Nicor Gas has proposed to revise its Rider 7 to include the recovery of all franchise and related costs imposed on Nicor Gas by a unit of local government so that these costs are recovered from customers taking service within the boundaries of that local governmental unit and not all customers. (Harms Dir., Nicor Gas Ex. 12B.0, 30:673 – 32:723; Harms Reb., Nicor Gas Ex. 27B.0, 10:215 – 11:251; Harms Sur., Nicor Gas Ex. 44.0, 37:834 – 39:875; Nicor Gas Ex. 44.10) For example, in 2004, Nicor Gas compensated 464 municipalities for the right to work in the community. (Harms Sur., Nicor Gas Ex. 44.0, 38:854 – 855) Some compensation was via a cash payment and other via free gas for municipality use. (*Id.* at 38:855 – 857) Nicor Gas' original proposal included annual reconciliations of costs and collections. (Harms Dir., Nicor Gas Ex. 12B.0, 30:683 – 31:687)

Staff witness Mr. Luth opposed Nicor Gas' proposal to change Rider 7 on two grounds. (Luth Dir., Staff Ex. 7.0, 17:324 – 19:358; Luth Reb., Staff Ex. 16.0, 17:356 – 19:391) First, he claimed that it would be administratively burdensome for Staff to track and reconcile the various charges that may come about in the future. (Luth Dir., Staff Ex. 7.0, 18:348 – 18:350) Second, Mr. Luth contended that Nicor Gas has not shown that changes to Rider 7 are needed to avoid significant subsidies between customers. (Luth Dir., Staff Ex. 7.0, 19:356 – 358)

Nicor Gas has recognized Mr. Luth's concerns and has proposed that a separate rider, Rider 2, Franchise Cost Adjustment, be implemented that would recover franchise gas costs from customers residing within the boundaries of that governmental unit. (Harms Sur., Nicor Gas Ex. 44.0, 37:834 – 39:875, Nicor Gas Ex. 44.10) Rider 2 would collect the value of the gas provided to each franchisee from those Nicor Gas customers within its boundaries. (Harms Sur., Nicor Gas Ex. 44.0, 38:857 – 59) For each municipality that received free gas in 2004 or other monetary contribution, Nicor Gas has calculated a monthly charge per customer that would recover the value of gas from the customers within the municipality, shown in Rider 2. (*Id.* at 38:858 – 861, Nicor Gas Ex. 44.9) Staff's concern about reconciliations is addressed, because the proposed charges would remain stable until the next rate case. (Harms Sur., Nicor Gas Ex. 44.0, 38:861 – 39:866)

Nicor Gas' proposal still includes Rider 7. However, Rider 7 would be limited to certain costs other than franchise fees that a governmental agency might impose on Nicor Gas. (Harms Sur., Nicor Gas Ex. 44.0, 39:867 – 870) As modified, Rider 7 would essentially be equivalent to Commonwealth Edison Company's ("ComEd") existing Rider 28. (*Id.* at 39:870 – 871) Several agencies currently are considering imposing such costs and Nicor Gas anticipates more agencies will be imposing these costs in the future, and thus a modified Rider 7 is needed. (*Id.* at 39:871 – 873) Nicor Gas has revised proposed Rider 7 to make it consistent with proposed Rider 2 and ComEd's Rider 28. (*Id.* at 39:874 – 875; Nicor Gas Ex. 44.10)

It should be noted that the surrebuttal testimony of Nicor witness Mr. Harms included an inadvertent error in regard to Rider 7 and Rider 2. While Mr. Harms described correctly Nicor Gas' proposal, the tariff sheet for the proposed Rider 7 (Nicor Gas Ex. 44.10) included an incorrect effective date. (Harms Sur., Nicor Gas Ex. 44.0, 37:834 – 39:875, Nicor Gas Ex.

44.10) As described by Mr. Harms, the proposed Rider 2 will become effective January 1, 2007 as dictated by programming requirements for franchise gas cost recovery and Rider 7 should become effective immediately upon approval by the Commission. The Commission should approve Nicor Gas' proposed modification of Rider 7 and the addition of Rider 2.

14. Other Customer Select Issues

a) Billing and Gas Supply Administrative Costs

DRI has proposed that gas supply administrative charges be eliminated from Customer Select rates. DRI argues that Customer Select suppliers incur billing and gas supply administrative charges and must include them in their gas prices. (Crist Dir., DRI Ex. 1.0, 18:22 – 19:6) Therefore, DRI argues that Nicor Gas should be required to also include such administrative costs in Nicor Gas' cost of gas rather than in base rates. (Crist Dir., DRI Ex. 1.0, 18:22 – 19:6)

Nicor opposes DRI's proposal. As discussed in regard to carrying costs on gas in storage, DRI's proposal is an attempt to readdress issues decided by the Commission in the consolidated Dockets regarding Customer Select charges, *In re Citizen's Utility Board, et al.*, Docket 00-0620 Cons., 2002 Ill. PUC Lexis 16 at **70-71 (Order on Rehearing Jan. 3, 2002). (Harms Reb., Nicor Gas Ex. 27B.0, 13:278 – 286) Nicor Gas has not proposed any changes in Customer Select charges in this case as the cited Commission decisions were completed only recently. (Harms Reb., Nicor Gas Ex. 27B.0, 13:278 – 286) The Commission should deny DRI's proposal to modify the Commission's prior decision regarding treatment of gas supply administrative costs.

b) Mailing List

DRI witness Mr. Crist proposes that Nicor Gas should provide a mailing list of its customers to Customer Select providers. (Crist Dir., DRI Ex. 1, 19:17 – 22) In light of DRI's request, Nicor Gas is investigating the possibility of making available a list of residential customers, but among the issues that it needs to evaluate are customer privacy right implications and potential additional obligations and liabilities that this might impose on Nicor Gas. (Harms Reb., Nicor Gas Ex. 27B.0, 13:287 – 294) This subject has no direct bearing on the proposed tariffs at issue in this Docket, and should not be the subject of a Commission directive on an inadequate record.

c) Customer Select Signup (Account and Meter Numbers)

DRI witness Mr. Crist proposes that Nicor Gas should permit Customer Select sign-ups to be submitted by providers without having to provide both an account number and a meter number as currently is required. (Crist Dir., DRI Ex. 1, 19:23 – 24:15) This proposal should be rejected because the existing system works well, and the proposed system may lead to erroneous switching. (Harms Reb., Nicor Gas Ex. 27B.0, 13:294 – 14:303; Harms Sur., Nicor Gas Ex. 44.0, 35:787 – 36:799; Nicor Gas Ex. 44.8; Nicor Gas Ex. 46)

15. Energy Efficiency Programs

The Environmental Law and Policy Center has proposed that the Commission order Nicor Gas to spend \$38,000,000 per year, or alternatively, \$10,000,000 per year, to pursue energy efficiency programs. (Kushler Dir., ELPC Ex. 1.0, 5:110 – 112, 6:124 – 128) Mr. Thomas, testifying on behalf of CUB/CCSAO, agreed with the \$10,000,000 figure, and

suggested that it be added to Nicor Gas' base rates as an operating expense.³¹ (Thomas Reb., CUB/CCSAO Ex. 3.0, 34:760–762, 35:789 – 790) Dr. Kushler testified that \$38,000,000, which would equate to about \$10 per year for the average residential customer, would not be an onerous amount. (Kushler Dir., ELPC Ex. 1.0, 6:119; Tr. 823 – 824) However, the record in this Docket does not provide sufficient information to determine costs, develop an appropriate rate design, and prepare an appropriate tariff for recovery of costs. (Harms Reb., Nicor Gas Ex. 32.0, 43:919 – 923) Staff agreed that the record lacks sufficient detail required to implement the cost recovery contemplated. (Borden Reb., Staff Ex. 17.0, 18:358 – 360)

History has proven that energy efficiency initiatives can be cost-effective, and can also not be cost-effective. (Kushler, Tr. 807) It is therefore important to “get it right.” (Kushler, Tr. 805 – 806) Nicor Gas does not oppose energy efficiency initiatives; however, before seeing millions of dollars of the ratepayers' money spent on projects, there should be the appropriate mechanisms in place to insure that cost-effective programs are designed and selected. There are also fairness issues, considering that some of the more cost-effective efficiency measures may be concentrated in particular classes of customers. (Kushler, Tr. 821 – 822)

The problem with simply earmarking funds to energy efficiency is that the process of deciding on a process and program is typically a lengthy and tortuous one. (Jensen, Nicor Gas Ex. 33.0, 3:48 – 58) Before launching a compulsory energy efficiency initiative, the Commission should consider its fundamental policy, especially given the abolishment of Illinois' integrated resource planning process. P.A. 90-561, repealing 220 ILCS 5/8-402 (effective

³¹ Although in Dr. Kushler's direct testimony, he alluded to at least the possibility that shareholders might bear some of the expense of efficiency programs (Kushler Dir., ELPC Ex. 1.0, 6:120-122), that concept was criticized as bad policy by Dr. Gordon (Nicor Gas Ex. 19.0, 15:345-16:355) and Mr. Jensen (Nicor Gas Ex. 33.0, 8:167-171) and it was not supported by any party.

Dec. 16, 1997). (*See also* Jensen Reb., Nicor Gas Ex. 33.0, 3:48 – 58) This means that the Commission would need to inform itself about the potential for, costs, and benefits of energy efficiency – to a much greater extent than this record permits. (Jensen Reb., Nicor Gas Ex. 33.0, 3:66 – 4:73) The Commission would also need to decide who is going to implement policies, who is going to administer the programs, who is going to implement programs, and how programs will be evaluated for effectiveness. Also, of course, the Commission must consider the amount of funding. (Jensen Reb., Nicor Gas Ex. 33.0, 4:75 – 6:123) Mr. Kushler merely scaled his suggested funding level from a generic study regarding the amount of energy efficiency potential, and not a specific study that this was an appropriate amount to spend. (Jensen Reb., Nicor Gas Ex. 33.0, 4:75 – 6:123; see Kushler Dir., ELPC Ex. 1, 5:108 – 112) A separate proceeding would be a better forum for considering ELPC’s suggestion. (Jensen Sur., Nicor Gas Ex. 45.0, 5:97 – 102)

16. Other

Nicor Gas made certain other rate-related proposals that are uncontested and should be approved: (1) the change in the budget payment plan review schedule, (2) the cancellation of Rate 10, (3) the cancellation of Rate 11 (discussed in subsection “B(6)” of Section VI), (4) the cancellation of Rider 9, (5) the non-sufficient funds charge update, (6) the damage to pipe charge update, and (7) the service pipe extension charge update. (*E.g.*, Northern Illinois Gas Company’s Pre-Trial Memorandum, pages 12 – 13)

VII. CONCLUSION

The Commission should approve Nicor Gas' proposed tariffs, subject to the revisions proposed or accepted in its rebuttal and surrebuttal testimony and exhibits. They are just and reasonable for Nicor Gas, its stockholders, and its customers, they comport with the law, and they are fully supported by the evidence in the record.

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Respectfully submitted,



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