STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Northern Illinois Gas Company d/b/a Nicor Gas Company	:	
	:	**ICC Docket No. 04-0779**
Proposed general Increase in rates, and revisions to other terms and conditions of service	:	

REPLY BRIEF OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

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Staff of the Illinois Commerce Commission ("Staff"), by and through its counsel, pursuant to Section 200.800 of the Rules of Practice (83 Ill. Adm. Code 200.800) of the Illinois Commerce Commission ("Commission"), respectfully submits its Reply Brief in the above-captioned matter.

I. INTRODUCTION

The Initial Brief of the Staff of the Illinois Commerce Commission ("Staff IB" or "Staff's Initial Brief") was filed on June 22 2005. Northern Illinois Gas Company's Initial Post-Hearing Brief ("Nicor IB"), the Initial Brief of the Illinois Industrial Energy Consumers ("IIEC IB"), the Initial Brief of the People of the State of Illinois ("AG IB"), the Initial Brief of Environmental Law and Policy Center ("ELPC IB"), the Initial Brief of the Citizens Utility Board and the Cook County State's Attorney's Office ("CUB-CCSAO IB"), the Initial Brief of Constellation NewEnergy-Gas Division, LLC ("CNE IB"), the Initial Brief of the Retail Gas Suppliers ("RGS IB"), the Initial Brief of Dominion Retail, Inc. ("DRI IB"), and Vanguard Energy Services, LLC's Initial Brief ("Vanguard IB") were also filed on June 22, 2005.

As explained in Staff's Initial Brief, the Commission is investigating in this proceeding the tariffs filed by Northern Illinois Gas Company d/b/a Nicor Gas Company ("Nicor" or "Nicor Gas" or the "Company") on November 4, 2004, seeking a general increase in gas rates pursuant to Article IX of the Illinois Public Utilities Act ("Act"), (220 ILCS 5/9). Staff agrees that Nicor is entitled to a rate increase, but disagrees with Nicor as to the amount of increase that is just, reasonable and appropriate based on the record in this proceeding. Although the management of Nicor in a manner that allowed it to avoid the need for rate relief from 1995 until 2004 is laudable, as are the relative low gas distribution rates for Nicor in comparison to other Illinois local distribution companies, those facts in and of themselves do not establish Nicor's entitlement to its proposed rates. Rather, each component of Nicor's proposed rate increase and rate design must be judged on its own merits based on the facts as well as relevant legal requirements and policy considerations. When so considered, it is clear that the level of Staff's proposed revenue requirement and rate design are supported by the record, fair and reasonable. Staff's positions are fully described and supported in Staff's Initial Brief, and this Reply Brief further explains why Nicor's arguments to the contrary must be rejected.

Before addressing Nicor's specific arguments, one general point regarding Nicor's summary needs to be made so as to clarify the record and place Nicor's arguments in their proper context. As explained in Staff's Initial Brief, Nicor is requesting a base rate revenue increase of $61,726,000 and Staff is recommending a base rate revenue increase of $35,764,000.[1] (Staff IB, pp. 2-3; see Nicor IB, p. 1, n.2) Nicor argues that "Staff's proposal is actually far more draconian, as most of Staff's calculated [$35 million] 'increase' actually represents only transfers of revenues to base rates from Rider 6." (Nicor IB, p. 5) Nicor's argument is both unfair and misleading.

Although it is true that Staff is opposed to Nicor's proposal to recover what Nicor calls the commodity portion of its uncollectibles through Rider 6, it is Nicor's position (rather than Staff's) that proposes to change the status quo and has the effect of masking the total rate increase to ratepayers.[2] In other words, Nicor's proposal to recover the commodity portion of its uncollectibles through Rider 6 moves recovery of those expenses out of base rates (where they currently reside) and into Nicor's purchased gas adjustment ("PGA") clause rider. Thus, the base rate revenue increase for ratepayers under Nicor's proposal represents only part of the total rate increase to ratepayers (i.e., the base rate revenue increase net of the base rate expenses and revenues[3] transferred to Rider 6). Staff is not suggesting that there is anything improper about Nicor's proposal from a revenue impact perspective (and such impact was fully disclosed in Nicor's initial filing). However, Nicor's argument about the revenue impact of Staff's proposals do not follow the good form demonstrated in Nicor's

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[1] As noted in footnote 2 of Staff's Initial Brief, the $35,763 base rate revenue increase identified in Appendix A of Staff's Initial Brief reflects the correction of Staff's summary schedules. The $38,764,000 Staff proposed base rate revenue increase identified in Nicor's Initial Brief is based on Staff's uncorrected summary schedules. (*See* Nicor IB, p.5)

[2] Nicor's argument regarding the impact of Staff's opposition to Nicor's proposal to base weather normalization on 10 rather than 30 years of weather data seems similarly designed to create issues through hyperbole by confusing the distinction between revenue requirement and rate design issues. (*See* Nicor IB, p. 5)

[3] Nicor also proposed to move the credit for HUB revenues from base rates to Rider 6, offsetting in part the uncollectibles expense transferred to Rider 6. (*See* Staff IB, pp. 105-107)

initial filing, and improperly suggests that Staff's adjustment creates revenues that would not otherwise exist. To the contrary, although Rider 6 impacts[4] must be considered to assess the total impact on ratepayers, the adjustment (transfer of revenues from Rider 6 to base rates) that Nicor criticizes as unfair is an adjustment that maintains the status quo and avoids, rather than creates, the movement of expenses and revenues out of base rates.

II. Rate Base

B. Year-End or Average Rate Base Methodology

The evidence presented in this case demonstrates that the Commission should accept Staff witness Struck's recommendation to convert the Company's proposed year-end rate base to an average rate base for the test year. Staff discusses this evidence more fully at pages 4-12 of its Initial Brief.

In summary, an average rate base better matches the level of rate base investment with the revenues and expenses during the test year as compared to a year-end rate base. Because of this matching, an average rate base more accurately reflects the cost of providing utility service during the test year. (Staff Exhibit 1.0, p. 7, lines 128-137; Staff Exhibit 10.0-Revised, p. 14, lines 250-253) That, coupled with the fact that the Company chose a future test year, which is inherently forward looking, leads to the conclusion that the Commission should use an average rate base in this proceeding. (Staff Exhibit 10.0-Revised, p. 20, lines 388-393) Further, Staff's recommendation is

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[4] Staff's base rate revenue increase number does not reflect the HUB revenues to be credited through Rider 6.

consistent with the Commission's practice of using an average rate base with a future test year. (Staff Exhibit 1.0, pp. 6-9, lines 114-179)

Use of a Future Test Year Would Not Disallow Individual Rate Base Items

The Company argues that using an average rate base would deny recovery of prudently incurred costs that the Company has incurred or will incur in the test year that are used and useful in order to provide adequate, safe, and reliable tariffed services to customers this year and going forward. (Nicor IB, pp. 23-24) The evidence demonstrates that the Company's argument is incorrect.

The selection of one rate base measurement methodology over another does not, in and of itself, constitute the disallowance of individual rate base items. As explained more fully in Staff's testimony and Initial Brief, the Company confuses rate base methodologies with adjustments to individual rate base components. (Staff Exhibit 10.0-Revised, pp. 6-7, lines 113-129; Staff IB, pp. 7-8) Further, the Company's argument in this case is inconsistent with the Company's proposal in its last rate case. There, the Company itself proposed an average rate base with a future test year. There is no indication that the Company intended (or that the Commission understood) that proposal to be a disallowance of prudent and reasonable costs. Neither is there any indication that the Commission or the utilities in the 28 cases identified by Mr. Struck considered the use of an average rate base to constitute the disallowance of individual rate base items. (Staff Exhibit 10.0-Revised, pp. 15-16, lines 283-290, Attachment A) Simply, the selection of one rate base measurement methodology over another does not, in and of itself, constitute the disallowance of individual rate base items. (Staff Exhibit 10.0-Revised, pp. 7-8, lines 129-145)

The Commission's Rules are Consistent With and Reflect the Commission's Practice of Using an Average Rate Base With a Future Test Year.

The Company notes that the Commission's rules permit the Company to propose a year-end rate base with its 2005 future test year. (Nicor IB, p. 25) Staff agrees that 83 Ill. Adm. Code 285 ("Part 285") of the Commission's rules does not prohibit utilities from proposing a year-end rate base based on the type of test year chosen. However, the rate base a utility proposes is not always the rate base the Commission finds appropriate.[5] The fact that the Commission's rules do not prohibit Nicor Gas from proposing a year-end rate base with a future test year does not establish that a year-end rate base is appropriate in this case. (Staff Exhibit 10.0-Revised, p. 8, lines 146-154)

Nicor's argument with respect to the Commission's rules is not well founded. The fact that the Commission's rules are permissive, neither requiring nor prohibiting a particular measurement methodology based on the type of test year chosen, is hardly conclusive with respect to Nicor's proposal to use a year-end rate base with a future test year. Further, Section 285.110 of Part 285 provides that the "standard information requirements do not bind the Commission to a decision based solely on data provided pursuant to this Part . . . ." 83 Ill. Adm. Code 285.110. The lack of an affirmative requirement or prohibition, combined with the general caution as to the effect of the Commission's rules, deprives Nicor's argument of any reasonable foundation.

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[5] *See e.g.*, Central Illinois Public Service Company: Proposed General Increase in Natural Gas Rates, ICC Docket No. 90-0072, 1990 Ill. PUC LEXIS 625 (Nov. 28, 1990) ("90-0072 Order"); Staff Exhibit 1.0, pp. 8-9; Staff IB, p. 6.

What is more instructive, however, is that Part 285 specifically accommodates the Commission's practice of using an average rate base with a future test year. If a company chooses a future test year, as Nicor Gas has done in this case, and does not also propose an average rate base with that future test year, Part 285 requires the company to also provide workpapers from which the average rate base for the test year can be determined:

> If the rate base components of a future test year are not derived from average data for the test year or from monthly average data, provide work papers supporting Schedule B-1 that reflect the 13 month-end balances of all rate base items commencing with the month-end balance for the month prior to the beginning of the test year and ending with the month-end balance for the last month of the test year.

(83 Ill. Adm. Code 285.2005(e))

The Commission requires a company choosing a future test year to also provide information to determine an average rate base, regardless of the rate base measurement methodology the company actually proposes. Notably absent from the Commission's rules is a requirement for this information when a company chooses an historical test year. Thus, while the Commission's rules provide a utility flexibility in presenting its case, the Commission's rules are consistent with and reflect its practice of using an average rate base with a future test year. (Staff Exhibit 10.0-Revised, pp. 8-9, lines 155-174)

<u>The Use of an Average Rate Base is Fair and Logical</u>

The Company argues that the use of an average rate base is illogical and unfair because the rates to be set in this proceeding are likely to become effective in early or mid-October 2005 and will remain in effect for at least some years. (Nicor IB, p. 25) The Company's argument is unpersuasive for at least three reasons. First, Nicor Gas has flexibility regarding the timing of when new rates go into effect relative to the test year it chooses. Nicor Gas can use this flexibility to present a forward-looking case to the extent it chooses to do so. Second, the Company's history indicates that the Commission should not automatically assume that Nicor Gas' year-end rate base would be more forward looking than would an average rate base. Third, even if the Company's year-end rate base were more forward looking than the average rate base, the Commission should weigh that against the benefit of matching the rate base to the operating revenues and expenses for the test year. For these reasons, using an average rate base with a future test year is consistent with sound regulatory policy and is <u>neither</u> illogical nor unfair. (Staff Exhibit 10-0-Revised, p. 10, lines 190-203)

First, Nicor Gas has considerable flexibility in making its chosen test year and rate base forward looking. When preparing this rate case, it was Nicor Gas that chose whether to propose a future or historical test year and whether to use end-of-year or average rage base. However, Nicor Gas also made the choice of when to file its rate case. The ability to choose both a future test year and the timing of when a rate case is filed, gave Nicor Gas considerable flexibility in making its test year forward looking.

In the current case, Nicor Gas chose both a 2005 future test year and a November 4, 2004 filing date. Hypothetically, if Nicor Gas desired a test year that was more forward looking relative to the date on which its new rates would become effective, then it could have chosen a filing date earlier in 2004 or it could have chosen a filing date two months later and chosen a 2006 future test year. Presumably, Nicor Gas weighed its alternatives regarding the type of test year to use and the timing of its filing and made the choices it thought were best. The fact that Nicor Gas made the choices that it did, does not provide a sufficient reason to use a 2005 year-end rate base with the Company's 2005 future test year. Staff recommends that, in this case, the Commission continue to follow its practice of using an average rate base with a future test year. Doing so will better match the level of rate base investment during the future test year with the revenues and expenses during the future test year, chosen by the Company, that is already forward looking. (Staff Exhibit 10.0-Revised, pp. 10-11, lines 204-227)

Second, the Company's history indicates that the Commission should not automatically assume that Nicor Gas' year-end rate base is more forward looking than would an average rate base. Nicor Gas assumes that because the year-end rate base is larger than the average rate base, the year-end rate base will better represent the rate base that will be in place while the rates from this case are in effect. (Nicor IB, p. 25) However, the Company's history contradicts this assumption.

The *year-end* rate base the Company proposes in this case is lower than the *average* rate base the Company proposed 9½ years ago in its last rate case, Docket No. 95-0219. (Staff Exhibit 10.0-Revised, pp. 12-13, lines 235-238, Table 10.1) Even though Nicor Gas has invested roughly $1.24 billion in capital projects since its last rate case, the rate base that the Company itself proposes has declined over the last decade. Thus, the Commission should not automatically assume the Company's net investment in rate base will increase in the coming years, even though it may seem a reasonable assumption at first glance. (Staff Exhibit 10.0-Revised, pp. 12-14, lines 228-242)

Third, even if the Company's year-end rate base were more forward looking than the average rate base, the Commission should weigh that against the benefit of matching the rate base to the operating revenues and expenses for the test year. When deciding whether to use an average rate base or a year-end rate base with a particular test year, the Commission should weigh two important but different and sometimes competing concerns against one another. On the one hand, a year-end rate base can be more forward looking. On the other hand, an average rate base more accurately reflects the cost of providing service for the test year because it better matches the cost of capital for the rate base during the test year with the other costs incurred during the test year. A future test year is based on financial projections and therefore is already forward looking. Therefore, it is appropriate to give more weight to the matching concern than to the forward-looking concern in the case of a future test year. (Staff Exhibit 10.0-Revised, p. 14, lines 247-256)

The Commission has previously weighed these two concerns against one another and has given more weight to the forward-looking concern when dealing with historical test years and more weight to the matching concern when dealing with future test years.

> The Commission believes that the question of whether an average or year end rate base should be used in the instant proceeding is a close issue. Although CIPS has presented several well articulated arguments in support of its position, the Commission agrees with Staff that an average rate base should be used. As suggested by Staff, an average rate base generally provides a better matching of test year rate base with operating revenues and expenses, and recent forecast test year rate proceedings have consistently used average rate bases. The Commission also notes that utilities which want to use more forward looking rate bases have the option of making rate filings based on more forward looking test years than those which correspond to the pendency of the proceeding.

(90-0072 Order, pp. 6-7.)

As the Commission noted in its Order in Docket No. 90-0072, the question of whether an average or year end rate base should be used with a forecasted future test year is neither one sided nor easy to decide. However, it is an issue that the Commission has previously decided and a decision that Illinois utilities have followed. (Staff Exhibit 10.0-Revised, pp. 14-15, lines 227-275)

Contrary to the Company's assertions, the use of an average rate base is neither illogical nor unfair. As the evidence demonstrates, the use of an average rate base with a future test year is consistent with both sound ratemaking policy and Commission practice. Furthermore, the Company's arguments are inconsistent with its actions in its last rate case, where Nicor itself proposed an average rate base with a future test year. (Staff Exhibit 10.0-Revised, pp. 20-21, lines 394-406)

An Average Rate Base Better Matches the Test Year

The Company takes issue with Staff witness Struck's explanation that an average rate base better matches the test year. The Company accuses Mr. Struck of being unclear in his meaning and failing to identify any actual purpose served by matching the rate base to the test year. (Nicor IB, p. 26) To the contrary, Mr. Struck's testimony is clear as to its meaning and purpose, a meaning and purpose that the Company not only clearly understood but applied in its last rate case.

Mr. Struck clearly explained that an average rate base better matches the level of rate base investment with the revenues and expenses during the test year than does a year-end rate base. Matching the level of rate base investment with the revenues and expenses during the test year more accurately reflects the cost of providing utility service during the test year. It does so because it matches the components of the revenue requirement formula with one another in a consistent way for the test year. (Staff Exhibit 1.0, p. 7, lines 128-137; Staff Exhibit 10.0-Revised, p. 14, lines 250-253)

Mr. Struck also explained the factors the Commission should weight against one another when considering the type of rate base to use with an historical test year and with a future test year. (Staff Exhibit 10.0-Revised, pp. 14-15, lines 247-272)

Staff's Proposal to Use an Average Rate Base for the Test Year is Appropriate and the Commission Should Accept Staff's Adjustment

Contrary to the Company's arguments, it is the Company's rate base proposal, not Staff's, that is the unusual one. Staff's recommendation to use an average rate base in this case is appropriate and the Commission should continue its practice of doing so.

As explained above, the evidence demonstrates why it is appropriate to use an average rate base with the future test year the Company proposed in this particular case. An average rate base more accurately reflects the cost of service for the Company's chosen test year that, by its very nature, is already forward looking. It does so because it matches the components of the revenue requirement formula with one another in a consistent way for the test year. (Staff Exhibit 1.0, p. 7, lines 128-137; Staff Exhibit 10.0-Revised, p. 14, lines 250-253) Staff's proposal is consistent with the Commission's longstanding practice of using an average rate base with a future test year, as reflected in prior Commission decisions (Staff Exhibit 1.0, pp. 8-9, lines 151-173; Staff Exhibit 10.0-Revised, pp. pp. 15-16, lines 283-290, Attachment A) and in the Commission's rules. (Staff Exhibit 10.0-Revised, pp. 8-9, lines 155-174)

C. Utility Plant Balance

Staff witness Griffin proposed an adjustment to reduce the Company's forecasted Capital Expenditures for 2004 and 2005 by 3.3% based upon the average historical variance between budgeted Capital Expenditures and actual Capital Expenditures.

(Staff Exhibit 4.0, pp. 3-4, lines 47-68 and Staff Exhibit 13.0, pp. 2-4, lines 20-67) In Nicor's Initial Brief, the Company has repeated its same arguments made in testimony against Mr. Griffin's adjustments to the Company's proposed Capital Expenditures for the years 2004 and 2005. (Nicor IB, pp. 26-29) Staff has already addressed the Company's arguments in its Initial Brief. (Staff IB, pp. 12-14.

In its Initial Brief, the Company adds 7 bullet points based upon its cross-examination of Mr. Griffin, which the Company claims illustrate that Mr. Griffin's adjustments have "no valid basis". (Nicor IB, pp. 28-29) In fact, these points illustrate no such thing. If anything, they show that the Company's criticism of Mr. Griffin's analysis is based upon his failure to selectively skew his analysis so as to achieve a result more favorable to the Company rather than take the data as he found it.

In its first bullet point, the Company states: "Mr. Griffin confirmed the randomness of the inquiry underlying his selection of a six year data set starting in 1998." (Nicor IB, p. 28) The Company uses the word "random" as if it were a bad thing. To the contrary, the random selection of a data base is a necessary step to assure that a period is considered without any preconceived conclusions.

In its second bullet point, the Company states: "He acknowledged that his methodology weighted all years from 1998 to 2003 equally, and was not weighted for dollar amounts." (Nicor IB, p. 28) Of course this is true. Mr. Griffin's goal was to determine an average amount of variance between actual and budgeted capital expenditures. He could not do that if he had weighted the differences before considering them. If Mr. Griffin would have weighted the differences, the result would have been skewed.

In its third bullet point, the Company states: "He agreed his 1998 data point showed a variance more than twice as high as that in any other year." (Nicor IB, p. 28) Again, Mr. Griffin could not accurately calculate the average variance if he did not consider a number that was particularly higher or lower than other numbers in the sample. The Company would have Mr. Griffin include in his analysis only those values that produce a result more favorable to the Company.

In its fourth bullet point, the Company states: "Mr. Griffin, when asked to confirm that his methodology placed zero weight on Nicor Gas' forecasted capital additions for 2004 and 2005, responded: 'well, yes of course, that's the point'". (Nicor IB, p. 28) The 2004 and 2005 forecasted capital expenditures are the subject of Mr. Griffin's adjustment. Mr. Griffin adjusted them by applying to them the average amount of variance between actual and budgeted capital expenditures prior to 2004. Therefore, including the forecasted 2004 and 2005 amounts in the analysis of past variances and then applying the average of those variances to the 2004 and 2005 amounts would be circular and nonsensical. Mr. Griffin's answer, which the Company quotes, highlights this point. Thus, the Company's fourth point like the previous three is not a valid criticism of Mr. Griffin's adjustment.

In its fifth bullet point, the Company states: "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." (Nicor IB, pp. 28-29) Mr. Griffin's reasons for not considering the causes of the variances were neither unreasonable nor contradictory. It makes no difference why there is a variance from budget in any given year. Nor does it matter whether the variances were within the Company's control or not. The fact is that there will always be a variance for a number of reasons. Mr. Griffin's adjustment seeks to quantify the average variance for rate making purposes. The reasons for the variances, which differ from year to year, are accounted for by the fact that Mr. Griffin determined an average.

In its fifth bullet point, the Company states: "He agreed that his testimony contains no data regarding Nicor Gas' capital needs." (Nicor IB, p. 29) Mr. Griffin agreed to that statement because the capital needs of the Company is not relevant to his adjustment. In the budget process, the Company attempts to estimate its capital needs. For a variety of reasons, the budget will not be, and is not expected to be, equal to the actual amount spent. The purpose of Mr. Griffin's adjustment is that it quantifies, on average, the Company's accuracy in forecasting its own capital needs, and accounts for that in the test year. Therefore, there was no reason for Mr. Griffin's testimony to contain data relating to the Company's capital needs.

In its seventh bullet point, the Company states: "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." (Nicor IB, p. 29) The Company conveniently excludes that Mr. Griffin also pointed out that if he would have averaged the largest and smallest variances, then he would have had an even larger proposed disallowance. (Staff Exhibit 13.0, Corrected, p. 4, lines 64-67; Tr., p. 1110, lines 4-9) Again, the Company's essential criticism here is that Mr. Griffin took the data as he found it and did not skew the results of his analysis so as to achieve a result more favorable to the Company.

In addition to these 7 bullet points, the Company also notes that the capital expenditures for 2005 are now forecasted to exceed the budget by $1,500,000. (Nicor IB, p. 28) However, the facts in the record which indicate that the preliminary actual 2004 capital expenditures were 3.4% less than budget and that the 2005 capital expenditures are now forecasted to be $1,500,000 over budget only demonstrate the inaccuracy inherent in a budgeting process and the need for Mr. Griffin's adjustment, which, on average, corrects for this inaccuracy.

E. Daily Metering Project

Staff witness Griffin proposed an adjustment to reduce the cost of the Company's Daily Metering Project by the amount by which the Company exceeded its authorized expenditure for the project. (Staff Exhibit 4.0, pp. 4-6, lines 69-106 and Staff Exhibit 13.0, pp. 4-5, lines 68-85) On page 32 of its Initial Brief, the Company states that even if Mr. Griffin were right about his personal reading of the Nicor Gas policy, that would not be a basis for disallowing prudent and reasonable costs of a prudent, reasonable, and used and useful project. The fact is that the Company has not demonstrated that the cost of the project was prudent. The written policy which the Company has violated is an internal control measure that helps to assure that the money spent on a capital project is prudent. That the Company might be consistent at violating its internal controls does not change the fact that it is in fact violating its internal controls. Taken to its logical conclusion, the Company's argument would have the Commission permit recovery of costs that are unreasonable and imprudent so long as the Company is consistent in the way it proposes to recover those unreasonable and imprudent costs.

The plain language of the written policy is clear. It refers to actual cost and does not exclude overhead cost. The Company violated its own authorization policy and calls into question the reasonableness of the cost. Therefore, the Commission should accept Mr. Griffin's adjustment.

H. Pension Asset

Staff witness Pugh recommends an adjustment to reduce rate base by a net amount of ($105,410,000) to disallow what, for regulatory purposes, represents an over accrual of pension credits. The net amount consists of a ($184,192,000) pension asset less $78,782,000 of related accumulated deferred income taxes ("ADIT"). (Staff Exhibit 3.0, pp. 2-3, lines 38-55 and Staff Exhibit 12.0, p. 4, lines 66-70)

The Company in its Initial Brief states that 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. (Nicor IB, p. 40) The Company further states that 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. (Nicor IB, p. 40)

The Company's argument is simply incorrect. Despite Nicor's attempt to mischaracterize Staff's reliance on previous Commission Orders[6], it is merely a smoke

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[6] In particular, Nicor points to Staff's position on the exclusion of short-term debt when determining Nicor's capital structure, incentive compensation, rate case expense and use of an modified distribution main study. (Nicor Gas Exhibit 26A.0, p. 57, ll. 1285-1295) However, upon review of each issue, it is Nicor, not Staff, that is inconsistent with previous Commission Orders or rules. (See Staff Initial and Reply Brief Sections V.A, III. I., III., Q., and VI. A.)

and mirrors argument to disguise its own disregard in this proceeding of Commission Orders. As discussed more fully in Staff's Initial Brief, Staff witness Pugh's proposed adjustment <u>is consistent</u> with the Commission's finding in Nicor Gas' last rate order. (Staff IB, p. 18) On page 9 of the Order in the Company's previous rate case, Docket No. 95-0219, the Commission concluded that the overfunded pension asset was in fact created from ratepayer-supplied funds. Furthermore, the Company has acknowledged that due to the funded status of the pension plan, it was not required to contribute to the pension trust from 1997 through 2003. (Nicor Gas Exhibit 26A.0, p. 56, lines 1266-1267) Since the pension asset results from overfunding by ratepayers and healthy pension fund earnings, the Company has been allowed to record a negative pension expense since the previous rate case. This negative pension expense (credit) should be passed through to benefit ratepayers because it is the calculated projected net periodic benefit cost (credit) for the 2005 test year. Rates are based upon the Company's projected needs during the time in which the rates set in this proceeding will be in effect.

The Company fails to consider that, prior to the 1987 rate case, there was a positive pension expense that was included in the cost of service. (Docket No. 95-0219, Order dated April 3, 1996, p. 8) That positive expense was included in customer rates resulting in the customers funding the pension asset, not Nicor Gas. Since the overfunded pension asset was created by ratepayer-supplied funds, the shareholders should not be able to earn a return on the prepaid pension asset.

AG witness Effron also proposed an adjustment to reduce Retirement Benefits, Net by $186,882,000 and the related accumulated deferred income taxes by $79,919,000 for a net reduction to the Company's rate base of $106,963,000. Further, he eliminated the prepaid pension asset from rate base to be consistent with the Commission's findings in Docket No. 95-0219. (AG Exhibit 1.0, p. 11, lines 1-11) AG witness Effron's adjustment differs from Staff's in that he adjusts the year-end amounts and Staff's adjustment is based on average rate base amounts.

Accordingly, the Commission should accept Staff's recommendation to reduce rate base by a net amount of ($105,410,000), which includes the pension asset of ($184,192,000) and the related accumulated deferred income taxes ("ADIT") of $78,782,000.

M. Uncollectibles Reserve

Staff recommends the Commission reject the adjustment proposed by Citizens Utility Board and Cook County States Attorney's Office ("CUB-CCSAO") witness Mierzwa to reduce the Company's rate base by the balance of the reserve for uncollectible accounts. (CUB-CCSAO IB, pp. 13-14) The uncollectible reserve does not represent a ratepayer-supplied source of funds because of the way uncollectibles expense is matched to sales by accrual accounting. (Staff Exhibit 10.0-Revised, pp. 25-26, lines 501-516) Mr. Mierzwa's proposed adjustment would improperly reduce the Company's rate base by $24,185,247 resulting in a reduction of the Company's revenue requirement by approximately $3,806,494. (CUB-CCSAO Exhibit 2.2)

1. Uncollectible Expense Tracker

The Commission should reject the Company's proposal to recover the "commodity-related" portion of its uncollectibles expense through the PGA Clause.

(Nicor IB, pp. 112-113) The PGA is for the limited purpose of changing rates based upon changes in the cost of purchased gas. (Staff Exhibit 1.0, pp. 16-18, lines 311-388) Uncollectibles expense is not an unrecovered cost of purchased gas. Rather, it is a cost of doing business on something other than a cash-only basis. Therefore, uncollectibles should not be passed through the PGA. (Staff Exhibit 1.0, pp. 13-15, lines 254-310) Furthermore, Nicor Gas's uncollectibles expense does not stand out in comparison to the overall operating expenses in a way that warrants special treatment through a rider. Therefore, Nicor Gas' uncollectibles expense should not be separated out from other test year operating expenses to be given special treatment through the PGA. (Staff Exhibit 1.0, pp. 18-26, lines 389-503) Consistent with this recommendation, Staff witness Struck reversed the Company's proposed adjustment to remove $23,417,000 of uncollectibles expense from the test year. (Staff Exhibit 10.0-Revised, Schedule 10.09-Revised)

The Company argues that its proposal to recover what it calls the commodity-related portion of its uncollectibles through the PGA is consistent with Section 9-220 of the Public Utilities Act ("Act") and 83 Ill. Adm. Code Part 525 ("Part 525") of the Commission's rules. (Nicor IB, pp. 112-113) In doing so, the Company emphasizes the word "collected" as it is used in one sentence of Section 9-220 of the Act. (Nicor IB, pp. 112-113) However, the Company fails to note that its interpretation is inconsistent with the way in which the Commission has applied Section 9-220 of the Act and Part 525 previously. Furthermore, the Company's interpretation of Section 9-220 of the Act is inconsistent with its own proposal in this proceeding. Finally, the Company's interpretation is inconsistent with the way in which Nicor Gas has proposed, and the

Commission has approved, its very own PGA reconciliations. It is not a simple matter of emphasizing a single word. One must understand that word in its context and one's interpretation must be informed by the technical issues that underlie its application.

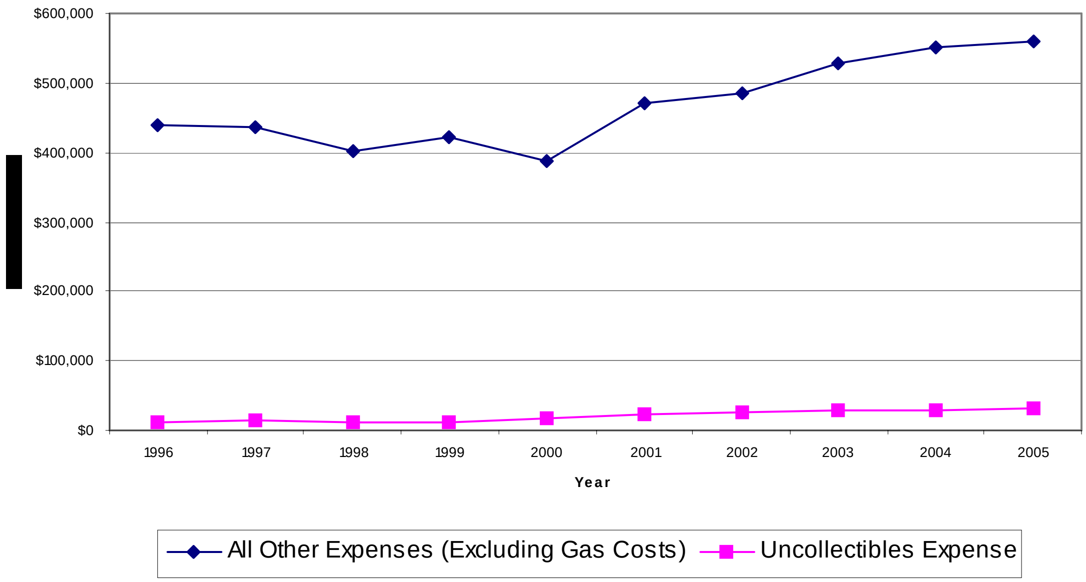
The Commission's PGA rule, Part 525 (which interprets and applies Section 9-220 of the Act), requires utilities to reconcile gas costs incurred with revenues arising through the application of the Gas Charge(s) to applicable therms during the reconciliation year. (83 Ill. Adm. Code Part 525.70(a); Staff Exhibit 10.0-Revised, pp. 21-22, lines 416-425) In other words, the gas costs incurred are reconciled to the revenues from the therms sold. This reconciliation is based upon accrual accounting, not cash accounting. Costs and revenues are recognized and reconciled to one another on the basis of when they are incurred and earned, not on the basis of when cash is paid or received. Indeed, if gas costs and sales were to be recognized and reconciled on a cash basis, that is cash paid and cash received, then there would be no commodity-related uncollectibles to be recovered in either the PGA or base rates. Since the Company proposal is to recover its commodity-related uncollectibles through the PGA rather than through base rates, the Company's own proposal in this proceeding is inconsistent with the idea of cash-based accounting for the PGA.

The Company's proposal also contradicts the way Nicor Gas has proposed its PGA reconciliations. In Nicor Gas's most recent PGA reconciliation for which the Commission has entered a final order, Docket No. 00-0718, the Company presented and the Commission approved a reconciliation of the difference between gas costs and the revenues recorded for the year. In that proceeding, Nicor Gas witness Thomas M. Moretti explained in his direct testimony, "The revenues are simply those that are recorded for the year." (Docket 00-0718, Nicor Gas Ex. No. 1, p. 4, lines 11-12.) Thus, in accordance with Part 525, Nicor Gas proposed and the Commission approved a reconciliation of gas cost incurred with revenues recorded, not cash collected. (Staff Exhibit 10.0-Revised, p. 22, lines 426-438)

The Company also asserts its commodity-related uncollectibles independently meet the criteria for a rider, given their amount, drivers, and volatility. (Nicor IB, p. 113) The evidence simply contradicts the Company's assertion. Staff presented evidence and analysis that Nicor Gas's uncollectibles expense does not stand out in comparison to the overall operating expenses in a way that warrants special treatment through a rider. Therefore, Nicor Gas' uncollectibles expense should not be separated out from other test year operating expenses to be given special treatment through the PGA. (Staff Exhibit 1.0, pp. 18-26, lines 389-503) Staff has already discussed this more fully on pages 27-32 of its Initial Brief.

The evidence also clearly demonstrates that uncollectibles do not stand out in comparison to the overall operating expenses in a way that warrants special treatment through a rider, a fact that the Company highlights through its cross-examination of Staff witness Struck regarding this issue. The Company asked Mr. Struck a series of questions about Figure 1 which is included in his rebuttal testimony and is shown below. (Staff Exhibit 1.0, p. 20 and Schedule 1.11, p. 1)

Figure 1
Uncollectibles Compared to All Other Expense (Excluding Gas Costs)



First, the Company highlighted the fact that uncollectibles are insignificant in relation to the other costs. The Company asked Mr. Struck whether the amounts for “Uncollectibles Expense,” reflected in Figure 1, are also included in the amounts for “All Other Expenses (Excluding Gas Costs).” Apparently the Company was unable to determine whether the Figure 1 “All Other Expenses” included “Uncollectibles Expense” because the inclusion of uncollectibles with the other expenses would not have a noticeable impact upon those other expenses. Mr. Struck clarified that the amounts for “Uncollectibles Expense” are not also included in the amounts for “All Other Expenses (Excluding Gas Costs).” Mr. Struck also noted that he had previously answered this question in response to a data request from the Company. (Tr., pp. 980-982, lines 15-8)

Second, the Company highlighted the fact that the scale needed on the Y-Axis of Figure 1 to show “Uncollectibles Expense” and “All Other Expenses (Excluding Gas Costs) in relation to one another is such that uncollectibles expense could double and it would appear insignificant. (Tr., p. 982, lines 13-21) Because the scale used on the Y-axis of Figure 1 is merely a function of the relationship between uncollectibles and the other expenses, the Company's question actually supports Staff's conclusion that uncollectibles do not stand out in comparison to the other operating expenses.

Finally, the Company continues to assert that if the Commission accepts the Company's proposal to recover a portion of its uncollectibles through the PGA, then the 66.6% allocation factor, which would identify and assign the commodity-related portion of uncollectibles to the PGA, should never be subject to revision. The Company contends that Staff's recommendation that the Commission review this allocation factor periodically is without merit. (Nicor IB, p. 113) The Company's position defies logic and is inconsistent with the basis for the Company's proposal to recover commodity-related uncollectibles through the PGA in the first place.

The Company's argument that the allocation is fixed in nature is inconsistent with its argument that the commodity portion of uncollectibles should be passed through the PGA because it is volatile. (Nicor Gas Exhibit 27A.0, p. 5, lines 111-112) If the commodity portion of uncollectibles fluctuates and is unpredictable as the Company claims, then it follows that the split between the commodity and non-commodity portions of uncollectibles expense should be evaluated periodically to consider the impact of that fluctuation and unpredictability. (Staff Exhibit 1.0, p. 26, lines 504-517; Staff Exhibit 10.0-Revised, pp. 24-25, lines 477-495)

The Company further argues that "… the requirement to review the factor each year would simply add potential for disagreements in the reconciliation process." (Nicor Gas Exhibit 27A.0, p. 5, lines 111-112) If it is correct that reviewing the allocation factor will be a likely source of disagreement in future reconciliation proceedings, then that merely reinforces the need for the Commission to review it periodically. (Staff Exhibit 10.0-Revised, pp. 24-25, lines 496-500) Therefore, the Company's own argument supports a need for a periodic review and adjustment of the allocation factor should the Commission accept the Company's proposal to recover a portion of its uncollectibles through the PGA.

III. Expenses

C. Storage Gas Losses

Staff witness Pugh proposed an adjustment to include the cost of storage gas losses in Account 823 (Gas Losses), an operating and maintenance cost, instead of recovering the cost through the PGA charge. (Staff Exhibit 3.0, p. 8, lines 165-168 and Staff Exhibit 12.0, p. 11, lines 217-221) The Company continues to disagree with Staff's adjustment because the Company has been including the 2% storage withdrawal adjustment factor in the same manner since the 1970's, which is recovery through Rider 6. (Nicor Gas Exhibit 27B.0, p. 7, lines 145-150) If the Company should continue to recover gas losses through the PGA, it will be in violation of the 83 Ill. Adm. Code Section 525, the Commission's PGA rule, and 83 Ill. Adm. Code Section 505, the Uniform System of Accounts for Gas Utilities ("USOA").

Expenses related to the operation of a storage field, including adjustments for inventory losses due to cumulative inaccuracies of gas measurements or other causes, should be recorded in Account 823, Gas Losses, an operating and maintenance expense. 83 Ill. Adm. Code Section 505.8230, Account 823 (Gas Losses) states:

> This account shall include the amounts of inventory adjustments representing the cost of gas lost or unaccounted for in underground

> storage operations due to cumulative inaccuracies of gas measurements or other causes. … If, however, any adjustment is substantial, the utility may, with approval of the Commission, amortize the amount of the adjustment to this Account over future operating periods.

Company witness Gorenz, in Surrebuttal Testimony, Nicor Gas Exhibit 41.0, p. 22, lines 470-473, described an amount of the 2% withdrawal factor that is attributable to sales customers. That amount, 61% of total aquifer storage withdrawals, is used to calculate the estimated gas storage losses for Nicor Gas-owned gas from on-system storage for the forecast 2005 test year (demonstrated on Exhibit 1 of the Company's response to Staff data request LAP 11.03 entered into the record as Staff Exhibit 23 (Tr. 763)). Staff accepts this calculation as a reasonable estimated amount of storage gas losses to be charged to Account 823 instead of recovery through the PGA. In Staff's Initial Brief, Appendix A, Schedule 2, p. 1, column f, Staff captures the acceptable total cost related to Storage Gas Losses in the amount of $9,972,000, which the Company states is the correct amount of the adjustment to increase operating expenses. (Nicor IB, pp. 54-55)

Staff recommends that the Commission approve the amount of storage gas losses as calculated on the Staff Exhibit 23. This amount increases Other Operating and Maintenance, Storage costs by $9,971,865 and decreases taxes associated with the storage gas losses by $3,963,318.

D. Industry Association Dues

Staff witness Pugh proposed an adjustment to remove expenses associated with certain community organizations from the Company's miscellaneous expense for dues and memberships because the nature and purpose of the organizations demonstrate that membership in the community organizations are of a promotional, goodwill or institutional nature. (Staff Exhibit 3.0, pp. 15-16, lines 345-350 and Staff Exhibit 12.0, p. 17, lines 365-371) The Company continues to argue that these expenses are not for promotional or goodwill purposes; rather, Nicor Gas argues that it participates in these industry associations in order to better serve its customers and, as such, these expenditures are properly recovered. (Nicor IB, p. 56)

The chambers of commerce and economic development organizations are not necessary to providing utility service and should not be included in the revenue requirement. The Commission, in its Order in a Commonwealth Edison Company rate case, Docket No. 90-0169, recognized the importance of utility companies interfacing with these types of organizations, yet ruled that the shareholders, rather than the ratepayers, should bear the cost of interfacing with such organizations. *Commonwealth Edison Company: Proposed General Increase in Electric Rates*, ICC Docket No. 90-0169, Order, 1991 Ill PUC Lexis 99 at 64-65 (March 8, 1991) ("90-0169 Order") Furthermore, in Staff witness Pugh's direct testimony, she included numerous cases in which the Commission has consistently affirmed its position to remove the costs of such organizations. (Staff Exhibit 3.0, pp. 16-17, lines 365-374) Therefore, Staff witness Pugh proposed an adjustment to remove these expenses from the Company's test year operating expenses because they are promotional in nature and benefit the shareholders rather than ratepayers. This adjustment is reflected on ICC Exhibit 12.0, Schedule 12.04. On Staff Exhibit 12.0, Schedule 12.04, page 2 of 2. Staff did allowed recovery of the Midwest Energy and Southern Gas Association dues on the understanding that membership in energy-related organizations is an excellent resource for energy-related information.

Staff recommends that the Commission approve its adjustment to reduce Industry Association Dues by $93,000.

E. Social and Service Club Dues

Staff witness Pugh proposed an adjustment to remove expenses associated with the dues and memberships for certain organizations from the Company's miscellaneous general expense because participation in such groups is a promotional and goodwill practice. (Staff Exhibit 3.0, p. 17, lines 378-384 and Staff Exhibit 12.0, p. 20, lines 417-423) The Company continues to argue that Nicor participates in these social and service clubs, however, to benefit the community and to better serve customers. (Nicor IB, p. 56)

In the Company's Schedule C-6, pages 9-11, the purpose and nature of the organizations clearly reveals that these organizations are to promote the interest of business in the community. (Staff Exhibit 3.0, p. 17, lines 378-384 and Staff Exhibit 12.0, p. 20, lines 420-423) The chambers of commerce and economic development organizations are not necessary to providing utility service and should not be included in the revenue requirement. As noted above, in its 90-0169 Order the Commission recognized the importance of utility companies interfacing with these types of organizations, yet ruled that the shareholders, rather than the ratepayers, should bear the cost of interfacing with such organizations.

Furthermore, in Staff witness Pugh's direct testimony, she included support in which the Commission affirmed its position to remove the costs of such organizations. (Staff Exhibit 3.0, p. 18, lines 395-397) Ms. Pugh pointed out that in Central Illinois Light Company's ("CILCO") delivery service tariffs docket, Docket Nos. 99-0119/99-0131 (Consolidated), the Commission accepted this type of adjustment from Staff over the objections of CILCO. Therefore, Staff proposed an adjustment to remove these expenses from the Company's test year operating expenses because they are promotional in nature and benefit the shareholders not the ratepayers. This adjustment is reflected on ICC Exhibit 12.0, Schedule 12.05.

Staff recommends that the Commission approve its adjustment to reduce Social and Service Club Dues by $85,000.

F. Office Supplies Expense

AG witness Effron proposed an adjustment to Office Supplies and Expense to limit expenses charged to Account 921. Mr. Effron found an increase of 37% to Office Supplies and Expense to be unreasonable and unsupported by Nicor. He proposed that the forecasted increase in this expense reflect an allowance for inflation and real system growth together of 4% annually. (AG Exhibit 1.0, p. 27, lines 4-11) The Company continues to argue that the test year budget was developed from the bottom-up, requiring preparers to build their budget from the lowest level of detail. (Nicor IB, p. 57) While Staff did not make a similar adjustment to Office Supplies and Expenses, Staff agrees that Mr. Effron's adjustment to Office Supplies and Expenses is reasonable.

G. Branding Expense

AG witness Effron proposed an adjustment to advertising expense charged to Account 913. The Company has included $630,000 of advertising expense charged to Account 913 in test year operation and maintenance expense. The advertising expense includes $340,000 that is described as "Branding." This is the Company's allocated share of expenditures by Nicor, Inc. for corporate communications. The purpose of these expenditures appears to be to improve the corporate image and corporate reputation of Nicor, Inc. As such, Mr. Effron determined that the expenditures are not necessary for the provision of utility service and should not be included in the Company's revenue requirement. (AG Exhibit 1.0, p. 28, lines 2-11) The Company continues to claim that these funds are used to inform and educate customers and the community on important issues, such as gas cost, financial assistance, and safety. (Nicor IB, p. 58) Staff did not make an adjustment to advertising expense but did propose an adjustment for Promotional and Goodwill Activities which the Company did not oppose. (See Staff IB, p. 34) While Staff did not propose an adjustment to Advertising Expense in its testimony, Staff agrees that Mr. Effron's adjustment to Advertising Expense is reasonable.

H. Stock Option Expense

The Company included $891,000 of stock option expense in the forecasted test year operation and maintenance expenses. AG witness Effron initially proposed to eliminate the expense for the fair value of stock options from utility cost of service in his direct testimony. Mr. Effron based his adjustment on the fact that stock options reward employees based on the increase in the price of common stock shares. This is a goal that benefits shareholders, not ratepayers. He further stated that it is unreasonable to assign the costs of the stock options to ratepayers if the benefits of increased share prices inure to shareholders. Mr. Effron asserted that stock options reward management and employees for maximizing value to shareholders, not ratepayers, and recommended the expense for stock options be eliminated from the utility cost of service. (AG Exhibit 1.0, p. 23, lines 19-22 through p. 24, lines 1-11)

Staff witness Pugh concurred with AG witness Effron's adjustment and in her rebuttal testimony proposed an adjustment to eliminate the expense for the fair market value of stock options from utility cost of service. (Staff Exhibit 12.0, p. 24, lines 515-518) The Company continues to reject Mr. Effron's and Staff witness Pugh's adjustment stating that neither Mr. Effron nor Ms. Pugh offer any expert opinions on any question of how to manage human resources. In contrast, the Company notes that Ms. Bacidore has extensive knowledge of Nicor Gas' "total compensation" approach to employee compensation. (Nicor IB, p. 59) Notably the Company failed to support its position by providing the detailed evidence of objectives measured by tangible or quantifiable results and the specific dollar savings or tangible benefits conferred upon ratepayers from its stock options program. Thus, Staff witness Pugh disagreed with the Company's grounds for rejection, reiterating that stock options reward management and employees for maximizing value to shareholders, not ratepayers, and recommended the expense for stock options be eliminated from the utility cost of service. (Staff Exhibit

12.0, p. 24, lines 514-518) For the reasons stated above, Staff recommends that the Commission approve the adjustment to reduce Stock Option Expense by $891,000.

I. Incentive Compensation

Staff witness Pugh proposed an adjustment to disallow incentive compensation and associated payroll taxes related to the 2005 Bonus Plans.

The Company continues to disagree with Staff's adjustment and AG witness Mr. Effron's similar adjustment, stating that those proposals are without merit and should be rejected. (Nicor IB, p. 63)

However, it is the Company's arguments that are without merit. The information provided by the Company demonstrates that the programs are based on the financial goals of the Company. As stated in Staff witness Pugh's direct testimony, these types of goals are based upon circular reasoning; that is, the larger the rate increase granted, the more success Nicor will have in achieving its earnings goals. Thus, Nicor will further enhance its ability to award incentive compensation to the extent that incentive compensation is included in the Nicor's new rates. These goals primarily benefit shareholders; therefore, shareholders should bear the cost. (Staff Exhibit 3.0, p. 5, lines 93-102)

Furthermore, the Company has failed to support its position by providing the detailed evidence of objectives measured by tangible or quantifiable results and the specific dollar savings or tangible benefits conferred upon ratepayers from its incentive compensation plan. The Company did not cite any specific instances of hiring problems within its labor market and did not provide clear evidence that incentive compensation payments are necessary to pay the labor market average and to retain employees. (Staff Exhibit 12.0, p. 9, lines 174-180)

The Commission has applied a consistent set of principles that have disallowed recovery of incentive compensation expense in cases where the plan ties incentive compensation to criteria designed to ensure shareholder benefits but not ratepayer benefits. In Docket No. 93-0183, the Commission concluded that, since financial goals benefit shareholders, ratepayers should not have to bear the cost:

> Two of the goals, earnings per share and reduced O & M expenses are goals that benefit shareholders. If the shareholders are the ones to benefit, they should be the ones who foot the bill.[7]

Staff recommends that the Commission exclude from test year operating expense a total of $6,555,000 ($6,089,000 for incentive compensation expense and $466,000 for associated payroll tax expense) related with the bonus plans dependent upon financial goals of the Company which benefit shareholders and not ratepayers. This adjustment is reflected on ICC Exhibit 12.0, Schedule 12.02.

J. Payroll Expense

AG witness Effron made two adjustments to payroll expense: (1) adjustment to payroll expense, based on the actual 2004 employee level; (2) removal of incentive compensation expenses, based on the Commission's general practice.

Nicor assumed that the employee count would increase by 50 in 2005. However, Mr. Effron noted that the number of employees in recent years has not shown

[7] Illinois Power Company, ICC Docket No. 93-0183, p. 52 (Order entered April 6, 1994).

any noticeable upward trend, and the Company did not demonstrate that the assumed increase of 50 employees in the 2005 test year was reasonable. Therefore, he did not reflect the assumed increase in determining the 2005 payroll expense. Mr. Effron's adjustment to payroll expense also excludes incentive compensation. (AG Pretrial Memorandum, pp. 8-9) Staff addressed the incentive compensation issue in Section III, I. Incentive Compensation, above. The Company argues that Mr. Effron's adjustment is erroneous and unwarranted. (Nicor IB, p. 67) Staff did not make a similar adjustment relating to the increase of 50 employees in the 2005 payroll expense. If the Commission determines an adjustment is warranted, AG witness Effron's adjustment to remove the costs associated with the assumed increase of 50 employees is a reasonable alternative.

K. Payroll Tax

AG witness Effron proposed an adjustment to Payroll Taxes which is a result of his adjustment to Payroll Expense. Staff proposed an adjustment to Incentive Compensation which results in a corresponding adjustment to Payroll Taxes. The Company argues that the associated payroll tax adjustments should be rejected because the proposed adjustments they are dependent on are without merit and should be rejected. (Nicor IB, p. 68) If the Commission determines adjustments are warranted to Payroll Expense and Incentive Compensation, then the corresponding adjustments to Payroll Tax are reasonable and should be accepted as well.

L. Corporate Benefit Plan Expense

AG witness Effron proposed an adjustment to Corporate Benefit Plans to reduce test year expenses by the increase to administrative and general salaries due to the Company's assumption that the payout would increase to 100% in 2004 and stay there in 2005. (AG Exhibit 1.0, p. 24, lines 16-21) Mr. Effron stated that the Company has not provided any reason to believe that the forecasted payout ratio of 100% is any more likely than the actual payout ratio of 50% experienced in 2003. (AG Exhibit 1.0, 25, lines 3-5) The Company continues to argue that this proposed adjustment is another inappropriate attempt to make a selective update of Nicor's test year forecast which Nicor has shown to be on track. (Nicor IB, p. 68) While Staff did not make an adjustment to Corporate Benefit Plans, Staff agrees that Mr. Effron's adjustment to Corporate Benefit Plans is reasonable.

N. Interest Synchronization

The Company takes issue with Staff witnesses Struck's proposed interest synchronization adjustment. (Nicor IB, pp. 69-70) However, the Company objection to Mr. Struck's adjustment is limited to the adjustment's underlying contested rate base adjustments and weighted cost of debt. (Nicor Gas Exhibit 26B.0, p.88, lines 1974-1988; Nicor Gas Exhibit 41.0, p. 28, lines 614-620) Staff and the Company do agree with respect to the methodology to be used for the interest synchronization adjustment and that the final interest synchronization adjustment in this case should be based upon the rate base and weighted cost of debt approved by the Commission in this case. (Tr., p. 358, line 6 through p. 360, line 6)

O. Uncollectibles Expense

The Office of the Attorney General of the State of Illinois ("AG") disagrees with the Company's proposal to revise its test year uncollectibles expense from that presented in its direct testimony to reflect higher Rider 6 revenues and a higher loss ratio. The AG contends that Nicor Gas' proposal is inconsistent with the Company's historical experience and with established Commission practice. (AG IB, pp. 23-24) Nicor Gas contends that AG witness Effron's analysis is flawed because (1) it relies on historical averages to predict future uncollectibles expenses when historical data indicate that uncollectibles are trending upward and (2) it compares projected net charge-offs to current revenues, rather than revenues eight months earlier, to determine the uncollectibles ratio. (Nicor IB, pp. 70-72) Staff reflected the Company's revised uncollectibles amounts in its schedules. (Staff Exhibit 10.0-Revised, Schedules 10.07and 10.08-Revised)

P. Income Tax Expense

Staff witness Struck reflected the respective income tax impact of each operating income statement adjustment proposed by Staff in his revenue requirement schedules. (Staff Exhibit 1.0, Schedules 1.01 and 1.02, lines 19-20; Staff Exhibit 10.0-Revised, Schedules 1.01-Revised and 1.02-Revised, lines 19-20) AG witness Effron also proposed an adjustment to incorporate the collective income tax effect of his proposed adjustments. (AG Exhibit 1.0, p. 29, Schedule C-5) The Commission should also reflect the income tax impact of those adjustments it accepts in this proceeding.

Q. Rate Case Expense

The Company continues to claim that since the amortization period approved in its last rate case as well as that approved in recent rate cases for other utilities has been no longer than five years, that same period is reasonable in the current case. (Nicor IB, p. 73) This reasoning is analogous to approving a level of an expense in one case simply because that same level was approved in an earlier case, without analyzing the basis of the expense level in the earlier case.

The utility also lists a number of dockets in support of its claim that a five year amortization period is reasonable and consistent with prior Commission Orders. (Id.) Staff has already responded to this argument in rebuttal testimony:

> In most of the examples cited, the decision on the appropriate amortization period for rate case expense was based on each individual company's history for filing rate cases.
>
> For instance, in South Beloit Water, Gas and Electric Company ("South Beloit") Docket No. 03-0676 Cons., Staff proposed an amortization period longer than that proposed by South Beloit based on the latest previous rate cases filed by the company as well as the fact that the company was able to recover fluctuating supply costs through purchase adjustment clauses (Docket No. 03-0676, ICC Staff Exhibit 2.0, p. 5, lines 89 – 101). South Beloit accepted Staff's adjustment.
>
> Further, in Utilities, Inc. ("UI") Docket No. 03-0398 Cons., Staff proposed to increase the amortization period to 5 years based on the history of those specific companies that filed rate cases. The Commission was convinced by UI's argument that its more recent rate cases, while not for the same companies, were more in the 3-year range between rate case filings. Nonetheless, the amortization periods evaluated were all under the control of the parent company (UI) not from unrelated companies.
>
> In AmerenCIPS/UE Docket No. 02-0798 Cons., the five-year amortization period proposed by Staff and approved by the Commission was based on "the average time period between rate case filings since

> 1982 for CIPS" (Docket No. 02-0798 Cons., ICC Staff Exhibit 1.0, p. 9, lines 168 – 169).
>
> In CILCO Docket No. 02-0837, Staff's proposed five-year amortization period was based on the Company's more recent gas rate cases (Docket No. 02-0837, ICC Staff Ex. 2, pp. 2-3, lines 42-44). CILCO's attempt at using the amortization period approved in MEC Docket No. 99-0534 was not convincing to Staff or the Commission (Id., p. 3, lines 51 – 62). When the Company further argued that CILCO's acquisition by Ameren supported a three-year amortization period, Staff countered that none of the rate case histories for CILCO, CIPS nor UE would support a three-year amortization period (Docket No. 02-0837, ICC Staff Exhibit 8, pp. 2 – 3, lines 37 – 52).
>
> In Sundale Docket No. 00-0513, Staff amortized rate case expense over 4 years based on the company's plan to file another rate case in 4 years (Docket No. 00-0513, Order, p. 7), which it indeed has done in Docket No. 04-0637.
>
> In United Cities Gas Company, Docket No. 00-0228, Staff's 3-year amortization period was based on "six filings in approximately sixteen years (Docket No. 00-0228, ICC Staff Exhibit 3.0, p. 11, lines 243 – 244).

(Staff Exhibit 11.0 Revised, pp. 7-8, lines 126 – 160) Staff witness Ms. Ebrey further testified as follows:

> In three of the examples given (Dockets 01-0432, 01-0423, and 00-0337), Staff did not contest the amortization periods proposed by the companies involved. There is nothing in evidence to explain the basis of Staff's decision not to object to the amortization period for rate case expenses in those cases. (Id. p.9, lines 162 – 165)

In the final case cited by the Company in its Initial Brief, Consumers Gas Co. (Consumers), Docket No. 00-0575, Staff proposed a four year amortization period rather than Consumers' proposed three year period based on five rate cases filed in eighteen years. (Docket Nos. 00-0575/00-0618 (Cons.), ICC Staff Exhibit 1.0, pp. 13-14, lines 278-289)

As Staff has stated previously, the Company's so-called support for its five year amortization period only reinforces Staff's methodology for its proposed eight year amortization period. (Staff IB, p. 53, Staff Exhibit 11.0 Revised, p. 9, lines 172 – 180) Unlike the Company proposal, Staff's approach is clearly consistent with prior Commission orders; therefore, Staff's proposed adjustment decreasing rate case expense by $268,000 should be approved.

R. Gross Revenue Conversion Factor

Staff's Gross Revenue Conversion Factor ("GRCF") differs from the one the Company used in its direct testimony. The Company used a state income tax rate of 7.5%. The state income tax rate should be 7.3%. AG witness Effron makes the same proposal. (AG Exhibit 1.0, p. 4) In its rebuttal testimony, the Company concurred with this change. (Nicor Gas Exhibit 26B.0, p. 89, lines 2005-2011) The Commission should adopt the GRCF proposed by Staff.

IV. Weather Normalization

A. Staff's Position

Determining normal weather for Illinois' electric and gas utilities is a straightforward process: calculate the average of 30 years of heating degree day data (for natural gas companies) or of cooling degree data (for electric companies) as measured by weather stations located in the various utilities' service territories. All of Illinois' gas and electric utilities' rates are currently based on this model. Deviating from this model should occur not on a case-by-case basis, but only after the Commission is well-informed of the effects upon and the positions and recommendations of Illinois' natural gas and electric utilities and other parties that want to comment on the utilities' proposals. (Staff Exhibit 9.0, p. 7, lines 148-152)

Staff recommends that the Commission reject Nicor Gas' proposal but agree to further consider this issue in a single, broad-based proceeding that allows input from all Illinois' gas and electric utilities, as well as other interested parties. (Staff Exhibit 18.0, p. 2, lines 38-41) As indicated by Mr. Beyer in his testimony and during cross examination, Staff is in the process of seeking input on this issue via a letter from all interested parties. (Staff Exhibit 18.0, p. 18; Tr., pp. 837, 853-854) Staff intends to analyze parties' responses, follow-up as needed, and arrange a meeting or workshop to discuss the issues as warranted. The results of this work, together with a recommendation on initiating a proceeding, will be presented to the Commission for their consideration. (Tr. 853-854)

B. The Company Incorrectly Characterizes Staff's Position

The Company, in its initial brief, continues to incorrectly portray Staff's position on this issue. The Company unfairly characterizes the basis for Staff's testimony as "but we've always done it that way." (Nicor IB, p. 77) To the contrary, the reader can easily look to the record to recall Staff's true position on this issue. In Mr. Beyer's direct testimony, he states, "The Commission's employment of a long-standing practice is not, in and of itself, a reason for rejecting change." (Staff Exhibit 9.0, p. 2, lines 44-45) Mr. Beyer further testifies that the Commission can change its long-standing practice of determining normal weather, but should only do so after hearing from all companies and interested parties. (Staff Exhibit 9.0, p. 4, lines 71-72)

Also crucial to Staff's recommendation on weather normalization was ensuring fairness to ratepayers and shareholders alike. (Staff Exhibit 9.0, p. 3; Staff Exhibit 18, pp. 16-17) Changing weather normalization methods (to reflect recent global and regional warming trends (*see* Staff Exhibit 18, p. 5)) on a case by case basis, as proposed by Nicor Gas, will certainly result in Nicor Gas' customers being subject to different weather normalization methodologies by their gas and electric utilities regardless of whether there is any basis for such inconsistent treatment. Such inconsistency is unfair to ratepayers if not fully supported, particularly when one considers that warmer weather has the opposite effect on gas and electric utilities (i.e., raising per unit prices for gas utilities and lowering per unit prices for electric utilities). (Staff Exhibit 18, pp. 3-4) The opposite effect of warmer weather on per unit prices of gas and electric utilities is one reason why it is important to consider this issue in a broad based proceeding involving all utilities and to maintain the status quo at this time. Although Professor Takle's attempt to limit his direct testimony regarding the recent warming trend to Nicor Gas' service territory and the winter heating season is not credible in Staff's view, his statement that he only analyzed the winter heating season for Nicor Gas' service territory makes clear that the record in this proceeding is not adequate to make the sweeping changes proposed by Nicor. (Nicor Gas Exhibit 29.0, p. 2).

C. Company Pointlessly Continues to Call Attention to a "Rulemaking"

In his direct testimony, Mr. Beyer stated, "I recommend that the Commission consider initiating a separate proceeding, such as a rulemaking, in which input from all natural gas and electric utilities …can be evaluated." (Staff Exhibit 9.0, p. 2, lines 28-29) Later, on page 7, lines 136-141, Mr. Beyer's testimony reads, "Please summarize your position and recommendation that a change in the basis for determining normal weather as measured by heating degree days should be considered in a separate proceeding, perhaps a rulemaking, in which input from all natural gas and electric utilities…can be evaluated…." While the question and answer presented in Mr. Beyer's testimony offered a rulemaking as a possible vehicle for the separate proceeding, it is clear that he was not recommending a rulemaking as the only way to review the weather issue.

In his rebuttal testimony, Mr. Beyer never refers to his recommended separate proceeding in terms of a "rulemaking". He does, however, refer to a "generic proceeding" or "broad-based proceeding" or "statewide proceeding" at least a dozen times. It is clear that Staff's emphasis is on a separate proceeding and not a rulemaking.

The Company criticizes Staff for not taking advantage of various opportunities to institute, propose, or otherwise advocate a rulemaking on the weather normalization issue:

1. "Although Nicor Gas advised Staff of its proposed weather normalization calculation before it filed its revised tariffs, Staff made no move toward a rulemaking." (Nicor IB, p. 79) Staff responds that the Company notified Staff on October 28, 2004 that it intended to use a 10-year period instead of the 30-year period for normalizing weather in a rate case the Company expected to file in early November. Having no testimony to review, and given the Company's

expectation to file a week or two later, the Staff would not have wasted time trying to initiate a rulemaking during that period. As it was, the Company did not file until mid-December.

2. “After Nicor Gas filed its direct testimony spelling out exactly why it was using a ten-year average, Staff did not seek a rulemaking.” (Nicor IB, p. 79) In its direct testimony, Staff clearly called for a separate proceeding to address the weather issue.

3. “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…” (Nicor IB, p. 79) This report, referred to as Easterling *et al.* in this docket, apparently did not cause Illinois’ gas and electric utilities to consider alternatives to the 30-year period for determining normal weather. The report was published in 1990. Beginning in 1991, there have been 24 electric rate cases and 26 gas rate cases filed at the ICC, two of which were by Nicor Gas: Docket No. 95-0219 and the present case. (Source: ICC Website, Rate Case History report, http://www.icc.illinois.gov/rl/docs/ratehist.xls) Except for the present case, Staff is aware of no reference to the Easterling *et al.* report nor of any company’s proposal to base rates on a period of time other than 30 years, including Nicor Gas’ rate case filed in 1995.

D. No Party Questioned Dr. Herrera's Analysis

The Company is correct that Staff did not challenge the method or results of Dr. Herrera's analysis.[8] Staff did challenge, however, the Company's and/or Dr. Herrera's decision to select the 10-year period for determining normal weather versus some other period of time, such as 8 or 12 years, that also falls within the 6-20 year recommended range. This range was presented in the testimony of Prof. Takle. (Nicor Gas Exhibit 16.0, line 576-577) Staff raised this issue in direct testimony: "Nicor Gas' proposal is partly based on the opinion testimony of its scientific and statistical experts regarding climate changes, and as such, its proposed change is not one supported by a simple change of fact." (Staff Exhibit 9.0, p. 3, lines 66-69)

In rebuttal testimony, Mr. Beyer stated, in reference to the recommended 6-20 year range, "This suggests that, under the Company's view, there is more than one period of time the Company could have proposed as an alternative to the Commission's 30-year practice. In this case, Nicor Gas proposes a weather normalization period of 10 years, but does not provide evidence that the proposed period of 10 years is superior to some other period within that range, such as 8 or 12 years." (Staff Exhibit 18.0, p. 3, lines 51-57)

[8] Illinois case law on expert testimony also holds that a court is free to evaluate the expert evidence presented and accept or reject it in whole or in part. *Prince v. Herrera*, 261 Ill. App. 3d 606, 633 N.E.2d 970, 199 Ill. Dec. 174 (1994). Further, a court need not accept the opinion of one expert, even where that expert's testimony is not directly countered by the expert opinion of another. *In re Marriage of Petraitis*, 263 Ill. App. 3d 1022, 1031-32, 636 N.E.2d 691, 201 Ill. Dec. 259 (1st Dist. 1993). Thus, the lack of a point for point counter by Staff or any Intervenor to the testimonies of Messrs Takle and Herrera with respect to 10-year average weather normalization proposal does not obligate the Commission to Nicor's proposal.

The Company never responded to Staff's challenge to the Company's selection of a 10-year period. It is certainly conceivable that some period of time other than 10 years may statistically be a better predictor of future weather, but would result in a lower rate per therm, thereby making it an inferior choice in the Company's eyes. The absence of a Company response on this point provides support for Mr. Beyer's contention that, if allowed, utilities will seek and support weather normalization periods that best suit their purposes. (Staff Exhibit 18.0, pp. 2-3, lines 45-49)

E. No Party Contested Professor Takle's Conclusions

The Company states in it reply brief that no party contested Prof. Takle's conclusions regarding climate changes. That is true. Staff, in fact, embraced Prof. Takle's conclusions that demonstrated that not only has the winter climate in Nicor Gas' service territory begun to warm, but also that the warming trend is a year-round phenomenon. Additionally, Prof. Takle presents evidence that the warming trend is not limited to northern Illinois, but also affects the United States Midwest region, the United States in general, and the whole earth.

This evidence led Staff to conclude that the same warming trends affecting the heating season in northern Illinois will also likely affect the cooling season in northern Illinois, and, likewise, the heating and cooling seasons affecting all of Illinois' gas and electric utilities. (Staff Exhibit 9.0, p. 3, lines 57-62; Staff Exhibit 18.0, p. 5, lines 92-112) Staff's conclusion on this issue supports the position that a generic proceeding is the best way to determine if a change to the Commission's long-standing policy of using 30 years is warranted, and, if so, to determine the method or criteria that results in fairness to ratepayers and utilities throughout Illinois. The Commission should not reach inconsistent conclusions by dealing with this issue on a case-by-case basis. (Staff Exhibit 9.0, p. 3, lines 62-65; Staff Exhibit 18.0, p. 3, lines 57-61)

Staff provided a specific example illustrating a potential downside to accepting the Company's proposal in this case. The effects of a warmer weather trend on the development of rates for Nicor Gas will have the opposite effect on the development of rates for an electric utility (ComEd) serving the same area of northern Illinois. (Staff Exhibit 18.0, p. 3, lines 66-69) If the Commission adopts Nicor Gas' position and argument that a weather normalization adjustment should be based upon data for the most recent 10-year period to reflect a recent climatic change toward warmer weather and follows that decision in the next rate case for ComEd, the result will be to drive downward the rate per kilowatt hour for that electric utility's new rates. (Staff Exhibit 18.0, p. 4, lines 71-77) This example further illustrates the benefit of developing a new policy for determining normal weather in a separate, generic proceeding.

F. Mr. Beyer is Not a Scientist, Nor a Statistician, Nor an Engineer

The Commission does not employ climatologists or others to offer expert opinions on climate or weather trends. A separate proceeding as proposed by Staff would therefore be beneficial wherein (1) utilities and other interested parties may find it worthwhile from a cost-benefit perspective to employ climatologists who may offer opinions different or even contrary to the opinions proffered in this case, and (2) the Commission through Staff may find it similarly worthwhile to employ such experts, when doing so otherwise on a case-by-case basis would be impractical on a costs basis.

G. Warmer and Colder Weather Effects Upon Revenues

The Company, in its initial brief, discusses the impacts of actual versus normal weather used to set rates. To address the Company's concerns, regardless of the period chosen by the Commission for determining normal weather in this case, Mr. Beyer also recommended that the Company be required to file a weather adjustment tariff subsequent to the final order in this case that would mitigate the revenue effects of variations between actual and normal weather. (Staff Exhibit 18.0, lines 337-342, and lines 369-382) A weather adjustment tariff would provide assurance to the Company that it can recover its costs, and it would also provide assurance to the customers that they are reimbursing the Company for no more and no less than its prudently incurred costs.

H. Summary

In summary, Staff's position recognizes that determining the best approach to normal weather is a complex task based on objective and subjective elements. The Commission has used one standard for many years and has applied that standard to determine normal weather for all natural gas and electric utilities whose customers' usage is affected by weather. The proposal made by Nicor Gas presents a universal issue that is neither unique to Nicor Gas nor limited to natural gas utilities. It is Staff's position that the Commission can deviate from its long-standing practice, but should only do so after having considered the positions and recommendations of all natural gas and electric utilities and other parties that want to comment on all utilities' proposals. (Staff Exhibit 9.0, lines 142-152)

V. Rate of Return

A. Capital Structure (Inclusion of Short-Term Debt)

Nicor Gas argues that there are errors in Staff's proposal which result in Staff's rate of return being not just and not reasonable. (Nicor IB, p. 81). Such claims are without merit. Staff's proposal is based upon a valid application of sound financial theory. (Staff IB, p. 95). Nicor Gas argues that it is using its "actual" capital structure to establish its overall rate of return and that Staff wrongly attempts to include short term debt in its proposed capital structure. (Nicor IB, p. 85). Staff addressed this argument in its Initial Brief. In short, Staff is not adding anything to Nicor Gas' capital structure. Staff is leaving in what is already a part of Nicor Gas' capital structure, i.e., short term debt. Nicor Gas' proposal ignores the fact that it forecasted that it will use short-term debt for nine months during 2005 and historically has relied upon short-term debt to finance its operations. (Staff IB, pp. 61-62). The fact that Nicor Gas does not forecast outstanding short-term debt for three months out of twelve during 2005 is insufficient reason to exclude short-term debt from Nicor Gas' capital structure. As fully explained in Staff's Initial Brief (Staff IB, pp. 62-64), a positive continual balance of short-term debt is not a prerequisite for including short-term debt in the capital structure. Prior Commission orders support Staff's position. In Docket No. 95-0076 the Commission included short-term debt in Illinois American Water Company's ("IAWC") capital structure where, like in this proceeding, IAWC projected zero short-term debt balances for three months of the test year (Order, Docket No. 95-0076, December 20, 1995, pp. 49 and 51). (Staff IB, p. 64) Furthermore, the Commission included short-term debt in MidAmerican Energy Company's capital structure in Docket No. 99-0534, stating "having low or zero net short-term debt balances during the test year and consistent annual re-financing of short-term debt are insufficient reasons to exclude short-term debt from the capital structure." (Order, Docket No. 99-0534, July 11, 2000, p. 10)

The Company claims that it finances its rate base solely with long term capital and that investors view it the same way and require a long-term return on rate base. (Nicor IB, pp. 86-87.) The evidence in the record simply does not support such a statement. First, the Company's proposed rate base exceeds the long-term capital in its proposed capital structure by over $291 million. Thus, it cannot fund its rate base solely with the long-term capital in its recommended capital structure. (Nicor Gas Exhibit 20B.1; Nicor Gas Exhibit 41.0, p. 8) Second, as Company witness Mudra acknowledged, the other sources of funds the Company claims are used to finance the variable portion of Nicor Gas' rate base are insufficient to fund the variable portion of Nicor Gas' rate base. (Nicor Gas Exhibit 20B.0, pp. 27-28.) Third, to assert that an asset is financed only with long-term capital is to assign a source and a use of capital. The Company's attempt to draw a distinction between how an asset is financed and a dollar-for-dollar tracing of capital from source to use merely creates a distinction without a difference.[9] Moreover, the Company's emphasis on the long-term financing of rate base versus the daily tracing of capital, again implies that Nicor Gas' rate base balance

[9] This is another example of the Company trying to support its position with labels rather than substance.

is constant over time. As explained in Staff's Initial Brief, such a notion is erroneous. (Staff IB, pp. 62-63.) Fourth, the Company has no "rate base investors," but rather its investors invest in the Company's entire asset base. Clearly, investors in Nicor Gas' short-term debt do not seek long-term returns on that investment. (Staff IB, p. 62.) Fifth, despite the Company's claim that the record is "clear and uncontradicted that investors understand that Nicor Gas' rate base investments … are not financed with short-term debt," (Nicor IB, p. 86), a review of the record shows that no such investors offered testimony in this matter. Indeed, the Company has provided absolutely no unbiased independent testimony that anyone other than the Company itself views rate base to be financed solely with long-term capital. In contrast, Staff showed, unequivocally, that rate base must be financed in part with short-term debt. Moreover, Staff presented evidence that Standard & Poor's ("S&P") also concluded that Nicor Gas uses short-term debt to finance a portion of its rate base. (Staff IB, p. 67.) Finally, Staff fully explained that insistently labeling Nicor Gas' rate base as "long-term" is misleading. (Staff IB, pp. 62-63.)

The Company acknowledges that short-term debt is used for <u>seasonal</u> requirements (Nicor IB, p. 88) and further acknowledges that its rate base includes assets that are <u>seasonal</u> in nature (Nicor IB, pp. 88-89). Further, Staff witness McNally demonstrated that those rate base seasonal requirements correspond remarkably closely with the seasonal use of short-term debt. Thus, it is not reasonable to simply assume, as the Company did, that short-term debt does not finance its rate base. To the contrary, it is reasonable for the Commission to conclude, as S&P did, that Nicor

Gas' uses short-term debt to finance its rate base, including the purchase of gas in storage. (Staff IB, p. 67)

Nicor Gas makes the incredible argument that since gas in storage goes hand-in-hand with its long-term investment in its aquifer storage fields, and investors expect a long-term return on investment in the storage fields, it "makes sense" that investors expect a long-term return on gas in storage as well. (Nicor IB, pp. 88-89.). Nicor Gas' attempted analogy defies all reason. As explained in Staff's Initial Brief, Nicor Gas has no rate base investors. (Staff IB, p. 63) Second, even if one were to suspend disbelief and accept the proposition that a "rate base investor" exists, it most certainly would <u>not</u> make sense that investors would require a long-term return on a seasonal asset. While Nicor Gas undoubtedly has some long-term assets in its rate base, it also undeniably has short-term assets in its rate base. Its short-term assets include gas inventory. The cushion gas that is necessary for the operation of Nicor Gas' aquifer storage fields, to which the Company apparently refers, is not a part of the Company's gas inventory, but rather, is included in the Company's net plant. (Staff Exhibit 6.0, pp. 3-4; Nicor Gas Exhibit 11B.0, p. 16.) It is completely illogical to conclude that because investors expect a long-term return on the long-term assets in rate base, they must also require a long-term return on a seasonal asset. The return required is a function of the length of time funds are invested. As an asset with "seasonal characteristics," funds invested in gas in storage are not all invested long-term and thus, do not require a long-term return.

The Company claims that its LIFO accounting supports its conclusion that the assets in rate base should all be treated as long-term assets. (Nicor IB, p. 89.) The Company's argument should be rejected. First, LIFO accounting is merely an accounting mechanism whereby a specific unit cost is assigned to identifiable layers of inventory. Nevertheless, contrary to the Company's conclusion, LIFO, or last in, first out accounting actually supports Staff's analysis. LIFO accounting suggests there is a relatively permanent layer of assets (the "first in" portion) and a variable layer (the "last in" portion that is assumed to be the "first out"). That is precisely the case for Nicor Gas and precisely what Staff is arguing. For example, Nicor Gas maintains a portion of its gas in storage as a largely fixed balance, which it calls "cushion gas," and a variable portion it refers to as "working gas," which is forecasted to vary by over $331 million during 2005. (*See* Nicor Gas Exhibit 26.1, Schedule 1.01, p. 2 of 3 (November 2005 gas in storage less April 2005 gas in storage - i.e., 336,099 - 4,938 (largest net figure less the smallest net figure) (Staff IB, p. 63). Contrary to the Company's implication, Staff did not suggest that gas in storage should be treated as "a purely short-term asset." (Nicor IB, p. 89.) Rather, Staff correctly argues that the variable portion must have a variable source of financing and that source must be included in the capital structure. (Staff IB, pp. 67.)

The Company continues to assert that the inclusion of short-term debt would unfairly introduce short-term interest rate risk into Nicor Gas' rate of return and, now argues that it would encourage other firms to abandon use of short-term debt in favor of long-term capital instruments. (Nicor IB, p. 89.) The Company's argument should be rejected. First, the Company has provided no evidence that the inclusion of short-term debt in Nicor Gas' capital structure would encourage other firms to abandon use of short-term debt instruments. Indeed, were that the case, no Illinois utilities would currently use short-term debt, since short-term has been included in the capital structures of numerous Illinois utilities. Second, as explained in Staff's Initial Brief, the inclusion of short-term debt does not penalize the Company, but merely accurately reflects the capital costs incurred by the Company. (Staff IB, p. 66.) Indeed, if the Company truly believed that the use of short-term debt is too risky, it would not have forecasted a continued use of short-term debt. The Company's argument suggests that Company investors should be allowed to reap the benefit of using short-term debt when such use is in their best interest, while saddling rate payers with the higher cost of long-term capital and the risk associated with the volatility of short-term debt costs.[10] Clearly, this "customers pay, investors benefit" philosophy is inconsistent with equitable regulatory policy.

The Company continues to argue that Staff's recommendation to include short-term debt in Nicor Gas' capital structure is inconsistent with past Commission rate case decisions. (Nicor IB, p. 90.) Staff fully addressed this argument in its Initial Brief. (Staff IB, pp. 64-65.) The Company notes that, in Docket Nos. 00-0620/00-0621 (Consol.), the Commission determined that the avoided carrying cost of Nicor Gas' gas in storage should not reflect short-term debt, and that Staff argued that Nicor Gas' storage gas was not financed by short-term debt. The Company states that Staff cannot reconcile its position in the instant docket with its position in Docket No. 00-0620. (Nicor IB, p. 90.) Nicor Gas' claim in this regard is misleading and merits clarification. The Commission's decision and Staff's statement in that proceeding are not applicable to the instant docket. An important distinction that Nicor Gas fails to acknowledge is that

[10] For example, S&P takes into consideration usage of short-term debt in rating Nicor Gas' long-term debt. (See Staff Cross Exhibit 19.0).

Docket Nos. 00-0620/00-0621 (Consol.) was not a general rate proceeding; thus, neither Staff nor the Commission were stating an opinion or position regarding the appropriate capital structure for Nicor Gas. Rather, both Staff and the Commission were merely acknowledging that the capital structure that was incorporated into the then-current rates did not include short-term debt. The Order on Rehearing summarizes the arguments:

> The Commission rejects Nicor Gas' proposal to apply its cost of short-term debt to the cycled portion of gas inventory storage that will decline as a result of Customer Select. <u>In this proceeding, Nicor Gas has argued</u> <u>that short-term debt</u>, in the form of commercial paper, <u>is used exclusively to finance cycled gas</u>. However, <u>in the Company's last rate case</u>, Docket No. 95-0219, <u>short-term debt was excluded from Nicor Gas' capital structure at Nicor Gas' urging</u>. Thus, it cannot be reasonably concluded that cycled gas, which was included in rate base in that proceeding, is financed with short-term debt. The Commission, therefore, concludes that it is appropriate to apply the 9.67% rate to the entire reduction in gas storage inventory resulting from Customer Select. The Commission finds that the use of the 9.67% rate results in a reasonable estimate of the reduction of the Company's carrying charges.

(Order on Rehearing, Docket Nos. 00-0620/00-0621 (Consol.), January 3, 2002, p. 18. <u>emphasis added</u>).

What is pertinent to this proceeding is the Company's statement to which Staff was responding in that proceeding. The Staff statement from Docket Nos. 00-0620/00-0621 (Consol.) to which the Company now refers was in response to the Company's proposal to calculate the savings resulting from a reduction in gas storage attributable to the Customer Select program by applying Nicor Gas' relatively low cost of short-term debt to gas in storage. Staff argued that in order to accurately calculate savings the calculation should be based on Nicor Gas' last authorized rate of return, since that was the rate of return that was reflected in Nicor Gas' current rates at the time. In response, the Company argued against applying the overall cost of capital established in Docket

No. 95-0219, asserting that "its seasonal, cycled gas inventory purchases are and have always been financed through issuance of short-term debt." (Order on Rehearing, Docket Nos. 00-0620/00-0621 (Consol.), January 3, 2002, p. 16.) The Company now makes the capricious assertion that its gas inventory purchases are not financed through issuance of short-term debt, despite stating that it still uses short-term debt in the same manner it did at the time of Docket No. 95-0219. (Nicor Gas Exhibit 36.0, pp. 2 and 9.) Thus, it is the Company, not Staff, that takes a directly contradictory position from that which it took in Docket Nos. 00-0620/00-0621 (Consol.).

The Company's flip flopping of its position with regard to short-term debt from that in Docket No. 95-0219 (where a higher return would have been beneficial to the Company) to that in Docket Nos. 00-0620/00-0621 (Consol.) (where a lower return would have been beneficial to the Company) and then back again in the instant docket (where a higher return would once again be beneficial to the Company) exposes the Company's position on this issue as disingenuous and belies its claim to be consistent whether it hurt or helped. [11] In view of the foregoing, it is quite astonishing that the

[11] The Company claimed that it opposed including short-term debt in its capital structure to its detriment in a case in 1987. Note that the Company did not even identify the case let alone provide a full citation to support its supposedly principled stand on short-term debt. (Nicor IB. p. 92) The testimony Nicor Gas cites contains no such reference – neither the two pages cited from Nicor Gas Ex. 3A.0 nor the <u>20 pages</u> cited from Nicor Gas Ex. 20B.0. The only Nicor Gas case in which short-term debt was an issue during 1987 is Docket No. 87-0032, a Commission investigation of Nicor's earnings and rates. While Mr. Mudra's rebuttal testimony did not address how Nicor Gas was "hurt" by the exclusion of short-term debt in its capital structure in 1987, Mr. Mudra did supply evidence that demonstrates that Nicor Gas benefited from that exclusion. Specifically, Mr. Mudra testified that short-term rates were near 7% in 1987 (Nicor Gas Ex. 20B.0, 23:535-537). In contrast, the Commission authorized rates of return on rate base of 11.14% and 11.18% for Nicor Gas in Docket No. 87-0032 (Order Docket No. 87-0032, January, 20, 1988, p. 38) Clearly, excluding short-term debt with a cost of 7% from Nicor Gas' capital structure did not "hurt" Nicor Gas.

Company should choose this particular argument to level the charges that Staff "has been inconsistent, apparently choosing whatever position lowers Nicor Gas' rate of return" and that its approach is "apparently results-driven." (Nicor IB, p. 92.)

With respect to the Commission's order in Docket No. 95-0219, as Staff set forth in its Initial Brief, the Commission official policy position concerning short-term debt changed. Since the time the order was issued in Docket No. 95-0219 the Commission revised its rules, in particular 83 Ill. Adm. Code Section 285.4010. Thus, as discussed below, short-term debt is currently required to be included in the capital structure with certain exceptions under Part 285.

The Company takes issue with Staff's reliance on part 285 with respect to short-term debt. The Company claims that "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" and suggests that Staff witness Griffin's testimony demonstrates an inconsistency on Staff's part with respect to its treatment of part 285. (Nicor IB, pp. 91-92.) With regard to the former, 83 Ill. Adm. Code Section 285.4010(a) provides that:

> …short term debt shall be included in the capital structure unless the utility demonstrates that short term debt is entirely financing assets, such as CWIP or seasonal working capital, that are not included in the utility's rate base…

The Commission's Second Notice Order in Docket No. 02-0509 supports Staff's position. In Docket No. 02-0509 a rule making to revise 83 Ill. Adm. Code Part 285 and the adoption of 83 Ill. Adm. Code 286 and 287, the issue of whether short term debt was to be included in the capital structure was addressed by the Commission. In that proceeding Staff argued, and the Commission concurred in its order, that the only valid reason to exclude short-term debt from a capital structure was if the utility demonstrated that short-term debt was entirely financing "assets, such as construction work in progress ("CWIP") or seasonal working capital, that are not included in the utility's rate base." Staff further argued, and the Commission again concurred, that if short-term debt is supporting the utility's rate base, it must be included in the capital structure to accurately calculate the utility's cost of capital. (ICC Docket No. 02-0509, 2nd Notice Order, Order at 22).

With regard to the latter, Staff witness Griffin's testimony regarding Part 285 does not conflict with Staff's interpretation of 285.4010(a). (Nicor IB, pp. 91-92) 83 Ill. Adm. Code 285.110, which sets forth the purpose of the rule, states that the Commission need not restrict its decision to information supplied pursuant to Part 285.[12] (83 Ill. Adm. Code 285.110(b).) Similarly, 83 Ill. Adm. Code 285.4010(a) does not require that the Commission base its decision regarding short-term debt solely on the information provided pursuant to Part 285. Rather, 83 Ill. Adm. Code 285.4010(a) clearly states that the Commission will presume that short-term debt shall be included in the capital structure <u>unless the utility demonstrates otherwise.</u> Significantly, Section 285.4010(a) places no restrictions on the sources of information on which the utility can supply to rebut the presumption in favor of including short-term debt in the capital structure.

Finally, the Company argues that if the Commission concludes that Nicor Gas' short-term debt should be included in its capital structure, the balance should only be $36,625,000. (Nicor IB, p. 93) Underlying the calculation of that amount is the assumption that gas in storage is the only rate base item financed with short-term debt,

[12] In fact, information supplied pursuant to Part 285 does not become a part of the record unless admitted into evidence in accordance with Commission Rules of Practice. (83 Ill. Adm. Code 285.110(c).)

and that it is financed with short-term debt only to the extent that its balance exceeds the total of customer deposits, budget plan balances, and customer advances for construction. The Commission should reject Nicor Gas' argument. There is no need to reduce the amount from that which Staff proposes. Staff's inclusion of one hundred percent of Nicor Gas' net short-term debt in its rate base does not assume that one hundred percent of Nicor Gas' net short-term debt supports rate base. Rather, Staff's approach assumes that all assets, including both assets in rate base and assets not in rate base, are financed by all sources of funds in proportion to total capital. For example, a ratemaking capital structure that includes 50% common equity does not assume or imply that common equity is supporting only rate base. Rather it means that common equity is assumed to support 50% of the amount invested in rate base assets and 50% of the amount invested in non-rate base assets. Moreover, if one were to attempt to assign capital to rate base or non-rate base uses, one would have to remove some of the long-term capital, since it is unreasonable to simply assume that long-term capital exclusively finances rate base assets. However, that creates a problem. As the Company argued in its most recent rate case, there is no need for capital sources to match the value of rate base. (Staff Exhibit 14.0, p. 4.) This is particularly problematic if one were to attempt to do so using the Company's recommendations, since the Company's proposed rate base exceeds the long-term capital in its proposed capital structure by over $291 million. Therefore, a comprehensive matching of capital to uses, which would be necessary if one were to try to match any capital, is an impossibility.

Indeed, given that the Company's requested rate base is 1.25 times the total capital in its recommended capital structure, if the Company's recommendations were adopted, the Company's overall allowed return would actually be 25% higher than the return the Company asserts that investors require. That is, an investor-required overall rate of return 9.03% applied to the Company's requested rate base of $1,441,082,000 produces earnings of $130,129,705. However, earnings of $130,129,705 on the $1,149,933,000 of capital in the Company's recommended capital structure results in an overall return of 11.32% and a <u>13.56%</u> rate of return on common equity. (*See* Appendix A for calculation). The same would not be true of Staff's recommendations so long as short-term debt remains in the capital structure. However, if short-term debt is removed from Staff's capital structure, the overall rate of return on capital would increase significantly. First, the overall investor-required rate of return would increase to 8.33% due to the removal of the Company's relatively lowest-cost source of capital. Second, with the removal of short-term debt, the total capital in Staff's recommended capital structure would fall well below the value of Staff's recommended rate base. Thus, similar to the Company's recommendations, Staff's recommended rate base would be approximately 15% higher than the total capital in Staff's recommended capital structure and the actual overall return on capital would be 15% higher than the 8.33% investor-required rate of return, or 9.55%, and the return on equity would be 11.55%, rather than the investor-required return on 9.54% . (*See* Appendix A for calculation).

In Docket No. 81-0609, the Commission recognized that a large divergence between rate base and the dollar amount of capitalization would prohibit the conclusion that there are no other sources of capital supporting rate base. In that proceeding, the Commission found that a 6.4% differential between capitalization and rate base was acceptable. In contrast, there is a 25% differential between Nicor Gas' proposed capitalization and rate base in this proceeding, and there would be a 14% difference between Staff's proposed capitalization and rate base if short-term debt were excluded.[13] Such large discrepancies certainly cast doubt on the conclusion that there are no other sources of capital supporting Nicor Gas' rate base. (Order, Docket No. 81-0609, July 1, 1982, p. 9.)

B. Adjustments to Capital Structure Component Balances

The Company claims that Staff inappropriately deducted unamortized debt discount/expense for retired issues from the long-term debt balance. (Nicor IB, p. 93) Significantly, the Company did not make this argument until it filed its surrebuttal testimony, when Staff no longer had an opportunity to respond through testimony. Regardless, Staff's approach is consistent with the approach the Commission has accepted in numerous other rate cases. In contrast, the Company's argument is inconsistent and illogical. The Company measured its cost of debt by dividing its total debt expense by the carrying value of its debt, which reflects unamortized debt discount/expense for retired issues. Thus, the Company is arguing that unamortized debt discount/expense for retired issues should be reflected in its long-term debt cost but not in its long-term debt balance. Such an adjustment would actually reduce the Company's weighted average cost of capital ("WACC"). According to Staff's unofficial tally, this is the third time that the Company has taken issue with an item that, if

[13] In contrast, Staff's proposed capitalization, including short-term debt, exceeds Staff's proposed rate base, with a difference of less than 1%. Thus, with Staff's proposal, there is no concern regarding the divergence between capital and rate base.

changed, would actually lower Nicor Gas' WACC. That is, on three occasions (Zack's betas, CAPM, (Staff IB pp. 88-89) and this item) Staff could have lowered the Company's cost of capital but did not. That fact highlights that Staff witness McNally did not bias his analysis and demonstrates that the Company's repeated accusation that Staff chooses whatever position lowers Nicor Gas' cost of capital (Nicor IB, pp. 83 and 92) is baseless. [14]

C. Cost of Short-Term Debt

The Company criticizes Staff because it "did not use the time-weighted rate format outlined by the Commission on Schedule D-2." (Nicor IB, pp. 94-95.) The Company misrepresents Schedule D-2, which does not outline a time-weighted cost of short-term debt. The phrase "time-weighted" does not even appear in the section of the Code Part that pertains to Schedule D-2. (83 Ill. Adm. Code 285.4020) To the contrary, the approach that Staff has taken in this docket is consistent with both the Schedule D-2 instruction that "Interest rates shall equal the annualized rates that the utility paid no more than 60 days prior to the rate filing date or the prevailing or forecasted interest rates on short-term debt of similar risk and terms" (83 Ill. Adm. Code 285.4020(d)(5)) and the approach that Staff has followed and the Commission has accepted in other dockets.

[14] The tone of Nicor's repeated criticisms (as well as its apparent knowledge concerning the motivation behind Staff's cost of capital proposals) are both unwarranted and troubling. ("Staff's results oriented position on short-term debt" (Nicor IB, p. 83); "Staff, on the other hand, has been inconsistent, apparently choosing whatever position lowers Nicor Gas' rate of return." (Nicor IB, p. 92); and "The Commission should reject such an [i.e., Staff's] apparently results-driven approach" (Nicor IB, p. 92)). While Staff believes that, in the context of an adversarial proceeding, it is acceptable to have a principled disagreement with a party about the facts and the relative weight those facts should be given, Staff takes exception when the arguments of one party to such a disagreement veer into the realm of personal attack.

(*See e.g.,* Order, Docket No. 99-0534, July 11, 2000, pp. 20-22; Order, Docket No. 02-0690, August 12, 2003, p. 78)). It is telling that, in this instance, Nicor Gas views part 285 as setting forth a Commission standard that must be followed; however, Nicor Gas refuses to acknowledge such a standard in Section 285.4010(a) with respect to the inclusion of short-term debt in its capital structure, as discussed above.

The Company claims that "substantial, undisputed evidence demonstrates that Nicor Gas' commitment fees are necessary and reasonable" and, thus, commitment fees should be included. (Nicor IB, p. 95.) Despite Nicor Gas' claim, there was no "substantial, undisputed evidence." Nicor Gas simply provided self-serving testimony claiming that the fees were necessary and reasonable. What is evident from the record is that Nicor Gas failed to (1) establish the amount of the new bank commitments, (2) establish the amount of the commitment fees that are assigned to Nicor Inc. and (3) establish whether the $1.6 million new bank commitment fees reflects a proper 3 year amortization of those costs over the 3-year life of the agreement. (Nicor Gas Exhibit 20B.4; Tr., p. 239; Staff IB, p. 70) The absence of these facts in the record prevent the Commission from adding a single basis point to Nicor Gas' cost of capital for the fees without violating 220 ILCS 5/9-230. (<u>Illinois Bell Telephone Company v. Illinois Commerce Commission</u>, 283 Ill. App.3d 188, 207 (1996); Staff IB, pp. 70-71)

D. Cost of Equity

The Company claims that the 70% of revenue from gas utility operations criterion which Staff used to select its Gas Sample is an inappropriately relaxed standard. (Nicor IB, p. 97) The Company's claim is unfounded. As Staff explained in its Initial Brief, the

70% threshold was selected to balance measurement error due to sample composition against measurement error due to individual company cost of equity estimates. (Staff IB, pp. 83-85) The 70% revenue requirement is not a rigid requirement. As Staff witness McNally explained in his testimony, the Commission has accepted various revenue thresholds and some samples not based on revenues at all. (Staff Exhibit, 14.0, p. 17) In fact, the Commission has accepted the cost of equity from a sample with a company with percentage of revenue from gas distribution as low as 42%. (Staff IB, p. 85)

The Company also criticized Staff for continuing to use its Gas Sample even though it would no longer meet the 70% criterion based on 2004 data unavailable at the time of Staff's analysis. (Nicor IB, p. 97) Staff fully addressed this argument in its Initial Brief at pages 83 to 87. As noted above, to obtain 70% of revenue from gas utility operations is not a rigid requirement. The general purpose of the 70% threshold is to produce a sample of companies whose operations are largely gas distribution. Staff witness McNally testified that he found that each of the four companies that Company witness Makholm recommended eliminating from Staff's Gas Sample remained appropriate for inclusion in the Gas Sample. (Staff Exhibit 14.0, pp. 17-18; Staff IB, pp. 84-85)

The Company claims that "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." (Nicor IB, p. 98) The record evidence does not support Nicor Gas' claim. First, with respect to risk profiles, the only "evidence" that Nicor Gas points to is the percentage of revenue from utility operations, which only roughly approximates the operating risk portion of total risk. As Company witness Makholm acknowledges, it is <u>total risk</u> that drives the company's cost of capital (Nicor Gas Ex. 21.0, p. 29.) and should ultimately be reflected in rates. The Company <u>cannot</u> validly claim its sample better reflects Nicor Gas' total risk, since Nicor Gas completely ignored financial risk. (Staff IB, pp. 81-82.) Second, as explained above, the 70% threshold does not mean Staff's sample is a poor proxy for Nicor Gas. Nicor Gas' sample is most certainly <u>not</u> superior to Staff's for the following reasons: (1) Nicor Gas presented absolutely no analysis to show that its sample is more reflective of Nicor Gas, in terms of total risk, than Staff's Gas Sample (indeed Dr. Makholm's sample would require an adjustment similar to that which Staff made to its Gas Sample, which he failed to make); (2) Staff has shown that the two for four substitution Nicor Gas proposed would reduce the sample size, thereby increasing the risk of measurement error, with no demonstrated benefit (Staff Exhibit 14.0, pp 20-21.); and (3) Staff showed that its Gas Sample better balances between the two types of measurement error than the six-company sample resulting from Dr. Makholm's proposed substitution. (Staff IB, p. 86.)

The Company takes issue with Staff's twenty-three basis point adjustment. The Company claims that Staff's twenty-three basis point relative risk adjustment to Nicor Gas' cost of equity is inappropriate because it's based on an invalid sample. (Nicor IB, p. 98) As explained above and previously in Staff's Initial Brief, Staff's sample is not invalid. If it were true, which it is not, that Staff's sample was not representative of Nicor Gas, then the justification for an adjustment such as Staff's is even greater. (Staff IB, p. 89.) As explained above, Nicor Gas' cost of equity should reflect its total risk, not just its business risk. Thus, after creating a sample based on an operating risk criterion, further review of the relative total risks of the sample and the target company should be, and was, performed by Staff. (Staff Exhibit 14.0, pp. 19.) Such further review is necessary regardless of how one develops a sample since each sample has an inherent risk level, which may differ from that of the target company. (Tr., pp. 906-908) If the sample does not accurately reflect the total risk level of the target company, an adjustment should be made. That is precisely why, consistent with the approach previously accepted by the Commission, Mr. McNally reviewed his Gas Sample's total risk and adjusted his cost of equity estimate accordingly. (Staff IB, p. 90.) To be consistent with the Commission's past practice, Dr. Makholm should have done the same. He did not. (Staff Exhibit 14.0, pp. 17-19 and 23-24; Order Docket No. 98-0632, March 24, 1999, pp. 4-5; Order Docket No. 02-0798/03-0008/03-0009 (Cons.), October 22, 2003, pp. 80 and 89-90; Staff IB, p. 90.)

The Company in its initial brief claims that Staff improperly used debt risk as a proxy for equity risk to calculate its twenty-three basis point adjustment. (Nicor IB, p. 99.) The Company's argument should be rejected. Staff in its Initial Brief pointed out that Nobel Prize winners Modigliani & Miller concluded that equity costs are affected by debt leverage. S&P ratings are similarly affected by debt leverage. Staff acknowledges that while there is no way to directly measure the relationship between debt and equity; to ignore the significant risk differential would be inappropriate. (Staff IB, p. 90). Furthermore, as noted above, Staff's approach is consistent with the approach previously accepted by the Commission.

Finally, in its initial brief Nicor Gas argues that Staff witness McNally made a number of errors regarding the growth rate for his DCF analysis. (Nicor IB, p. 99). Staff's Initial Brief addressed all of these arguments. (*See* Staff IB, pp. 78-81 and 87-88.) Mr. McNally made no such errors. Further, it is worth noting that Nicor Gas' position that the Commission should reject a known dividend for an estimate of that same dividend (Nicor IB, p. 100) was so absurd that Dr. Makholm abandoned it once Staff revealed its folly. (*See* Nicor Gas Exhibit 37.0, p. 11, Table 3.)

E. Flotation Costs

The Company claims that sworn testimony constitutes "undisputed evidence" and that "Mr. McNally cannot dispute that Nicor Gas' testimony and exhibits are proper evidence." (Nicor IB, p. 101.) The Company fails to recognize that the burden of proof to establish the justness and reasonableness of proposed rates is on the utility not Mr. McNally. (220 ILCS 5/9-201(c)). The record shows, that, despite the Company's claims, Nicor Gas failed to demonstrate that it has incurred for the benefit of Nicor Gas rate payers, but not recovered, the fees upon which its flotation cost adjustment is based.. While Nicor Gas' witnesses argue that the Commission has not previously allowed recovery of flotation costs (Staff Exhibit 21.0; Staff IB, p. 92.), Nicor Gas did not cite from a single Commission Order or provide any independent verifiable documentation to support that claim. (Staff IB, p. 93). The only documentation that the Company provided was excerpts from its annual reports which show only $478,277 of discount on common equity recorded each year since 1973. The Commission has previously found this type of documentation to be insufficient evidence. Yet, Nicor Gas' flotation cost adjustment reflects $4,142,661 of underwriting discounts and commissions as well as $454,000 of estimated issuance expenses related to five issuances totaling $173,364,332 of proceeds. (Staff IB, p. 94).

Staff has identified and reviewed the following Nicor Gas general rate orders:[15] Docket Nos. 58783 (November 14, 1974), 78-0043 (November 29, 1978), 79-0133 (January 3, 1980), 81-0609 (July 1, 1982), 87-0032 (January, 20, 1988) and 95-0219 (April 3, 1996).

- In Docket Nos. 58783 and 78-0043, the Commission did not mention common equity flotation costs at all.

- In Docket No. 79-0133, the Commission Order states that (1) the Company witness included a flotation cost adjustment in his cost of common equity recommendation; (2) the flotation cost adjustment was smaller than the one the Company witness presented in the previous Nicor Gas rate case (i.e., Docket No. 78-0043); and (3) the Company met all of its needs for common equity capital with internally generated cash. The Commission included an adjustment for common equity flotation costs in its DCF-based 13% estimate of Nicor Gas' cost of common equity but ultimately set an authorized rate of return on rate base that included a 12.55% cost of common equity. The Commission did not articulate in detail the rationale for its finding on cost of equity (Order, Docket No. 79-0133, January 3, 1980, 1980 Ill. PUC Lexis 38 at 44-50.)

- In Docket No. 81-0609, the Company witness included a flotation cost adjustment in his cost of common equity recommendation while Staff did not. The Commission's authorized rate of return on common equity equaled the low-end of Staff's recommended range, which the Commission based on Nicor Gas' lower risk. (Order, Docket No. 81-0609, July 1, 1982, 1982 Ill. PUC Lexis 22 at 37-38.)

- In Docket No. 87-0032, both Company cost of equity witnesses recommended an adjustment to the cost of common equity for flotation costs, while Staff opposed such an adjustment. (Order, Docket No. 87-0032, pp. 29, 31, and 33) The Commission concluded "that since no issuance costs will be incurred by Respondent and the evidence does not show issuance expenses have been incurred in the past, no adjustment for issuance, flotation or market pressure should be made." (Order, Docket No. 87-0032, p. 36.)

[15] Staff has not identified any other Nicor Gas general rate order.

- In Docket No. 95-0219, Nicor Gas' last rate case, Staff criticized the Company for advocating inclusion of a flotation cost adjustment in its ROE without presenting any evidence that these costs actually were incurred (Order, Docket No. 95-0219, April 3, 1996, p. 41.) The Commission concluded, "We also agree with Staff that the Company has failed to demonstrate that any flotation costs have been incurred by the Company." (Order, Docket No. 95-0219, April 3, 1996, p. 46.)

While the Commission's rejection of a common equity flotation cost adjustment is explicit in the last two Nicor Gas rate orders (i.e., Docket Nos. 87-0032 and 95-0219), and implicit in Docket No. 81-0609 (on the basis that the Commission adopted the low-end of Staff's recommended range, which did not include such an adjustment), the first three Orders, those that occurred closest in time to the period of Nicor Gas common stock issuance activity (i.e., 1961. 1971, and 1973; Nicor Gas Ex. 21.8), are ambiguous.[16] It is debatable whether the Commission included a flotation cost adjustment in Docket No. 79-0133, whereas Docket Nos. 58783 and 78-0043 do not mention a common equity flotation cost adjustment at all. Indeed, the Commission did not reveal that a common equity flotation cost adjustment was proposed in Docket No. 78-0043 until its Order in Docket No. 79-0133 and even then did not state how it disposed of the issue.

In Docket No. 91-0193, the Commission held that the Commission's silence on the disposition of a common equity flotation cost adjustment is insufficient to conclude that those flotation costs were not recovered:

> Based on its review of the record, the Commission determines that there should be no adjustment to CIPS' cost of equity to reflect a return on flotation costs incurred due to common equity issuances. There is no evidence that CIPS will be issuing new common stock in the near future.

[16] Note the 1979 and 1980 common stock issuances depicted in Nicor Gas Ex. 21.8 were made by Nicor Gas' parent company, Nicor Inc. *See* Nicor Gas Ex. 3.4.

> While the evidence presented by Staff and the Company shows that certain issuance costs have been incurred since 1952, it does not establish that the Company has not recovered a part or all of these expenses. The Commission finds that the lack of a reference to recovery of such costs in the orders reviewed by Mr. Pregozen is not sufficient evidence to support an adjustment for flotation costs incurred from 1952 to the present.

(Order, Docket No. 91-0193, March 18, 1992, p. 106.) Thus, neither the evidence the Company presented nor a review of its rate orders is sufficient to support the Company's demand for an adjustment for common equity flotation costs.

Nicor Gas' flotation cost adjustment also fails to comport with 220 ILCS 5/9-230 in that Nicor Gas failed to demonstrate that all the $4,142,661 of underwriting discounts and commissions were incurred for the benefit of Nicor Gas and not Nicor Inc. Section 9-230 precludes the Commission from including the flotation costs from Nicor Inc. unless the Company can prove that the proceeds from the issuance were used for the benefit of Nicor Gas and that the issuance were not the result of capital structure manipulation. (<u>Illinois Bell v. Illinois Commerce Commission</u>, 283 Ill.App.3d 188, 207 (1996)) (Staff IB, p. 94). The Company's inclusion of the Nicor Inc. issuances in its calculation of Nicor Gas' flotation costs is definitely <u>not</u> irrelevant, as the Company claims. The flotation costs associated with the Nicor Inc. issuances would only be irrelevant if one incorrectly assumes, as the Company does, that the flotation cost percentage, based on the costs and proceeds of the five issuances presented, can be applied to the entire equity balance. Staff explained that the Company's application of that flotation cost percentage to its entire equity balance produces an adjustment that reflects an even higher level of flotation costs than the total flotation costs depicted in

Nicor Gas Ex. 21.8, which the Company has neither demonstrated to have been incurred for the benefit of Nicor Gas rate payers nor remain unrecovered.[17] (Staff IB, p. 95.) Thus, although the Company claims to have verified $4,596,661 of reasonably incurred, unrecovered flotation costs, its adjustment would effectively allow a return on $16,463,162 of flotation costs. (*See* Appendix B.)

Finally, the Company's estimate of its flotation cost expenses is not consistent. The Company's estimate of its issuance expenses in its rebuttal testimony ($4,596,661) differs from that which it provided in response to a CUB-CCSAO data request ($4,685,771). (Nicor Gas Exhibit 21.08; CUB-CCSAO Exhibit 3.04, p. 2.)

F. Overall Cost of Capital

The Company claims that its rate of return proposal is reasonable (Nicor IB, p. 81) and that Staff's rate of return recommendation is not reasonable and <u>could</u> have a negative effect on the Company's financial strength. (Nicor IB, p. 85.). In support of its argument, Nicor Gas states that its overall rate of return proposal is within the range of returns allowed other gas distribution companies. (Nicor IB, p. 81). However, every other gas distribution utility in the U.S. has a lower S&P credit rating than Nicor Gas' AA rating. (Staff IB, p. 91) Thus, one would expect Nicor Gas' required return on equity to be considerably lower than average. In contrast, Nicor Gas' proposal is <u>greater</u> than the

[17]In fact, not a single dollar of common stock expense or discount associated with parent company Nicor Inc.'s common stock issuances has been reported in Nicor Gas' Form 21 ILCC annual reports to the Commission. (Nicor Exhibit 20B.7). That omission casts additional doubt on the proposition that Nicor Inc.'s common stock issuances were for the benefit of Nicor Gas.

average of the returns to which the Company refers, indicating that Nicor Gas' proposal is not reasonable. Further, Nicor Gas presented no evidence to show that Staff's return recommendation would have a negative effect on the Company's financial strength. Of course, it is a truism that if the allowed return is set too low, it would have a negative effect on the Company's financial strength. However, the only "evidence" the Company offers in support of its claims that Staff's return recommendation is not reasonable is a comparison to other allowed returns on equity established during 2004 and early 2005. Staff fully addressed the flaws in the Company's argument in Staff's Initial Brief. (Staff IB, pp. 90-92.) The Company did not even attempt to demonstrate that those companies for which it is in the "range" are comparable in total risk to Nicor Gas. Indeed, the results of other allowed equity returns relative to Staff's recommendation in this proceeding should not be surprising. Staff explained that it is quite consistent for Staff's cost of equity recommendation to be below the costs of equity authorized for a group of various other gas utility companies over the past 3½ years and that, in contrast, the Company's recommendation is inconsistently higher than the average of that varied group.

Staff provided the only analysis in the record on the direct effects of Staff's recommendation on Nicor Gas' financial strength. Staff's analysis demonstrated that Staff's recommended total debt ratio of 50.27% is consistent with S&P benchmarks for an AA-rated utility with a business profile score of 2. Also, Staff's recommendations produce a pre-tax interest coverage ratio of 3.82x, which is very generous for an AA-rated utility with a business profile score of 2, based on benchmarks S&P previously employed. Thus, Staff's recommendations reflect a reasonable level of risk and should allow Nicor Gas to maintain its strong financial condition. (Staff IB, pp. 91-92.)

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

A. Cost Of Service Study

2. Embedded Cost Of Service Study

a. Modified Distribution Mains Study ("MDM Study")

In their initial briefs, Nicor and the Illinois Industrial Energy Consumers ("IIEC"), disagreed with Staff's adjustment to Nicor's MDM Study, which is used to allocate distribution mains. (Nicor IB, p. 109; IIEC IB, pp. 12-14)

The resolution of the MDM Study differences among Nicor, the Citizens Utilities Board, IIEC, and Staff is linked with the resolution of the use of the Average and Peak ("A&P") method to generally allocate transmission and distribution costs (Section VI, A, 2(c) of Staff's Initial Brief and this Reply Brief), and the effect that the calculation of the peak demand for each rate class has on the MDM Study so that the allocation of costs through the MDM Study is properly balanced between demand and throughput (Section VI, A, 2(b) of Staff's Initial Brief and this Reply Brief).

Nicor did not explain its disagreement with much detail, except to express its belief that no party, including Staff, had identified an error in the study. (Nicor IB, p. 109) Staff witness Luth, however, identified two problems with Nicor's use of the MDM Study. The first problem is the Nicor MDM Study's reliance upon Coincident Peak ("CP") to allocate distribution mains costs. (Staff IB, p. 98) The second problem is Nicor's calculation of rate class demands to allocate distribution mains usage among the rate classes, even with the Company's acceptance of A&P to allocate transmission and distribution costs, including costs allocated through the MDM Study. (Id., pp. 99-102)

IIEC was somewhat more specific in its disagreement with Staff's adjusted MDM Study. IIEC continues to argue for the allocation of costs through the MDM Study based upon CP, despite the fact that, while the Commission accepted the MDM Study in the previous Nicor rates docket, it was to be used to allocate only 70 percent of the Company's transmission and distribution costs so that mains costs were allocated based upon the size of mains and gas flows (Order, Docket No. 95-0219, p. 49). Staff explained that IIEC's proposal is inappropriate for two reasons. First, it is inconsistent with previous Commission Orders to allocate mains costs solely upon CP. (Id.; Order, Docket No. 04-0476, pp. 64-65; Order, Docket No. 02-0837, pp. 90-91; Order, Docket No. 94-0040, pp. 63-67) Second, distribution mains are used throughout the year, not just on peak days. (Staff IB, p. 105) As in the previous dockets, no party has shown that there is a direct, proportionate relationship between increases in demand and increases in costs, such that, for example, a doubling of demand would cause a corresponding doubling of mains costs (Id.; see also Order, Docket No. 04-0476, p. 65; and Order, Docket No. 94-0040, pp. 65-67).

In previous dockets, the Commission has appropriately found that demand does not fully explain how mains costs are incurred and that mains are used throughout the year, as a result, A&P should be used to allocate mains costs. Thus, Staff's use of the MDM Study in this docket continues the Commission's practice, and strikes a proper balance between demand and throughput that does not overweight demand. Nicor's MDM Study overstates Rates 1 and 4, as explained in this Reply Brief in Section VI-A-

2b, “Coincident Peak (CP) Allocation Methodology”, and should be adjusted in the manner recommended by Staff. The Commission, therefore, should apply the results of Staff’s adjusted MDM Study to allocate distribution mains costs in this docket.

b. Coincident Peak (CP) Allocation Methodology

Nicor and IIEC do not agree with Staff’s adjustment to Nicor’s calculation of the peak demand of individual rate classes and prefer Nicor’s calculation of peak demand that favors larger, daily-metered customers. (Nicor IB, pp. 109-110; IIEC IB, pp. 14-15) In its rebuttal testimony and in its Initial Brief, Staff explained that Nicor overstated peak demand for Rates 1 and 4 relative to other classes. (Staff IB, pp. 99-101 and pp. 103-104) Nicor’s overstatement of peak demand for Rates 1 and 4 was the result of adding 18.49 percent to the peak demand calculated for Rates 1 and 4 to account for, or balance, one of the Company’s calculated system design peak days with the sum of the Company’s calculated peak demands for each rate class. Rates 1 and 4 were already calculated based upon a 79 Heating Degree Day (“HDD”) system design peak day, without the 18.49 percent add-on, as compared to daily-metered rate classes whose peak demand was based upon the Maximum Daily Contract Quantity (“MDCQ”) of each class. The problem with Nicor’s approach is that the MDCQs were based upon calendar year 2003 data. The coldest day in 2003 was only 61 HDDs. A 79 HDD is nearly 30 percent colder than a 61 HDD, so it is possible that daily-metered MDCQs would have been higher had a 79 HDD been experienced in 2003. As a result, Nicor’s peak demand calculation for Rates 1 and 4 may already be overstated, even without Nicor’s 18.49 percent add-on. An additional 18.49 percent in peak demand charged to

Rates 1 and 4 over allocates demand-related costs to Rates 1 and 4. Nicor's proposed add-on should not be used to balance or reconcile Nicor's preferred calculation of overall system design peak day throughput with the sum of the calculations of peak demands of the individual rate classes.

Nicor describes Staff's adjustment to the calculation of the peak demand charged to the individual rate classes as "arbitrary" and "unsubstantiated". (Nicor IB, p. 110) Neither allegation is accurate. In fact, it is Nicor's calculation of peak demand that is arbitrary and unsubstantiated. Nicor's 18.49 percent add-on to the peak demands calculated for Rates 1 and 4 based upon the system design peak day of 79 HDDs is arbitrary because there is no support that its projection for Rates 1 and 4 is understated and requires an add on of 18.49 percent. The effect of Nicor adding 18.49 percent to the projection of 79 HDD demand from Rates 1 and 4 is similar to realizing that 2 + 2 does not equal 5, but since Nicor wants the equation to equal 5, Nicor adds 1 to one of the factors, increasing 2 to 3, so that, voilà, 3 + 2 equals 5. Staff's adjustment was clearly identified as being based upon Nicor's calculation of the peak demands for each rate class provided in the Company's response to CCSAO/CUB data request 5.38 (Staff Exhibit 16.0-Revised, p. 9, lines 178-187), and is therefore substantiated.

In surrebuttal testimony, Nicor attempted to support its claim that Staff witness Luth's adjustment to rate class peak demands was "arbitrary" by indicating that the sum of Mr. Luth's rate class peak demands did not total the Company's projected system peak day throughput. (Nicor Gas Exhibit 44.0, pp. 6-7, lines 129-152) Even if the MDCQs for daily-metered customers are "adjusted" to a 79 HDD based upon a regression analysis of the use of those customers in December, January, and February

(Id., pp. 8-9, lines 174-187), the regression analysis is no more than a projection similar to the 79 HDD projection the Company uses to calculate peak demand for Rate classes 1 and 4. Nicor witness Harms' uses the paradoxical phrase "precise estimate" to describe the peak demand calculated for daily-metered customers. (Id., p. 9, line 184) While Mr. Harms may believe that the MDCQ estimate is "precise", it is, nonetheless, no more than an estimate, similar to the estimate of 79 HDD demand from Rates 1 and 4.

Nicor witness Harms also terms Staff witness Luth's sum-of-the-parts calculation of relative rate class peak day demands as "Almost Peak". (Id., p. 7, lines 151-152) While Mr. Harms is somewhat witty with his characterization of the throughput resulting from the sum of Staff's adjusted peak day demands by rate class, the throughput resulting from that sum is not at odds with the range of projected peak day throughputs depicted in the Company's own workpapers to support its projection of peak day throughput, where one of the Company's peak day studies projects between *****BEGIN CONF** xxxxxxxxxx **END CONF***** of throughput (Confidential Nicor WP (285.315)2, p. 2, *****BEGIN CONF** xxxxxxxxxx **END CONF*****) for a midpoint of *****BEGIN CONF** xxxxxxxxxxx **END CONF*****, which is *****BEGIN CONF** xxx **END CONF***** than the sum of Staff's calculated rate class demands of 49,073,199 therms; or 4,907 MmBtu (Staff Exhibit 16.0-Revised, Schedule 16.3, column (h), "Grand Total"). While Staff witness Luth neither endorses nor rejects the Company's use of a projected 52,580,000 therms of system design peak throughput, the range of projections in the Company's own workpapers to determine design day throughput demonstrates that 52,580,000 therms is merely an estimate, no more or less supported than other estimates presented in its workpapers. Since the sum of the rate class demands calculated by Staff witness Luth is comfortably within the range of system design day throughput forecasts in the Company's workpapers, Staff witness Luth's adjustments to rate class peak day demands cannot be considered arbitrary or unsubstantiated. Therefore, the Commission should base rate class allocations of demand upon Staff's adjustment to remove the 18.49 percent added by Nicor to the 79 HDD projection for Rates 1 and 4.

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

Staff recommends the use of A&P to allocate transmission and distribution costs, which also includes costs allocated through the MDM Study. (Staff IB, pp. 104-105) Nicor does not object to the use of A&P, but objects to Staff's adjustment of peak demand. (Nicor IB, pp. 109-110) IIEC continues to object to the use of A&P and also objects to Staff's adjustment of peak. (IIEC IB, pp. 14-16) Staff's A&P should be used to allocate transmission and distribution costs because it is a fair balance of cost causation represented by peak demand and average throughput, also referred to as average usage. In addition, Staff's A&P does not overweight demand in the allocation because the 79 HDD projection of Rates 1 and 4 demands are not overstated, as explained in Section VI, A, 2 (a) and (b) of both Staff's Initial Brief (Staff IB, pp. 99-101) and this Reply Brief.

IIEC objects to the use of A&P, regardless of how demand is projected for each rate class, because it is IIEC's belief that transmission and distribution costs are not caused by lower than peak demands. As explained under Section VI, A, 2 (a) of this Reply Brief, as well as the previously referenced sections of Staff's Initial Brief, transmission and distribution mains costs cannot be fully explained by differences in demand. In previous dockets, the Commission has found that there is no direct, proportionate relationship between increases in demand and increases in transmission and distribution mains costs. (Order, Docket No. 04-0476, p. 65; and Order, Docket No. 94-0040, pp. 65-67) Similar to previous dockets, neither Nicor nor IIEC has shown that there is a direct, proportionate relationship between increases in demand and increases in capacity costs.

Certainly, there is a cost component to having the gas transmission and distribution system in place throughout the year because the cost of placing the system in use for only a few peak days during the year would be prohibitive as well as ridiculous. Heavier users of the system should pay at least some of the costs of having the system in place throughout the year to reflect the relatively greater benefit those customers receive from the use of the system throughout the year, as well as to reflect that their use throughout the year plays a role in the necessity for the system's installation. Hence, A&P provides a balance between the costs to install, operate, and maintain the capacity to service peak demand on a few days or weeks during the year, and the costs to install, operate, and maintain the same equipment for use throughout the year. (Staff Exhibit 16.0-Revised, p. 13, lines 263-282) Thus, the Commission should continue to allocate transmission and distribution costs based upon the A&P as determined by Staff.

IIEC claims Staff witness Luth "refused to use a version of a cost of service study he provided in response to data requests filed by IIEC". (IIEC IB, p. 11; and Nicor Exhibit 57; Tr., pp. 1407-1413) There is a very good reason for Mr. Luth's refusal, and that is that the version of the cost of service study referenced by IIEC was provided under objection and does not represent, and has never been presented as, Staff's position on A&P in applying the MDM Study. (Tr., pp. 1299-1304, and pp. 1407-1413) It was a response to a data request in which a major parameter was set by IIEC, "Please provide a version of Mr. Luth's cost of service study that incorporates the Company's direct assignment of mains, as well as the Average and Peak method…." (Nicor Exhibit 57) As stated in Staff's response to the data request, the cost of service study implements **Nicor's** MDM Study for distribution mains costs, and A&P for non-mains costs. As stated earlier, Staff disagrees with Nicor's MDM Study because it allocates distribution mains costs on the basis of peak demand, not A&P. (Staff IB, p. 98)

Further, if IIEC or Nicor interprets the response's reference to A&P in the allocation of non-mains costs as also meaning the MDM Study, then that interpretation would be wrong. The response clearly explains that mains are allocated according to the Company's direct assignment of mains, which was based upon Nicor's MDM Study that allocated mains costs according to peak demand (Staff IB, p. 98). A&P is not used to apply Nicor's MDM Study in the response to the IIEC data request. The Commission should reject the use of the cost of service study provided in response to IIEC data request 3 because the Company's MDM Study is not applied according to A&P. Application of the MDM Study should be based upon A&P, as the Commission recognized in the Order in the previous Nicor rates proceeding (Order, Docket No. 95-0219, p. 49). A&P should be based upon Staff's calculation of relative rate class demands. (Staff Exhibit 16.0-Revised, Schedule 16.2, p. 2; and Schedule 16.3, column (h))

B. Rates, Riders, and Other Terms

3. Rider 6

a. Treatment of Hub Revenues and Expenses

(1) Hub Revenues

While there is general agreement between Staff and the Company concerning the Company's proposal to credit Hub revenues to customers through its PGA clause, i.e., Rider 6, an important clarification is necessary. Staff disagrees with the Company's assertion that IIEC's and Vanguard's position that transportation customers should share in these revenues is not warranted. (Nicor IB, p. 111) As previously explained, transportation customers that utilize storage pay for storage facilities that are utilized for Hub services and thus should benefit from Hub revenues through the PGA. (Staff IB, p.107) Since Nicor suggests it may be possible to credit Hub revenues to transportation customers via the PGA (Nicor Gas Exhibit 44.0, p. 14, lines 301 – 308), Staff recommends that the Company be directed to implement such a proposal so that transportation customers continue to receive an allocation of Hub revenues. (See Staff IB, pp. 106-107)

4. Rate 1

Nicor and Intervenor Citizens Utilities Board ("CUB") object to Staff's recommended Rate 1 charges, and prefer the continuation of Nicor's current declining three-block volumetric distribution charges (Nicor IB, pp. 116-117; and CUB IB, pp. 44-45), adjusted for the differences in Rate 1 revenue requirement in this docket. Staff recommended a slightly declining two-block volumetric distribution charges under Rate 1. (Staff Exhibit 16.0-Revised, Schedule 16.6-Revised)

Nicor claims that Staff's Rate 1 volumetric distribution charges have no justification in economic theory, provide poor price signals to customers, would make customer bills more sensitive to weather, and would leave Nicor with a huge risk of underrecovery of its allowed revenue requirement. Staff's proposed charges more closely follow how demand costs are allocated; therefore, Nicor is wrong in claiming that Staff's volumetric distribution charges have no justification in economic theory and provide poor price signals to customers. (Staff IB, pp. 113-114) Nicor's proposal to steeply discount third block usage, which bills high-volume, high-demand usage, is the inverse of how demand costs are allocated because higher demand results in a higher allocation of demand costs. Staff's distribution charges do not steeply discount high-volume, high-demand usage, and are therefore more closely linked to the allocation of demand costs because rates do not send a message that higher-volume usage costs less than lower-volume usage.

Staff also explained why Nicor's claims that customer bills would be more sensitive to weather are less of a concern than its claims would suggest. Placed into context with the far more significant aspect of a customer's bill, gas supply costs typically billed through the PGA Charge under Rate 1, the 2.57¢ per therm difference between Staff's recommended high-volume, high-demand rate and Nicor's proposed third block rate, is dwarfed by the 35+¢ per therm increases in gas supply costs over the past few years. (Staff IB, p. 114) Weather sensitivity, or volatility, in distribution charges is a relative concept. When compared to gas supply costs, weather sensitivity in distribution charges is less of a concern than requiring high-volume, high-demand customers to pay for the increased demand costs allocated to Rate 1 customers in general as a result of their usage patterns.

The weather-related risk discussed by Nicor is typical of the natural gas distribution business risk for which Nicor is compensated through return on rate base. Nicor's concerns about risks that it faces in recovering its allowed revenue requirement (Id.) would be a year in which Nicor distributed less gas as a result of warmer than typical weather. The converse is also true. Nicor would have the opportunity to distribute more gas than included in the test year when a year is colder than typical, and therefore could recover more than its test year revenue requirement. Nicor has not shown that Staff's distribution charges significantly increase Nicor's weather-related risk than the risk faced by other similarly-situated natural gas utilities. Nicor's concern about its weather-sensitive risk is outweighed by appropriately charging high-volume, high-demand customers in line with the costs allocated to Rate 1 customers in general by the usage patterns of those customers.

As explained earlier in this brief and in Staff's Initial Brief, Staff's recommended Rate 1 distribution charges better match volumetric distribution charge billing with demand cost allocation than Nicor's proposed declining three block distribution charges. Therefore, the Commission should find that Staff's approach to Rate 1 distribution charges is the appropriate structure for billing usage under Rate 1.

5. Rate 4

Nicor disagrees with Staff's recommended Rate 4 charges. First, as Nicor claims, Staff's proposed rates fail to recognize that Rate 4 is a companion rate to Rate 74. Staff recognizes that Rate 4 is a companion rate to Rate 74. (Staff IB, p. 115) Further, Staff agrees that there should not be any non-gas supply rate incentives to switch between rates.

Second, Nicor claims that Staff's recommended Rate 4 volumetric distribution charges are essentially flat or uniform, regardless of usage. (Nicor IB, p. 118) Similar to Staff's recommended Rate 1 distribution charges, Staff's recommended two-block Rate 74 distribution charges with a narrow difference between the first and second block better matches cost allocation with billing. (Staff IB, pp. 116-117) High-volume, high-demand customers cause demand costs to be allocated to Rate 74 customers in general, and should therefore pay near the same per therm for high-volume therms as low-volume therms. Nicor's rate design would invert billing from cost allocation by charging a rate for high-volume therms that is only 1/3rd the rate for low-volume therms (Nicor Gas Exhibit 44.4, p. 9, column (e), line 22 compared to line 20), yet demand costs are allocated according to peak demand, which is billed through the high-volume distribution charge block. The difference between per-therm billing for high-volumes and low-volumes should be narrowed considerably in the manner reflected in Staff's proposed rates, rather than the 2/3^{rds} discount for high volumes off the low volume distribution charge suggested by Nicor.

6. Elimination of Rate 81 – Energy Transportation

7. Rate 21 – Interruptible Transport and Storage Service[18]

The Company indicates in its Initial Brief that its expansion of the term limitations for Hub Loans and other Hub services is similar to the treatment under FERC jurisdictional tariffs and will likely result in the expansion of these services to the benefit of ratepayers. (Nicor Brief , pp. 119-121) The Company also indicates that the term limitations that it seeks to remove are for master agreements and would thus allow for more efficient administration of Hub services. (Ibid.) Staff is concerned that removal of the term limitations on Hub services will encourage longer term contracts that may result in higher costs to utility customers through the PGA. Although the Company identifies an administrative benefit by having longer term master agreements, the changes proposed are not limited to master agreements, i.e., Hub loans and services (and their master agreements) today can be no longer than 120 days and one year, respectively, and this reflects the short-term nature of the service. Staff's concern is that by removing these limitations Hub loans and services will increase in term length and will compete with sales customers for the use of facilities, which result in higher PGA costs for sales customers. For this reason, the Commission should maintain the current short term nature of Hub transactions as a protection for public utility ratepayers.

[18] In Staff's Initial Brief, Staff discussed the HUB issues together under the Rider 6 brief heading VI.B.3.a. Staff in its Initial Brief inadvertently failed to include a cross reference under the Rider 21 brief heading VI.B.7. In this Reply Brief, Staff has included its reply regarding Rider 21 HUB issues under the Rider 21 brief heading VI.B.7.

8. Rates 74, 76, 77, Riders 15 and 16, and Terms and Conditions

a. Allocation

(1) Storage capacity allocation

Nicor indicates that its estimate of 120 BCF to be cycled from storage should be the basis for the storage allocation for transportation customers; this results in SBS capacity of 23 times the customer's MDCQ. (Nicor IB, p. 125) The Company is concerned about the flexibility that transportation customers have today, whereby they can withdraw all of their storage before the design day of January 20, refill it and withdraw it again all before April 1. (Nicor IB, pp. 124 – 125) If this type of cycling of gas is problematic then the Company's approach should be to revise their withdrawal rates and cycling parameters rather than reduce storage capacity because, historically, the Company's system has been capable of far greater use of storage on peak days than is afforded from the Company's proposal. Staff witness Borden showed that the three year, five year, and ten year historical coincident peak withdrawals from storage resulted in SBS capacity of 27 times the MDCQ. (ICC Staff Schedule 17.2). The coincident peak withdrawals indicate that the Company's storage facilities can afford more storage capacity to transportation customers than what the Company proposes, and the Commission should adopt Staff and the IIEC's recommendation of 27 times the MDCQ.

b. SBS Charge

Staff explained that, to determine the SBS Charge, the Commission must determine the volume of gas cycled through storage to complete a fairly straight-forward calculation. (Staff IB, pp. 119-120) The Commission should reject IIEC's proposed lower SBS Charge (IIEC IB, p. 23) because it is not based upon the embedded revenue requirement of storage capacity available to and reserved by transportation customers, even if transportation customers have not fully used the reserved capacity.

c. Cycling

Injections

Staff supports the Company's proposal regarding injection requirements by November 1st. (Staff Exhibit 8.0, p. 10) Staff differs with the Company position on this matter only with respect to the penalty for failure to meet the 90% targeted level. Staff's proposal is that critical day withdrawals be decreased based on the 90% target instead of the Company's proposed 100% level. Given that the injection requirement is a significant change for transportation customers, Staff recommends its compliance penalty as a gradual approach that may or may not need tweaking in the future. (Staff IB, pp. 120 – 121)

Withdrawal Targets

Staff continues to oppose the Company's proposal that requires a 10% withdrawal balance by April 1. As discuss in Staff's Initial Brief, the Company has failed to justify the need for this specific targeted level. (Staff IB, p. 121) The Company's proposal for all transportation customers to require a maximum 10% storage inventory level by April 1 is not specifically supported by the Company's own behavior and it provides no variability for customers that cannot meet the target. Further, the Company has not shown that the lack of the 10% maximum inventory by April 1 is costly to sales customers on a systematic basis and it does not match the Company's own practices. For these reasons, the Company withdrawal target proposal should be rejected.

d. Level of rate increase

Nicor did not address Staff's Rates 76 and 77 recommendations, but Staff agrees with the Company that the Commission should not accept IIEC's proposal to place more than the entire revenue requirement increase burden upon residential customers. (Nicor IB, p. 137) IIEC continues to overstate the significance of Staff's proposed increases in the tail block of the demand charge under Rate 77 by claiming that the increases are "disruptive" and "not justified". (IIEC IB, p. 27)

Staff's proposed increase in Rates 77 is not disruptive because the increase is justified. (Staff IB, pp. 123-125) Staff's recommended increase in Rate 77 rates is justified because revenue recovery under Rate 77 is nearly the same as the Rate 77 revenue requirement (Staff Exhibit 16.0-Revised, compare Schedule 16.6-Revised, p. 6, line 188, column (G) with Schedule 16.1-Revised, p. 2, line 35, Nonresidential – Rate 77 – Large Volume Transportation, "Total" column). Staff's recommended Rate 77 charges are not disruptive because, when placed in context, the increases are less on an average per-therm basis than other rates. The average Rate 77 per-therm increase under Staff's proposed rates is less than 1¢ per therm compared to an average Rate 1 per-therm increase under Staff's proposed rates of approximately 1.71¢ per therm (Staff IB, p. 124), more than double the average Rate 77 per-therm increase. The testimony of IIEC witness Rosenberg concerning gas supply costs demonstrates that IIEC's depiction of Staff's recommended average 2.461¢ per therm under Rate 77 as "disruptive" is overstated, because, as Dr. Rosenberg discussed, gas supply is now at least 70¢ per therm (Id., pp. 124-125). Gas supply costs of at least 70¢ per therm are more than 28 times Staff's average charge per therm under Rate 77 (70¢ divided by 2.461¢), which completely overshadows the Staff recommended Rate 77 cost for distribution.

Therefore, the Commission should conclude Staff's approach to Rate 77 is reasonable and not disruptive when viewed in the context of other Nicor rates and gas supply costs.

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

Staff sees nothing new in the Company's Initial brief regarding this issue. The Company indicates its concerns regarding the operations of its system as well as the lack of participation in the record by Customer Select Suppliers other than DRI. Staff does not disagree with the Company's criticisms in the sense that Staff wants daily withdrawals from storage to be refined in a manner such that suppliers have more daily variability and service to Sales customers is not impaired. Staff also would prefer more suppliers' participation to less, but Staff has no control over interventions in this case and the issues themselves are best treated, if possible, within the context of the rate case. For a company that has general rate proceedings as infrequently as Nicor, not addressing the issues could mean little or slower paced change for improvements for the next 7 plus years. Given that DRI is the largest supplier in the market, Staff believes that the Commission can have some assurances that they are receiving proposals from a company that wants Customer Select designed properly so that it remains attractive to responsible suppliers for many years. Staff still maintains its position and DRI's regarding this issue. If the Commission decides that the issue should be addressed outside this case, then Staff recommends that the Commission set a deadline to have a tariff in place no later than the end of this calendar year.

12. Rider 12 – Environmental Cost Recovery

The Company wants to make "clear" that Research & Development ("R&D) costs associated with manufactured gas plants ("MGP") as well as "certain other R&D expenses" are includable for recovery under Rider 12. (Nicor IB at 144) Staff has already acknowledged that the Company has recovered R&D costs under Rider 12 after careful analysis of those costs under the terms of the Rider. (Staff Exhibit 11.0 Revised, p. 10, lines 198 – 204) The Commission has considered and rejected certain other R&D costs as not being allowable under the utility's MGP Rider. (Id, pp. 11 – 12, lines 205-228) Thus, the blanket recoverability of R&D costs that the Company desires should be rejected.

The Company also contends that it wants the same treatment afforded other Illinois utilities in recovering costs relating to MGP operations that are other than remediation costs. (Nicor IB at 144-145) The Company however never provides any evidence of costs it has been prevented from recovering on a discriminatory basis. Staff addressed this very issue in rebuttal testimony, comparing the two Riders cited by the Company without finding merit to the Company's discrimination argument. (Staff Exhibit 11.0 Revised, p. 13, lines 243 – 253) The addition of the words "Manufactured

Gas Operations" does not accomplish what the Company claims and, accordingly, should also be rejected.

13. Rider 7 – Local Government Compensation Adjustment

Nicor proposed Riders 2 and 7 to recover franchise and related costs resulting from local government requirements. (Nicor IB, pp. 145-147) The proposed Riders 2 and 7 would recover approximately $7.9 million in test year revenue requirement, which is approximately 4/10ths of one percent of total test year revenues. (Staff IB, pp. 131-132) Staff explained why the Nicor's Riders 2 and 7 proposals would add unnecessary duties to the Commission that could be extensive, given the relatively small amount of revenue recoveries from the more than 1,000 potential different Riders 2 and 7 that could be in effect. (Id., pp. 131-133) In addition, Nicor's Riders 2 and 7 proposals were incomplete and late so that an adequate review could not be completed. Nicor did not adequately explain what the effects of proposed Riders 2 and 7 would be upon general service rates, which is of further concern because the Company changed the nature of its Riders 2 and 7 from a volumetric-based rate in direct testimony to a customer-based rate in rebuttal that was again revised in surrebuttal testimony. Since Nicor's Riders 2 and 7 proposals are incomplete and unnecessary, Nicor should continue to recover franchise and other local government required costs through general rates. The Commission should reject Nicor's Riders 2 and 7 proposals because the proposals are incomplete and could possibly add extensive duties to the Commission that would be unnecessary given the amount of revenues recovered under proposed Riders 2 and 7.

14. Other Customer Select issues

c. Customer Select Signup (Account and Meter Numbers)

The Company continues to oppose changes proposed by DRI that would allow customers to provide an account number instead of both the account and meter number to authorize a customer switch. (Nicor IB, p. 148) Staff believes that the Company was prudent by initially requiring both numbers to authorize a switch because the program itself was new and incidents of slamming could potentially harm its growth. But now the Company has the opportunity to fine tune the program by allowing customers to provide only the account number. The Company will still require all other information and electronic voice recording can be used to verify authorizations. In a business where customer acquisition costs are high and margins are thin, Staff recommends approval of the DRI proposal in order to promote customer and supplier participation in Customer Select.

15. Energy Efficiency Programs

Staff continues to oppose the Environmental law Policy Center's proposal regarding energy efficiency for the reasons set forth in Staff's rebuttal. (Staff Exhibit 17.0, pp. 17 – 18).

VI. CONCLUSION

WHEREFORE, for all the reasons set forth herein, the Staff of the Illinois Commerce Commission respectfully requests that its recommendations be adopted in this proceeding.

Respectfully submitted,

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